



# The Emerging Markets Style Rotation

By Howie Schwab

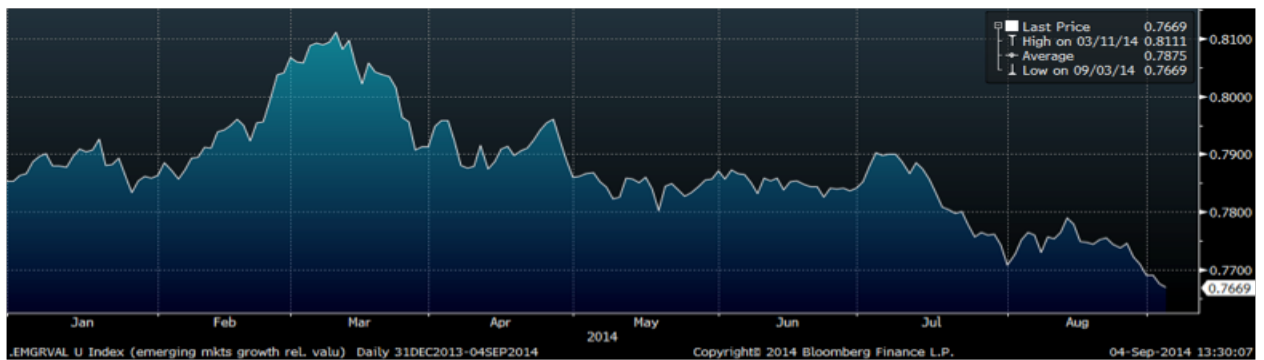
Emerging market equities experienced a sudden and extreme style rotation beginning in March 2014. While higher quality earnings growth stories led performance at the start of the year, value-oriented, high beta (flow-driven) names have led the market since the end of the first quarter (Exhibit 1). In the following text, we isolate the risk factors that explain the rapid change in emerging markets equity leadership. We also review how these changes affected the performance of the Driehaus Emerging Markets Growth strategy, the portfolio's current positioning and our outlook for the remainder of 2014.

## YTD Market Review

For the first two-and-a-half months of the year, smaller companies and earnings growth were positive drivers of equity returns within emerging markets. In mid-March, a period of style rotation unfolded. During the second quarter, leading performance factors within the EM universe included value and large cap,

while the earnings revisions factor significantly underperformed. We believe much of this was a result of passive ETF vehicles accounting for more than 90% of net inflows into emerging markets during the period. Coming off of 22 consecutive weeks of outflows from emerging market equities, which ended in March 2014 (Exhibit 2), the heavy flows into ETFs were likely

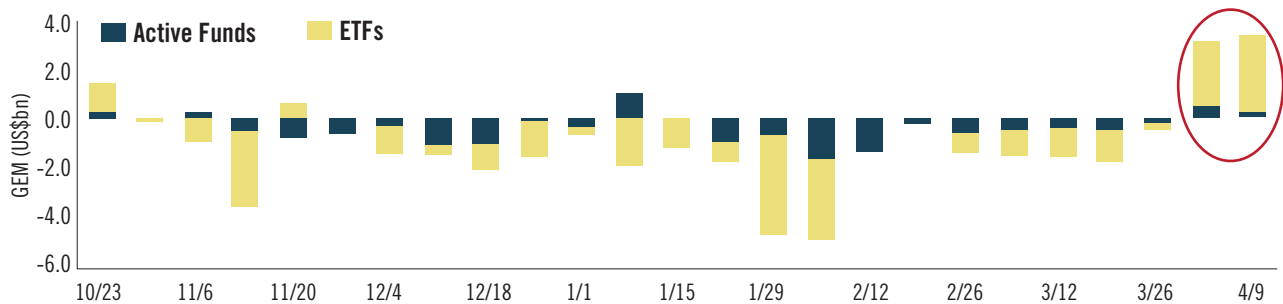
EXHIBIT 1: MSCI EM GROWTH INDEX/MSCI EM VALUE INDEX



Source: Bloomberg

EXHIBIT 2: EMERGING MARKET FLOWS

The style rotation in mid-March likely led to short covering, ending 22 consecutive weeks of outflows from EM.



Source: Credit Suisse Research

emblematic of short covering and macro allocations to emerging markets.

During the second quarter, the U.S. yield curve also flattened, counter to the consensus view for higher long-term interest rates. This proved treacherous as higher short-term rates caused investors to more aggressively discount valuation multiples for more expensive (and higher growth) companies. Exacerbating the situation, lower long-term yields reignited the carry trade in EM currencies, which helped boost stock returns in certain countries regardless of growth fundamentals or revisions (e.g., Brazil).

