PERSPECTIVE

Emerging from the Global Competitiveness Ranks

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The World Economic Forum (WEF) recently released its annual “Global Competitiveness Report,” which details the strengths and weakness of 144 countries in myriad factors including education, infrastructure, health and technology. There aren’t many huge surprises in the developed markets, as most countries’ overall rankings were fairly stable from the prior year. There were, however, a few interesting shifts in the ranks among emerging markets: some making leaps forward, and others, regressing. Although we are bottom-up investors and make investment decisions on a stock-by-stock basis—regardless of rankings like this—it is interesting to examine the overall environment for doing business, and the potential sticking points a particular company in a particular country may be facing.

The WEF’s Global Competitiveness Report outlines “12 pillars” that are the core of its analysis:[1]

- Institutions
- Infrastructure
- Macroeconomic Environment
- Health and Primary Education
- Higher Education and Training
- Goods Market Efficiency
- Labor Market Efficiency
- Financial Market Development
- Technological Readiness
- Market Size
- Business Sophistication
- Innovation

The report then drills down to examine data within each pillar, for example, within the “Institutions” pillar are measures including the burden of government regulation, business costs of crime and violence, protection of minority shareholders’ interests, and property rights. Within the “Goods Market Efficiency” pillar are prevalence of trade barriers, prevalence of foreign ownership, and number of days to start a business, to name a few. As investors, these are areas of particular interest to us. In many cases, what is perhaps more important than the actual barriers to doing business is how a particular business copes with them. For example, the reliability of power is a big problem in parts of Africa, so many companies will have their own power source—through a generator. Mobile phones help circumvent the need for physical infrastructure such as landlines or brick-and-mortar bank branches and retail stores, reaching consumers in far-flung locations in new ways.

Breaking Down the Competitiveness Rankings

The top of the WEF's global competitiveness list was fairly stable among the developed country ranks. What is interesting from my perspective is the movement among emerging and even lesser-developed frontier market countries. Algeria, a frontier market, moved up 21 places to 79 from 100 last year. Generally speaking, we are excited about the prospects for frontier markets, particularly in Africa, and find the upward climb encouraging. The European frontier market of Romania moved up to 59 from 76 in 2013. The emerging markets of Indonesia, China and Russia also moved up in the global competitiveness ranks while on the flip side, Brazil, Turkey, South Africa and India all dropped in the rankings. Let's take a look at a few of these countries making moves in 2014 in more detail.

**Romania**

Romania has made progress on a number of fronts, and it's not a big surprise to us to see that the country has improved in global competitiveness. Romania weathered the sovereign debt crisis that hit the eurozone a couple of years ago, as well as the more recent tensions between Ukraine, Russia and the West. In the first quarter of 2014, Romania's GDP rose 3.8% on a year-over-year basis, making it one of the fastest-growing economies in the European Union (EU).[2] While the second quarter 2014 growth figures were a little softer at 1.4%, Romania's growth still outpaced the EU at large.[3] Domestic demand has been aiding this growth spurt, and an increase in the minimum wage in January has played a part in boosting consumption.

I think Romania's compliance with the International Monetary Fund (IMF) in the past few years has been beneficial and has brought stability for public financing. We also see some positive developments in Romania in general; unemployment and interest rates are currently low, and disposable income is growing. That said, progress has been slow, and local consumption had been very depressed since 2008 and is just now starting to recover. Romania has made strides forward, but we think it still has a ways to go to become even more competitive globally. People were not really spending, so we think domestic demand is where the next growth engine of Romania could come from, on top of increased industrial production and exports.

We are managing the country's largest investment fund, Fondul Proprietatea, investing in a wide variety of Romanian industries. This fund was established to compensate those who lost their properties during the Communist period. Shares of a wide variety of government companies were injected into the fund. It has been our job to help bring those companies into profitability by working with the managements and government to institute reforms in line with a market economy. When we took over management in September 2010, we first worked to get the fund listed on the Bucharest Stock Exchange, making it the largest listed fund on that exchange.

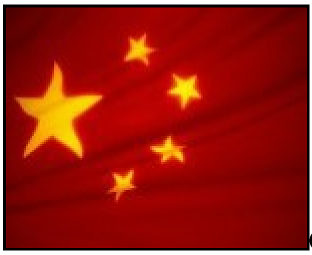
As investors in Romania, we pay close attention to the implementation of proper corporate governance standards, and we believe it's essential for state-owned companies to become more competitive and profitable. Romania's government is also considering the sale of more shares in state-controlled companies, which we view as positive. We have observed that good corporate governance usually leads to market performance, and should benefit shareholders and the country.

**Indonesia**

Indonesia held its presidential election in July, and there's hope that new leadership will help ignite positive change and boost investor sentiment in Southeast Asia's largest economy, akin to what we have seen in India. Jakarta Governor Joko Widodo emerged victorious, although not without a bit of controversy, including a court challenge of the results. Similar to the case of India, we've seen a positive market reaction, at least in the post-election glow.

There are signals from Widodo that market-centered economic policies are on the agenda that could potentially boost both longer-term economic performance and corporate profitability. He has stated a focus on education, infrastructure and health care, as well as reducing fuel subsidies that swallow a big chunk of the government's spending budget. Whether investors' confidence will prove justified ultimately remains to be seen. Indonesia faces a legacy of corruption and bureaucratic walls that need to be torn down, as well as political polarity. Getting opponents on board with some unpopular but needed policy changes may be a tough challenge in Indonesia, but we are hopeful positive reforms can be accomplished.

