

Scouring the globe for alpha

The Sophus Capital Emerging Markets Team combines analytical tools and fundamental research to pick equities.

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A VICTORY CAPITALTM INVESTMENT FRANCHISE



Mike Reynal
is head of the
Sophus Capital
Emerging
Markets Team.

ALPHA: A STATISTICAL MEASUREMENT USED TO QUANTIFY THE VALUE ADDED OR SUBTRACTED BY A PORTFOLIO MANAGER. SPECIFICALLY, ALPHA MEASURES THE PORTFOLIO'S ACTUAL RETURN AGAINST THE PORTFOLIO'S EXPECTED RETURN GIVEN THE RISK OF THE PORTFOLIO.

MEET THE EMERGING MARKETS TEAM

MUCH OF THE DEVELOPED WORLD is marred by low growth and high debt. That's not a particularly appealing backdrop for equities, so it should come as no surprise that both institutional and retail investors are keen to explore the far reaches of the globe in order to find that elusive growth.

Although the willingness to broaden one's investment horizons far beyond the comforts of home is an important first step, dallying in markets with varying degrees of opacity and liquidity is no easy feat. Succeeding in emerging market equities and capturing alpha over multiple economic cycles requires deep experience, uncommon skill, and the right approach.

"Emerging markets are an unbelievably diverse, dynamic, and thriving arena for investors," explains Mike Reynal, head of the Sophus Capital Emerging Markets Team. "And, in our opinion, picking stocks is the most consistent way to generate excess returns in emerging

markets—much more so than country selection, sector rotation, or market timing. Our process combines the powerful aspects of analytical tools with deep fundamental research. We aim to build a portfolio of stocks with superior growth potential at attractive valuations."

Even for stock pickers who prefer to focus on individual companies, it's critical to monitor the macroeconomic picture and pay close attention to the various layers of political, sovereign, and currency risk inherent in emerging markets. It can be difficult for investors to access corporate information and government statistics. And although fraud is not exclusive to emerging markets, it is sometimes more difficult to identify than in developed markets.

"We're undeterred by these challenges because that's what creates the information gaps and biases that are embedded in emerging markets," continues Reynal. "For us, that inefficiency spells opportunity, and picking the

Capitalizing on the potential of emerging market equities takes unique skill. The Sophus Capital Emerging Markets Team is a diverse group of professionals long on experience with a proven process that marries the best of analytical tools with fundamental research.

Collectively, the team holds 1,500 company meetings in person per year, not including conference calls. We believe being close to management is critical for understanding both industry trends and individual companies. We think proximity to

emerging markets trumps being in a single location. Five of the 10 members are located in Asia, which illustrates the team's commitment to closely following some of these enormous emerging markets. And when our Asian-based analysts wake up in the morning we want them to read about Sino-Japanese relations first and the U.S. Presidential elections second—not the other way around. Plus, our strict implementation of our investment philosophy encourages us to be in multiple locations and still preserve fluid communication.

right stocks from within this dynamic is how we seek to generate alpha versus the benchmark.”

Tilting toward growth

The Sophus Capital Emerging Markets Team adheres to a strict investment philosophy focused on building a portfolio of emerging market companies based on four key characteristics: superior earnings growth, attractive relative valuation, improving earnings expectations, and potential for positive earnings surprise. The team believes these are the characteristics of stocks that have the highest likelihood of delivering share price appreciation. And within that universe of stocks, the team is forever committed to paying a reasonable price for above-par growth potential. Discipline and valuation are critical components of their philosophy.

“We don’t fit comfortably into a single style box,¹ which is sometimes a challenge for consultants and investors,”

admits Portfolio Manager Michael Ade. “We can easily straddle that core-growth space, but the bottom line is that our emerging markets investment philosophy tilts toward growth even if we monitor valuations very closely.”

The team opts for sustainable growth because that’s what equity markets typically reward. Certainly, value can be a powerful factor and outperform dramatically, as in the post-crisis period in the spring of 2009. But according to the team’s extensive research and back-testing, equity markets usually reward factors such as positive and improving earnings growth.

“Still, we think it’s important to pay attention to valuation and believe that if we buy growth at a discount, we can maximize our potential alpha,” explains Ade. “That’s one of the benefits of our process—the combination of analytical tools with fundamental research can help us buy growth at a discount.”



Michael Ade, CFA is a portfolio manager at Sophus Capital.

¹The Morningstar Style Box is a nine-square grid that provides a graphical representation of the “investment style” of stocks and mutual funds. The Style Box defines three size categories (small, mid, or large company stocks) and three style categories (growth, value, and core). Core represents those stocks for which neither value nor growth characteristics dominate.

