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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Seeking Stability and Growth in Volatile Emerging Markets

ROHIT KHULLER, CFA, is Vice President - Investment Management and Partner at Letko Brosseau & Associates Inc. Mr. Khuller is a McGill University graduate (MBA) with a bachelor's in engineering from Delhi College (B. Eng). A CFA charterholder, he has also completed the Harvard Business School General Management Program (GMP). Prior to joining Letko Brosseau in 1998, he held a senior sales engineering position at Carrier Aircon Ltd., after completing internships with major companies such as Suzuki India, Indian Airlines and Bank of America. Mr. Khuller's career in various industries such as automotive, aerospace and banking in several countries has enabled him to deepen his knowledge in different fields. After 25 years with Letko Brosseau, in addition to his role as Portfolio Manager, he is now Vice President, Investment Management and member of the Investment Council, overseeing portfolio strategy and risk management for all the company's assets, and is responsible for the firm's emerging markets equity investments. Mr. Khuller is recognized for his talent as an investor, his strong analytical skills, and his diligence in his work.

SECTOR — GENERAL INVESTING

(AHW550) TWST: Could you tell us about the firm and your role there?

Mr. Khuller: I'm the Vice President and Portfolio Manager at Letko Brosseau in Montreal, Canada. We manage about CAD18 billion in assets for our clients in Canada, the U.S., and Europe. I am the lead portfolio manager for the Emerging Markets Equity fund at Letko Brosseau, which now totals roughly CAD1.7 billion, which would be about $1.3 billion in U.S. dollar terms.

TWST: Do you have an overall investment philosophy and approach to the fund?

Mr. Khuller: Absolutely. Our investment process focuses on bottom-up stock selection with in-depth fundamental research, coupled with a top-down macro-overlay. I'll briefly describe each of these areas to you.

The goal of doing research in emerging markets is to spot wonderful companies trading at a reasonable price. So, we focus on identifying the top two or three companies in each global sector. We're looking for companies with a sustainable competitive advantage, companies that operate on a low-cost structure, companies where there's a clear or a visible path to revenue growth, earnings growth, and cash flow growth over the next three to five years. And then we try to do fundamental work around these potential investments.

The idea here is to construct a portfolio of our 50 best ideas across all these emerging markets. Next, to complement our fundamental bottom-up process, we do a top-down kind of macro-overlay. The reason behind this is that we want to avoid riskier countries.

We have two in-house economists at the firm who do a lot of work in terms of trying to make sure that the companies that we identify in these emerging markets are operating in stable economies. They look at the trends on trade deficits, the current account deficits, what the debt structures of these countries look like, what the household incomes are in these emerging markets. They also investigate the trends on leverage and consumption growth.

So, the entire idea behind the top-down macro-overlay is really to minimize exposures to the EM currencies that may depreciate over the next few years. We want to avoid or minimize that type of scenario.

In a nutshell, that's a little bit about our investment process. And we believe that our investment process follows a disciplined investment approach and repeatability to our performance returns.

We invest in companies that are stable, growing their cash flows, companies that pay good dividends or do buybacks, companies that have exceptionally good management. And as I said before, we want to avoid negative surprises on the country-side or at least keep them to a minimum. That's really our approach.

TWST: Do you consider yourself a value-style strategy?

Mr. Khuller: Absolutely. We believe we have a strong value tilt in our portfolios. Our EM portfolio trades at about nine times next year's earnings as compared to MSCI EM Index, which is trading at more like 13 times next year's earnings. That's just one metric.

With other metrics, for example, our portfolio yields about 250 basis points higher than the MSCI EM index and our portfolio trades at nearly a 30% discount on a book value and cash flow basis. So clearly, there's a strong value tilt in our portfolio.

TWST: Did you want to talk about some of the countries that might be interesting for investors in the emerging market space?

Mr. Khuller: Sure. Now that I've told you about our investment process, you have a fairly good idea about how we go about constructing this portfolio. We target 50 holdings, the 50 best ideas we can identify in emerging markets.