### Factor Analysis

On a risk factor basis, value and beta<sup>^</sup> have been the most significant drivers of returns since the leadership rotation in March. This is in stark contrast to the previous period when earnings revisions explained performance.

**EPS Revisions.** We believe earnings and earnings growth are the primary drivers of a stock's value over the long term. When a company has an upward earnings revision, it generally serves as a catalyst to increase a company's valuation. As shown in Exhibit 3, at the beginning of the year EM equity performance responded as expected,

EXHIBIT 3: NTM EPS FACTOR ANALYSIS  
Performance Attribution: Driehaus Emerging Markets Growth Strategy vs. MSCI Emerging Markets Index

12/31/2013 to 2/28/2014	Strategy			MSCI Emerging Markets Index		
NTM EPS Est 3M Change	Port. Average Weight	Port. Total Return	Port. Contrib. To Return	Bench. Average Weight	Bench. Total Return	Bench. Contrib. To Return
Next 12 Months EPS Est 3M Change Quintile 1	23.88	4.05	1.06	17.92	-0.21	0.10
Next 12 Months EPS Est 3M Change Quintile 5	6.50	7.66	0.39	14.91	-3.68	-0.28
Next 12 Months EPS Est 3M Change Quintile 3	20.91	-3.61	-0.50	30.77	-3.83	-1.52
Next 12 Months EPS Est 3M Change Quintile 2	27.01	-4.65	-1.91	17.67	-4.07	-0.61
Next 12 Months EPS Est 3M Change Quintile 4	8.60	-3.78	-0.23	18.22	-4.75	-1.08
[Cash]	4.78	-0.00	0.00	--	--	--
[N/A]	8.32	1.28	0.18	0.52	-3.72	-0.02
<b>Total</b>	<b>100.00</b>	<b>-1.02</b>	<b>-1.02</b>	<b>100.00</b>	<b>-3.41</b>	<b>-3.41</b>

2/28/2014 to 8/18/2014	Strategy			MSCI Emerging Markets Index		
NTM EPS Est 3M Change	Port. Average Weight	Port. Total Return	Port. Contrib. To Return	Bench. Average Weight	Bench. Total Return	Bench. Contrib. To Return
Next 12 Months EPS Est 3M Change Quintile 3	21.68	10.14	2.07	22.33	17.94	4.16
Next 12 Months EPS Est 3M Change Quintile 2	24.48	4.10	1.06	20.26	15.09	3.04
Next 12 Months EPS Est 3M Change Quintile 4	10.66	-3.10	-0.38	20.90	13.54	2.73
Next 12 Months EPS Est 3M Change Quintile 5	6.78	4.69	0.33	17.93	11.03	2.00
Next 12 Months EPS Est 3M Change Quintile 1	25.87	11.50	2.76	18.00	7.16	1.31
[Cash]	5.92	0.00	-0.00	--	--	--
[N/A]	4.61	16.85	0.60	0.58	17.21	0.10
<b>Total</b>	<b>100.00</b>	<b>6.45</b>	<b>6.45</b>	<b>100.00</b>	<b>13.34</b>	<b>13.34</b>

Note: Quintile 1 includes stocks with the the most significant positive earnings revisions; Quintile 5 the lowest Shows the three-month change of the next 12 months EPS estimate  
U.S. dollar

Please see standardized performance and important disclosures on page 6.

<sup>^</sup>Beta is a measure of the volatility of a security in comparison to the market as a whole.

\*Source: Factset, Driehaus Capital Management LLC

with the top quintile of earnings revisions providing the strongest stock performance. However, starting in March, earnings revisions stopped explaining emerging markets equity performance and the stocks with the most positive earnings revisions were the worst performers.

**Price/Earnings.** Exhibit 4 shows that the year started with stocks with the highest P/E valuations leading market performance and the lowest quintile offering the lowest return. Since February, this dynamic has reversed and value has been the single most significant performance

factor within the MSCI Emerging Markets Index. The lowest P/E quintile has posted the strongest returns and the highest P/E companies have been the worst performers. This is emblematic of the value bias within emerging markets during this period.

