

SHINING A LIGHT ON..... BLACKROCK EMERGING EUROPE

At a glance

For investors prepared to accept high volatility investing in Eastern Europe can provide greater returns than Western Europe. Russia remains the dominant economy and most funds will be skewed in this direction. This means investors may not fully benefit from the potential upside from other Eastern countries as the Russian weighting is high.

Our Adventurous Portfolios have exposure to Eastern Europe via the JPM New Europe Fund. The manager deploys a high conviction investment style (the top ten holdings account for 50% of the fund), with a bias to Russia (68.5%), Poland (12.8%) and Turkey (8.2%).

As an alternative the BlackRock Emerging Europe Investment Trust is more diversified both in terms of economies and sectors. It is a high conviction concentrated portfolio of 25 stocks (the top ten make up nearly 60% of the fund); with the main exposures in Russia (52.3%), Turkey (21.9%), Poland (14.7%), Hungary (8%) and Turkmenistan (7.2%). Across sectors its focus is on Financials (39.7%), Energy (30%), Consumer Staples (13%) and Information Technology (8.4%).

For investors looking to access the market this appears to be the most diversified fund covering this region. In 2010, 2011, 2013 and 2014 (to date) it outperformed the JPM Fund and as an investment trust it carries a discount of nearly 10%.

This review will provide more details on this option.

Who are the team behind the fund?

Sam Vecht and David Reid are the co-managers of the Trust; Sam is head of the BlackRock Emerging Markets Specialist team. Sam manages the BGF Emerging Europe Fund, the BSF Emerging Markets Absolute Return Fund, the Emerging Europe Investment Trust, the Frontiers Investment Trust and the Emerging Frontiers Hedge Fund.

David is a member of the Emerging Markets Specialist team in the Fundamental Equity division of BlackRock's Alpha Strategies Group. He focuses on investments in Emerging Europe. David's service with the firm dates back to 2005, including his years with Merrill Lynch Investment Managers (MLIM), which merged with BlackRock in 2006.

What is the story behind the investment?

Ever since the fall of the Berlin Wall in 1989, the former Eastern Bloc nations have been steadily closing the gap on their developed western neighbours. Years of communist rule and economic stagnation left the region decades behind the West and facing a sizeable task to reduce their enormous wealth superiority.

With the help of EU funding, years of infrastructure projects were put in place to modernise the region and transform it into a low-cost manufacturing base for Western Europe, the US, Japan and South Korea.

The collapse of Lehman Brothers, and the subsequent end of cheap credit, hurt Eastern Europe particularly hard because its rapid growth was funded by exports to developed Europe and the credit boom funded by Western European banks.

This effect on the region's growth prospects has been painfully prolonged by the seemingly never-ending rollercoaster of the Eurozone crisis.

To counter the risk of a collapse in the developing markets, initiatives were put in place to limit the damage caused by the erosion of western European finances. For example, the European Investment Bank, World Bank and European Bank for Reconstruction and Development pumped €30bn into the region last year, while the 2009 Vienna Initiative saw a pact between regulators and international financial institutions agreed to prevent Western European banks from withdrawing from the region.

As a consequence Eastern Europe is cheap compared to both emerging and developed markets. It provides an interesting investment opportunity in economies with lower deficits, lower debt burdens and higher growth.

For example, in Hungary the government has halved the country's deficit through austerity policies. Turkey's public debt is below 40 per cent of GDP and, its banks are well capitalised through a strongly regulated sector.

Russia has low debt to GDP, low unemployment and inflation is at a record low with the stock market being updated to international standards.

These economies will continue to get stronger. However, the unrest in Ukraine demonstrates the vulnerability of the region (as with any emerging economy). Investors may therefore look to blend Eastern and Western European Funds benefit from the recovery across the whole of the region.

Fund highlights?

The previous managers were replaced by BlackRock four years ago. Since then the new managers have repositioned the portfolio. The fund is no longer benchmark constrained which gives them greater diversification in stock section; for example they can invest in Russian Internet Businesses, Shale Gas Projects, Emerging Energy Powers and Pharmaceutical Innovation.

Examples stocks include Luxoft and Dragon Oil. Luxoft is a Russian outsourcing provider based in Eastern Europe. Its revenues have grown by 50% over the last five years and it continues to beat expectations. Its clients include Deutsche Bank and Boeing.

Dragon Oil is a UK and Dublin listed company producing energy in Turkmenistan's Caspian Sea. It has strong cash flow and within 3 years could buy-back all its equity. The management team is strong and they are using the cash to invest wisely in projects in Tunisia, Iraq and Egypt.

The fund also has exposure to the Turkish Financial Sector; Halk Bank is an example where it has consistently delivered 20% returns throughout different market cycles.

There is exposure to the Ukraine; the Ukraine is one the cheapest Chicken producers in the world the fund invests in a company involved in this.

In summary Eastern Europe has been painful for investors in recent years however the low valuations against the potential returns make a strong investment case. There will be a bias to Russia however this fund does have exposure to a number of other countries.

Fund performance

The table below shows performance over the last five years and going into 2014:

	2009	2010	2011	2012	2013	2014
BlackRock Emerging Europe Investment Trust	80.62%	39.38%	-28.25%	11.80%	4.40%	-9.99%
JPM New Europe Fund	103.23%	30.53%	-31.97%	22.41%	-1.60%	-11.92%
iShares MSCI Emerging Markets (Inc)	54.30%	21.85%	-20.53%	9.50%	-7.31%	-5.07%

You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well as rise. The total return reflects performance without sales charges or the effects of taxation, but is adjusted to reflect all on-going fund expenses and assumes reinvestment of dividends and capital gains. If adjusted for sales charges and the effects of taxation, the performance quoted would be reduced.

Conclusion

For investors looking to invest in Emerging Europe this Trust provides a diversified approach both in terms of economies and sectors. There remains a bias to Russia but this is only around 50% of the fund. Over 3 years investors will have seen negative returns and with the unrest in the Ukraine it would seem that stocks continue to get cheaper. The discount on the trust means that when the market corrects this could deliver significant upside.

We will replace the JPM Fund with this fund for these reasons.

The source of information in this note has been provided by BlackRock and is correct as at February 2014. These are notes from meeting the fund manager or representative and should not be seen as a recommendation to purchase any fund mentioned. Any reference to shares is not a recommendation to buy or sell. Should you wish to make a decision based on these notes we cannot take responsibility for this and you should carry out your own research before making a decision. You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well rise.