

BEYOND BORDERS INVESTMENT STRATEGIES, LLC  
Q2 2016: ANOTHER STRONG QUARTER  
JULY 15, 2016

**Q2 2016: ANOTHER STRONG QUARTER**

BOSTON, MA – 07/15/16 – Beyond Borders Investment Strategies, LLC (BBIS) announced today that the firm’s international equity portfolio further outperformed its benchmark, MSCI All Country World (ACWI) ex USA Value Weighted Index, during the second quarter of 2016. The value of the portfolio increased by 2.34%, while the value of the benchmark dropped by 1.48%. Since the beginning of 2016, the portfolio outperformed the index by 12.28%. In absolute terms, the value of BBIS’ portfolio increased by 10.86% since the beginning of the year. See *Table 1 for monthly, quarterly, and year-to-date (YTD) performance numbers.*

**Table 1. Returns of Beyond Borders Investment Strategies’ Portfolio vs. Index, 2016**

Returns (Gross of Fees)	Q1 2016	Apr-16	May-16	Jun-16	Q2 2016	2016 YTD
BBIS Portfolio	8.32%	4.23%	-4.92%	3.28%	2.34%	10.86%
MSCI ACWI ex USA Value Weighted Index	0.06%	4.04%	-3.03%	-2.35%	-1.48%	-1.43%
Alpha	8.26%	0.19%	-1.89%	5.62%	3.83%	12.28%

Sources: Datastream, Beyond Borders Investment Strategies.

**REASONS FOR OUTPERFORMANCE: COUNTRY SELECTION**

Our “quantamental” investment process that is based on both quantitative and fundamental principles has allowed us to pick strong single-country ETF investments over the last several years. For each country, we quantitatively evaluate stock markets valuations in comparison to their long-term historical levels, and identify countries where valuations are low and expected returns are high. We identify investment themes or reasons for the low valuations by performing global, regional, or country analyses from the economic, business, political, social, and other perspectives. This constitutes the fundamental part of our analysis. *We described our investment process in detail in the report titled Quantamental Investing in International Equity Markets that was published on the firm’s website on August 14, 2015.*<sup>1</sup> The application of our process has allowed us to identify and invest in the “commodity-exporting emerging markets” theme, or ETFs of commodity-exporting emerging markets.

<sup>1</sup> Beyond Borders Investment Strategies, Quantamental Investing in International Equity Markets, August 14, 2015.

<http://bbistrategies.com/our-publications--events/quantamental-investing-in-international-equity-markets>

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More specifically, the firm's outperformance during Q2 2016 can be explained by the fact that we had sizable positions in five out of the top ten best performing single-country ETFs in our investment universe (48 developed, emerging, and frontier markets). Importantly, the weights of these positions in BBIS' portfolio were higher than in MSCI ACWI ex US Value Weighted Index. The application of our investment process has also allowed us to avoid investing in some countries that have been hit the hardest during the quarter. For example, BBIS has totally avoided investing in six out of the ten worst performing countries during Q2 2016. Our positions in four countries out of the ten worst performing countries where we invested were relatively small compared to other positions in our portfolio.

**THEMATIC INVESTING: COMMODITY-EXPORTING EMERGING MARKETS**

Vitaly Veksler, the firm's CEO and Portfolio Manager, attributed most of the outperformance to the fact that the firm's investments were not bound by the weights of countries in the index. "As we talked in the firm's Q1 2016 performance and outlook newsletter published in April of this year, over the last two years we have invested in a few commodity-exporting emerging markets as the stock markets of these countries have been trading at low valuations. In 2016, we have benefitted from a number of these investments as they started to perform in both absolute terms and relative to MSCI ACWI ex US Value Weighted Index. The weights of these countries in our portfolio are much higher than those in the index. We have been ready to invest in smaller emerging markets rather than just join the crowd in investing in the giants of this investment universe."

