

Nomura Asset Management investment specialist Peter Jenkins believes the whole structure of emerging markets means it is an area where disciplined investors can add value

# Where is the alpha?

Investing in emerging market equities rewarded investors with solid returns in 2007 and has produced excellent returns over a longer period (+390pc in a five year period to the end of 2007). Looking forward, the short-term outlook is somewhat cloudier. Newsflow from developed economies and markets will likely determine market direction and in any global market downturn emerging markets look ripe for profit-taking as investors lock in profits wherever they have them. For those investors that have been well weighted in this asset class for any length of time, there are temptingly big gains to be taken. It is for this reason that in times of crisis markets move together; correlations tend towards one.

In essence Nomura believes that, over the longer term, equity markets 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 we expect trend growth of 6pc-7pc per annum in emerging markets, a figure two to four times greater than in G7 economies. Against this backdrop of robust growth, emerging market valuations remain attractive; the forecast price/earnings ratio (PER) on 2008 earnings is less than 11 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 we believe that they are still under-represented in investors' portfolios; G7 investors and savers are structurally underweight this asset class. This is all the more surprising given that global equity indices generally carry neutral emerging market weights at well below 10pc. This under-exposure augurs well for the future.

An additional attraction of emerging markets is the opportunity afforded to significantly outperform what we already expect to be an outperforming asset class. We believe the whole structure of emerging markets means it is an area where disciplined investors can add value over and above the movement of indices; they can add 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 market.

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 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 open 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 compared to those between developed markets. 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.

Consequently, skilful 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 may well lead to greater outsourcing by first-world companies and prime beneficiaries of this trend such as India and China could be over weighted. On the other hand when commodities are strong Russia and Brazil might look more attractive.

As a recent example of asset allocation opportunities: from the beginning of the 2008 to February 13, the MSCI World fell by 9pc in dollar terms, and although emerging markets on the whole have fallen more sharply, dropping 11pc. The only region where equities have risen over this period has been the emerging region of the Middle East. Benefiting from high energy prices, gainers include Jordan, Oman, Qatar

and Kuwait, where the market rose 9pc.

Secondly, within emerging markets there are excellent opportunities for stock selection. The main drivers of most emerging markets are foreign fund flows. Overseas investors tend to focus their attention on the representative, larger capitalisation stocks within each market. 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 accordingly.

Thirdly, emerging markets present more opportunities than developed markets by virtue of their greater volatility. On a five year view the standard deviation of returns of the MSCI Emerging index is 5.3 compared to a figure of 2.9 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 pure market size but an additional factor is the structure of the market. 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 their attractiveness at any specific time; resulting 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, pension funds and alike are usually in their infancy and hence do not have the same clout and are correspondingly less of a stabilising influence on the index.

This leaves retail investors as a more significant factor than is the case in developed markets and this also adds to volatility. As a result stock prices tend to get pushed to the limits of valuations. Such volatility presents opportunities for the cool-headed, well-researched investor.

So not only do the prospects for the emerging market asset class look good but there are also significant opportunities to outperform within. The key for the foreign investor is to structure an investment approach to take full advantage of the considerable opportunities that currently exist and to produce alpha.