If you look at the portfolio right now, we are able to spot a lot of exciting bottom-up opportunities in Brazil, in China, in Mexico, in the Philippines, in India, in Peru, and other emerging markets. If you look at the portfolio today, roughly 25% of the portfolio is invested in Chinese companies and 22% is invested in Indian companies. Roughly 18% to 20% is invested in Brazilian companies and 12% to 13% in Mexican companies. Those are our most heavily weighted country allocations.

And what you'll notice is our active share is quite high; we are quite different from the MSCI EM Index. The index has much smaller allocations to Brazil and to Mexico. Therefore, it would be fair to say that in some ways, these countries are the most interesting or the most exciting emerging markets for us.

TWST: Are there certain sectors or even individual stocks that you wanted to highlight?

Mr. Khuller: Sure. Emerging markets is generally a volatile asset class, and we strongly dislike large portfolio variances. We like stable but growing sectors like infrastructure, for example, airports, ports, highways, railways. We like the utilities sector, particularly the water supply and wastewater service companies. We like hydro electricity generators. We like transmission and distribution assets.

We are a little cautious on the banks generally in the emerging markets. But that said, if you come across good management in these emerging markets, and coupled with things like their track record on managing bad loans, what type of franchise they've built over the longer period of time. We pay attention to all these things. And if I were to say one thing or one phrase about our banking investments in the emerging markets, it's that we are highly selective.

1-Year Daily Chart of Alibaba Group Holding Ltd. – ADR

Chart provided by www.BigCharts.com

So, while there are opportunities all across these sectors, approximately half the portfolio is invested across four sectors; infrastructure, utilities, health care and modern retail. I'm not including banking in that for now, but those four sectors which are quite sticky, long-term positions for us, account for about half our portfolio.

"We like stable but growing sectors like infrastructure, for example, airports, ports, highways, railways. We like the utilities sector, particularly the water supply and wastewater service companies. We like hydro electricity generators. We like transmission and distribution assets."

It is in these areas where emerging markets have a lot of room for future growth and more importantly, consistent future growth at slightly lower levels of risk and especially over longer time periods. So, these are very large sectors for us.

And then there are ample opportunities in the health care space in the emerging markets. We've invested in a few investments in China, Brazil and the Philippines in this sector. We also have a few investments in modern retail sectors, companies like **Alibaba** (NYSE:BABA), and investments in the financial sector, like stock exchanges and banks. For example, the **Warsaw Stock Exchange** (WSE:GPW) in Poland, the **Mexican Bolsa** (OTCMKTS:BOMXF), banks like **HDFC Bank** (NYSE:HDB) and **Axis Bank** (NSE:AXISBANK) in India. We hold investment across pretty much all these sectors.

But that said, we are very selective about our banking investments because banks have much higher leverage than a typical business. No matter which sector you look at, banks usually are trading anywhere between 10 to 20 times leverage. They have that kind of leverage.

TWST: What advice would you have for investors interested in emerging markets?

Mr. Khuller: I think it's fair to say that because EM is a volatile asset class, one should try to focus on easy-to-understand companies. But these companies should be the ones that are likely to grow over the next three to five years. And most importantly, you want to pay a fair price or a reasonable price for these companies.

You don't want to buy the best company by paying a big premium. For sure everybody wants to buy the best companies, but it's very important to buy a wonderful company or a wonderful business at a reasonable, fair price.

I think investors should focus on easy-to-understand companies in the emerging markets that are growing and that are available at reasonable prices.

We like companies that pay dividends back to their shareholders or do buybacks. But more importantly, investors should figure out how these companies are paying these dividends or how are they financing these buybacks. It is very important that these companies are not diluting the shareholders and paying money out of that capital raise. So, these two things are quite important.

The traditional thinking is that you should avoid the highly levered names or highly levered sectors. So, stay away from tomorrow's disasters. And then diversify your portfolio. We've got 50 best ideas across emerging markets. Even though there are 1,400 stocks in the index, most don't qualify for our portfolio because of their low quality or high volatility or high variance.

