Q2 Global Markets Call with Vontobel CIO Matthew Benkendorf
Moderated by Joe Terranova
Recorded April 25, 2016
(Edited transcript)

John McCormack: *My name is John McCormack. I'm the sales manager at Virtus Investment Partners. It's my pleasure to welcome you to the call. Joining me are Joe Terranova and Matt Benkendorf. Many of you will recognize Joe Terranova as an ensemble member of CNBC's Half Time program. Joe also serves as Chief Market Strategist at Virtus. Joe will be moderating today's call with Matt Benkendorf. Matt is the chief investment officer at Vontobel Asset Management, subadviser to four Virtus funds, Virtus Emerging Markets Opportunities Fund, Virtus Foreign Opportunities Fund, Virtus Global Opportunities Fund, and Virtus Greater European Opportunities Fund. At Virtus, we are committed to driving better client outcomes. We believe that insightful market perspective is key to helping investors meet their objective. Now, it's my pleasure to turn the call over to my friend Joe Terranova.*

Joe Terranova: *Thank you very much, John, and thank you to all of you who have called in this afternoon and taken time out of your busy days to listen in on the conversation between Matt and myself. Matt, welcome. We're very excited to hear your thoughts, comments, expectations as they relate to what we just witnessed in the first quarter of 2016, and your expectations for the second quarter. So let's go back and talk about the first quarter. Certainly it was a Jekyll and Hyde personality for the capital markets, more specifically, the equities markets. In January, markets came out with one of the more significant declines we've seen in almost a hundred years. We had a very strong rebound to basically bring the quarterly performance for the S&P 500® back to unchanged. Matt, give us your overall assessment of what we experienced, the tale of two different quarters in the first quarter of 2016, and then more specifically walk us through how you navigated the environment in your funds.*

Matthew Benkendorf: Sure. Thanks, Joe. Thanks for having me and thanks everybody for joining us today. Yes, I think you summed it up pretty well with your Jekyll and Hyde comment. You've had a balance of two equally irrational events. The selloff to start the year was very irrational; it built upon some extreme continued pessimism in emerging markets, but then extreme pessimism all of a sudden on the continuity of the U.S. recovery that sent people into a bit of a tizzy.

And then you effectively had what's been the dysfunctional part of our markets that's continued over the last couple of years that sort of reversed course, which was the clarification that the Fed would delay future interest rate increases. So once again it seems that asset financial market pessimism pushed the Fed into a corner again to push back the rate increase, and that sort of reversed things completely — it reversed the energy complex, reversed sentiment, and set the markets back to where we are now today.

As I said, both elements of the extreme pushdown were irrational to begin with because nothing deteriorated that sharply. And in effect, as we've seen in the continued economic data, the U.S. has continued to be rather solid and progressively better, nothing shooting the lights out, but not bad by any means, and as I said, getting progressively better slowly. And then you had this sharp reversal, which indicated a real massive reflation going on, which also is a little bit exaggerated.

As we look back, we weathered the downdraft better, clearly. Where we sit now, net-net at the end of the first quarter across our different products, the one that's had a more difficult time from a relative performance standpoint clearly has been emerging markets. That's a very style-driven phenomenon. That's where we got caught in the back updraft, as I said, when energy took off again. Given our style, that's the product where we're a little bit more exposed, or most prone to the relative underperformance, because of that market environment.

When we had the complete reversal and pessimism in emerging markets generally, when we had the sharp rally in the price of oil, when that overflowed into appreciation of some of these emerging markets' currencies as well after the dollar strength broke a bit, that left us most prone style-wise in emerging markets versus the other products. And that's how we sit here right now.

Joe Terranova: *Let's talk about that for a second, because so much of the emerging markets and the index itself is made up of energy commodity/resource types of equity names. Vontobel historically has a bottom-up investment approach, and within that approach and understanding it, that's why the underweight exposure to energies, resource, and commodities is there. My question is the believability in the rebound in the energy/resource/commodities story, the sustainability in it. And if you were to see that, what is it exactly that would cause you to move your waiting and your allocation to a far greater increase?*

Matthew Benkendorf: Great question. That's clearly where we sit right now. I'd say our general feeling has been that the rebound's been exaggerated in that commodity complex. You essentially didn't have a lot of fundamental change other than the change in timing of the Fed increase. Certainly that did change the timing; I think people still expect rate increases but the timing has been pushed back. You haven't seen a heck of a lot of reversal in underlying economic data in the underlying economies tied off the energy price. So you saw in the energy price itself no changes, and you know as well as I, in the supply-demand dynamic, that would have fundamentally justified the rally.

