



Who's got the alpha in emerging markets?

This article makes the case for appointing dedicated managers of emerging market equities. Further, it explores the merits and difficulties of obtaining this exposure through regional specialists within the EMEA, Asia and Latin American emerging markets. The results of independent research and research conducted by Oliver Wyman on behalf of Nomura Asset Management U.K. Ltd. ("NAM") suggest that a considerable increase in alpha is available to investors prepared to appoint regional specialists.

First steps into specialist management

Roughly 20 years ago, the idea of "balanced" mandates was set aside in favour of specialist managers of equities, bonds, property, etc, working within a strategic allocation governed by fixed weights and/or market capitalisations. The rationale was simple: few investment managers could (in good conscience) claim to be skilled in managing all asset classes and fewer still could claim to be skilled tactical asset allocators.

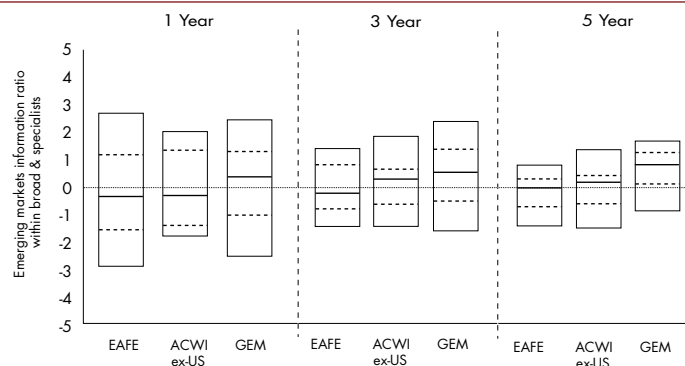
That rationale applies equally today and

balanced mandates have become vastly outnumbered by specialist structures. The number of investment houses with genuine expertise in managing just bonds and equities (let alone the increasingly overwhelming array of alternative investments) remains low, and tactical asset allocation is a specialist world dominated by a few highly-resourced quant houses.

Equity mandates lack specialisation

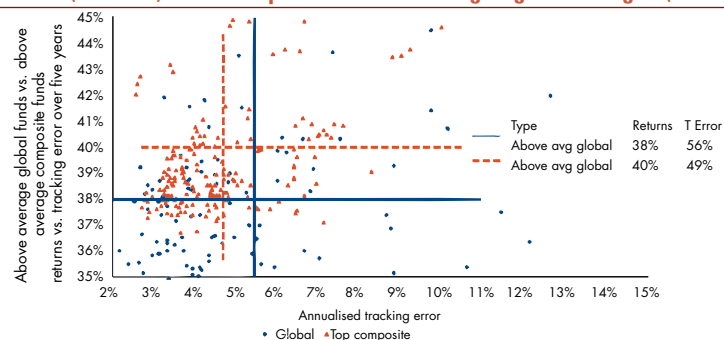
If we drill down one strategic level into equities and particularly the emerging markets, the idea of abandoning generalist managers in favour of specialists has not taken hold. Worldwide, institutions award Global or "International" equity mandates far more frequently than any other appointment. These mandates often allow managers a small allocation to the emerging markets, as either an off-benchmark allocation from a developed market mandate (which has provided a useful boost to performance in recent years), or as part of an "All Countries" benchmark. This seems contrary to the idea of specialisation that is so established at the equity/bond level.

Chart 1: Information Ratios of Europe, Africa and Far East ("EAFE"), International ("ACWI ex US") and Global Emerging Market ("GEM") managers over periods ending 31 December 2007



Source: Intersec Research

Chart 2: Annualised returns plotted against tracking error for above-average global emerging market funds (blue dots) and for composites of above-average regional managers (red dots)



Source: Bloomberg, MSCI, Nomura, Oliver Wyman analysis. Note: Above average funds are defined as funds comprised of managers with above average returns over the defined time period.