Some of the drivers for this theme have been potential oil production cuts, positive economic growth in the US, and slow but positive economic growth in the Eurozone due to an economic stimulus package implemented by the European Central Bank (ECB). We described these drivers and gave examples of countries that could benefit from them in BBIS' Q1 newsletter.<sup>2</sup> However, the most powerful of these drivers, in our opinion, is the continued development of infrastructure in China. According to our calculations based on the IMF forecasts, China will be responsible for 33% of the

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<sup>2</sup> Beyond Borders Investment Strategies, Strong Investment Performance in Q1 2016, April 15, 2016.  
<http://bbistrategies.com/our-publications--events/-strong-investment-performance-in-q1-2016>

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real global GDP growth during the five-year period from 2016 to 2020.<sup>3</sup> This contribution will be twice as big as that of the second largest contributor, United States, which is forecasted to contribute 15%.<sup>4</sup>

The majority of investors did not agree with us on the attractiveness of the stock markets of commodity-exporting emerging markets as recently as in early 2016 before the powerful rally in March. The consensus was that there would be an oversupply of commodities as demand for them, especially in China, slowed. As a result, prices of many commodities and stock markets of countries exporting them, dropped to very low levels. But as investors say, low prices are the best cure against low prices. When prices drop, producers first stop expansion projects and then often stop production even on existing projects. As the commodity production drops, prices recover to the benefit of remaining producers and investors.

This sequence of events has been playing out on the world's zinc markets. In Q4 2015 and Q1 2016, the price of zinc dropped to a 6-year low not seen since 2009 due to an oversupply in the industry. Discouraged by low prices and facing zinc ore depletion in their mines, several zinc producers stopped production at some of the world's largest mines.<sup>5</sup> In January and February of 2016, Vedanta Resources Plc's closed its Lisheen mine in Ireland and MMG Ltd.'s closed its Century mine in Australia, thus, significantly cutting the world's supply of zinc. Just as the global supply of zinc has dropped, the demand has suddenly increased. The announcement about new massive infrastructure projects included in China's 13<sup>th</sup> five-year economic plan in March led to the price of zinc jumping by 32.0% since the beginning of 2016 and by 16.3% during Q2 2016 alone.<sup>6 7</sup>

Recently, China's leaders announced many new infrastructure projects that the country's companies would build inside and outside of the country. This led to a commodity rally during the quarter (*see a section on Peru on some of the numbers describing the rally*). On May 11, China's Transport Ministry announced that the country would invest around \$724 billion in transport infrastructure projects over the next three years.<sup>8</sup> In addition to building infrastructure in China, the country is

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<sup>3</sup> The International Monetary Fund, World Economic Outlook, April 12, 2016.

<sup>4</sup> Ibid.

<sup>5</sup> Barrons.com, Zinc's Rally May Be Just Getting Started, June 25, 2016. Thanks to Guy Spier from Aquamarine Capital in Zurich, Switzerland for attracting our attention to this article and zinc shortage.

<sup>6</sup> The Economist, The National People's Congress: Unlucky for Some, March 12, 2016.

<sup>7</sup> London Metals Exchange, Zinc Price for Cash Delivery.

<sup>8</sup> Reuters, China Eyes \$724 billion of Transport Investment over Next Three Years, May 11, 2016.

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developing infrastructure outside of its borders. The “One Belt One Road” (OBOR) initiative, which is aimed at connecting China to Europe, Africa, and other parts of Asia, is the centerpiece of President Xi Jinping’s economic agenda. According to recent estimates from IHS, a global consultancy, China will invest up to \$1.2 trillion in projects under the aegis of this initiative.<sup>9</sup> The estimated investment is ten times bigger than the US spent on the highly successful Marshall Plan aimed at helping to restore Western European economies devastated by World War II. That investment was \$120 billion in the inflation-adjusted terms.<sup>10</sup> A large portion of the OBOR funds will go into transport infrastructure projects, such as roads, railroads, ports, and airports. UBS, an investment bank, evaluates that close to \$100 billion will be invested in infrastructure projects in the next three years from 2016 to 2018.<sup>11</sup>

### BEST PERFORMER

The best performing ETF in our portfolio was iShares MSCI All Peru Capped ETF (Ticker: EPU) that had total returns, which included both price appreciation and dividend payments, of 18.0% during the quarter. It was also the largest position in our portfolio (just over 10% at the end of Q2 2016). We think there are three reasons explaining the outperformance of this country’s ETF.

1. EPU benefitted from a rebound from very low stock market valuations at the beginning of the quarter in line with the other Latin American countries. Prices of four out of five Latin American ETFs that we follow increased. Our second best performer was a Brazilian ETF (iShares MSCI Brazil ETF (Ticker: EWZ)) that had total returns of 15.6% during the quarter.
2. Peru is a commodity exporter, and prices of commodities increased in aggregate during the quarter. Total return of S&P Goldman Sachs Commodity Index during the quarter was 12.7%.<sup>12</sup> Peru’s largest exports include copper (the world’s 2<sup>nd</sup> largest after Chile), gold, oil, and zinc (the world’s 2<sup>nd</sup> largest after Australia).<sup>13</sup> While the price of copper dropped during the quarter by 0.8% due to Rio Tinto Group and its partners’ approval of a \$5.3 billion

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<sup>9</sup> Turloch Mooney, IHS Maritime Portal, One Belt One Road to Provide \$1.2 Trillion in New Infrastructure Financing, June 17, 2016.

