EMERGING MARKETS UPDATE

EM Sell-Off: Cause for Concern or Buying Opportunity?

June 2018

Dear Makena Investors,

After outpacing broad equity markets in 2017, the Emerging Market (EM) equity index has underperformed other markets during the first half of 2018. A series of negative news stories – including higher U.S. interest rates, a stronger U.S. dollar, unstable political conditions, escalating trade wars and weakening domestic economies – have led to the recent declines. The EM equity index has lost -10% since January (through May), leading to meaningful outflows from EM mutual funds. In our 2017 annual letter, we highlighted our conviction in Makena's EM equity investments as a long-term theme based on attractive valuations, robust growth and the ability of our managers to exploit less efficient opportunity sets. We noted that our exposure to EM public equities is at its highest level since our inception in 2006. In the wake of recent events, we want to offer our reaction to such developments and an update on how we are navigating these markets.

Although we measure the success of any investment over long time periods (e.g., at least three to five years), we are pleased with our recent performance during this volatile environment. Our EM equity portfolio is up +2% in 2018 through May, outperforming the EM benchmark[1] by +450bps, led by our Regional EM manager strategies, which are up +4% YTD.[2] While we are sympathetic to the concerns surrounding many developing economies, these markets are all different, and the characteristics of underlying EM portfolio companies are even more varied. We don't have an edge in timing the entry and exit of these different markets. Our edge is sourcing and researching exceptional investment managers who can find high-quality, fast-growing and reasonably-priced companies in these markets. Our EM investments continue to offer superior long-term growth at attractive valuations, and our managers are predominantly closed to new investors. Further, during these macro-driven sell offs, our managers opportunistically add capital to high conviction positions, recognizing the often-unchanged underlying fundamentals of their companies.

CYTD 2018 in Review

Investors' souring sentiment towards Emerging Markets is largely driven by three factors: the strengthening USD (e.g. vs. Turkey and Argentina), domestic political volatility (e.g. Brazil), and stormy geopolitics and trade tensions (e.g. U.S. and China). Of the three, a rally in the dollar has been felt most acutely within these markets: all told, EM countries have *tightened policy 22 times in 2018* as the US dollar has rallied. Despite the cries of contagion, several important caveats must be made. First, the drawdown in broad EM equities to date has been somewhat muted relative to prior crises, declining only -2.6% YTD through the end of May. Second, currency has been a meaningful headwind for dollar investors as the EM index was effectively flat in local currency over the same time-period, reflecting resiliency in underlying corporate assets. Lastly, the largest drawdowns have been restricted to a select group of countries and are not widespread. The common features among the hardest hit countries – Turkey, Brazil, Argentina, Philippines, South Africa – are large current account deficits, dollar denominated debt and on-going political turmoil and uncertainty.

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[1] As measured by the MSCI Emerging Markets Index.
[2] Estimated preliminary performance, CYTD January 1, 2018 through May 31, 2018.

Is History Repeating or at Least Rhyming?

The list of historical EM downturns is long, providing investors simple examples upon which to anchor when the going gets tough: The Tequila Crisis in 1994 (-26%), the Asian Financial Crisis in 1998 (-56%), and the Taper Tantrum in 2013 (-10%).[3] In May, we experienced the largest outflow of assets from EMs in the last 18 months, yet outflows and prices haven't reached anywhere near the sell-off of prior drawdowns. The reality is that most emerging economies appear to be in better economic shape than prior crises: more countries have floating exchange rates, controlled levels of inflation, substantial FX reserves and extended maturities on their debt. In addition, according to the Bank of International Settlements, only 14% of EM fixed income is denominated in foreign currency, reducing the threat of escalating dollar-denominated liabilities. From a fundamental perspective, we believe most EMs still offer attractive growth prospects in the form of improved productivity, favorable demographics, and a burgeoning middle class. Emerging and developing countries are responsible for three quarters of global GDP growth today.[4] Despite these favorable dynamics, EM equity returns for the last decade have been lackluster: a meager 1.6% annualized in dollar terms.[5] Valuations, too, reflect this recent, misguided pessimism: today the EM cyclically adjusted P/E ratio stands at nearly half that of the U.S. (EM at 17.0x vs the U.S. at 32.0x). Over the long run, we expect these returns to revert to more reasonable levels rewarding the patient, contrarian investor. Over the past 30 years, EM equity indices have outperformed developed markets by nearly +300ps on an annualized basis.

