APRIL 2019

A CONVERSATION WITH HAROLD KOTLER & TOM MASI

HAROLD G. KOTLER, CFA
Chief Executive Officer
Chief Investment Officer

THOMAS A. MASI, CFA
Vice President, Portfolio Manager
GW&K Emerging Wealth Strategy

MARKET INSIGHTS, GROWTH TRENDS & OPPORTUNITIES IN EMERGING MARKETS

Harold: Hasn't this been a fun year? The stock market continues to rise, interest rates continue to moderate and drift lower, with no inflation and decent growth. I believe that things will continue in the same direction, and that this is truly a long-term bull market. In fact, the *Wall Street Journal* recently published an article about how people still hate stocks and are underinvested in domestic equities.

It's unfortunate that people allow the negative political environment to color the business environment. Business is actually very good and is growing around the world. Interest rates will stay low, the stock market will continue to rise long term, inflation won't be a problem, and the price of oil may slow down consumer sentiment, but not to the extent that it will change trends. We continue to be quite optimistic.

Over the last six months we've seen the Fed address interest rates saying they were nowhere near normal in October, to being data dependent in December, and now officially on hold. Do you think the Fed is in the right spot? Do you believe they went too far with raising rates?

Harold: I think they're in the right spot. I also think that the Fed's overriding concern is deflation. It's not spoken of much because it's too fearful, but a Japanese like economy, a mature system with marginal growth, is the worst thing that could happen in the United States.

Yes, the Fed has increased interest rates to some degree, and it's also good that they stopped. Interest rates are not going to go up or down on the short end. The long end came down because there's no inflation, so that discount mechanism is working perfectly. I don't fear that the Fed is out of synch, I think they're working very hard.

At the most recent Fed meeting, they decided to stop the reduction of their balance sheet later this year. Prior to the financial crisis, the Fed owned less than $1 trillion of bonds on their balance sheet, and now they own about $3.7 trillion. So they're going to start reinvesting these proceeds later this year to keep their balance sheet steady. Do you think this will put further downward pressure on long term rates?

Harold: No. The bigger question is the balance sheet deficit. This whole deficit issue in the balance sheet is really hard for any of us to put our arms around and what it means for the long term. I don't believe anyone can understand how this plays out, if it plays out, or if it matters since we're the best currency in the world. Can we keep on perpetuating this level of debt and huge balance sheet? I don't have an answer to that, I've never seen anybody with good insight into this dilemma.

I don't think it's a concern for the foreseeable future, so I don't think it's relevant to our job today investing your money. I can't project 5, 10, 15 years from now. I'm trying to understand today, and today I think the balance sheet is a moot point, as are interest rates.

ABOUT GW&K

- **Founded in 1974**
- **$37 Billion Under Management**
- **Affiliate of AMG since 2008**
- **19 Actively Managed Strategies**
- **Senior Management Continuity**
  Average 23 years with firm

Assets as of 3/31/19

It seems the Fed is foreseeing U.S. economic growth to trickle downward, where a couple years from now our GDP may be around 2%. They're not always right, but do you agree with that, and is it a bad thing if we're only growing 2%?

Harold: That's my point. I think we will be growing at that lower rate. We don't have immigration, and we don't have an expanding population or great productivity gains. Our growth will come from exporting to the rest of the world.

Once tariffs are settled we'll be able to put more focus on exporting our products, and, depending on world demand, we will likely grow in the neighborhood of 1.5% - 2.5%. I doubt very much we'll grow beyond that. And there's no reason to do so. We are a mature economy. Growth of 2% - 2.5% I think is perfectly fine. It means some companies will do well, while others will not. That's OK. It won't be inflationary, it won't be deflationary, it will be muddling along and there will be winners and losers. And this is an environment we like for our bottom up stock picking discipline.

If a couple of years from now we see GDP dip below 2%, do you think the Fed has to cut rates at that point?

Harold: I don't believe a Fed cut will stimulate the economy. I think at these absolute levels it's modest enough, that whatever economic activity is occurring will continue to occur.

Previously when the Fed cut rates 25 to 50 basis points, it impacted on the upside because people didn't know how far it was going. It was an interpolation of where it may go, and that frightened the stock market, the economy, and businesses.

On the downside any impact will be much more moderate. You can only go down 2% and rates will not go back to zero. I don't think a rate cut would have anywhere near the impact of a declining short rate as it did a negative impact on the rising interest rate, so I think it's a moot point. They won't do it.

Now we will move on to a discussion of our new emerging markets capabilities. Earlier this year GW&K added to its global equity capabilities by adding the investment team of Trilogy Investment Advisors, a firm with a long history of investing across emerging markets. I am pleased to introduce Tom Masi, a portfolio manager on our Emerging Wealth Strategy. Tom was one of the founding partners of Trilogy in 2003, and we are very excited to have him and the entire team on board. Tom will introduce you to emerging markets investing, discuss the opportunities that they see, and how the team invests within those markets.

Tom: To start, I want to say that we are thrilled to be a part of the GW&K family, and I look forward to meeting many clients in the months and years ahead.

As an introduction to emerging markets, sometimes it's helpful to define what an emerging market country actually is. Essentially these countries are moving towards advanced economies. It is based primarily on per capita income and stages of development in the stock market. There are 22 countries officially defined as emerging market countries, and they are in different phases of development.

As far as the big picture, we see tremendous growth potential in emerging markets. This growth is already occurring and we see it continuing in the years ahead.

