Commentary on...

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Emerging markets – opportunities in the acronyms

Since the turn of the century emerging market (EM) assets have provided investors with higher returns relative to developed market (DM) assets. 2013 however, provided a salutary warning to investors about the dangers of assuming a good thing will last forever as EM assets significantly underperformed DM assets.

We start this note by considering what we mean by EM assets and how investors have historically gained exposure to these assets. We conclude, perhaps unsurprisingly, that the past is not a good guide to the future and investors should re-consider their approach to investing in EM assets.

The second part of this note then goes on to consider, in light of our conclusions in the first part, how trustees should assess their exposure to emerging economies.

Highlighting the dangers of index investing

Starting with a definition - what is an emerging market?

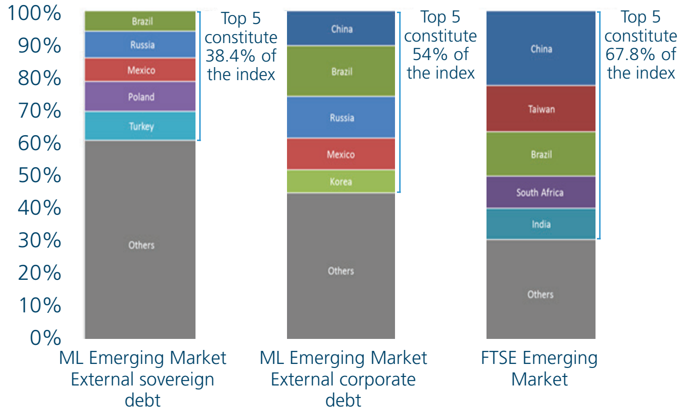
An EM may well be different to an emerging economy. Indeed an emerging economy may not be emerging in the sense that investors may think.

From an investor's perspective the key definition of an EM is that set by the index provider. Taking FTSE for example they define an EM not according to the economy, or its outlook, but by its financial markets. They have fifteen defined quality of markets criteria that include; treatment of minority shareholders, liquidity of equity market, quality of settlement of trades. It is the extent that a country's stock market meets these criteria that determines whether it is classified as developed, emerging or frontier.

This differs from definitions used by the likes of the IMF who will also look at economic indicators such as GDP per capita and the level of diversification within the economy.

So who makes it into the emerging index?

The chart below sets out the largest constituents of sovereign debt, corporate debt and equity markets.



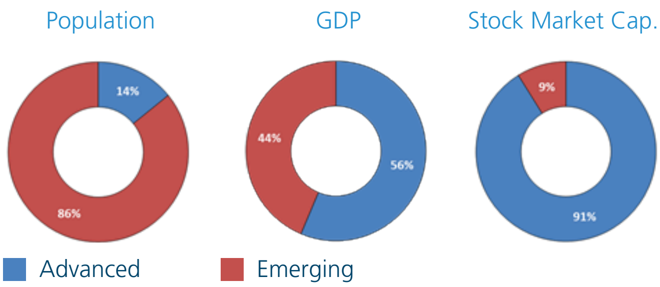
Source: Merrill Lynch, FTSE

If we focus for now on the equity market this immediately raises a number of concerns regarding the use of indices for gaining exposure to EMs. Firstly, the index is relatively highly concentrated, with the five largest economies accounting for nearly 70% of the index. When making a passive allocation to EM equities, investors are really choosing to make an allocation to China, Taiwan, Brazil, South Africa and India.

Secondly, like all indices, we know the constituents of the index are not static over time. Taking the largest weight in the index, China, this originally joined the index in 1996 and then accounted for around 5% of the index. Over the subsequent 15 years this has grown to around 20% of the index as shown above. This growth has not been due to stellar returns for investors over that period, but the large number of Initial Public Offerings (IPOs) on the Chinese stock markets. The passive investor has been a forced buyer of such IPOs. Analysing returns from the Chinese stock markets relative to the wider EM markets suggests these purchases have done little to provide superior returns.

This concentration of Chinese shares could be exacerbated in the future if Chinese A-shares were to be included within the index, a move that some have predicted could occur in the next 3 to 5 years. Such a move would increase the weight of Chinese shares in the index to 40 - 50%.

Countries can also join and leave the index, not always for positive reasons. For example, Greece has recently re-joined the MSCI emerging index having been classified as a developed economy previously. To us an economy that has contracted by around 25% since the onset of the financial crises does not meet the criteria a typical investor would set for an 'emerging' economy. EM investors that track those indices are therefore forced buyers of Greek stocks.
Finally, the number of countries that have been included within the EM index has grown. The concept of an EM has changed since the term was first introduced 25 years ago, then the 10 countries made up less than 1% of the global stock market capitalisation and around 15% of global GDP, now they are a far more significant part of the global economy as shown in various measures below:

