

Global Emerging Markets

David da Silva of Nomura Asset Management UK Limited explains the essentials of investing in GEMs

What is a GEM fund?

GEM funds invest in stocks listed on stock exchanges in emerging markets, frequently referred to as developing countries. Although there is no exact definition of emerging markets, it is safe to see these as being all the markets outside the established developed markets of North America, Europe, Asia and Australia. Although this includes a broad cross section of countries around the world, it is worth noting that market capitalisation of emerging markets of the global index is approximately only 11%, as calculated by the MSCI Index*. GEM funds attempt to capture the growth potential across these markets by detailed stock selection and country allocation.

The term 'emerging market' refers to the stock market itself rather than to the underlying economy. For example Korea, Taiwan and Israel are included in the emerging markets universe whereas on a number of criteria these economies could be categorised as developed. This means that within the investment universe a broad range of underlying economies are represented. This gives the fund manager the opportunity to invest in a very wide range of industries and themes.

How does it differ from other emerging markets funds?

GEM funds differ from other emerging market funds in that they can invest anywhere across the developing world. Many other emerging market funds narrow the universe of available investment to specific regions or countries. A popular option at present is BRIC investing, focusing on the powerhouses of the emerging world, Brazil, Russia, India and China. But there are other options such as BRICS including South Africa, Chindia (China and India), Latin America and the Middle East. In our view this narrowing of the universe excludes some of the exciting growth opportunities typical of less well covered countries and regions of the world. This is why Nomura Asset Management have concentrated on the global option with coverage by three regional specialist teams, to capture as many investment opportunities as possible.

What types of GEM fund are available?

GEM funds can be distinguished by the management structure in place. Many are single-manager funds, where one firm covers all the emerging regions with a single fund management team, each team member sharing either regional, country or sector responsibilities. This requires resources to ensure optimal coverage. It is a significant challenge to do well, given the diversity, on a regional, country, language and economic level.

Another option is to choose fund of funds or manager of manager products. These can group together several global fund management firms into a single product taking into account each manager's style preferences. There can be several layers of fees to accommodate the managers and the product providers. There is also an option to create a global product by grouping together regional specialists who focus on emerging countries in Asia, Latin America and EMEA (Europe, Middle East and Africa). The intuitive appeal of grouping together three regional specialists, needs to be weighed up against the governance costs required to monitor the managers. We have followed this regional specialist approach in constructing our Nomura GEM product, and have found that regional specialists with their local knowledge and experience are well placed to uncover stocks likely to outperform that might not be obvious to more generalist investors.

Is a GEM fund right for my pension scheme?

Although emerging markets have outperformed developed markets over the long term, they are characterised by greater medium term volatility. It is important to consider whether your pension scheme can bear this higher risk. A key consideration therefore has to be the scheme's investment time horizon. Generally we would consider that the investment horizon would have to be at least 5 to 10 years, allowing the fund to deliver enough of a return to compensate for the extra volatility. This risk should also be considered in light of how correlated emerging markets are to your scheme's existing investments. Generally speaking emerging markets have had a lower correlation with developed markets. There can be valuable diversification benefits to

schemes overall, by including emerging markets in the scheme's investment line-up, although remember that in times of crisis correlations can rise significantly. As with all investments we would recommend that you explore all possible risks before investing.

How have GEM markets been affected by the recent stock market problems?

Emerging markets fallen more sharply than their developed counterparts. Despite this we retain a positive long term view on the asset class based on strong fundamentals. Emerging economies are now in a far healthier economic position than they have ever been. Many economies now have current account surpluses, governments have tightened fiscal controls and corporate debt remains at modest levels. Although for the moment they are dependent on trade with the developed world, we are already witnessing emerging markets benefiting from rising domestic demand and growing trade between emerging economies. This development will increasingly insulate them from any broader slowdown.

That said, in times of severe market turmoil globally, such as in January 2008 investors will take profits where they are available and the strong performance of emerging markets in recent years has created a lot of gains. In this sense the selling of emerging markets might be characterised as 'technical' in that it is a pure market reaction and not an indication of more fundamental problems. Distinction should be made between economic and market decoupling. Markets tend to move together in any sell off but over time they should reflect the underlying earnings (and economic growth picture) and we retain strong bullish view on GEM fundamentals.

**Morgan Stanley Capital International Emerging Market Index as at 31st December 2007. ■*



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