

# Assessing Corporate Governance—A Bulwark Against Emerging Markets Volatility

Artisan Partners Emerging Markets Team

PORTFOLIO MANAGER  
Viewpoints

September 2018

After a period of declining emerging markets volatility, 2018 has seen a resurgence of volatility in the EM space. However, we believe relatively high volatility is inherent to the asset class. It is what we expect, and we anticipate that emerging markets will remain turbulent. As such, we have tailored our investing process to account for volatility, and to pursue what we believe to be the best representation of the EM opportunity set of the future. One key component of this process is our focus on and disciplined approach to assessing corporate governance.

Among the oft-cited drivers of EM volatility in recent quarters are rising developed-world interest rates and a strong US dollar, which could prompt EM capital outflows. However, to believe that outcome is likely, one has to believe that the preceding years of EM inflows were predicated exclusively on the developed world's long pursuit of easy monetary policy. While lower developed-world interest rates no doubt contributed to sustained growth in emerging markets, we believe there are other factors explaining EM's relative attractiveness to investors in recent years. Among them, EM's ability to effectively compete in global markets, as well as some unique domestic dynamics, which have been aided by prudent fiscal policies (though not universally, to be sure).

Furthermore, we've seen this movie before: Similar concerns arose in 2013, tied to speculation the Fed might begin tightening sooner rather than later. However, the "taper tantrum" largely came to naught for EM overall, though it did impact some countries more than others. Positively, it also forced EM companies to deleverage, improve profitability and better allocate capital. We believe this most recent iteration of developed world monetary tightening may similarly impact vulnerable countries more than others—but overall, we believe EMs are better positioned now to weather rising developed-world rates.

Regardless of changes to near-term volatility levels, we believe emerging economies should continue to provide growth in excess of developed markets over the long term. The question then becomes how to identify the best investment candidates within the emerging markets opportunity set.

We focus on two primary qualities in the companies we invest in: *unique access to growth* and a *sustainable competitive advantage*. Our focus on unique access to growth is about avoiding what we consider the "lucky companies" which have relatively easy access to general growth within their space. During the inevitable periodic economic ups and downs, the lucky companies will have a much harder time surviving than those that take advantage of a growth opportunity and develop a business model around it, allowing the company to translate the growth of today into sustainable growth and sustainable earnings down the road—hence the importance of the second trait, a sustainable competitive advantage.

In order to identify investment candidates which we believe may meet these criteria, we employ a rigorous process—a critical piece of which is our corporate governance scoring. We have developed a nine-point scale which we use to score any company we are researching. It's important to note, however, that this scoring is not used as a negative screen in our process. In other words, we would very rarely exclude altogether a potential holding simply because of a relatively lower corporate governance score. Rather, we use a company's score to adjust our calculation of its upside potential, which allows us to better reflect the amount of added risk we believe we may be taking on.



**Maria Negrete-Gruson, CFA**  
Portfolio Manager

**27** Years Investment  
Experience



We believe this is important because of the tremendous potential for improvement in many EM companies. For example, we don't want to preclude a holding like E Ink Holdings, which we currently own in our portfolio and which has not historically scored particularly well from a quality of communications perspective—one of the nine corporate governance factors we consider. E Ink is an off-benchmark, small-cap company based in Taiwan and has a near-monopoly on the production of ePaper technology used in eReaders such as the Amazon Kindle. However, we believe its growth prospects extend far beyond the Kindle—something we don't believe the market has appreciated in the past, likely tied to the company's generally poor level of investor communications.

Our corporate governance scoring allows us to account for E Ink's flaws as well as its strengths and adjust our target price accordingly. Following this exercise, we have found the upside potential sufficiently compelling to warrant an investment in a holding we might not otherwise have considered.

In other instances, a declining corporate governance score may erode enough upside potential such that we exit the position. Importantly, our approach to corporate governance allows us to be dynamic, adjusting scores as we revisit companies in which we may not have initially invested. We believe this approach is particularly important when volatility is rising—where rapid price fluctuations have made some companies relatively more attractive from an upside potential standpoint.

As a team comprised almost exclusively of analysts indigenous to the emerging world, we care tremendously about EM countries and their people. Through our investments and due diligence, we are committed to detecting the areas of opportunity for improvement and change toward sustainable and profitable business practices. We believe good governance is crucial in EM investing, particularly given many countries' relatively less robust legal systems and private-property protections. A commitment to maintaining, or even improving governance standards, can help EM firms navigate through difficult periods of rising country risks or macroeconomic shocks. Ultimately, we care about good governance because of the transformative power EM growth can have for local residents. Effective and conscientious allocation should maximize returns to us as shareholders and to all stakeholders.

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