

Stocks With Growth Drivers

Despite an incessant flow of information on Eastern Europe, Russia and the Middle East, the region is still not well covered by brokerage houses and finance media when it comes to investing. Portfolio manager Leigh Innes explains how T. Rowe Price Emerging Europe & Mediterranean Fund handles volatility, currency risks, and an invariable lack of liquidity through a concentrated portfolio of bigger holdings on fewer stocks.

What is the background of the fund?

T. Rowe Price Emerging Europe & Mediterranean Fund was launched on August 31, 2000. It has quite a broad definition across emerging Europe, which has given us the scope to invest in the core region of emerging Europe, Russia and the Commonwealth of Independent States, and parts of the near Middle East countries like Egypt.

When the fund was initially started, it focused on the convergence of Central Europe to Western Europe. But more recently, the focus has shifted from Central Europe to Russia and parts of the CIS, and that is why it should be considered a broad emerging Europe fund in terms of its country scope.

“Generally, the markets in emerging Europe and the Mediterranean region are inefficient and the stocks are not as well covered. Our knowledge of the companies helps us in uncovering stories that are not fully priced in, as well as finding others that are not really covered by brokerage houses.”

What are the investment objectives of the fund?

The fund seeks long-term growth of capital through investments primarily in the common stocks of companies in the emerging market countries of Europe and the Mediterranean region.

We are a growth-focused fund and the aim is to build performance from bottom up stock picking. We look for stocks with a clear growth driver that can be in the top line or through gross or operating margins or improving returns and cash flows.

How do you deal with discrepancies in valuations in such a vast region?

We believe in knowing the companies we invest in and their potential helps us in tackling valuation discrepancies. It is our conviction that in a boom market a company's growth potential factors can be significantly underestimated. Analyst estimates tend to undershoot, and it is up to us to find out where those market estimations might be wrong in order to exploit those valuation differences.

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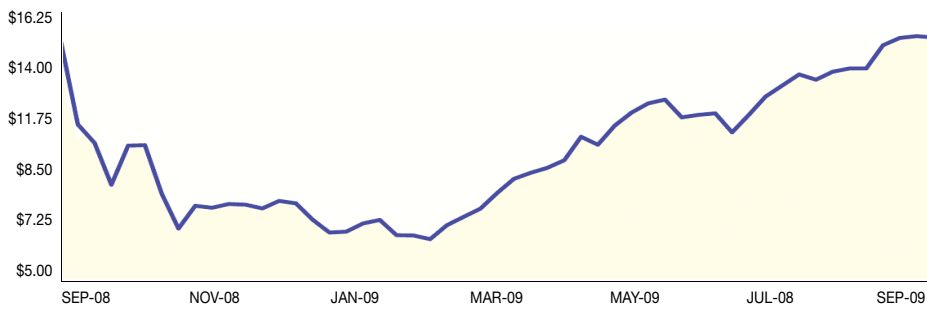
LEIGH INNES, CFA is a vice president of T. Rowe Price Group, Inc. She is a vice president of T. Rowe Price International, Inc., and a portfolio manager in the Equity Division. Innes is chairman of the Investment Advisory Committee of the Emerging Europe & Mediterranean Fund.

Prior to joining T. Rowe Price in 2002, Innes was a fund manager/analyst with Merrill Lynch covering Latin America.

Innes earned an M.A., with honours, in mathematics from Oxford University. She also has earned the Chartered Financial Analyst designation.

Performance - Price History N.A.V.

T. Rowe Price Emerging Europe & Mediterranean Fund (TREM)



	2007	2008	2009*
MSCI Emerging Markets Europe and Middle East Index	28.88%	-93.61%	57.78%
T. Rowe Price Emerging Europe & Mediterranean Fund	27.91%	-75.85%	103.46%

*AS OF 09/30/2009

are inefficient and the stocks are not as well covered. Our knowledge of the companies helps us in uncovering stories that are not fully priced in, as well as finding others that are not really covered by brokerage houses.

How does your investment philosophy translate into the fund's investment strategy?

A: The fund normally invests at least 80% of assets in the emerging markets of Europe, including Eastern Europe and the former Soviet Union, and the Mediterranean region, including the Middle East and North Africa. We may purchase the stocks of companies of any size, but we typically focus on large- and, to a lesser extent, medium-sized and small-cap companies in these regions.

What perceivable changes have taken place in Emerging Europe over the last five years?

Historically, the first set of countries in Central Europe that are now part of the European Union would have been the first part of the emerging European market. These Central

European countries interested us as they converged towards Western European levels. But there is obviously still scope in segments such as wages in the region, which are still well below Western European levels.

More recently, we are focusing on Russia, CIS, and Turkey which have a higher momentum of the economic convergence going forward.