Looking at China and India as an example, these countries are growing so rapidly they will soon exceed the GDP of the United States by the year 2025. China and India today represent 77% of the U.S. GDP. Over the past five years these two economies have grown at 6%-8% per year. By comparison the U.S. has grown at 2.4%. Over the next five years, they are expected to grow between 5.5%-8%. The U.S. is expected to decelerate to 1.8%-2%.

China and India represent 36% of world population, and the growth that they are experiencing is giving birth to a whole new class of consumers. By 2030 the emerging market middle class will approach 4.8 billion people. That's up from 1.9 billion people in 2009!

What we are seeing is consumption growth accelerating. In India, consumption growth has been 10% for the past 10 years. In China, it has grown at 15% for the last 10 years. This compares to consumption growth in the United States at about 3%. By 2025 to 2030, China and India consumption will be five to seven times the U.S. consumption in total dollar terms.

Our Strategies, particularly our Emerging Wealth Strategy, are focusing on identifying those companies that are in front of this consumption growth trend in the years ahead.

Now let me tell you about the opportunity that we see. We believe emerging market equities are at a similar place to where U.S. equities were in the 1980s. As many of you know, U.S. equities went on to generate returns that averaged well in excess of 10% for the next 10 years.

U.S. equities traded at nine times earnings in 1980. Emerging market equities today trade at 11 times earnings, but we think the earnings growth rate will be at least 10% for the next five years. Without any valuation expansion, emerging market equities could produce at least a 10% return for the next five years.

As far as the Strategies we offer, we have the Emerging Wealth Strategy which is managed by myself and Nuno Fernandez. We focus on consumption in the fastest growing areas of emerging markets. Today we have higher concentrations in China and India because these are the economies that are growing the fastest right now. This Strategy is more concentrated than many emerging markets strategies. We hold only 40 - 60 stocks in this portfolio and we aim to fill the portfolio with best in class companies. Another important component is that this Strategy is benchmark agnostic. We are much more focused on finding quality companies than driving exposure to countries and sectors in line with the benchmark index.

The second Strategy we have is the Emerging Markets Strategy managed by Pablo Salas and Brad Miller. They too focus on finding high quality companies, but the Strategy is more sensitive to the allocation within the benchmark index and is well diversified by sectors and countries. This Strategy will produce lower volatility, and it's also had an excellent long-term track record. Both Strategies are available at GW&K today.

Both of these Strategies are run by experienced, seasoned portfolio managers, and we are supported by a team of analysts whose sector experience exceeds on average more than 15 years in their respective sectors. Importantly, our analysts are multilingual and they come from different cultural backgrounds.

In summary, we focus on the emerging markets that are experiencing more rapid growth, we continually look for evidence of that growth, and we seek out the best companies we can find to be in front of this growth that we see for the next 5, 10, 15, and 20 years.

Tom, I think it's interesting how much the growth in emerging markets has exceeded that of developed countries over the last 10 years. And yet there's been a huge performance lag within emerging market equities versus the U.S. Can you comment on those valuations and what you're seeing?

Tom: U.S. valuations have done better over the last few years for a couple of reasons. First, low interest rates provided a nice tailwind for U.S. equities. Interest rates coming down created a migration of some money away from fixed income over to stocks to capture some of the more attractive equity returns. You've seen an improving valuation in the U.S.

I think the second thing is that earnings in the U.S. have come through over the last few years, better than most people had anticipated. That's partially due to margin expansion as companies ran their businesses better. There also have been benefits from the tax reforms over the last year or so.

Lastly, I think investors are generally more comfortable investing in the U.S. than they are in emerging market countries. That is really what has created this valuation gap between emerging markets and the U.S.

Harold: I think it's very interesting. I sit here as an investor believing the opportunities you talk about, but most investors can't help but worry about the stability of governments in emerging countries. Truthfully, I think that is a concern that won't ever come to bear, but that's just my opinion. In the end, most investors will underinvest in emerging markets because of that concern. There's probably nothing that you can say to take that fear away, but it also creates the tremendous opportunity of revaluation as time goes by when those concerns don't play out.

Tom: I think it is a really good point. There are fairly dramatic differences between the governments and the pace of reform that we see in different countries. We have a core belief that information is plentiful around the world, and the populations in emerging countries are aware of how they might get left behind. That puts the onus on leadership within these governments to move their economies forward.

Economies like China and India really seem to grasp that, and the pace of reform is what gives us comfort. We see other countries that are falling behind, and I think the populations will wake up in a few years from now and realize how far behind they've fallen. Examples include South Africa, Brazil, and Russia. They are lagging in terms of the pace of reform.

If you look at their historic growth rates, they have been basically flat to down over the last few years. I agree with you, that's something that is important to monitor. Are these governments doing what is right for the underlying population?

Harold: It's very interesting. The Tiananmen Square conflict and the revolt of the farmers, really was an important juncture in Chinese history. I believe that with over 350 million people comprising China's middle class, the Chinese government has to meet those people's demands. People think they're an autocratic government, but an autocratic government still has to work with the population. With a middle class that's growing so dynamically, who's really in control, the citizens or the government? I think China knows that they need to strike a balance. The needs and demands of the rising middle class necessitates more progressive behavior from the central government.

Tom: One last point along those lines is that we believe very strongly that these economies, particularly China, realize that our economy is more mature, and they can't count on growth by exporting to us well into the future. We believe that they're engineering a transition to consumption led growth. China is spending more on healthcare and insurance to make people feel more comfortable so they spend more of their savings and consume more.