PERSPECTIVE

Reforms in Asia Bring Big Potential for Small Companies

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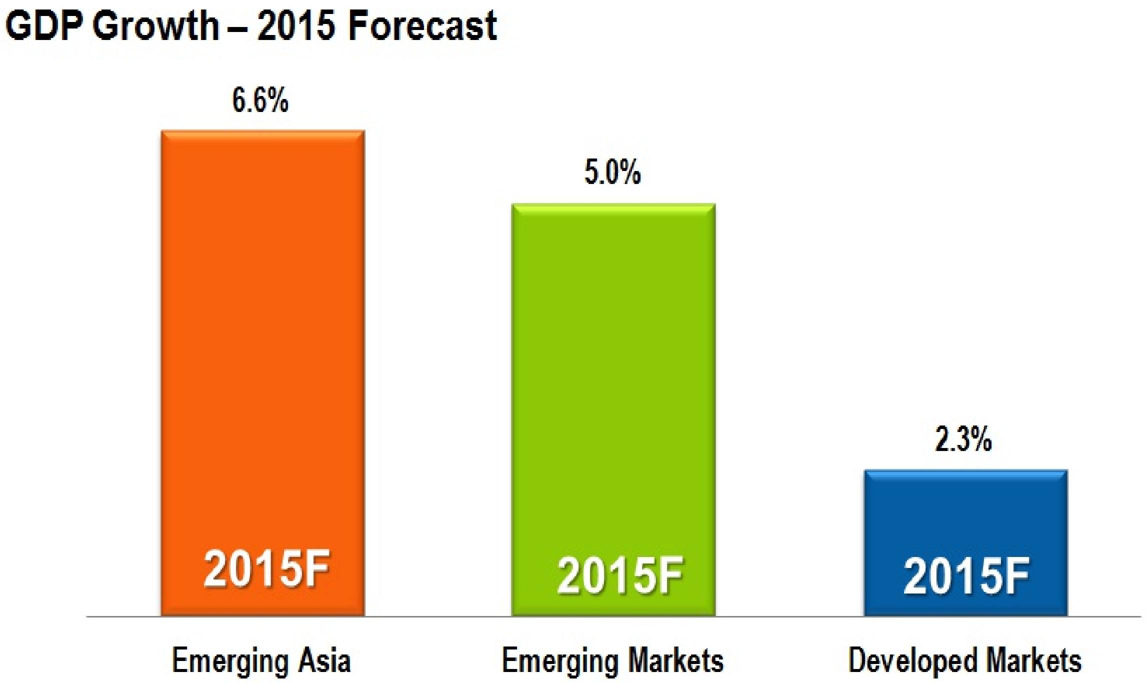
At Templeton Emerging Markets Group, we believe Asia's combination of rapid economic growth, generally strong national finances and economic fundamentals has created an attractive landscape for equity investors. Seismic changes have been taking place in Asia's political arena over the past couple of years, including major elections, leadership transitions and even a military coup. These political shifts have economic reform implications as well. Although some of these reforms are historically unprecedented, we believe they offer investors reasons to be optimistic. In particular, smaller companies in emerging markets appear poised to potentially benefit amid more market-friendly reforms that break down barriers to entry and inspire entrepreneurship. Additionally, since small-cap companies are driven primarily by domestic demand, the recent drop in oil prices could be an added boon to these companies by freeing up consumer dollars.

Expectations of high economic growth rates in emerging Asia (driven by China and India) remain a key attraction to us. We believe such growth rates will be comfortably in excess of developed market growth rates in 2015.

Emerging Asia vs. Emerging and Developed Markets



Source: IMF World Economic Outlook Database, October 2014. Emerging Asia comprises the ASEAN-5 (Indonesia, Malaysia, Philippines, Thailand, Vietnam) economies, China, and India. There is no assurance that any forecast will be realized. See www.franklintempletondatasources.com for additional data provider information.

Moreover, many Asian markets, among them China, India, Indonesia and South Korea, have announced or embarked upon significant reform measures differing in details, but generally aimed at sweeping away bureaucratic barriers to economic growth, encouraging entrepreneurship and exposing inefficient industries to market discipline. Most are also looking to rebalance economic activity away from export- and investment-heavy models to become more oriented toward consumer demand. Let's examine a few of these reforms in select countries.

South Korea: Promoting Innovation and Entrepreneurship

In 2014, South Korea launched a three-year plan to attract investors by focusing on innovation and cutting red tape for business. In our opinion, the most exciting element lies in proposals for "the creative economy," which feature a set of measures aimed at fostering entrepreneurship and funneling funds toward startups, with an emphasis on projects that apply South Korea's strengths in information and communications technologies to other economic areas. Measures such as tax breaks for "angel investors," visas for foreign entrepreneurs, state loans and purpose-built "incubators" providing facilities for high-technology startups are aimed at smoothing the way for new business launches. Another strand of the policy to encourage entrepreneurship is a pledge to reduce bureaucracy in key service industries such as health care, education, finance, tourism and software. We feel the health care and retail sectors could likely benefit most from these reforms.