MICHAEL REYNAL



TITLE: Portfolio manager

HOME: Des Moines, Iowa
EXPERIENCE: 24 years

RESPONSIBLE FOR: Financials, healthcare

CURRENTLY WATCHING: Property market dynamics in the Middle East

ANTONIO ALVAREZ, CFA



TITLE: Analyst

HOME: Singapore
EXPERIENCE: 13 years

RESPONSIBLE FOR: Materials and energy

CURRENTLY WATCHING: The outlook for energy storage systems

MICHAEL ADE, CFA



TITLE: Portfolio manager

HOME: Singapore
EXPERIENCE: 14 years

RESPONSIBLE FOR: Consumer staples, discretionary

CURRENTLY WATCHING: An emerging consumption recovery trend in Korea

Quant is fundamental

The Sophus emerging markets philosophy may tilt toward growth, but what really sets the team apart is the systematic way that it goes about identifying companies and building the portfolio. The team uses proprietary, multifactor models to help focus its fundamental research efforts on those companies exhibiting favored characteristics. These screens systematically sift through thousands of stocks every week and indicate where sustainable growth is likely to be available at a discount.

The team ranks the broadest universe of stocks by using these screens that have been developed and back-tested over nearly two decades. These are multifactor models that help identify a number of fundamental and behavior attributes, giving the team a unique ability to cull through reams of data.

MAINTAIN DISCIPLINE

In investing parlance they carry nondescript names like overconfidence, anchoring, and familiarity. In reality, these are simply behavioral biases that can lead to costly investing mistakes. The Sophus Capital Emerging Markets Team uses its analytical tools to help mitigate the potential fallout from any of the biases that are known to undermine analysts and investors.

By their very nature, models are brutally objective, explains Daniel Do Vale, an analyst on the Sophus Capital Emerging Markets Team. "When a stock falls out of the top quintile, it forces the team to re-evaluate its original investment thesis to determine whether it still deserves a place in the portfolio. The model doesn't have feelings or an ego. It doesn't care what price you paid for a stock. It merely highlights a potential concern, thereby forcing a discussion and deeper analysis of the company."

Conversely, many investors may be predisposed to sell their winners too early. But the team can resist this urge by looking to see how a stock screens even after it has appreciated. If the company is still ranking well, the team will be disinclined to sell.

Models are not a panacea, but they can go a long way in helping analysts avoid some of the common psychological investing mistakes inherent in human nature. The models are not a replacement for company research but rather help orchestrate the fundamental process.

TAMMY BELSHAW, CFA



HOME: UK

EXPERIENCE: 19 years

RESPONSIBLE FOR: Financials

CURRENTLY WATCHING: Monetary policy across emerging markets

TITLE: Head of Emerging Markets Research

REX CHEN



HOME: Des Moines, Iowa

EXPERIENCE: 11 years

RESPONSIBLE FOR: Information technology, including software, Internet, and solar sectors

CURRENTLY WATCHING: Online payment companies across emerging markets

TITLE: Analyst

ZOE CHOW



HOME: Singapore

EXPERIENCE: 9 years

RESPONSIBLE FOR: Telecom, industrials, and real estate

CURRENTLY WATCHING: Real estate developments in Korea and Southeast Asia

TITLE: Analyst

TONY CHU, CFA



HOME: Hong Kong

EXPERIENCE: 14 years

RESPONSIBLE FOR: Consumer discretionary, financials, and utilities

CURRENTLY WATCHING: Health care and pension reforms in Chinese insurance

TITLE: Portfolio manager

This is then complemented by a fundamental, deep-dive research process on individual companies, which leverages the sector and regional expertise of analysts with boots on the ground in that particular geography.

“Every analyst on the team has full visibility of the screens and models,” emphasizes Tammy Belshaw, head of Emerging Markets Research. “This is not a black box and far from a pure quant process. Rather, it’s a fundamental process that leverages very sophisticated and powerful models.”

Capturing efficiency

Emerging market managers operate in an expansive universe encompassing 3,300 companies across more than 20 countries. That’s a great deal of ground to cover for any team, no matter how large. Thus, the systematic screening

process, coupled with fundamental research, is really about enhancing efficiency and capturing a far wider set of opportunities than would otherwise be humanly possible.

“The proprietary models we’ve built simply point us to where inefficiencies live within the markets,” explains Daniel Do Vale, an analyst on the Sophus Capital Emerging Markets Team. “These models rank the most attractive opportunities in a way that an analyst alone cannot.”

At the same time, it’s important to underscore the fact that the model does not pick stocks—the analyst does. Any decision on including or jettisoning stocks is based on growth potential and fundamentals. This is why relevant emerging markets investing experience actually matters.

“In our opinion, picking stocks is the most consistent way to generate excess returns in emerging markets.”

MARIA FREUND, CFA



TITLE: Portfolio manager



HOME: Des Moines, Iowa
EXPERIENCE: 12 years

RESPONSIBLE FOR:
Consumer staples, discretionary, and industrials

CURRENTLY WATCHING:
Signs of a true recovery in the Mexican consumer

ROY LAW, CFA



TITLE: Analyst



HOME: Hong Kong
EXPERIENCE: 9 years

RESPONSIBLE FOR:
Financials, industrials, and healthcare

CURRENTLY WATCHING:
Biosimilar development and its implication for Asian Healthcare

DANIEL DO VALE



TITLE: Analyst



HOME: San Francisco
EXPERIENCE: 9 years

RESPONSIBLE FOR:
Energy, utilities, and telecommunication services

CURRENTLY WATCHING:
The energy supply glut and political developments in Latin America

"A screening system alone cannot identify risk on a company level," Do Vale continues. "What it can do is create a pool of stocks that has more sustainable growth potential. From there, each sector specialist has the opportunity to capture the story and identify the triggers of why we are going to make money from each stock based on both growth potential and valuation analysis."

