

Investing in 'emerging' Europe

Many economies in Central and Eastern Europe offer attractive investment opportunities to trustees, says **David da Silva**, CFA of Nomura Asset Management UK Limited

What are the market opportunities in emerging Europe?

The investment opportunities in the region stem from the favourable political and economic climate which has been ushered in post the communist era. The market friendly conditions have created opportunities for individuals and firms alike: low labour costs, coupled with high education standards, and strong productivity have prompted many multinational companies to set up bases in the region. Our GEM strategy philosophy at Nomura Asset Management is to work with regional specialists who are best placed to extract the alpha from these markets. For emerging Europe we work with Charlemagne Capital, an emerging market specialist company with extensive experience in the region. They add that an important factor supporting the macro environment has been accession, or even potential accession, to the EU which has prompted a responsible fiscal, regulatory and legal framework to the clear benefit of the corporate sector. Russia is a special case, although not subject to the influence of the EU in the same way as the countries of central Europe, it is nevertheless pursuing an equally ambitious programme of reform which is seeing its economy move away from a dependency on the energy and materials sectors to more broadly based activity with consumer demand at its core. Furthermore it is worth noting that as economies close to the EU mature and develop, others appear on the radar screen, offering perhaps the same opportunities to investors as central European economies offered ten years ago and more. These markets include those labelled as "Frontier", such as Kazakhstan, and prospects for these countries have been recognized by the likes of the index provider MSCI as well as by the number of funds now beginning to invest in this area.

Consequently, from a fundamental perspective emerging Europe seems attractive, but what is important from an investor's perspective is whether the valuations reflect this yet. We believe that valuations are attractive though specialist regional skills are needed to uncover the best opportunities. On a relative basis, forward price to earnings ratios for MSCI EM Europe are currently approximately 30% below the average ratios in MSCI EM Asia and EM Latin America. Furthermore, the current level is in line with the five year average whereas for the other regions they are above their respective averages. These favourable valuations however should be weighed against the fact that earnings growth rates are at roughly a 30% discount to the other regions, and over

the 12 months to 25th April 2008, EM Europe has lagged the performances of Asia and Latin America by 11% and 28% respectively, delivering a modest 10% return in US dollars. All data references taken from MSCI and IBES Aggregates, 25th April 2008.

What are the key macro dynamics in the region?

As stated in the previous answer, the favourable macroeconomic backdrop is underpinning its competitiveness, and this in turn is attracting foreign direct investment. As confidence grows, we are seeing rising consumer demand. However, the region cannot be separated from current global themes: financial distress, rising commodity and food prices, inflationary concerns and the monetary policy response. Charlemagne make the point that the impact of the sub-prime crisis and credit crunch is nowhere near as pronounced as what we have seen in developed economies. This is a consequence of the fact that these emerging economies are not as closely linked into the international credit markets, and are funded in essence by their own domestic depositor bases. Regardless, we believe that it is perhaps better to view these markets in the context of their relationship with Developed Europe. The latter has shown encouraging resilience to the current global slow down and this has provided some support to the satellite emerging economies which are dependent on these export markets.

It is also worthwhile considering the region from a longer term perspective, as Charlemagne highlight, emerging Europe is still throwing off its communist yoke and putting its own economies in order. To a large extent this process is helped by the lure of the EU and the Euro, as touched upon earlier. The results however are already apparent in improving fiscal balances and current account surpluses (though not in every country), which some would say were necessary prerequisites for successful investment. The increasing importance of the consumer sector is also providing some insurance against external woes.

Does the region offer less risk by virtue of its proximity to EU?

EU accession and integration have resulted in what many perceive as a less risky environment in which to invest, a view supported by our regional specialist Charlemagne. They add that the proximity of the EU has been central to the economic renaissance of the region and will most likely continue to provide a positive input for many years to come. Though physical

proximity is important, especially in terms of trade, the influence of the EU is deeper than this and is having an impact further afield. In comparison to such regions as Asia and Latin America, it would perhaps be fair to say that this European tie does equate to less risk as policy actions are constrained by such ambitions. However, it is worth pointing out that as with any market, risks remain and that unexpected political and or economic developments might jeopardise future returns.

How well established are these stock markets?

The region's stock markets, in their present form, are relatively new arrivals, having been set up in the early 1990s following the collapse of Communism. However, despite this short history the Russian stock market has become a dominant player in the region, thanks to the size of its economy and the strong performance of its energy and materials sector, with a market capitalization in excess of USD 1,000 billion. This places it in the same league as the largest stock markets anywhere in the world. National stockmarkets in some other countries continue to struggle however and this may, in time, lead to some consolidation in the industry. As Charlemagne make clear, from an investors point of view, it matters little whether emerging European companies are traded locally or abroad. Indeed, in some respects it may be more secure and less risky to use western exchanges, particularly when investing in some of the new Frontier markets. ■

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