Makena Positioning in an Uncertain EM Environment

Although certain emerging economies are undergoing genuine economic difficulties (e.g. Turkey), we believe our portfolio remains highly attractive. Investors often indiscriminately sell EM investments during these volatile market environments. These short-term market drawdowns represent opportunities for long-term investors like Makena to add capital to closed EM managers, and opportunities for these managers to size up positions in quality companies at better prices. For example, when Indian equity markets sold off -10% in Q1 of 2018, we quickly worked with our local Indian manager, Steadview Capital, to invest an additional $50M in Indian public equities as they saw **no** evidence of fundamental deterioration in their portfolio companies. Steadview has returned over 8% since our capital addition, generating +570bps of alpha above MSCI India YTD through May 2018. Our approach towards emerging markets is rooted in a belief that focused regional and country managers – like Steadview – have competitive advantages to global funds. This approach has been validated over time and continues to pay off in today's volatile EM environment: over the trailing 5 years through May 2018, Makena's Regional EM Portfolio was up 11.4% annualized versus the MSCI EM 4.5% return, *resulting in +690bps of annualized outperformance.*

Moving forward, we will continue to invest the internal resources to identify best-in-class managers not only in EM but also in Frontier Markets. Frontier Markets have experienced an even worse decline than their larger EM cousins with CYTD losses of -7.6%, and a -2.3% per annum return in USD for the last decade.[6] Currently, only 3% of our listed equity portfolio is allocated to Frontier Markets, largely in Africa and the Middle East, but we believe that these markets offer attractively priced and inefficient opportunities with long runways for growth. In fact, one of the most interesting opportunities we are currently researching is a manager investing in consumer franchise businesses in frontier economies.

[3] MSCI Emerging Markets index returns on monthly basis. Analysis performed by Makena; crises measured from peak to trough.
[4] International Monetary Fund figures.
[5] MSCI Emerging Markets Index. 10 year annualized returns through May 2018.
[6] As measured by MSCI Frontier Markets Index. Annualized returns through May 2018.

Portfolio Quality: Underscoring our Bottom-Up Investment Approach

Strong macro conditions are certainly welcomed but are neither necessary nor sufficient for our approach towards EM investing. Ultimately, it is the quality of the underlying portfolio companies assembled by our managers that drives our investment conviction. We believe that owning quality businesses at reasonable prices will lead to meaningful outperformance over time. Higher quality businesses not only prove more resilient during turbulent times but also emerge from crises in stronger competitive positions than lower quality peers allowing for powerful compounding of intrinsic value. We can observe the quality of our portfolio through its underlying business fundamentals. Our EM companies are growing top line revenue at 22% per year and driving bottom line earnings growth of 26% per year without debt (our portfolio is net cash).[7] These favorable characteristics are coupled with an average return on equity of 18%. Conversely, the MSCI EM Index is growing revenue at 3% with earnings growth of 14% assisted at least somewhat by debt (1.6x net debt to EBITDA). In terms of price, our higher quality EM portfolio trades at 2019 P/E of just 13.3x vs. 14.1x for MSCI EM – *a near 60% discount when adjusting for growth rates*. In short, these dynamics underscore our conviction behind our all-time high allocation of $1.2B of capital to the Emerging Markets public equity opportunity in the Makena Endowment Portfolio.

We are happy to discuss our EM investments with you at any point. As always, we thank you for your continued support.

Sincerely,

The Partners of Makena Capital Management

[7] Portfolio and valuation statistics provided by Makena managers.