

# The poacher's guide to game-keeping in emerging markets



The performance of emerging market investment managers over recent years has been (on average) so dismal\* that an observer might conclude these markets are amongst the most efficient in the world. This is patent nonsense. Liquidity-driven bubbles in China, far-beyond-consensus commodity price appreciation, unexpected political instability, fundamentals ignored – we have heard the excuses. What should the investor in emerging markets be looking for from his manager – how to pick the winners in emerging markets? Somewhat unusually, Nomura Asset Management (“Nomura”), one of the “poachers” in these woods, can offer an interesting perspective.

## How should we know?

This article sets out some key points you should be looking for when appointing an emerging markets manager. However, before we begin, we ought to establish a little credibility. Nomura is an asset manager after all, so why should anyone trust an asset manager on the subject of how to pick asset managers?

Nomura's regional emerging market strategy is somewhat unique. We have built a global emerging product by

choosing external investment managers in Emerging EMEA and Latin America to complement our own expertise in Emerging Asia. We also select back-up managers and monitor the universe of suitable candidates. That puts us in the business of manager selection as well as asset management. So we are both “poacher” and “game-keeper”. We hope that by reading this article, you will appreciate how we choose investment managers, and this knowledge will be useful in making your own selections. We also hope it will stimulate you to be interested in our fund.

We suspect that many of the ideas raised in this article would be shared by the true “game-keepers” – the investment consultants, many of whom have enviable manager research resources. For those investors with insufficient in-house resource to undertake the research described in this article, we recommend that the advice of an investment consultant is sought in the manager selection process.

## Take pity on the managers

It can be difficult to feel sorry for any investment manager, but consider the challenge faced by an emerging markets specialist:

- 785 benchmark companies;
- 14,000 off-benchmark companies;
- 25 countries, 26 currencies, 60+ languages.

The geographical spread of the countries alone implies considerable time spent on aircraft, not to mention regular exposure to jetlag – provided that you need to actually go and see the companies, of course. Quantitative managers, or those based in a major centre such as London or New York, expecting their investee companies to come to them, do not suffer from this issue. However, we believe that a fundamental manager will derive benefit from meeting companies on the ground, and so we look for firms that make regular trips to the regions they invest in (and have the language skills and relevant cultural awareness), or base their analysts close to the companies they research. Research must be focused and organised to suit the resources of the firm and its philosophy.

Quantitative managers have their own challenges to face; high on the list will be the difficulty of sourcing accurate data as inputs and ensuring that models, often imported from developed markets and “adapted”, add genuine value. There are undoubtedly some excellent quantitative emerging markets managers, but they do not suit our requirements, and hence we do not consider them. As a result, we make no comment on their selection in this article.

## Local presence, language ability

We believe that local knowledge of the markets in which managers invest is preferable. Therefore we seek (ideally) managers whose analysts or portfolio managers have lived, or do live, in the countries of their speciality and speak their languages.

That local knowledge will aid decision-making is intuitive, particularly given the strong influence of local politics on the emerging world, and given the largest sector in the MSCI Emerging Markets Index is Financials, where profits are heavily influenced by local economic conditions. However, there is little statistical evidence to back up the theory. In 2007, a study by Melvyn Teo (*The Geography of Hedge Funds*, Melvyn Teo, University of Singapore) showed that hedge funds with a physical presence in their investment region outperform others. Hedge funds and long-only active equity funds are very different animals of course, but they share the goal of adding value through informational advantage, so we believe this research supports our preference.

Similarly, Oliver Wyman's 2008

\*An analysis of a universe of 182 global emerging market funds constructed by Oliver Wyman found more than 75% of funds underperformed the MSCI Emerging Market Index (net of fees) over two years to 31 March 2008.



study (Emerging Markets Product Analysis, Year end 2007 update) of regional emerging market equity managers demonstrated that regional funds, when combined to give global coverage, outperform global emerging market managers. Regional managers can be closer to the markets in which they invest, and their alpha advantage is proven. Chart 2 illustrates the results of the study.

**Digging deep**

Large cap stocks in the emerging markets are well covered by sell-side analysts. Whilst this coverage can have an unobtrusive (sale focussed) agenda and can be short termist in nature, the sheer number of investors delving into company finances, absorbing newsflow and forecasting “fair value” implies a degree of efficiency. At the mid to small cap end, the number of analysts covering companies drops away sharply. To give an indication of this, Gazprom (the Russian oil giant, and one of the largest index stocks) was examined in 46 separate reports posted to Bloomberg in July alone. By contrast, there have been just 15 reports relevant to Arabtec (one of the more recent and smaller cap stocks added to the Nomura portfolio) added so far in 2008.