**Beta.** The year started with the lowest beta names providing the strongest returns. After February, this dynamic inverted. By quintile, higher beta equated to stronger returns. The outperformance has been remarkable, with the highest beta quintile more than doubling the returns

EXHIBIT 4: P/E FACTOR ANALYSIS  
Performance Attribution: Driehaus Emerging Markets Growth Strategy vs. MSCI Emerging Markets Index

12/31/2013 to 2/28/2014	Strategy			MSCI Emerging Markets Index		
Price to Earnings	Port. Average Weight	Port. Total Return	Port. Contrib. To Return	Bench. Average Weight	Bench. Total Return	Bench. Contrib. To Return
PE Quintile 1	32.02	4.08	0.98	16.53	0.83	0.09
PE Quintile 3	16.42	-1.22	-0.31	17.44	-1.89	-0.40
PE Quintile 2	23.68	-2.13	-0.40	15.59	-2.43	-0.29
PE Quintile 4	10.02	-5.39	-0.63	18.59	-4.89	-0.92
PE Quintile 5	5.92	-6.16	-0.32	31.19	-6.04	-1.89
[Cash]	4.78	-0.00	0.00	--	--	--
[N/A]	7.16	-4.93	-0.35	0.67	-0.37	-0.00
<b>Total</b>	<b>100.00</b>	<b>-1.02</b>	<b>-1.02</b>	<b>100.00</b>	<b>-3.41</b>	<b>-3.41</b>

2/28/2014 to 8/18/2014	Strategy			MSCI Emerging Markets Index		
Price to Earnings	Port. Average Weight	Port. Total Return	Port. Contrib. To Return	Bench. Average Weight	Bench. Total Return	Bench. Contrib. To Return
PE Quintile 5	8.95	3.49	0.25	29.46	15.95	4.62
PE Quintile 4	8.78	7.65	0.63	19.38	15.29	2.93
PE Quintile 3	16.00	1.87	0.30	18.71	14.44	2.72
PE Quintile 2	26.49	11.75	3.10	15.83	12.88	2.11
PE Quintile 1	28.28	7.23	1.74	15.73	5.78	0.92
[N/A]	5.60	12.17	0.44	0.90	3.96	0.04
[Cash]	5.92	0.00	-0.00	--	--	--
<b>Total</b>	<b>100.00</b>	<b>6.45</b>	<b>6.45</b>	<b>100.00</b>	<b>13.34</b>	<b>13.34</b>

Note: Quintile 1 includes the highest P/E; Quintile 5 the lowest U.S. dollar

Please see standardized performance and important disclosures on page 6.

\*Source: Factset, Driehaus Capital Management LLC

of the lowest beta companies within the MSCI EM Index (Exhibit 5). We believe this beta rally resulted from short covering, geopolitical developments and inflows into passive vehicles.

### **Driehaus Emerging Markets Growth Portfolio Positioning and Outlook**

Because our firm is a fundamental growth equity manager that focuses on positive inflections in company earnings, the past six months have been challenging for our investment style. Importantly, however, we have remained consistent with the investment philosophy that

has guided the strategy's long-term success. Bouts of fundamentally unfounded performance such as what we have just experienced tend to transition into periods of new market leadership. We expect that fundamental earnings growth and revisions will again take the helm in terms of market performance, and that passive flows will migrate back into active stock positions.

The strategy is positioned for a modest pick-up in global growth. We continue to find attractive opportunities in secular growth areas within emerging markets, such as e-commerce, the Internet of Things and the proliferation

EXHIBIT 5: BETA FACTOR ANALYSIS  
Performance Attribution: Driehaus Emerging Markets Growth Strategy vs. MSCI Emerging Markets Index

<i>12/31/2013 to 2/28/2014</i>	Strategy			MSCI Emerging Markets Index		
Beta	Port. Average Weight	Port. Total Return	Port. Contrib. To Return	Bench. Average Weight	Bench. Total Return	Bench. Contrib. To Return
Beta Quintile 5	22.50	-1.44	-0.30	12.17	-2.12	-0.29
Beta Quintile 4	24.23	2.14	0.30	17.01	-2.92	-0.46
Beta Quintile 2	13.77	-1.89	-0.31	28.70	-3.37	-0.95
Beta Quintile 3	22.37	2.15	0.54	20.85	-3.86	-0.86
Beta Quintile 1	10.73	-6.18	-0.58	21.26	-4.59	-0.84
[Cash]	4.78	-0.00	0.00	--	--	--
[N/A]	1.62	-30.51	-0.68	--	--	--
<b>Total</b>	<b>100.00</b>	<b>-1.02</b>	<b>-1.02</b>	<b>100.00</b>	<b>-3.41</b>	<b>-3.41</b>