We believe this gives us enough diversification, and at the same time gives us a very high active share of close to 95%.

TWST: Are investors concerned sometimes too about the risk involved with investing in emerging markets?

Mr. Khuller: Absolutely. I think running into crooks in the emerging markets is quite common. You have to really take a hard look at family-owned businesses in the emerging markets. But the important thing is to focus on companies that pay back to their shareholders, and analyze how they are paying back to the shareholders. Because as long as it's sustainable then you should be OK.

portfolio, we've been able to find incredible value in the emerging markets and our portfolio is trading at nine times earnings.

If you add something at nine times earnings to your current portfolio that's really tilted towards the U.S. and really tilted towards those seven companies, the Magnificent Seven, then you can actually add a lot of value without sacrificing earnings growth. It's a great place to do that.

We are able to spot a lot of opportunities in those sectors right now where we can see earnings growth of 10% to 15% over the next five years. And this is an annualized number, by the way. Over the next five years, you could see as high as earnings being doubled at the end of the fifth year.

It is a good place to diversify. Over the next few years, the emerging markets should be quite exciting because now close to three-fourths of the global growth is likely to come from the emerging markets. Three-fourths of the total global growth is likely to come from the emerging markets. That's a big statement.

And then if you look at the emerging markets, their economies, the global GDP, 60% of the global GDP is now coming from these emerging markets. But these emerging markets account for only one-third of the total stock market capitalization.

"We look at companies where we can double our investment over five years. So basically, we are targeting investments where companies are growing their earnings by about 10% to 15% CAGR over the next five years."

There are other types of risks one needs to figure out. Investing in stable countries, stable currencies is critical. You don't want to get into a currency like the Turkish lira or the Venezuelan and Argentine currencies. You want to avoid these potential disasters.

That is why you need to do a lot of macro work. You need to figure out what is the purchasing power parity for these different EM currencies, so that you don't get hurt by investing in companies that are based out of these emerging markets.

TWST: Can emerging markets also be a very good way to diversify a portfolio for, let's say, an investor in the United States or Canada?

Mr. Khuller: Absolutely. If you look at the MSCI World, MSCI World now has 70% weight in the U.S. index or the U.S. markets. And if you further dig deeper down within the U.S., for example, the S&P 500, seven companies dominate that index. I think about a little bit more than 30% of the index is invested in those Magnificent Seven companies.

If you want to diversify away from this concentrated exposure in the U.S. markets, then EM is a very good place to do that because you can do it without sacrificing earnings growth.

We look at companies where we can double our investment over five years. So basically, we are targeting investments where companies are growing their earnings by about 10% to 15% CAGR over the next five years. So, if you want to diversify away from the U.S. without sacrificing earnings growth in your portfolio, then EM is a good place to look at.

I think from the perspective of adding value to your portfolio, EM is again a great place for that. Because if you look at the emerging markets — I talked about the index trading at 13 times earnings, and our

Everything is pointing towards great value, whether you slice it this way or you slice it the p/e ratio, or you slice it the price to earnings growth ratio, or you slice it by dividend yield. There's a lot of evidence that points to incredible value in the emerging markets.

1-Year Daily Chart of HDFC Bank Ltd.

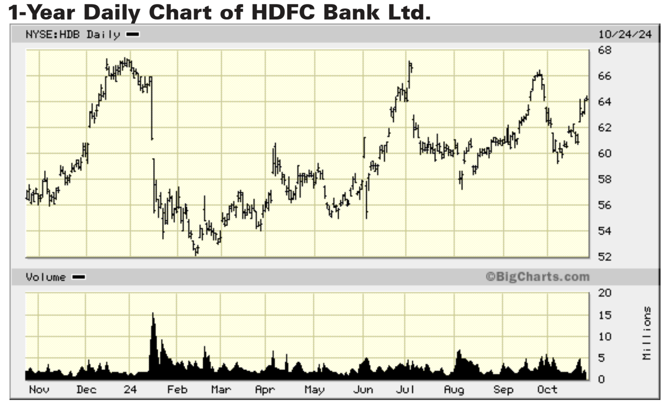

Chart provided by www.BigCharts.com

TWST: Did you want to add anything we haven't discussed?

