THE LEAD

September 7, 2018

"The best companies in China are cheaper than the best companies in the United States."

-Charlie Munger, May 2018

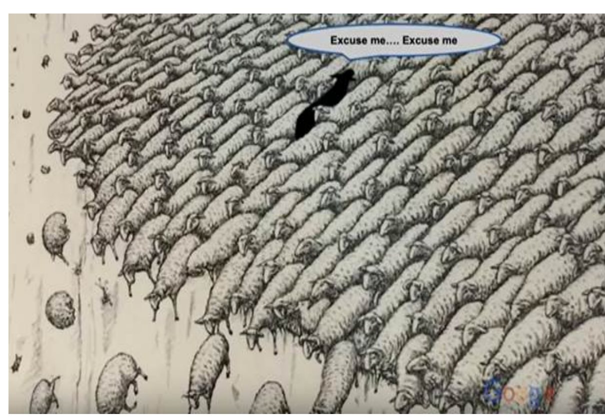
Price Performance of Emerging Market Index vs. S&P 500 Over Last Two Years

Source: Bloomberg

In looking back at prior missives from our group in 2001, one theme that remains consistent to this day is "questioning consensus." Back in June of 2001, Merrill Lynch's Chief Strategist Rich Bernstein (who now has his own firm) noted that low quality stocks ranked "C" and "D" by Standard and Poor's outperformed high quality stocks by 1691 basis points and the average P/E of the C's and D's was 75x versus 20x for the A rated stocks. Fast forward 17 years later and we have the same dynamic where those "C" and "D" stocks are outperforming by 1824 basis points and valuation is a detractor to returns. In 2001 we noted the "carnage" that was later inflicted on speculative names and remaining true to an investment process focused on "a positive sum game based on the beauty of compounding, [versus] one based on guessing the money flow."

We're on the lookout for inexpensive quality companies. While the Economist magazine this summer recommends an attractive consensus secular story burning investor's cash (Netflix), we'd prefer to question the consensus. Is it possible to find something better?

As Berkshire Hathaway Vice-Chair Charlie Munger noted back in May, great stocks overseas looked cheap, but this assessment has only gotten more pronounced since May with the tariff concerns and the relative rise of the U.S. dollar. The underperformance of emerging market stocks has been pronounced as seen in the chart above, but is there the opportunity folks like Munger are suggesting? Taking action here requires "questioning consensus" and going against the herd. The following picture is hung in offices around the world at Brookfield Asset Management. They attribute "going where others are not" to their investment success as one of the largest property and infrastructure investors in the world.



Source: Brookfield Asset Management

What's interesting is that some of the largest stocks in the emerging markets index are names one might not expect. Most of the top names are internet software stocks exposed to the rapidly growing market in China. J.P. Morgan this week acknowledged the headwinds in

Figure 24: China vs US internet: valuations

Fwd P/E, x

Source: Datastream, J. P. Morgan Asia Equity & Quant Strategy

this area, but also the opportunity in terms of the valuation gap (see above) with their view, "we are optimistic about equity prospects in Asia going into year-end."

Largest Holdings in the MSCI Emerging Markets Index

	Name	Weight
1	TENCENT HOLDINGS LTD	4.6%
2	TAIWAN SEMICONDUCTOR MANUFAC	4.2%
3	SAMSUNG ELECTRONICS CO LTD	3.8%
4	ALIBABA GROUP HOLDING-SP ADR	3.7%
5	NASPERS LTD-N SHS	1.8%
6	CHINA CONSTRUCTION BANK-H	1.6%
7	BAIDU INC - SPON ADR	1.2%
8	CHINA MOBILE LTD	1.2%
9	RELIANCE INDUSTRIES LTD	1.0%
10	IND & COMM BK OF CHINA-H	1.0%

Source: Bloomberg

Tencent, for example, is a name added to the Global Leaders strategy last month. The company has a video service similar to Netflix, sports a similar growth rate, but unlike Netflix generates positive and growing free cash flow plus trades at a lower valuation across a variety of metrics. S&P places an A+ rating on Tencent stock which is a welcomed addition to the portfolio for a process focused on buying unique companies at unique prices.

As always thank you for your interest and trust managing your investments.

Chip Wittmann, CFA®
Executive Director
(757) 417-4901
cwittmann@sterling-capital.com