Emerging markets

LOOKING BENEATH THE EMERGING MARKET BONNET

With the overall emerging market sector not producing great returns relying on geographies is insufficient when trying to paint a proper picture, Jassmyn Goh finds.

EMERGING MARKETS OFTEN get lumped together and treated the same, making the case for the asset class difficult to justify if markets or a company in a particular geography enter a rough patch.

Just like developed countries, emerging markets should not be treated as equal. As Australia is vastly different to the US, does Mexico differ from Indonesia.

This is one of the biggest mistakes advisers make when considering emerging markets, according to William Blair's global economist, Olga Bitel.

"If you think about the US and how it's different from Australia, Europe, Japan, these differences are many more times amplified amongst emerging markets. They are a very, very heterogeneous bunch of countries that really favour an active management approach and more nuanced thinking," Bitel said.

Agreeing, Ibbotson Associates portfolio manager, Bryce Anderson, said while emerging markets looked reasonably attractive on a headline level, it did not tell the entire story as the sector is a very divergent universe.

"Not all economies and companies are created equal. Some markets have a high level of government control and ownership. So it's worth looking underneath the bonnet and seeing what is driving that overall return," Anderson said.

"When you lift the bonnet on the headline level it's very divergent in terms of what we have in our differences between our forecast returns in the different markets inside emerging markets."

Bitel said when considering emerging markets thinking about countries alone was not sufficient because of the different economic structures and drivers of growth, both cyclical and structural in a

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OLGA BITEL

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certain point in time and in broader terms.

"Particular overweights or underweights are sector related. For example we were very overweight in Brazil in 2010, but in 2010 if you bought the index you would have been overweight in commodity exporters," she said.

"Instead what we invested in was the domestic story, the consumer, the retail stores, and the consumer brands on the back of very strong credit growth and domestic demand support policy.

"It's a much more nuanced story than just to say be overweight or underweight in a particular country because of the macro fundamentals."

According to Morningstar data, the average returns for emerging market share funds are -14.56 per cent for one year, 1.79 per cent for three years, and 0.99 per cent for five years.

Fidelity investment director, Alva Devoy, said emerging markets currently did not look attractive on a valuation basis because earnings had declined so far.

"We actually see overall headline value as not a huge amount of upside from a valuation perspective," she said.

"Where the companies that have done it tough that would benefit from oil price but also things like the US Federal Reserve going on hold, which it looks like it's done, those countries are Indonesia, Brazil, South Africa, and Turkey."

LOOK BEFORE YOU LEAP ELSEWHERE

Despite the low figures, Anderson believes it is a good time to invest in emerging markets.

"There is a disconnect in the story that gets told in the papers and what the fundamentals actually are. Great companies get dragged down with short-term volatility, and client money in emerging markets should have a long-term investment horizon.

"It's not just good enough to go blindly into emerging markets. You need to know what you're investing in and what you're trying to get out of allocation. There are plenty of harpoons in emerging markets that you can get hurt on."

Anderson said advisers needed to think about how emerging markets interact with other aspects of client's portfolios, such as Australian equities, global equities, fixed income, and so forth.

"Don't just look at the standard numbers and correlations but conceptually think about if you have unintended slants in the portfolio and if that is something you want. If that bias is what you want, what are the risks to that? And so on," he said.

Anderson also noted another mistake advisers often made was to only think of equities when considering emerging markets.

"It's become a very broad asset class and there's more than one way of gaining exposure to emerging markets. There's the opportunities to invest in debt markets be it local, hard currency, and there's emerging market currency," he said.

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>
> \- Olga Bitel

Devoy said advisers should be looking for active managers because of macroeconomic, transparency, accountancy, and currency risks within the region.

"So look for an active manager who approaches investing in emerging markets with almost an absolute return mindset. You need a manager who is very focused on never having a permanent impairment of capital in a portfolio, and one that takes a cautious approach to investing stocks in region," she said.

Devoy warned that a lot of the countries do not demand the transparency many Australian companies would.

"As you've got managers going in looking for high growth stocks in a broadly low growth environment, the necessity to be more infinitely forensic in your approach to research on company accounts in this region have just heightened," she said.

"Some managers do employ forensic accountants when looking at new investments in the emerging markets region if they can't get clarity on company accounts.