Dedicated emerging market managers outperform

Studies conducted by US-based Intersec Research™ reveal that the focus of dedicated emerging markets managers has led them to outperform the emerging market allocations of Europe, Africa and Far East ("EAFE") and International managers. Chart 1 illustrates this result, comparing the information ratios of broad mandate – EAFE and International (labelled "ACWI") managers – with those of global emerging market ("GEM") specialists. Over all periods shown, the median GEM specialist manager has generated positive information ratios, higher than those of the median EAFE and International managers.

The evidence suggests that the appointment of a dedicated emerging markets specialist would have been beneficial for investors over recent years. Not only would such an appointment have allowed investors to fully participate in the emerging market growth story that has driven returns so strongly over recent years, it would also have ensured that investors achieved a superior alpha contribution from their active managers.

Whilst a dedicated emerging markets manager is therefore a worthy addition to a broader equity manager line-up, is there merit in taking the idea of specialist management further?

Can regional specialisation improve returns in emerging markets?

If specialism at the global emerging market level can increase returns, it seems natural to pursue the concept and investigate specialism one level further down; to check whether regional specialisation within the emerging markets improves performance. The case for doing so appears still stronger when we consider the obstacles to successful, fundamental emerging market equity research:

- Benchmark of 900+ stocks (MSCI EM)
- Circa 14,000 stocks off-benchmark
- 27 countries, 27 currencies, 70+ languages
- Geographical spread of markets
- Varied accounting and reporting practices
- Country-specific factor influence on equity performance

NAM commissioned Oliver Wyman in 2006 to investigate the potential of regional specialist manager combinations. They found that an average of the regional specialists in the EMEA, Asia and Latin America regions, combined (at regional market weights) to form a synthetic "global" strategy, outperformed the average global emerging market manager over one, three and five years ending 31 December 2005. This study was conducted on a net of fees basis. Oliver Wyman has since repeated the study on two occasions, using data ending December 2006 and December 2007; the results are consistent with the original findings. On each occasion, combinations of regional specialists were found to have outperformed global managers.

Increased return is beneficial for investors, but it is reasonable to expect combinations of regional managers to yield some diversification of manager style also, so we might expect to see a decrease in risk. From the latest Oliver Wyman study, Chart 2 compares a universe of "composites", formed by combining (at random) above

average performing regional managers, with the universe of above average global managers. The composites of regional managers not only outperform the global managers by 2%p.a. on average, they do so with lower tracking errors to the MSCI Emerging Market Index.

In our view, the results of this analysis also cast doubt on the extent to which global managers add value through active regional asset allocation. The composites of regional managers were neutrally weighted to the regions (and thus had no access to this potential alpha source). Nevertheless, (on average) they outperformed global emerging market managers.

Difficulties of appointing regional specialists

There are downsides to appointing specialist managers. The investor may well have to allow for higher overall fees in a specialist structure and greater governance and administration costs. If the allocation to emerging markets is small, the use of pooled funds may be unavoidable if specialists are used, since the assets available are split between a greater number of managers. Also, the difficulty of finding skilled managers and monitoring their progress can be considerable. NAM can certainly testify to this point; since NAM first built a combination of regional specialists into a single product in 2006, it has been a continuous challenge to identify a sufficiently broad set of skilled candidate managers in each region that remain open to new business.

For the very largest institutions, with extensive in-house resources, these difficulties may be surmountable, and NAM's experience suggests the effort involved can be amply rewarded. However, smaller institutions may have their options limited to a small number of providers or fund-of-funds (many with an additional level of fees) if they are to benefit.

Conclusion

As demonstrated by the research, specialist emerging market managers have, on average, outperformed the emerging market allocations of more broadly-mandated investment managers. Similarly, research shows that combining specialists within the EMEA, Asia and Latin American regions has, on average, improved risk/return outcomes over those of more traditional global emerging market managers. This reinforces the widely accepted idea that specialist managers with more focus and resources to devote to a particular area of investing will outperform generalists. For large investors with sufficient resources, or smaller investors with access to cost-effective fund-of-funds or similar products, seeking regional specialist emerging market managers should be strongly considered based on our evidence.

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