<i>2/28/2014 to 8/18/2014</i>	Strategy			MSCI Emerging Markets Index		
Beta	Port. Average Weight	Port. Total Return	Port. Contrib. To Return	Bench. Average Weight	Bench. Total Return	Bench. Contrib. To Return
Beta Quintile 1	11.25	4.28	0.44	22.18	20.02	4.29
Beta Quintile 4	19.44	11.23	2.12	16.01	12.53	1.97
Beta Quintile 3	17.52	3.19	0.74	19.06	12.45	2.38
Beta Quintile 2	20.11	10.27	2.11	31.56	11.54	3.68
Beta Quintile 5	25.07	3.59	0.96	11.20	9.15	1.02
[Cash]	5.92	0.00	-0.00	--	--	--
[N/A]	0.69	11.55	0.09	--	--	--
<b>Total</b>	<b>100.00</b>	<b>6.45</b>	<b>6.45</b>	<b>100.00</b>	<b>13.34</b>	<b>13.34</b>

Note: Quintile 1 includes the highest beta stocks; Quintile 5 the lowest beta stocks  
U.S. dollar  
Please see standardized performance and important disclosures on page 6.  
\*Source: Factset, Driehaus Capital Management LLC

of low-cost smartphones and Internet access. We also remain optimistic longer-term on India and selective other reform-oriented markets or areas (e.g., environmental reform in China) where margin and efficiency improvements can underpin stronger growth rates and revisions even amidst a more challenging growth environment. Additionally, we continue to see long-term opportunities in various frontier markets, consumer service sectors, Internet/technology and telecom, health care and through consumption themes, including e-commerce, tourism and formalization of retail distribution.

Similar to the spring of 2009, short-covering and currency appreciation can only carry equities so far without an associated improvement in fundamental growth. While the current environment is providing us with some attractive opportunities, we anticipate a return to normal in the coming months. Until then, our objective will be to use the intervening choppiness to accumulate quality growth companies at attractive levels.

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#### **ABOUT THE AUTHOR**



Howard Schwab is the lead portfolio manager of the Driehaus Emerging Markets Growth strategy and co-portfolio manager of the Driehaus Emerging Markets Small Cap Growth strategy. In addition to his portfolio construction responsibilities, he oversees the emerging markets research team and analyzes macro-level trends and associated market risk. He joined Driehaus Capital Management in 2001.

## DISCLOSURES

This update is not intended to provide investment advice. Nothing herein should be construed as a solicitation, recommendation or an offer to buy, sell or hold any securities, other investments or to adopt any investment strategy or strategies. You should assess your own investment needs based on your individual financial circumstances and investment objectives.

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Driehaus Capital Management LLC (DCM) is a registered investment adviser with the United States Securities and Exchange Commission (SEC). DCM provides investment advisory services using growth equity strategies to individuals, organizations, and institutions. The firm consists of all accounts managed by DCM (the Company). Prior to October 1, 2006, the firm included all accounts for which Driehaus Capital Management (USVI) LLC (DCM USVI) acted as investment adviser. On September 29, 2006, DCM USVI ceased conducting its investment advisory business and withdrew its registration as a registered investment adviser with the SEC. Effective September 30, 2006, DCM USVI retained DCM as investment adviser to these portfolios.

DCM claims compliance with the Global Investment Performance Standards (GIPS®).

This performance information is estimated for the period. **The performance data shown represents past performance and does not guarantee future results. Current performance may be lower or higher than the performance data quoted.**

### % AVERAGE ANNUAL TOTAL RETURN (as of 8/31/14)

	MTD	QTD	YTD	1 Year	3 Year	5 Year	10 Year	Inception <sup>2</sup>
Driehaus Emerging Markets Growth Composite <sup>1</sup>	2.82	2.66	6.72	18.06	6.35	11.37	14.85	13.14
MSCI Emerging Markets Index (Benchmark)	2.29	4.36	10.95	20.40	4.70	8.24	12.52	7.54
MSCI Emerging Markets Growth Index	2.18	3.35	9.79	20.46	5.52	8.89	11.69	6.68

Sources: Driehaus Capital Management LLC, Factset Research Systems, Inc., eVestment Alliance  
Data as of 8/31/14. Net of fee returns.

The performance data represents the strategy's composite of emerging markets growth accounts managed by Driehaus Capital Management LLC (DCM) (the Composite). These returns are estimated for the period as all underlying accounts have not yet been reconciled. All rates of return include reinvested dividends and other earnings and are net of fees and brokerage commissions. The performance data shown above represents past performance and does not guarantee future results. Current performance may be lower or higher than the performance data quoted. The performance results for the Composite are shown in comparison to an index. Unlike the Composite, the index is not actively managed and does not reflect the deduction of any advisory or other fees and expenses. While the securities comprising the index are not identical to those in the Composite, DCM believes this comparison may be useful in evaluating performance. **Please see the notes section for other important information.**

<sup>1</sup>Composite assets include those accounts that meet the composite objectives and eligibility requirements. Please see notes at the end of this presentation for descriptions of composite objectives and eligibility requirements. <sup>2</sup>1/1/1997.