Mr. Khuller: Yes, when people talk about emerging markets, sometimes they also want to include frontier markets. And we've largely stayed away from frontier markets primarily because of liquidity reasons.

We find that these frontier markets have low liquidity. But that's not to say that we won't invest in it if the right opportunity comes along. Certainly, if the right opportunity comes along where we can see the earnings of a business double over the next five years, then we'll definitely take a look.

But we've got to get comfortable with the liquidity, how quickly we are able to build a $20 million, $30 million position. That's a factor. But if everything fits in just right, we are open to investing in frontier markets as well.

TWST: How would you define a frontier market?

Mr. Khuller: By frontier market, I mean something that's a little bit smaller than emerging markets, like Egypt, for example, or one of the African countries or maybe some of the Middle Eastern markets as well.

TWST: And anything else you would like to bring up?

Mr. Khuller: Yes. We didn't talk about currency hedging.

A lot of people ask us, do you hedge the currency exposure of the emerging markets? Traditionally, we've stayed away from hedging because it's expensive to initiate these hedges and especially rolling over the hedges is quite expensive.

And the other reason is, as companies are going global, they've got revenues, they've got their cost pretty much widely distributed across different regions, different geographies of the world.

So how do you hedge a business like that, that has revenues coming from India, China, Japan, Australia, U.S., and also has costs spread out across these countries? Hedging becomes very complex in cases like that because companies are going global.

I'll give you an example. A company like **Toyota**, it manufactures cars pretty much everywhere in the world and has cost pretty much everywhere in the world. It's very difficult to hedge a business like **Toyota** or **Honda**.

And with regard to what we are buying or selling recently, the fund lately has been buying companies like **HDFC Bank**, **Bolsa Mexicana**, which is Mexico's main capital market or equity market. We've been increasing positions in health care businesses in China, like companies like **Sinopharm** (OTCMKTS:SHTDY), like **Shandong Weigao** (OTCMKTS:SHWGF), and we've been taking some profits in India.

We've done very well in India over the last seven, eight years. And even though we've got about 22% invested in India, we are taking some profits in India, because India seems to be priced to perfection at this point.

TWST: Of the recently acquired companies that you're investing in, is there a common theme to all of them?

Mr. Khuller: Yes. As I said before, our investment process is focused on spotting wonderful companies, companies with low-cost structures, companies that have long-term sustainable advantages, long-term competitive advantages. We look for easy to understand businesses where we can see a visible path to a 15% earnings growth annualized over the next five years. So, these are some of the things we are looking at.

And we don't want to overpay for these companies. We don't want to end up buying these companies, these wonderful businesses, at a 50% premium to the net asset value or a 30% premium.

Ideally, we want to buy them at a fair price, which would be at their net asset value. But we are not going to stay away if we see a small premium, like 10% or 5%, because longer term, if you own an asset that can go up like three or four times over the next 10 to 12 years, a 10% or a 20% premium may turn out to be peanuts.

But you want to make sure that you don't overpay too much for these companies, so pay a reasonable price for them.

And in context to some of the recent buys we've been doing — so for example, the **HDFC Bank** example I gave you, this is the largest private sector bank in India and it has one of the lowest non-performing loans ratio or bad loan ratio in the entire Indian banking industry. It has an excellent management team and we were able to buy the business at less than 15 times next year's forward earnings. So, these are some of the qualities that we look for in a business.

The Mexican equity exchange, **Bolsa Mexicana**, it's a classy business and we were able to buy that business at close to 10 times earnings.

So, we are quite mindful of the price we are paying for these companies. We are a big fan of growth, but we will make sure we don't get too excited and buy these growth companies at any price. You want to focus on the low price to earnings ratio and the low PEG ratio that I talked about earlier. That's what's going to drive your portfolio over the next five years.

TWST: Thank you. (ES)

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