You saw the expectation and hopes of a supply cut, which haven't come to fruition yet, which once again goes back to the delayed rate increase as the bigger catalyst, as I said, in the underlying economies. The emerging markets you alluded to are a little bit more commodity sensitive, certainly a lot more energy commodity complex-driven depending on which market we're talking about. But overall, emerging markets are more sensitive to that and are positively biased to that recovery. So there you've had the rally.

I'd say net-net with all that being said, the rally itself has certainly got ahead of the fundamentals. Look at the hardest rallying market in the quarter, Brazil, and there you have the energy commodity rally plus the political situation, which is giving some people some hope of change. Fundamentally, on the ground nothing is changing right now, despite the massive rally in the Brazilian equity market and now the impeachment process underway. You still have a very deep economic recession going on, and you need the political process to play out, and then you need a reversal of that cyclically.

So not to spend too much time belaboring this and give you a more concise answer to your question, about emerging markets, we had a structural plus a cyclical slowdown. So now the cyclical slowdown in a number of places has abated, yes, certainly. In some markets where the energy complex is very important, an alleviation in the price will help, but certainly with $40 dollar oil, no one is really jumping up and down yet as a massive stimulus to those economies particularly.

The currencies that have rallied the most too, as well, which is a big factor in emerging markets like the real or the Russian ruble, Chilean peso, South African rand, which are tied to the commodity energy complex, rallied harder. That provides a lot of forward-looking hope. I think that's the net answer to your question of where we see or how we see that position.

In terms of our positioning, that doesn't change. Our underweight energy, basic materials, more cyclical businesses is a style issue for us. It's not a change in environment where we want to be more prescient or need more data to change our tact. It's about what we buy and what we invest in fundamentally over complete market cycles. And you're seeing now a perfect — in a short snippet — a perfect period where we will relatively underperform because of our style.

Now, net-net over full cycles, I think we've shown we can add a lot of value because of the downside capture protection, because of the upmarket participation, so even though we relatively underperform in a product like emerging markets, we're still getting absolute returns and we'll continue to get absolute returns. And if things do turn out even better economically than we even envisioned, we'll get even better absolute returns. But the relative underperformance will have to always be there as a hallmark of our style. There's nothing meaningful that will change that or would cause a significant shift.

Over full cycles, have we owned a few names in the space in smaller positions? Yes. But that's only when we get them at a deep discount too. So you need a huge margin of safety in there as well. So it's a rare sort of opportunity and that's hard to envision in a market that's very apt to forward-price euphoria very quickly.

Joe Terranova: *So as it relates to pricing and euphoria, there hasn't been much euphoria surrounding the emerging market asset class the last couple of years. And I guess we're in a cycle that can be identified as one that's fraught with many challenges and headwinds. What we've witnessed here in the last couple of months seems to be just a little alleviation of the pressure in the overall space. Can you just walk us through, Matt, when you take this bottom-up approach in your style, how is it that you incorporate some of the headwinds, which I think in listening to you, I'm hearing you saying hey, these headwinds aren't going to remove themselves anytime soon. And we speak specifically as it relates to oil. You could also talk about what's going on with Brazilian politics, which will clearly extend throughout the summer and oddly enough the timing potential to end right when the Olympics are coming. And there are some secondary issues out there. There's the impact of a possible Brexit. There's central bank policy and then there's certainly the political uncertainty in the United States. So share with me for a second in the bottom-up style, how do you navigate around those many multiple headwinds that don't look like they're really going to alleviate themselves anytime soon?*

Matthew Benkendorf: You're getting at the heart of what we're doing here. We truly do focus on the businesses first. That's where we focus on how we handle that, the uncertainty at the macro level. And it's a hard thing. Everybody is very easily prone or subjective to the news or the macroeconomic environment. But we have a very rigorous discipline and we look at each company individually. And we make assessments of that business franchise first in terms of quality and then we make assessments around the growth of that franchise, taking conservative assumptions, i.e., being more cautious that what can this business deliver even in the more difficult period? And does that deliverance meet our hurdles, meet our criteria?