Overcoming biases

Although the Sophus Capital Emerging Markets Team does not invest thematically, a multitude of opportunities are originating from the globalization of trade and growth of a powerful consumer class. There are legions of first-time credit card holders and automobile owners. This is an undisputed megatrend. In addition, outsourcing of manufacturing to the Guangdong Province (and elsewhere) is increasingly being diversified to places like the Philippines, Mexico, and the Czech Republic. With the services sector furthering this outsourcing trend, opportunities are emerging everywhere.

Yet in order to capitalize on these inefficient markets, we believe investors need to be able to overcome their preconceptions and behavioral biases. Again, this is where the models are very powerful because they can highlight areas of the market and individual stocks that most people overlook. And having unique insights is especially important for an emerging markets manager seeking to generate alpha.

Experience matters

Having the tools to capture efficiency and generate investing ideas is essential. But there is no substitute for emerging markets experience. One cannot simply invest based on the output of a model. There's more skill involved in picking emerging market stocks.

Consider that some Chinese property companies and banks may screen well with their robust growth metrics, but it's critical to understand that the policy environment trumps all in these sectors. Government-linked decisions and lending mandates can undermine any growth story. Thus, the screening may queue up potential opportunities, but we believe having experience and knowledge of policy, culture, and other local market nuances ultimately dictates success.

Brazilian utilities are another example where government policies could affect minority shareholder interests in the future. A systematic screen may not pick up the fact that the long-term earnings power of an entire sector is being eroded until it's too late. If you are following a model blindly and don't follow the political landscape and sector trends, you could find yourself in trouble.

Avoid the traps

Many emerging market managers prefer to focus exclusively on picking countries, which can be an all-or-nothing proposition. You might be a

"I buy [emerging markets] because I think I can get superior growth potential at an attractive value. And in our current environment, growth is a beautiful thing."

top performer one year, or you might just as easily find yourself with a bucketful of cheap Egyptian stocks—and getting cheaper. Country picking is a difficult game, so the Sophus Capital Emerging Markets Team prefers researching companies and selecting stocks as a means for generating alpha.

Another common mistake made by some emerging market managers is focusing only on the largest and most liquid names. But then again, not many managers use analytical tools in a disciplined way to help them identify hidden, fast-growing companies long

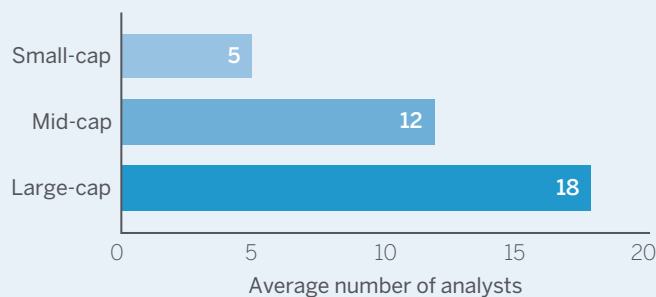
before they have a slick investor relations road show. Too narrow a focus is unnecessarily limiting and even risky should sentiment change and investors head for the exits. The Sophus Capital Emerging Markets Team believes it has a better way.

“Early in my career it was drummed into me that you buy emerging markets just because they are cheap,” says Reynal. “But that’s not why I buy them. I buy because I think I can get superior growth potential at an attractive value. And in our current environment, growth is a beautiful thing.” ♦

SKILL STILL MATTERS IN EMERGING MARKETS (As of May 31, 2016)

The Sophus Capital Emerging Markets Team offers investors a bit of advice: Make sure your emerging markets fund is not dominated by a few, mega-cap companies. Empirical research has shown that allocating to smaller emerging market companies exposes investors to an array of different sectors and competitive forces. In addition, emerging market small caps historically have had less analyst coverage than their large company counterparts. This makes small caps attractive to active managers willing to take positions other than the largest cap stocks that tend to dominate popular emerging markets indexes, according to the Sophus Capital Emerging Markets Team.

Sell-side analyst coverage of emerging market stocks



Sources: FactSet, Victory Capital Management, as of May 31, 2016.

Market Cap data sourced from MSCI EM Small Cap Index, MSCI EM Mid Cap Index, and MSCI EM Large Cap Index.

“The proprietary models we’ve built simply point us to where inefficiencies live within the markets.”

As with all mutual funds, the value of an investment in the Fund could decline, so you could lose money. International investing involves special risks, which include changes in currency rates, foreign taxation and differences in auditing standards and securities regulations, political uncertainty and greater volatility. These risks are even greater when investing in emerging markets. Small companies may be subject to a number of risks not associated with larger, more established companies, potentially making their stock prices more volatile and increasing risk of loss.

An investor should consider the fund's investment objectives, risks, charges and expenses carefully before investing or sending money. This and other important information about the investment company can be found in the fund's prospectus, or, if available, the summary prospectus. To obtain a copy, visit www.victoryfundliterature.com.

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