<sup>10</sup> Wikipedia, The Marshall Plan. Retrieved on July 14, 2016. The actual investment of over \$12 billion from 1948 to 1952 is approximately equal to \$120 billion in the current dollar value terms as of June 2016.

<sup>11</sup> South China Morning Post, China’s ‘One Belt One Road’ Investment to Reach US\$200 Billion in Three Years, October 28, 2015.

<sup>12</sup> Datastream.

<sup>13</sup> MIT Observatory of Economic Complexity, Peru Exports, 2014.

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expansion at the Oyu Tolgoi copper mine in Mongolia, the price of gold grew by respectable 6.8%.<sup>14 15</sup> The prices of the other two commodities soared: oil by 22.1% and zinc by 16.3%.<sup>16</sup>

3. The reason that the Peruvian market outperformed markets of other Latin American countries and commodity exporters in other regions of the world was a surprise election of a pro-business candidate, Pedro Pablo Kuczynski (better known as PPK), to the position of the President of the country. He won a runoff election against Keiko Fujimori, another pro-business candidate who also happened to be the daughter of a former President Alberto Fujimori, by the narrowest of margins of less than 0.25% (50.12% vs. 49.88%).<sup>17</sup> Out of three leading candidates, PPK had the strongest background in economics, business, and government. The Oxford- and Princeton-educated, PPK held economist positions at both the World Bank and the International Finance Corporation, the private finance arm of the World Bank. He has business experience in such industries as investment banking (Kuhn, Loeb & Company and First Boston, both in New York), mining (Halco in Pittsburgh, PA), and private equity (Latin American Enterprise Fund in Miami, FL).<sup>18</sup> He also served in the Peruvian government in such capacities as the manager of Peru's Central Reserve Bank, Minister of Energy and Mines, Minister of Economy and Finance, and Prime Minister.

The price of the ETF started to rally on the day when the initial results of the first round of the elections showed that the leftist candidate, Veronika Mendoza, was not likely to go to the runoff election, and two pro-business candidates would square off in the runoff. The price of the ETF increased by 24.8% over the 15-trading-session period from April 11 to April 29.<sup>19</sup> *See Chart 1 for the price movements of EPU during the quarter with the political events superimposed on the chart. Green and red arrows indicate our opinion on whether the events had positive, negative, or mixed impact on the price.*

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<sup>14</sup> London Metals Exchange, Copper Price for Cash Delivery. UK London Gold Price. Both retrieved via Datastream on July 14, 2016.

<sup>15</sup> David Stringer, Bloomberg, Rio Approves \$5.3 Billion Oyu Tolgoi Copper Mine Expansion, May 6, 2016.

<sup>16</sup> Brent Crude Oil Spot FOB Price. London Metals Exchange, Zinc Price for Cash Delivery.

<sup>17</sup> The National Office of Electoral Processes (Oficina Nacional de Procesos Electorales). Results retrieved on July 10. E<https://resultados elecciones2016.onpe.gob.pe/PRP2V2016/Resumen-GeneralPresidencial.html#posicion>