So even at the more conservative end, we get what we want, and in a better scenario we'll get even more than that. So at the emerging markets portfolio level, the key numbers we focus on to navigate the environment are what is the collective earnings growth of the businesses we own? The first step we take care of is making sure we get the franchises right so they'll be durable through the cycle. And then the second element is at what rate of growth should we expect those collective businesses to achieve and then that translates into the prospective investment returns. And still at the emerging markets portfolio level, despite the structure and cyclical slowdown, because we've consolidated the portfolio, trimmed out the weaker links or tails, gotten more concentrated around the core of the portfolio, the higher conviction names, the weighted average earnings growth of the portfolio is somewhere still in the low, even to mid-teens rate right now, of our collective businesses.

That's what we sit on in terms of portfolio potential. Now, multiples have expanded across the board in emerging markets, both in low-quality businesses, even in higher-quality businesses. We always address valuation along the way — sell out or trim businesses that become overvalued — but even businesses that are still undervalued aren't as particularly undervalued as they were in the crisis. But still for what we're paying and getting that low to mid-teens earnings growth rate, we can get a little bit of multiple compression even from here and I think still deliver attractive investment returns.

The key second element I think is volatility, and that's something we didn't talk about yet in emerging markets, and then we can move to developed markets as you asked the Brexit question. But in emerging markets, I'd certainly expect more volatility this year. We saw in one quarter what happens just with a change in timing of a Fed interest rate increase. And I think people generally appreciate this, but maybe not fully respect it, that those changes are still going to come at some point. And we see even with small minor changes, when you alter the bedrock upon which all risk assets are priced globally, there is some outcome of that, and the most obvious outcome is mostly volatility. Certainly we would expect that as the year goes on, which is also why from a style perspective, although in the short-term we've had some headwinds because of our style, and we're always transparent and I would openly say now if I expected a prolonged period of headwinds to our style, we're never cagy or hiding of that. But honestly, by looking at the environment and the expected volatility you should still get because there is a good element of euphoria here, because fundamentals aren't moving as fast as a sentiment change. With the volatility, I still feel pretty good, with higher-quality businesses, with that sort of growth rate of low teens to mid-teens earnings growth.

The last piece, not to belabor too long, but you introduced it, is Brexit. Shifting from emerging to developed markets, that's going to be the noise over the next couple of months. And as I said, it is noise mainly and not because we have a very strong view there. Even if you look at the experts on this topic and the Brits themselves, no one fully understands what it is actually. There's going to be a vote on it, which is seemingly a yea or nay vote largely on immigration. No one really fully understands the implications from a business perspective.

From a treaty perspective, as our own president weighed in on it last week, letting Brits know how that might change their priority in striking trade deals. So I think it is a lot of noise because there isn't a lot of real in-depth analysis about the outcome or what the outcome even is or means. That's certainly going to be and volatility over the next couple of months. There we are cognizant, even though I downplayed the knowledge of the exact outcome, we're cognizant of it and careful. And there we have what I would call very few or very little minor exposures within, say, our international or European portfolio, which would be mainly a U.K. domestic business, like a homebuilder, for example, where the tightness and supply-demand dynamics in the market could be altered by immigration or by sentiment towards or away from the U.K. I think we have very strong businesses in what we own there, but rather de minimis overall exposure even during this volatile period.

Joe Terranova: *So in an environment where growth opportunities are so challenged, how is it exactly Vontobel differentiates itself and finds growth opportunities in such a challenging environment?*

Matthew Benkendorf: That's the heart of it that you're hitting on. We are investors. We take positions and we expect outcomes, and we take a lower measure of risk in our particular style to get those outcomes of low double-digit consistent growth.

And that's where it's sort of a short story where you say, where are the opportunities? Because although it feels like it's been a decade from now since the end of 2015, because so much has transpired in such a volatile fashion, we're relatively similarly positioned. We were well positioned, we think, at the end of 2015. We were emboldened in the downdraft in terms of the security of the environment, how we were positioned, and then we had this relief rally and that didn't change our positioning too. And as you talked about, why would we change our view on some of these lower quality businesses. Well, we wouldn't no matter what.

So as we sit here today, as we did at the end of 2015, we have one of the more concentrated portfolios we've had in a while, and that's been going on not in one quarter; that's happened over the last 12 to 18 months. We've gotten more concentrated around our core ideas to make sure we have got at the portfolio level that collective earnings growth we strive to achieve. Also to make sure at the overall portfolio level, we have the durability we need, knowing full well we could get some continued volatility and we can't make successful macro predictions consistently from the top down, nor is it something we do.