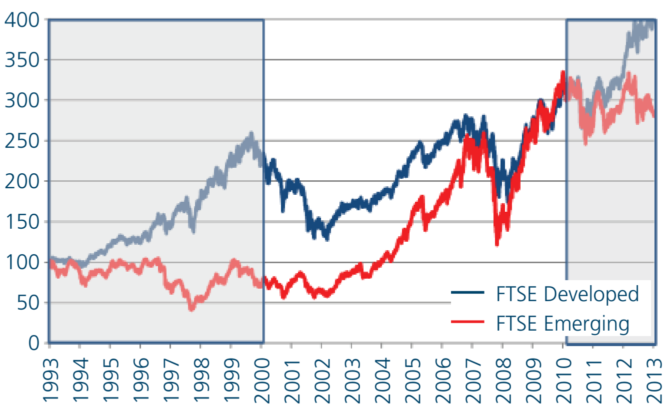


Source: IMF, FTSE

This provides us with further concerns regarding the approach of treating EMs as an entirely separate asset class to DMs. Given they each account for approaching half of global GDP and there is a huge amount of interdependence between each half, investors could be missing significant opportunities by not recognising this fact.

How has a passive allocation to emerging markets performed?

Over the past 20 years a passive allocation to EM equities has underperformed a similar allocation to DM equities for a sterling investor. During the opening decade of this century (the unshaded part of the chart below), EM equities produced exceptionally strong returns, recovering the entire underperformance from the previous 7 years.

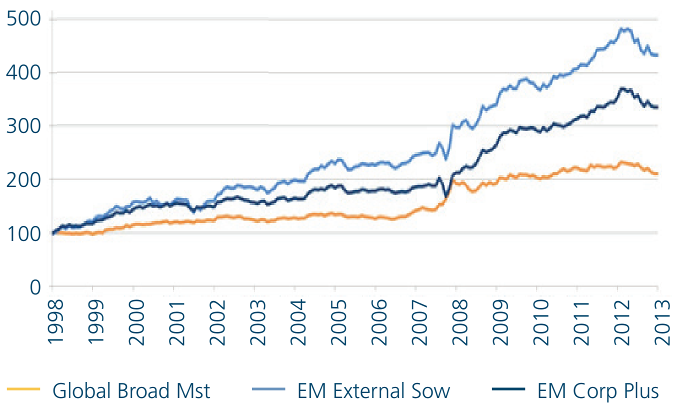


Source: FTSE

However, over the past 3 years, and principally over the past 9 months the EM index has significantly underperformed the DM index. Arguably, the cause for this underperformance is the same as the 'trigger' for the EM debt crises of the 1990's a tightening, or perceived tightening, of US monetary policy.

Whilst we feel that treating all EM countries the same is incorrect, it is clear that not all investors feel the same way, with the flow of money out of EM assets largely happening on an indiscriminate basis, regardless of the strength of the underlying economy or stock. The risk of contagion remains, albeit there is less of a risk than in the 1990's.

Whilst EM equities have underperformed DM equities over the longer term, the same is not true of the debt markets; the chart below shows the performance of the government and corporate bond markets from both the developed and emerging markets over the past 15 years. As ever, some care needs to be taken with the start date of such analysis, as this commences following the various EM crises of the 1990's. Taken in conjunction with the equity chart the bond analysis does highlight the dangers of restricting investments to a single asset class or index. Whilst not directly shown below, the correlation of EM and DM equity indices has been very high, particularly over more recent periods, whereas there remains a low correlation between developed and emerging market bond returns, even at an index level.



Source: Bank of America Merrill Lynch

So why do we invest in emerging markets?

The most commonly cited reason for an investment into EM economies is to gain access to the higher growth rates that have persisted over the past 15 years and are expected to continue to persist in the future. We spare the reader the details but history shows that economic growth is a very poor indicator of stock market returns and an equally limited indicator of bond returns. In short, this occurs because:

- There is a very high level of interdependence between economies. There is huge and growing linkage between all countries and this is true within those economies classified as emerging and between those classified as developed.
- The country in which a company chooses to list its shares does not necessarily indicate the source of its revenues. We know, for example, that around 75% of the earnings of FTSE listed companies are generated outside the UK.

- Indeed, EM listed companies often have very loose connections with the drivers of domestic economic growth.
- If investors already anticipate higher growth, it is likely that the market has priced that in, so will not deliver those perceived higher returns in the future.

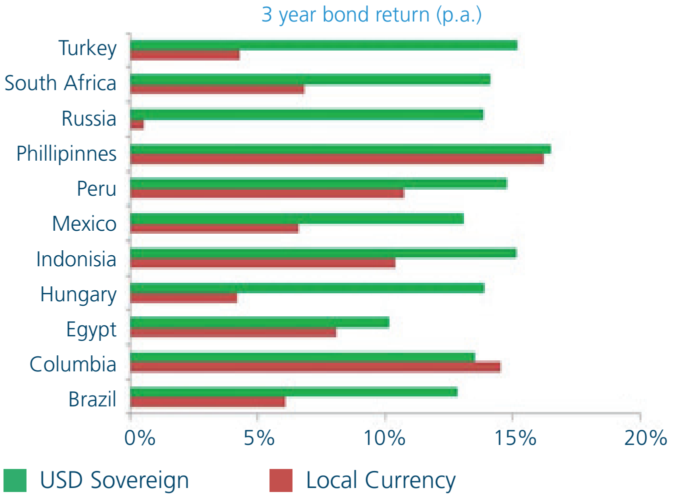
This leads us nicely into the conclusion of this initial section that index investing does not provide you with the exposure that you are expecting. That exposure will also change significantly over time, particularly within the volatile universe of EMs.