China: Changes in Financial, State-Owned Enterprise (SOE) Sectors Look Promising

Reform efforts in China seem to be gaining momentum. Key initiatives announced thus far include deregulation and the opening of more industries to private investment, financial liberalization, resource pricing reforms, SOE reforms to improve efficiency and productivity, and the relaxation of the one-child policy, which we believe should enhance China's long-term growth potential and promote greater domestic consumption. We have found good value in banks in particular, mainly larger banks with stronger deposit franchises, and in other financial companies that have the potential to benefit from the development of capital markets. We also see good long-term value in the building materials sector, which has undergone massive market consolidation and capacity rationalization. Underpinned by structural demand growth, pharmaceuticals and selected companies in the consumer sector should, in our view, also benefit. We believe the government's ongoing efforts to rebalance the economy away from exports and investment toward domestic consumption look positive for the long-term performance of both the economy and markets.

India: Modi Adds to "Can-Do" Track Record

Narendra Modi's Bharatiya Janata Party won an overwhelming victory during India's May 2014 elections, providing a single-party majority and a mandate for a strong central government. The prime minister's habitually long work days and focus on pro-growth policies have set a new tone for the government and have been contributing to the realization of Modi's 10-point agenda, which prioritizes better governance, a strong manufacturing sector, improved investment and low inflation.

Reducing barriers to foreign investment was one of the first changes made by the new government, and inflows of foreign direct investment into India increased significantly during 2014.[1] Progress has been made on the domestic front as well, with the government supporting a "Made in India" campaign, announcing a series of measures aimed at reducing red tape and relaxing the country's dated labor laws.

Toward year-end 2014, the government introduced a landmark goods and services tax bill in parliament. Other structural reforms in the works include infrastructure improvement, which, if realized, could in turn benefit the materials sector. We expect fuel subsidy reductions to continue, with state-owned oil firms potentially the prime beneficiaries. An expected reduction of government involvement in the financial sector could provide a boost to that sector.

Indonesia: Widodo's Initiatives

Joko Widodo's election as Indonesia's president in October 2014 bodes well for the country, in our view, given his ambitious plans to cut subsidies and increase investment. We anticipate that these proposed policies should encourage both foreign and local investment over time. Already, Widodo has cut popular fuel subsidies, which account for a sizeable portion of total government spending in Indonesia. Elimination of these subsidies, we believe, should give the government better flexibility to tackle other parts of Widodo's reform agenda.

Among the new government's key priorities are bolstering the country's electricity infrastructure, improving its ports and roads, and significantly enhancing education. While markets cheered the bold move to reform energy subsidies, these other structural reforms will likely take time to complete and will not have an immediate impact on economic growth. Nonetheless, optimism about the newly elected reformist government and some encouraging amendments to a proposed ban on metal ore exports bolstered investor sentiment in Indonesia this year. Although banning metal ore exports comes at a significant cost to mining companies, we believe this change means the industrials sector should grow over the longer term. Moreover, Indonesia has a rising middle class, and we believe consumer-oriented sectors such as banking and automobiles may benefit as Widodo's reform efforts gain traction.

Thailand: Business as Usual under Military Rule

After a military coup in Thailand in May 2014, civil unrest has abated and normal business operations have continued with little disruption. We believe it will take some time before the military steps back and civilian rule is reinstated. Before any changes occur to the current political situation, we believe a new constitution acceptable to all parties will need to be drafted, followed by another round of elections. In the meantime, the military regime has allowed the private sector to conduct business activities freely, so long as they do not breach national security. The military regime also is reviewing all major public investment programs as part of a pledge to fight corruption and bribery. Notwithstanding the political uncertainty, Thailand has a large middle class and a growing consumer population, which we believe bodes well for the economy over the longer term. We have focused on consumer goods and services, including banks and property companies, as people move to the cities and require housing.

Structural Interest in Small-Cap Stocks

The Asian small-cap space has been garnering considerable interest in recent years, and we believe this increased interest in small caps is structural and long term in nature, as investors approach emerging market investing with more granularity. We believe smaller companies in emerging markets could prove potential beneficiaries of the reforms touched on here, as well as others taking place in the region.

Additionally, since revenue for small-cap companies is driven primarily by domestic demand, the combination of good economic growth, a growing Asian middle class and lower oil prices could be an added benefit to these companies, freeing up consumer dollars to purchase their wares. The decline in oil prices also helps ease inflationary pressures in a number of emerging economies such as China. This not only boosts consumer purchasing power, but could enable central banks to be more accommodative in setting policy, both of which are likely positive for growth. Within the small-cap space in emerging Asia, we currently consider consumer-oriented companies to be particularly attractive given the growth opportunities we see across many markets, as well as health care, including pharmaceuticals and biotechnology.

We note that many smaller companies in emerging markets are overlooked by most investors, which allows us to utilize our on-the-ground research capabilities to spot potential bargains that don’t get much attention or research following.

If governments are unable to deliver on their promised reforms**,** investor optimism could diminish very quickly. However, markets are made up of individual companies. Good management and solid business models can prosper even when external circumstances appear difficult. And, periods when market sentiment is at its weakest are often those when the most rewarding investments can be made. Our investment research continues to identify companies—both large and small—across the emerging markets universe that we believe have strong long-term prospects and attractive valuations.

What Are the Risks?

All investments involve risks, including possible loss of principal. Foreign securities involve special risks, including currency fluctuations and economic and political uncertainties. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets.

Smaller, mid-sized and relatively new or unseasoned companies can be particularly sensitive to changing economic conditions, and their prospects for growth are less certain than those of larger, more established companies. Historically, these securities have exhibited greater price volatility than large company stocks, particularly over the short term.

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1. Source: Moody's, November 2014.