

Emerging markets provide the opportunity to add value

IF INVESTORS STRUCTURE A PORTFOLIO TO TAKE ADVANTAGE OF THE PROSPECTS OFFERED BY EMERGING MARKETS, THEY COULD ACHIEVE OUTPERFORMANCE, SAYS **PETER JENKINS**



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Emerging market equities rewarded investors with great performance over the last year and have produced excellent returns over a longer period. The MSCI Emerging Markets Index has produced long-term outperformance since its inception in 1988. Those of you wary of the volatility of emerging markets and aware that recent falls have been worse than those suffered in developed markets, might view these losses in the context of long-term gains achieved so far. For over 20 years the MSCI emerging markets returns have been more than double those achieved in, for example, the S&P 500, and four times those achieved by the MSCI World Index.

Looking forward, the short-term outlook is somewhat cloudier, reflecting a more uncertain global economic picture. As has happened in 2008 to date, developments in developed economies and markets will likely be the major factor determining market direction for the moment, particularly if the global market downturn continues as emerging

markets look ripe for profit-taking. International investors will take profits wherever they have them and for those investors that have had a decent exposure to this asset class for any length of time, there are temptingly large gains to be realised. It is for this reason that in times of crisis markets tend to move together; ie markets become more correlated. However, looking beyond the immediate concerns, the prospects for emerging markets remain very bright.

Over the longer term, equity markets will follow the growth of economies and corporate earnings, and both are likely to be significantly greater in the case of emerging markets than in developed markets. From our studies over the next few years we expect emerging market GDP growth to average 6%-7% annually, a figure two to four times greater than the equivalent for G7 economies, and we expect annual corporate earnings growth to exceed those numbers. Against this backdrop of robust earnings growth, emerging market valuations remain attrac-

- Emerging markets will define general market direction in the short term

- Underexposure to the asset class bodes well for future performance

- The DWP is taking a closer look at scheme governance

tive; the forecast price earnings ratio (PER) on 2008 earnings is less than 12 times, only slightly above the five-year average, and a substantial discount to developed markets.

Despite the fact the growth profile and valuations are attractive, and emerging markets have been receiving strong fund inflows in

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recent years, we believe that these will continue as emerging markets are still significantly under-represented in investors’ portfolios; in short G7 investors and savers remain structurally underweight this asset class. This state of affairs is all the more surprising given that global equity indices generally carry neutral emerging market weights at well below 10%. This current level of under-exposure augurs well for market performance in the future.

Over and above the attractions of top line growth, an additional attraction of emerging markets to investors are the opportunities they afford to significantly outperform the indices; in short, to out-

perform what we already expect to be an outperforming asset class. The whole structure of emerging markets and the way they operate gives fundamental and disciplined investors a chance to outperform the indices without taking undue risks; namely adding alpha. Alpha is a measure of the difference between a fund’s actual returns and its expected performance, given its level of risk against market indices as measured by beta. In this sense it is a good measure of the value added by a manager over and above movements of the index.

There are three main reasons why this is achievable in the context of emerging market equities. Firstly, the global emerging market universe allows for a much wider degree of diversification over and above that which can be achieved through a spread of investments across developed markets. Emerging markets embrace a wide range of countries in different geographical locations with different economic structures and at very different levels of development. They range from giant resource rich economies such as Russia and Brazil, through to manufacturing based economies such as Korea; from countries at a very basic level of development to countries as developed and wealthy as Taiwan; from relatively unrestricted economies such as Chile, to those with much state intervention and restricted capital accounts, such as China; and from

states which have freely floating exchange rates to those that actively manage or even peg their currencies.

The case for diversifying portfolios through emerging market exposure is captured in the relatively low correlations between emerging markets and developed markets compared to those between developed markets themselves. For example, the 15-year correlation between the S&P 500 Index and the FTSE 100 Index is 0.73 compared to 0.61 between the MSCI Emerging Markets Index and the FTSE 100. Further, correlations within the emerging markets universe are significantly lower than those within that of the developed markets. Consequently, skillful asset allocation between emerging markets enables investors to focus on those markets where the growth and corporate profiles are best for any stage in the economic cycle. For example, strong global growth and trade may well lead to greater outsourcing by first world companies, and prime beneficiaries of this trend such as India and China could be overweighted. On the other hand, when commodity prices are rising Russia and Brazil might look more attractive. To illustrate, a recent example of an opportunity to add value through asset allocation: over the first quarter of 2008, the MSCI World fell by 9.0% in US dollar terms; the MSCI Global Emerging Market Index also fell 10.9%, but within the index there was startling

outperformance from the Middle East region where, benefiting from high oil prices, markets such as Jordan, Bahrain, Oman, Qatar and Kuwait rose strongly, the latter up by over 10%.

Secondly, within emerging markets there are excellent opportunities for adding value through stock selection. One of the main drivers of most emerging markets is foreign fund flows. Overseas investors tend to focus their attention on the representative and larger capitalisation stocks within each market. These represent better-researched, more liquid investments, but by the same token they are usually well known stories and their stock is often fully valued. Consequently, the most attractive investment opportunities can often be found outside the larger names for those investors who are prepared to expand their investment horizons and research efforts accordingly.

Thirdly, emerging markets often present greater opportunities than developed markets by virtue of

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their greater volatility. On a five-year view the standard deviation of returns of the MSCI Emerging Index is 5.4, compared with a figure of 2.8 for the MSCI World Index, or 2.6 for the S&P 500. Some of this volatility can be accounted for by greater fluctuations in underlying economies, currency movements, or is just a function of market size, but an additional factor is the way the market works. In global portfolios individual emerging markets often represent relatively marginal positions. Consequently, foreign investors can be very heavily overweight or cut exposure to nothing depending on market attractiveness at any specific time, and this can result in some extreme money flows.

Local investors too can be somewhat fickle in their investment activity. Compared to developed markets, local institutions are usually more marginal players in the market; domestic insurance funds and pension funds are often in their infancy and hence do not have the same overall clout and are correspondingly less of a stabilising influence on the market. This leaves retail investors as more significant players than is the case in developed markets, and this

contributes to volatility. Retail investors tend to invest on newsflow, often trying to pre-empt foreigners. They often lack a deep understanding of the underlying fundamentals, global forces and company prospects. They often trade using borrowed funds, possibly on margin, and thus have a limited capacity to endure losses. As a result, stock prices tend to get pushed to the limits of valuations, both on the upside and the downside. Such volatility presents opportunities for the cool-headed, well-researched and longer-term investor to pick just the right moments to buy and sell.

The prospects for the emerging market asset class look good, and there are significant opportunities to outperform. The key for the foreign investor is to structure an investment approach to take full advantage of the considerable opportunities that currently exist.

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