So where we sit now versus where we were just three or four months ago is very similar: Same opportunities around the core holdings. Same meaningful exposure to consumer staples, for example, as people have known and understand and appreciate from us. Same sort of weighting to India; we still hold the same belief in our businesses in India. And that was a bit of a headwind in the first quarter because India, as you know, is assumed to be a little bit inversely correlated to the energy complex, quite funny enough, as the rest of emerging markets are more positively correlated. So that was a little bit of a headwind, but we have the same conviction there, and if we do get some more headwind there, actually that would open up the opportunity set even a bit wider to increase some positions. But right now, net-net, sort of similar positions there and sort of similar positions across the other sectors that we had at the end of 2015, similar exposure to financials, et cetera. So it's a long answer to your question. As I said, it was a simple answer but to just add some more color on it, we sit today just like we did three or four months ago because as much as sentiment seems to swing around and people think the world changes overnight, it actually hasn't. Despite some rapid developments in Brazil on the political front, where at the end of 2015 people were hopeful of political change, now that it's happening, still the fundamentals at the ground level haven't changed overnight.

So that's the reality. It's a patient world for impatient people, generally, investing as you know. But I think we're pretty patient on what we sit on and we have a lot of confidence in our patience because of the higher quality nature of the businesses we own.

Joe Terranova: *As it relates to the holdings in the portfolio, if the dynamic in the world, which has been one over the last couple of years of a significant deflationary environment, if it were to shift into an inflationary environment, how much of an impact would that have on holdings in your portfolio?*

Matthew Benkendorf: Joe, I think that's a great question because typically as you know, there's some difference of opinion even in the investment world, because some people view this rather superficially, but you've got to peel back the onion. For inflation, typically people think they want commodities or commoditized industry. But there's a big difference between owning a pure commodity, as you know, actually owning let's say the gold, or a barrel of oil, and owning a business which produces that. There's a huge difference in the underlying economics.

And that's why when we look at the foundations of why we invest the way we invest, one of the hallmarks that's a little bit underappreciated — and it's just underappreciated because we haven't been in this environment for some time — it's how does this high-quality style work in an inflationary environment. And to your question, as you can tell you're hitting on something that gets me a little bit worked up and passionate about, when we define high quality and the types of businesses we see as high quality, pricing power is one of the biggest components of high quality for us. And that's your greatest protection in an inflationary environment.

And as I mentioned, the difference between some producers and the commodities themselves, inflation is inflation. So yes, the cost of your goods if you are a commoditized business might be going up. But given the nature of which you do, you're probably in a capital-intensive industry where your costs are always still going up and your CapEx requirements are also going up. So your profitability might not be as positively correlated with the environment that people generally think is good for your business. When we look at the way we invest and how we define high quality, we tend to buy less capital-intensive businesses, number one. So that's a great protection against inflation when you don't have incremental CapEx needs which go up in an inflationary environment, and you don't have incremental higher CapEx needs to fuel additional growth. That's a great virtue of a high quality business. You can grow even faster off the same asset base. That's great.

And also pricing power. That's at the end of the day your best protection against inflation — pricing power. Do you sell something that you can charge a higher price for, which is not that elastic in demand? And that's how we define high quality and that's why we own a number of consumer staples. Look at the businesses we own whether they're the basic ones everybody understands, the Unilevers, the Nestles, et cetera, We've had agricultural commodity price inflation over time. We've had the cost of goods go up. Even they're affected in distribution and packaging from higher energy prices, but the incremental pricing power they have at the end of the day for the end product vastly outweighs that.

So yes, there's a little pressure on gross margin initially, a little compared to what other companies weather, but it's about having the pricing power for what you sell and that's why, to the heart of your question, we always feel fairly secure, whether it's deflation or inflation. And one of the bigger topical fears you're hitting on is maybe U.S. inflation picks up. Your best protection at the end of the day is pricing power in a business and that's incorporated in how we view high-quality businesses.

Joe Terranova: *Thank you, Matt. I always enjoy our conversations. I look forward to the next one. Have a successful quarter and we'll speak again soon. John, I'll turn the call back to you.*

John McCormack: *Thanks very much, Joe, and I just want to thank both of you gentlemen, Matt and Joe, for your time today. I appreciated the call very much and found it very informative.*

Matthew Benkendorf: Great. Thank you everybody.

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