"Another way is to look at companies who have major shareholders who are international companies. For example, Nigerian Breweries is 35 per cent owned by Heineken. So Heineken mandates accountancy practices to be European Union compliant which means that risk for Nigerian Breweries is mitigated."

King Irving Funds Management managing director, Kate Mulligan, said it was important to have a manager with local expertise on the ground in their capabilities.

"The importance of having a local presence particularly significant in emerging markets," Mulligan said.

"There's free information available and that research and analysis can be extracted through having local offices and people. It is so important to make sure you got that have that first-hand knowledge of what it is what you're investing in as opposed to doing it at a distance."

Bitel said advisers and clients needed to be willing to tolerate lower liquidity levels and be willing to go down the market cap.

"The best way to invest is through dedicated and active managers whether in fixed income and equities and be willing to tolerate lower liquidity hurdles and be willing to go further down the market cap," she said.

"A lot of the phenomenal or rapidly growing companies in emerging markets tend to be less heavily traded, less liquid, and also smaller, but that's where a lot of the growth is."

CAREFUL SELECTION

However, when looking at the markets overall, Standard Life Investments chief economist, Jeremy Lawson, believes emerging markets have been quite challenging from a macro perspective and will remain so for some time.

"The broader perspective is that a lot of imbalances have been built up over the past few years across a range of economies. Some places it's the private sector, or private sector debt. In places like Brazil it's public sector imbalances," Lawson said.

"There are relatively few places that have been pursuing structural reforms and so potential growth and productivity growth has been slowing. Obviously, the export outlook is softer of those economies tied to China and won't change anytime soon."

On a broader level, Lawson said globalisation had slowed down and emerging market growth had become slower and more dispersed.

"You can compare that with pre-crisis period when there was a generalised boom in emerging markets and most countries participated, so growth was strong and it was broad based," he said.

"That's unusual by historical standards and so now we're going back into an environment where you have to be much more selective.

"You can't just say I want to earn here, you actually need to be very careful and select the geographies and type of asset that you want to own specifically. Be more careful with the geographies."

Despite the challenging environment, there has been some debate on whether emerging markets have been able to garner some inflows or if they have continued down the negative side.

"Inflows into emerging markets have turned positive but nothing like prior expansions. Not the same story in the same decade of the current century. Everyone was used to robust growth in the early 2000s and that will not be repeated any time soon," Bitel said.

On the contrary, Devoy said there had not been any meaningful flows either through equities or through the debt side lately.

"We did see a relief rally happen in the region last October which was very short lived. It was purely momentum reversal, so it got really bearish, there were massive outflows, and it looked like oil was starting to bottom out," Devoy said.

"It looked like the bearishness was overdone and we had a bit of a relief rally but it wasn't supported by huge flows."

Anderson agreed and said in terms of positioning flows were in the negative as fund manager surveys found that managers were extremely underweight in emerging markets.

"The underweight in emerging markets is not at unseen levels but towards the end of last year were little worse than they are now but still well outside normal type range," he said.

"Flows are a short-term thing and they could continue to get more and more bearish and the markets could continue to go down and the positioning could continue to be bearish."

He noted that the fact that everyone else was underweight in emerging markets could be a good thing for those not investing in the sector.

"It's a case of we don't just want to go where the market goes. You're not going to make money where everyone else is," Anderson said.

"Everyone is bearish but if the fundamentals stack up then that's better than everyone being on the trade to begin with. You're more likely to make more money because people will eventually pile into that asset and you'll get a big kicker."

Looking to the future, Devoy believes that headwinds are beginning to turn into tailwinds but the level of macroeconomic risk that are relative to valuations would not be a push factor into emerging markets at the moment.

"However, when you reach the point that markets want to go risk on and there is positive sentiment towards markets – meaning the US has averted recession, China is on a stable growth path, the US dollar is on the way down or peaked, and oil price are rebuilding – then emerging markets will be a great source of growth for an investor," she said.

"But advisers have to choose a manager and route into emerging market investment very carefully.

"From an institutional level, we're seeing interest starting to build now in terms of the due diligence being down now. I think within the next six months you'll begin to see a turning point, and that is predicated on my own view that the US dollar has peaked." MM