Over the last five years there has been a tremendous improvement in corporate governance from all the emerging European countries. Improvements can be seen in other factors like access to the companies, the timeliness of the data that they report, or the ability to get answers to the type of questions we are constantly asking.

Lastly, for the predictability of earnings we spend a lot of time trying to get to know the companies as well as we can, considering different scenarios, and building our own models from scratch with elements like the drivers, factors, and sensitivity of earnings to different assumptions.

How has the recent economic growth affected Emerging Europe?

The biggest countries in terms of population in the region are Russia with about 140 million people and Turkey with about 70 million people. Even though the GDP per capita has increased considerably, the size of the corporate sector or the stock markets in these countries, unfortunately, are quite underrepresented compared to the population.

A large part of the interesting sectors have been consumer driven and products that did not exist in these countries earlier this decade like formalized retail, supermarkets and hyper markets, consumer banking products like mortgages, car loans, or personal banking have been growing quite rapidly. They have all started from a very low base. As these populations become wealthier with real wage increases, the changes will drive quite a lot of opportunity.

What kind of opportunities do you foresee in countries such as Turkey and Russia?

The Turkish and Russian economies have seen pretty sharp declines in more recent history. For a place like Turkey, the demographics are favorable with a very young population and a strong domestic banking sector, which will help the economy rebound quickly.

For instance, one of the stocks that has been working well for us is BIM Birlesik Magazalar Anonim Sirketi, which operates retail stores of fast moving basic consumer goods in Turkey. The company that started from scratch now has 2,500 stores across Turkey, growing from its internal cash flow modeled similar to the Aldi model in Germany. This model has worked well through the downturn but it works well again in terms of the formalization of the retail sector, bringing more customers into those formats. They have been able

to finance all their growth internally with very nice returns along the way.

There is another discount retailer launched more recently, and they are starting to build up as well but they have about a few hundred stores so far, so it does not really have the scale to be able to compete. Moreover, they are still slightly debt financed and they have not been able to move as quickly through the downturn.

Although there are many mainstream supermarket companies, BIM is doing well because prices tend to be 40% lower than those in the mainstream supermarkets. They are investing anything they gain on margins and efficiency straight back into prices to gain volume and market share, and they continue to keep that big price discount to their competitors.

In terms of demographics, Turkey is probably one of the fastest-growing countries in the region besides Egypt, which has a much younger population of people under twenty-five. The demographic factor obviously helps in terms of longer term outlook for growth.

Meanwhile, Russia and other parts of Central Europe have a slight headwind from the demographics. Their populations are slightly declining and relatively aged. For example, the economic growth potential in Russia is more about gaining efficiency from the capital stock rather than growth of the labor force.

A couple of the food retailing companies in Russia appear to be very interesting growth stories. Russia had even less competition in the formalized retail sector up until the last few years. The population growth is not going to affect the stocks we own in the very short-term, but we may have to consider these factors in the longer term.

How do you find and analyze companies before you add them to your portfolio?

Our research process is bottom-up driven. We have a team of analysts covering stocks in the region and we frequently travel to visit companies, meeting with management and various industry sources to assess both the companies and the industries.

We have a formal process with well-built models of companies, but we also allow analysts to stay flexible in order to find ideas that are not just in the benchmark. Our analysts conduct proprietary industry and company analysis to confirm growth prospects and valuations.

Other metrics that we focus on in our research process are sustainable earnings growth, cash flow characteristics, enterprise value relative to unit of output and quality of management.

For example, we have in our portfolio a company called Novatek OAO, which is an independent gas producer. We met the management of the company before they were listed. At that time we built up a relationship and gathered knowledge of the company before it had even come to the market. We were actually able to take a pre-IPO stake in the company before taking a bigger stake when it was listed in early 2005. Today, it is quite a big stock in the Russian index. They are very well known and well covered, but we made most of our money in that stock through owning it at a very early stage.

So, also being an independent company it was much more efficient, had higher returns and the ability to grow those returns, and being undiscovered was originally very cheap. So all those factors came together and it's still a position that we hold although it's not undiscovered anymore.

In terms of language, it helps specifically to have analysts who know the local language of a nation in the emerging European region. When we first started looking for investing in the region, a lot of meetings had to be translated and this obviously put us in a little disadvantage in terms of the flow of the conversation and the ability to make a judgment on the management team. At present, almost all of the meetings are in English, which has been a real change over the years. Another significant advantage for us is the presence of Russian speakers on our team.

What is your portfolio construction process?

The portfolio construction is based on the premise of finding ideas and building from the bottom up. We are not targeting a country bet to start with but are always aware of what our country and sector bets come out to be once building out from the bottom up ideas.