Nomura, by researching regional managers, typically comes into contact with teams who have the resource and the willing to research the small cap and off-benchmark areas of the market for pricing anomalies. Those investors seeking managers who operate on a global basis should seek similar reassurance.

**Capacity – how much is too much?**

One factor that prevents many managers from investigating small cap companies is capacity. Large funds will fail to research small companies simply because it is impossible for them to gain a meaningful position. Growing asset sizes lead to other symptoms which erode alpha: stocks ignored due to the inability to trade without moving markets and stocks held on to for too long once they pass price targets.

The question then becomes, ‘How much is too much?’, a question that provokes much mumbling and downward glances throughout the asset management world. The phrase, “We are reluctant to give a hard figure for capacity,” grows increasingly hackneyed with each manager interviewed. Here’s our hard figure: US\$5bn. That figure was derived from looking at the portfolios of each of our underlying managers

and ensuring they could continue to liquidate 75% of the portfolio over a ten-day period using only a fraction of average daily trading volume. However, that figure is (intentionally) conservative and, for some managers, a higher capacity figure may be appropriate. Moreover, it should be remembered that liquidity is not static. At end June, the free-float of the MSCI Emerging Market Index was US\$3.3trn, a figure that has doubled in three years. Larger, more liquid markets should yield higher capacity numbers.

**Portfolio construction and risk control**

Beyond looking for a clear link between conviction and risk allocation, it is important to identify any systematic biases in portfolio construction (particularly tilts that are not in keeping with the manager’s philosophy or research process). Many managers in this space rely on the output of BARRATM and “experience” to keep their risk under control, but we seek managers who are aware of the risks relevant to their forecasts (e.g. interest rates, oil price, etc) both at stock and portfolio level and stress test to confirm their thinking. We are content with managers using consensus forecasts for such variables where they feel they cannot add value, but they should understand the portfolio consequences of “consensus” being wrong.

**Organisation**

We look for product focus – firms not trying to be all things to all people, and focusing on their competitive advantages. Alignment of interests with clients is important, and the firm must have adequate retention policies in place, particularly in the case of smaller teams, where a number of individuals may be key. The support of parent organisations/owners is also an element to look for, as is a degree of autonomy.

**The details**

Through trading costs, errors and inefficiencies, alpha can be given away. It is an expensive luxury to have compliance, risk management experts and portfolio administration teams review the operations of the managers one selects – it is a review that few investors will undertake. From Nomura’s point of view, it is an unacceptable reputational risk not to undertake such a review (and we periodically re-check our findings). However, in place of such a detailed check, careful questioning about dealing functions (preferably

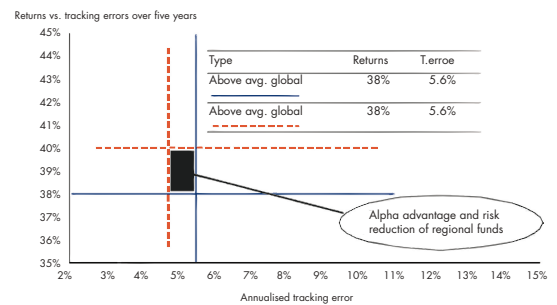
separate from portfolio management), broker use and assessment, order processing systems and trade cost monitoring can reveal potential sources of problems. This important area should not be ignored in the selection of managers.

**Conclusion**

This article cannot present an exhaustive list of what we look for in a manager (and no manager is “perfect”), but it gives a guide to what we believe to be vital. In choosing a fundamental emerging markets manager, we recommend seeking one close to its market, with product focus and the means to retain its key staff. Look for purposeful, organised research feeding into a clear portfolio construction process, with a dealing team and back office that will not “give back” the hard-earned alpha of the investment team. Keep an eye on capacity – walk away if you believe a manager to be hampered.

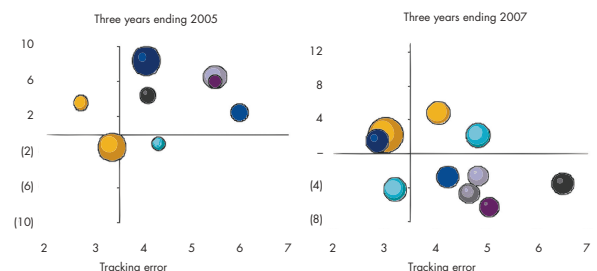
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**Chart 1: Above average regional (Asia, EMEA, Latin America) managers in combination have outperformed global emerging market managers over the five years to end 2007 by 2%p.a.**



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

**Chart 2: The charts indicate (by size of bubble) the size of assets under management of the greatest asset-gathering emerging market managers at end 2005, and the contrast in their performance over the three years ending 2005 and 2007**



Source: Provided by Intersec Research