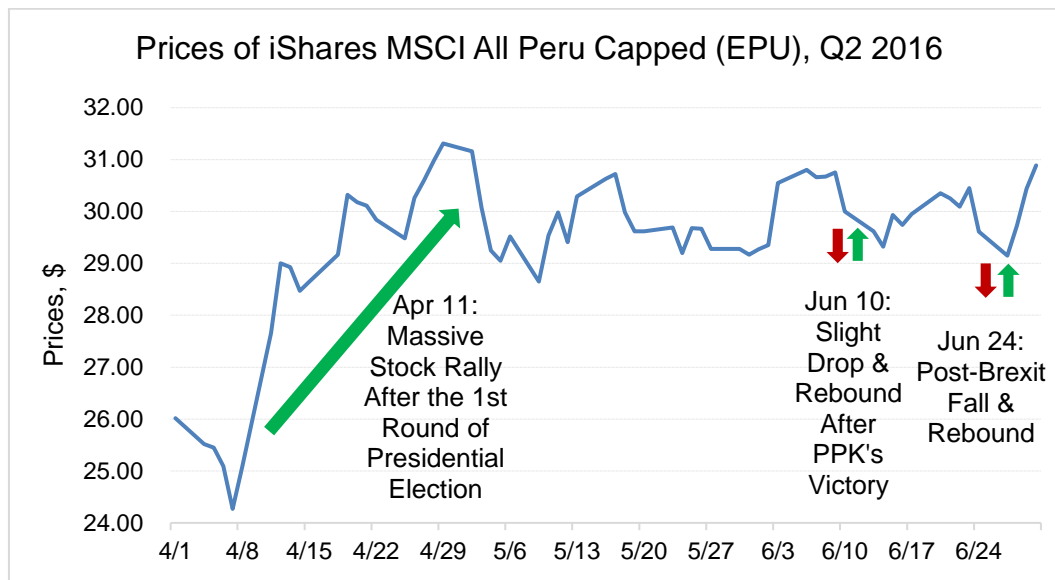
<sup>18</sup> Wikipedia, Pedro Pablo Kuczynski. Data retrieved on July 10.

<sup>19</sup> Datastream.

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We maintain our position in EPU because of the following factors. First, despite an 18.0% return over the last quarter, valuations of the Peruvian stock market and the ETF are still low and offer high expected returns. In our estimate, the ETF has expected returns of 9.2% over the next 8 years. Second, as we discussed at the beginning of the report, we think that the theme of investing in commodity-exporting emerging markets is attractive at this time. Peru's exports of zinc, for example, could be a positive contributor to EPU's performance over the next quarter. As we have mentioned earlier, there is shortage of this metal on the world's markets and we expect the price of zinc to increase further.

**Chart 1. Price Movements of iShares MSCI All Peru Capped ETF (Ticker: EPU), Q2 2016.**



Sources: Datastream, Beyond Borders Investment Strategies.

### THE BIGGEST DETRACTOR

iShares MSCI Austria Capped (Ticker: EWO) became the biggest detractor from BBIS portfolio's performance due to two unexpected and rather unique events: the first failed presidential election in Austrian history and the Brexit vote that paved the way for the first country, which also happened to be the bloc's second largest economy, to exit the European Union. However, due to low valuations of EWO at the beginning of the quarter and dividends that it paid during the quarter, the total returns' drop was limited to 8.2%.<sup>20</sup>

<sup>20</sup> Datastream.

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On June 8, Austria's far-right Freedom Party lodged a legal challenge to the result of the runoff presidential election on May 22, in which it lost by the tiny margin of 0.69% (49.65% vs. 50.35%), or by less than 31,000 votes.<sup>21</sup> The price of EWO dropped by 4.9% over the next seven trading sessions.<sup>22</sup> *Chart 2 demonstrates price movements of EWO during the second quarter with political events superimposed on the chart. Once again, green and red arrows indicate our opinion on whether the events had positive, negative, or mixed impact on the price.* The Freedom Party claimed that such irregularities as illegal handling of postal ballots could have affected more than 570,000 ballots.<sup>23</sup> The party also claimed that it had evidence showing that under-16s and foreigners were allowed to vote.<sup>24</sup> On July 1, the Constitutional Court of Austria announced that the results of presidential elections were annulled after it found that electoral rules had been disregarded resulting in over 77,900 absentee votes being improperly counted.<sup>25</sup> While the number of the affected votes was not as high as in the Freedom Party's claim, it was high enough to have impacted the outcome of the runoff election. The second round re-vote will take place on October 2, 2016.<sup>26</sup>

The ETF's price plummeted by the total of 13.1% on June 24 and June 25 as the results of the Brexit vote were announced.<sup>27</sup> In our opinion, investors were worried that Austria would become the next country to leave the European Union if the Freedom Party were to win a potential presidential election re-vote. The party came to prominence on its Eurosceptic anti-immigration platform, while the leaders of the Green Party, their main rivals who had won the runoff election, criticized the Austrian government for its current cap on asylum seekers.<sup>28</sup> The cap limits the number of asylum claims to 37,500 in 2016 and a total of 127,500 through 2019.<sup>29</sup> However, Norbert Hofer, the Freedom Party's Presidential candidate, stated that he would be against Austria leaving the EU should his party win the re-vote.<sup>30</sup>

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<sup>21</sup> Wikipedia, Austrian Presidential Election 2016. Data retrieved on July 11, 2016.