Ideally, our portfolio target is between 40 and 70 stocks with some position sizes ranging from about 1% to a maximum of probably around 7% of the fund. We run a relatively concentrated portfolio, which is as diversified as it can be. In terms of the exact position size, it depends on the level of conviction, upside potential, and the liquidity of the stock.

We focus on a good company within an industry where we can identify growth in the returns. Then, that company will also have to meet some liquidity and quality criteria. It is very much about trying to understand the drivers within the model and where our view might be different to the market, what is embedded in the market valuation, and where there is upside versus what the market is pricing in. We are screening pretty hard for liquidity, so that will cut-off a number of stocks that are just not so big or liquid enough to be able to build viable positions.

The country factor is extremely important to the emerging markets. If we like a stock idea, we need to know what is going on from a macroeconomic perspective and consider how that might affect the investment case for that stock. So, if there is a risk related to a currency, that may temper our enthusiasm for the size of bet or for having a position at all. What we have is a bottom-up process with an awareness of the top-down factors too.

The portfolio turnover is relatively low at levels around 30% to 40%. We are generally looking for ideas on a slightly longer-term perspective with a time horizon of at least one to three-years. That said, we may also take advantage of short-term opportunities.

Our benchmark is the MSCI Emerging Markets Europe and Middle East Index, which has 90 stocks, but our investable universe is larger than that because we are equally happy to earn in non-index stocks. We do not believe that the index in that region is especially efficient in picking up stocks, and there are a number of large companies that are not in the index for one reason or another. In general, there are about 120 to 150 stocks that we will consider for potential investment.

What risks do you perceive in the portfolio and how do you control them?


We have access to a number of risk metrics on the portfolio through a system on a daily basis and we go through all the data every two or three months with our risk experts. We use the BARRA Global Equity Model Version 2 and the Citigroup Global Risk Attribute Model factor analysis to look at the statistics on the portfolio. We seek to determine what the tracking error is versus the benchmark, how much risk is coming from various factors such as currency or Russian interest rates, and use all that to see how it is changing over time and how that fits in with our investment ideas.

Whenever we may be building up stock ideas with a particular scenario in mind, we want to make sure that the resulting portfolio will reflect that. It is quite important for us to be able to check that potential holdings will behave the way that we expect them to behave. Generally, most of the risks come from stock-specific factors rather than macro risk factors. The key to controlling risk is to know the companies well.

What is the role of currency in your investment process?

We do not hedge currency. If we make an investment, we are not hedging back to dollars. When are exposed to the local currency, we will definitely consider what might happen with the currencies in terms of the investment drivers for a company.

For example, earlier this year, we significantly increased exposures to Russian oil companies. That decision coincided with the bottom in the oil price, but the other developing factor was a significant devaluation in the Russian Ruble when a big part of the cost base of these companies is denominated in Rubles. So, they were going to have this sudden improvement in margins that had not been reflected because of the currency movement or prices. That was definitely something we could take advantage of, and it clearly shows how a currency movement might affect company fundamentals.

Since we have had some depreciations in the local currencies over the last year, we have tried to determine which companies have dollar-based debt on their balance sheet and if they are earning in local currencies that have dollar-based payments to make. That is certainly something that can present us with a potential problem. Therefore, we are trying to make sure that we either do not have excess exposure in such names, or that the currency is not going to change the picture of the balance sheet and the financial stability of the company. 

T. Rowe Price Emerging Europe & Mediterranean Fund

Symbol **TREMX**
 Website www3.troweprice.com
 Address T Rowe Price Associates Inc
 100 East Pratt Street
 Baltimore, MD 21202
 Telephone 800-638-5660
 Inception 08/31/2000

PORTFOLIO

Total Net Assets *	\$ 538.5
Avg Mkt Cap (\$ Weighted)*	\$20,700
Average Price/Earnings Ratio	17.18x
Average Price/Book Ratio	3.21x
Turnover Ratio	36%

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$2,500
Min Subsequent Investment	\$100
Min Initial IRA Investment	\$1,000

RISK (MSCI EMRG MKTS EUROPE AND MIDDLE EAST INDEX)

Alpha	- 0.32
Beta	1.71
R-Squared	0.77
Ann Std Deviation	44.16
Sharpe Ratio	-0.04

RETURNS VS. MSCI EMRG MKTS EUROPE AND MIDDLE EAST INDEX

	TREMX	Index
1 Year (Cum.)	-8.52%	-13.90%
3 Year (Ann.)	-9.58%	-9.80%
5 Year (Ann.)	9.57%	7.68%

FEES AND EXPENSES

Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee**	2.00%
Total Expense Ratio	1.32%

PORTFOLIO MANAGER

Leigh Innes	2007
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*millions **3 months after purchase
 09/30/2009; Source: Company Documents; Lipper

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