More effective ways to invest in emerging markets

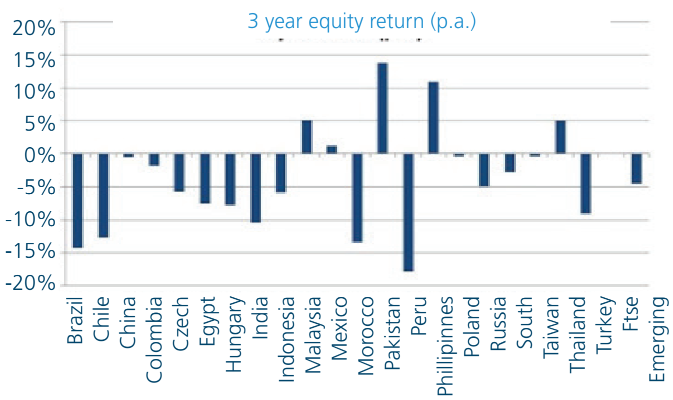
Should we even be invested in emerging markets?

There has been a lot written elsewhere about the outlook for various EM economies; how they are slowing down, how some are currently experiencing capital flight and the resultant depreciation of their currencies. These discussions are for a separate note and we feel are not necessarily the right question for trustees to be asking themselves in this regard.

We find it very hard to come up with an argument that investors should not gain exposure to almost half of the world's GDP. There are clearly some countries within the EM universe that face significant difficulties and growth and returns in those is likely to be subdued going forward. We include charts below showing the dispersion in individual EM country's equity and bond returns over the three years to 31 December 2013 to highlight that this is nothing new:



Source: Barclays/Bank of America Merrill Lynch



Source: FTSE

But that does not mean investors should shun the entire universe; the problems of Europe for example are well documented but do not mean investors shun all DMs.

The questions are how to achieve this allocation and what allocation to make? Given the shortcomings of the passive indices highlighted above this is one of the areas of the market where we believe active management can add value.

So how should we invest?

We believe the distinction between emerging and developed markets is becoming increasingly out-dated as the composition of emerging indices no longer solely represents those faster growing economies of the world that they were arguably invented for. Whilst this may have been appropriate when the EM index of countries accounted for one-sixth of global GDP and had fledging financial markets, it seems less valid now they are approaching one-half of global GDP.

So what is the answer - we believe it is thinking away from the indices and on a more global basis. We do not believe trustees have the ability or time to actively manage this so it is an area where employing an active manager can add value. Active management is often felt not to be worth the additional fees but we feel EMs are an area where there is a greater argument for the manager to be able to add value, over and above the concerns highlighted above on the index construction. These include:

- weaker corporate governance;
- higher risk of government interference and ownership of companies that may result in companies not acting solely in shareholders' best interest;
- less coverage of the markets making them more inefficient; and
- more volatile markets.

But like all areas where we believe in active management we feel trustees should give as much discretion as they can to their manager – don't ask them to actively manage and then tie one hand behind their back by placing restrictions on them. We therefore see two principal routes for trustees to go down:

An actively managed global mandate - this approach delegates the asset allocation decision making to the investment manager and would be suitable for investors who want to access EM as part of a wider global mandate. This could either be as part of a pure equity mandate or as part of a wider Diversified Growth Fund mandate. This would be most appropriate for those investors who feel country of listing is less relevant to a stock or bond's returns.

Emerging Market Multi-Asset Fund (EMMA's) - are a relatively recent addition to the pension fund investment universe. These funds invest in a range of different asset classes which are expected to give exposure to the growth of EMs. The opportunity set available to the managers of these funds is large. This enables the managers to target their return objectives and also to control the volatility of the portfolio through asset allocation, as well as stock selection, decisions. Such an approach would be most suitable for those trustees that feel structurally that assets directly linked to emerging economies will provide superior returns or who do not have another mandate within their portfolio with discretion to make meaningful allocations to EMs assets.

Conclusions

The EM economies have undoubtedly provided the strongest growth over the last 20 years. This has not however always fed through to greater returns from the local stock markets in particular. Over the full 20 year period DM equities have actually outperformed their EM counterparts for a sterling investor. We feel it is time for investors to recognise the shortcomings of index investing for this part of their portfolio.

Clients should however continue to gain exposure to these parts of the global economy. We believe EM mandates need to be actively managed or investors could turn out to be disappointed. This could be achieved by allocations to global mandates managed without reference to indices or to specific funds targeted towards EM economies.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

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