<sup>22</sup> Datastream.

<sup>23</sup> BBC, Austrian Far Right Challenges Presidential Poll Result, June 8, 2016.

<sup>24</sup> Ibid.

<sup>25</sup> Philip Oltermann, The Guardian, Austrian Far-Right Party's Triumph in Presidential Poll Could Spell Turmoil, April 25, 2016.

<sup>26</sup> BBC, Austria to Re-run Overturned Presidential Poll in October, July 5, 2016.

<sup>27</sup> Datastream.

<sup>28</sup> Philip Oltermann, The Guardian, Austrian Far-Right Party's Triumph in Presidential Poll Could Spell Turmoil, April 25, 2016.

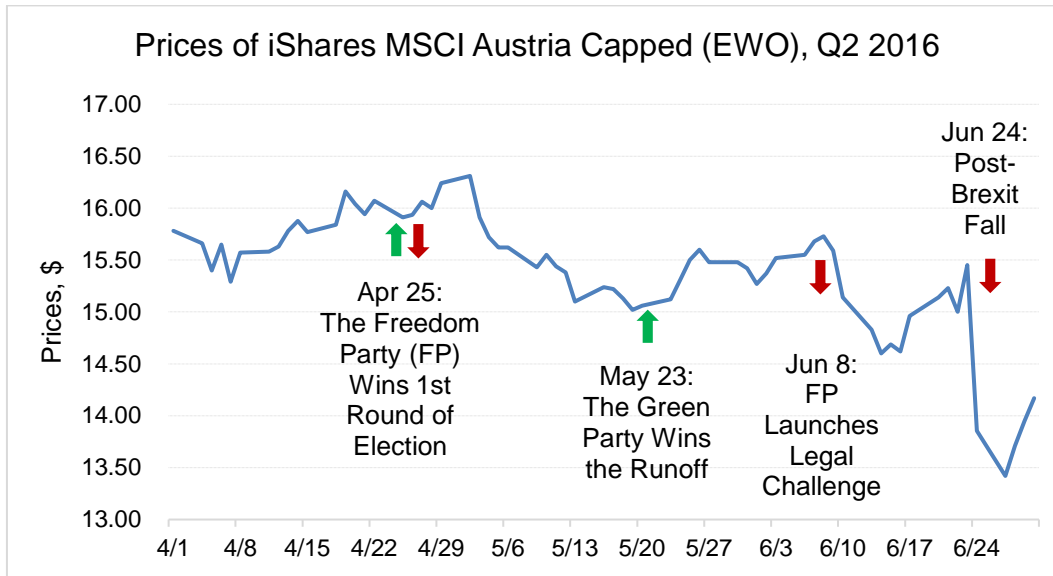
<sup>29</sup> Cynthia Kroet, Politico, Austria Will Reach Refugee Limit by the Fall: Interior Minister, July 12, 2016.

<sup>30</sup> BBC, Austrian Far-Right Leader Hofer Against Leaving EU, July 8, 2016.



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**Chart 2. Price Movements of iShares MSCI Austria Capped ETF (Ticker: EWO), Q2 2016.**



Sources: Datastream, Beyond Borders Investment Strategies.

We continue to hold our position in EWO because we believe that the current valuation of the Austrian stock market is low compared to its long-term levels. For example, it is lower than one standard deviation from the long-term average value on Market Capitalization/GDP measure.<sup>31</sup> In our opinion, the currently low valuation is likely to expand since the valuation levels were higher than those at the end of the second quarter 84% of the time during the last eight years. Therefore, despite some downward pressure on the stock market valuations before the re-vote on October 2, we think that the market is likely to rebound on potential positive economic news from Austria, Europe, or other places around the world. Some of the positive news could be related to the economic stimulus package expansion in the Eurozone or the other three themes that we described in the above-mentioned BBIS' Q1 2016 newsletter.<sup>32</sup>

Please let us know if you have any questions about Beyond Borders Investment Strategies, or would like to talk to Vitaly Veksler about macroeconomic or investment topics, by sending a message to [info@bbistrategies.com](mailto:info@bbistrategies.com). Thank you.

<sup>31</sup> Beyond Borders Investment Strategies. Calculations performed on data available as of July 11, 2016.

<sup>32</sup> Beyond Borders Investment Strategies, Strong Investment Performance in Q1 2016, April 15, 2016.

<http://bbistrategies.com/our-publications--events/-strong-investment-performance-in-q1-2016>