On a broader regional scale, major trading agreements are currently being negotiated in Southeast Asia, most notably the wide-ranging Trans-Pacific Partnership, which could potentially boost trade flows within the region and beyond—and further boost global competitiveness.



China

Reform efforts in China seem to be gaining momentum. The government's ongoing efforts to rebalance the economy away from exports and investment toward domestic consumption, coupled with wage growth of up to 20% experienced in recent years, are positive. Such reform has the potential to be very positive for the long-term performance of both the economy and Chinese equity markets.

Notably, reforms to the financial markets have generally been positive in our view, such as the announcement to allow for two-way investment between the Shanghai and Hong Kong stock exchanges and the widening of the trading band of the Chinese yuan. Further policy announcements could prove catalysts for equity market performance. The new agreement with the Hong Kong Stock Exchange to list China's domestic shares (through the Shanghai-Hong Kong Stock Connect), I think, could fuel an increase in investor interest in Chinese equities. Foreign investors will be allowed to place buy or sell orders on Shanghai's A-share market though Hong Kong brokers, while Chinese investors will be able to use mainland brokers to invest in Hong Kong's H-share market.

Over the medium to longer term, we believe the greater participation of foreign investors may change market dynamics in the direction of better governance at the company level. We also believe all these new reform initiatives could help gradually regain interest in China's A-share market among domestic investors. The goal of these efforts is to make China's capital markets much more diverse, structured and transparent. This is very important, in our view, as there is a large amount of private savings in China that could be invested. Such capital market development should enable companies to raise finance through share issues rather than depending on the state-owned banking system.

While China represents one of the largest economies in the world, it is a typical emerging market in that it still has a relatively low participation rate in capital markets. This provides good potential opportunities for value-oriented investors like us, as valuations had generally been depressed in the past year by the lack of market confidence. However, news of capital market reform initiatives by the government led investor confidence to begin to recover. We are optimistic the market momentum of recent months can continue into year-end, and even long term, that China can continue to become even more competitive globally.

India

India’s slip in the WEF’s global competitiveness ranking was disappointing, but not really surprising. I’ve long said reform has been badly needed there, with less red tape and fewer barriers to entry for businesses to thrive, and a climate that is friendlier for foreign investors. However, with new reform-minded leadership elected this year, we are hopeful this will change in the coming years. Investment in infrastructure, health and education could go a long way in boosting India among the competiveness rankings.

India’s market has reflected the optimism investors feel following the election of Prime Minister Narendra Modi in May 2014, along with improving economic growth. The Indian economy expanded at its fastest pace in more than two years in the April–June quarter, with GDP growth accelerating to 5.7% year-over-year, from 4.6% year-over-year in the prior quarter.[4] Improvements in the mining, manufacturing and financial services sectors supported growth.

We are quite positive about India and have been for quite some time despite the fact that the previous government did not really move the economy along as fast as we would have liked. And, we still feel corporate governance needs to improve so minority shareholder interests are protected.

With the new government, we think India may be turning a new page. The country has a blank sheet of paper and there is a lot to be written on it. I believe Modi is the right person to write the story of a brighter future. However, it isn’t going to happen overnight, so patience is important. From an investment standpoint, India offers attractive GDP growth rates, a strong culture of entrepreneurship, and access to a burgeoning consumer market.

Brazil

Brazil has been experiencing some economic woes this year that FIFA World Cup enthusiasm couldn’t cure. Brazil’s GDP contracted 0.9% in the second quarter 2014 on a year-over-year basis, compared to a revised 1.9% year-over-year growth in the first quarter.[5] Declines in the manufacturing and construction sectors, as activity slowed during the FIFA World Cup, were the main reasons for the contraction. On a quarter-over-quarter basis, GDP declined for the second consecutive quarter, putting the country into a technical recession. And, recent data have shown an uncomfortable rise in inflation. The big question on the minds of most market watchers is whether the upcoming elections in Brazil will inspire positive change.

The death in a plane crash of Brazilian presidential candidate Eduardo Campos in August transformed the election race. Mr. Campos’s running mate, environmentalist Marina Silva, was adopted as the new candidate of the Socialist Party, and polls had suggested her popularity was close to incumbent President Dilma Rousseff’s. Silva is seen as more business-friendly than the current government, so the prospect of defeat for President Rousseff helped send Brazilian equities up in August.

To increase its competitiveness on the global stage, Brazil needs to ramp up in a number of areas in our view, including improvements in infrastructure, without breaking the government’s coffers. Brazil’s position is pivotal for Latin America as a whole, and on the positive side, signs have appeared in recent months that the authorities there are starting to reconsider current interventionist policies.

We believe that longer-term fundamental drivers render Brazil, and Latin American markets in general, to be potentially attractive for investors. The continent has a tremendous endowment of natural resources, both mineral and agricultural, while relatively youthful populations offer the prospect of demographic benefits. The proximity of the huge US market represents a major source of export demand, and gradual ongoing US recovery should provide a boost to Latin American economies—Brazil included.

There Are Always Opportunities—If You Know Where to Look

Of course, this is just a small snapshot of the countries we're investing in today and the issues affecting them. As markets around the world fall in and out of favor among investors based on many different factors, I think the need to diversify[6] becomes ever more important. You don't want to have all your eggs in the wrong basket at the wrong time. There are always opportunities, if you know where to look.

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1. Source: World Economic Forum, "The Global Competitiveness Report," 2013–2014.

2. Source: Eurostat, 8/14/14.

3. Source: Ibid.

4. Source: Central Statistics Office, Government of India.

5. Source: Banco Central Do Brasil.

6. Diversification does not guarantee profit or protect against risk of loss.