BARRON'S
THE DOW JONES BUSINESS AND FINANCIAL WEEKLY www.barrons.com OCTOBER 8, 2016

EMERGING MARKETS

A Top EM Fund of 2016 Played Brazil, Avoided China

Brandes Emerging Markets Value also bought Russia while underweighting Chinese shares.

By DIMITRA DEFOTIS

The year's best-performing emerging market mutual funds share at least one trait: betting on Brazil.

Brazil's conflagration of negative news produced stock valuations too cheap to ignore for the five value-oriented managers of the Brandes Emerging Markets Value fund (ticker: BEMIX), one of this year's best EM funds. The fund started 2016 with a 20% weighting in Brazil—roughly three times the MSCI Emerging Market index's exposure. Fast forward: The MSCI Brazil index was up 60% this year, four times better than the benchmark through Sept. 30.

"When things are at the worst, it is probably the right moment to buy," portfolio co-manager Gerardo Zamorano tells Barron's. The $1.2 billion fund was up more than 26% over the first three quarters of 2016, 10 percentage points better than the MSCI EM index, making it No. 4 among dedicated emerging market funds, according to Morningstar.

Brandes Emerging Markets Value tends to hold about 70 names. These stocks often aren't covered by investment-bank researchers and can get mispriced in a country's full-fledged selloff. When the shares recover, the impact is greater on such a concentrated portfolio.

While they may hold stocks as long as five years, the co-managers took some profits after the surprising Brazil rally this year. Zamorano wouldn't name stocks, but said the fund sold a Brazilian water utility, a bank, and an equipment-rental company, and reduced stakes in an oil company and other banks. As of June 30, filings indicate what may still remain in the portfolio, including airplane maker Embraer (ERJ); meat and protein producer Marfrig Global Foods (MRRTY); education plays Estácio Participações (ECPCY) and Kroton Educacional (KROTY), which agreed to merge; state-controlled oil producer Petróleo Brasileiro (PBR), or Petrobras; and Telefônica Brasil (VIV).

The co-managers also favored Russian equities, which are up roughly 28% this year. Valuations were especially pressured last year by low oil prices and sanctions that followed Russia's annexation of Crimea. Similarly, when it looked like Greece could exit the euro zone, the fund picked up a telecom it still holds. Turkey's failed coup also provided a couple of opportunities, Zamorano says.

Of course, avoiding bad investments is also important. China makes up just about 10% of the fund, but is 24% of the EM index. For China bank stocks, Zamorano says there isn't enough loan transparency to gauge risk after years of aggressive government stimulus. And there is overcapacity in many industries. The managers do like undervalued China consumer-spending plays, including a wireless telecom and some unloved luxury plays with Hong Kong listings.

What's next? Zamorano doesn't expect wholesale EM investor flight, or havoc in the currency and bond markets, if U.S. interest rates increase modestly, as promised. He's watching the decline in stock valuations in the Philippines for opportunity as investors get nervous about political tensions under a new president. The team also is "digging deeper for value in Saudi Arabia."

The International Monetary Fund last week projected that global growth will be tepid, at roughly 3%, in 2017, but it expects decent growth from three big emerging markets. The IMF sees India gross-domestic-product growth of 7.6% in 2016 and 2017, as Brazil (0.5%) and Russia (1.1%) exit recession. But the IMF predicts that China growth will slow to 6.2% in 2017 from 6.6%.