#### **COMPOSITE OBJECTIVES AND ACCOUNTS ELIGIBLE FOR THE EMERGING MARKETS GROWTH COMPOSITE**

The Emerging Markets Growth Composite (the Composite) presented includes all unleveraged "emerging markets growth accounts" over which the Company exercises discretionary investment authority of both cash and equities using the same investment objective and philosophy. The Composite was created in January 1997.

An account is considered to be an emerging markets growth account if it seeks capital appreciation by investing primarily in equity securities of rapidly growing companies in emerging markets countries around the world. This strategy may invest substantially all (no less than 65%) of its assets in emerging markets companies.

Once an account has met the above criteria and is fully invested, it is included in the Composite in the next full monthly reporting period. Accounts that change investment strategies are transferred between composites in the first full monthly reporting period in which the account is managed under the new style. Terminated accounts are excluded from the Composite in the first month in which they are not fully invested as of the end of the month.

#### **PERFORMANCE RESULTS**

Asset-weighted, net of fee composite returns are presented. Monthly composite returns are calculated as the sum of the monthly returns of each account weighted by the account's beginning monthly value as compared to the Composite total. Equal-weighted composite returns are available upon request, but are not examined by independent accountants. For periods prior to November 1, 2004, time-weighted account rates of return were calculated on a monthly basis and allowed for the effect of cash additions and withdrawals using the Modified-Dietz method. If a cash contribution or withdrawal exceeded 10% of an account's value, the account was revalued and the return was calculated for the interim period. Effective November 1, 2004, account rates of return are calculated on a monthly basis by geometrically linking daily returns. Monthly composite returns are geometrically linked to determine annual composite returns.

Returns are presented on a net of fee basis. Gross of fee returns are available upon request, but are not examined by independent accountants. Net of fee returns reflect the account's applicable advisory fee and, in some instances, other fees and expenses, while the gross of fee returns do not. Both are net of brokerage commissions charged to the accounts.

The annualized rate of return is presented as the level annual rate which, if earned for each year in a multiple-year period, would produce the actual cumulative rate of return over that period.

For emerging markets growth accounts, valuations and returns are computed and stated in U.S. dollars. Since returns are stated in U.S. dollars, exchange rates were used in the conversion. The Company is not aware of any significant inconsistencies between exchange rates used in the Composite and those used in the benchmark indices. Securities transactions, which include brokerage commissions, are recorded on a trade date basis, and where information is available, income and expense items are recorded on an accrual basis. Returns are presented on a pretax basis and are net of any actual foreign taxes withheld on dividends and interest. Leverage is not a part of the Company's investment strategy for this Composite. Securities are valued in the foreign currency in which they are denominated and then translated into U.S. dollars at the spot rate. Forward contracts are generally purchased to hedge the risk of the currency fluctuation between the trade date and the settlement date of the underlying securities transactions.

Past performance is not indicative of future results. All investments have risks and you could lose money. Other methods may produce different results and the results for individual accounts and for different periods may vary depending on market conditions and the composition of the account. Care should be used when comparing these results to those published by other investment advisers, other investment vehicles and unmanaged indices due to possible differences in calculation methods.

Additional information regarding policies for valuing portfolios, calculating and preparing compliant composite presentations are available upon request. A complete listing and description of all composites is also available upon request. Please contact our sales, marketing and relationship management department at 312-932-8621.

#### **TAX EFFECT**

The rates of return presented are determined without regard to U.S. tax consequences. Income tax may be withheld on income depending on the tax laws of each country and its treaty, if any, with the U.S. Such withholding taxes are reflected in the performance of accounts.

#### **INDICES**

The performance results for the Composite are shown in comparison to indices. While the securities comprising the indices are not identical to those in any account in the Composite, the Company believes this may be useful in evaluating performance. Unlike the Composite, the indices are not actively managed and do not reflect the deduction of any advisory or other fees and expenses.

The Morgan Stanley Capital International Emerging Markets Growth Index (MSCI Emerging Markets Growth Index) is a subset of the MSCI Emerging Markets Index and includes only the MSCI Emerging Markets Index stocks which are categorized as growth stocks.

The Morgan Stanley Capital International Emerging Markets Index (MSCI Emerging Markets Index) is a market capitalization-weighted index designed to measure equity market performance in 22 global emerging markets.

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25 East Erie Street Chicago, IL 60611 (312) 587-3800 [driehaus.com](http://driehaus.com)