

Stephanie Spicer talks to Nomura Asset Management global emerging markets specialist David da Silva about the challenges facing the market

Safety in numbers

Nomura Asset Management global emerging markets specialist David da Silva is the first to admit that managing a global emerging markets mandate is a challenge. With three main regions to choose from, 27 countries in the MSCI Index, many non-benchmark options, and over 900 stocks in the MSCI benchmark as at December 2007, it takes some covering.

What is perhaps more of a challenge is getting across to investors just what they can expect from emerging markets. Da Silva acknowledges emerging market investing is frequently mentioned in the press as a source of strong but risky returns, and he believes it is important to define just what emerging markets encompass.

Da Silva says: "Emerging markets can broadly be defined as being those markets located outside the established markets of North America, Europe, Japan and Australia. For ease of reference these can be considered the stock exchanges of developing countries."

The point to note however, says da Silva, is that what is being referred to here are the stock exchanges rather than the underlying economies of these countries and this can explain a few exceptions. For example, he says, Korea, Taiwan and Israel are included in the emerging markets universe, whereas on a number of criteria these economies could be categorised as developed.

He adds: "As a result within this investment universe a broad range of underlying economies are represented, from poor primary producers to relatively prosperous modern industrial economies. This gives the fund manager the opportunity to invest in a very wide range of industries and themes."

Despite this da Silva says it is worth noting that emerging markets only have a combined weight of about 11pc of the MSCI World Index and around 50pc of this capitalisation is concentrated in the BRIC countries, i.e. Brazil, Russia, India and China.

He says: "There are an additional



23 countries in the MSCI EM index, however there are many other markets which do not meet the minimum requirements for index representation but contain investible opportunities. We have seen a significant increase in the weight of emerging markets in global indices, both from new entrants and from growing existing country allocations.

"Highlighting this point is that the MSCI EM index has more than doubled its weight in the MSCI World index in the past eight years. We see this percentage growing in response to the strength and breadth of the markets involved."

What investors want to know of course is which countries will be entering the official indices in the future, so that they can be there investing ahead of the pack.

Trustees may anyway be wondering how they need to perform – or outperform in emerging markets. Indeed, in the current market can they be expected to perform let alone outperform?

"Emerging markets have performed strongly versus developed markets in the recent past and we believe that this outperformance is set to continue over the long-term based on the favourable economic fundamentals underpinning these markets," says da Silva.

"Performance so far has been driven by the rapid expansion of emerging

economies with rising levels of GDP per capita.

"This has been accompanied by growing domestic demand within these countries and also by growing trade links between emerging countries and the developed world and notably among emerging countries themselves."

According to da Silva these markets have typically been characterised by less efficient information flows in terms of market fundamentals and in terms of stock specific news, all as a result of less comprehensive coverage of stocks and sectors.

He says: "Although it is true that the largest stocks are generally well researched, this coverage is not exhaustive and there are many opportunities to add value by those prepared to research companies more in-depth. Our emerging market philosophy is based on this premise, that having the resource to specialise on stocks in emerging markets places an investor in the best position to add alpha.

"Of course doing this with a global remit is a challenge, so we have employed a regional approach, whereby specialists run the respective regions Latin America, Asia and Europe, Middle East and Africa [EMEA]. It could be argued that taking this a step further to employ country specialists would also be beneficial,

however we have reservations about the resource and governance structure required to employ multiple country managers to run a combined global mandate.”

When we come to consider how emerging markets have been performing in recent years it is hard to escape the fact that they have exhibited more volatility than developed markets over the long run. While this is apparent if you look at a rolling five-year standard deviations, da Silva says it is probably more important from an investment perspective to consider how much performance has been achieved in conjunction with this risk.

The table below highlights the returns and risk levels achieved on the MSCI World, S&P 500 and MSCI Emerging Markets Indices. The higher the figure in the “Return per unit of risk” columns the better.

Look-back period	3 years			5 years		
	Returns (%)	Standard deviation (%)	Return per unit of risk	Returns (%)	Standard deviation (%)	Return per unit of risk
MSCI World	8.7	9.5	0.9	13.8	9.9	1.4
S&P 500	5.3	8.6	0.6	10.0	9.1	1.1
MSCI EM	26.2	20.0	1.3	30.2	18.3	1.7

Source: Datastream, Nomura. Monthly data as of 31/01/2008

The return per unit of risk figures above highlight that for a given level of risk over 3 and 5 year periods an investor would get more return from an emerging investment than for example the S&P 500 or MSCI World.

Over one, five and 10-year periods to the end of January 2008, emerging markets have outperformed their developed counterparts by a significant margin.

Over 20 years, since the inception of the MSCI Emerging Market Index in January 1988, the index has delivered a massive 895pc return, this is over 450pc better than the S&P 500 return and a massive 650pc better than the MSCI World. Figures to end of January 2008.

“However, possibly of greater importance to many investors is that emerging markets have exhibited a relatively low correlation to their developed market counterparts and consequently there are clear diversification benefits to be harnessed,” da Silva says.

“Although, it is true to mention that in times of crisis we often see correlations increasing, so in a sense diversification deserts you when you

need it most, however this probably holds for most equity investments.”

When it comes to where schemes and funds would have invested in emerging markets 10 years ago and how the different the emerging markets scene is today, da Silva says anecdotal evidence is that allocations to emerging markets by institutional investors are rising, although he concedes exact figures are hard to come by.

He says: “In many instances pension funds have granted their international or global managers the ability to invest in emerging markets. And these allocations have assisted in delivering outperformance, so much so, that many schemes have opted to farm out their emerging exposure to dedicated managers to participate more in these markets.

“We think that in the UK pension funds currently have on average 5pc

corporate debt remains at modest levels. This picture stands in marked contrast to the deteriorating positions we are witnessing in a number of the developed economies.

“Although for the moment they are dependent on trade with the developed world, going forward we will see 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, da Silva concedes in times of severe market turmoil globally, such as witnessed in January, investors will take profits where they are available. The strong performance of emerging markets in recent years has enabled a lot of gains to be taken.

“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 remain optimistic,” he says.

Part of this optimism stems from what Nomura sees as its solution to the challenges to the emerging markets fund manager.

“The greatest inefficiencies in emerging markets exist at the individual stock level – however country fundamentals must be supportive,” says da Silva.

“We believe that combining the skills of three specialist regional managers, one for each region, should permit greater depth of research of the region. This should produce a better understanding of the regional country and stock influences and permit greater individual sector and company research to be conducted.

“Greater focus should result in better information and this should produce better decisions and in turn more alpha.”

“Based therefore on our core emerging Asia competency we have identified and hired Charlemagne Capital as the specialist for the EMEA region and Gartmore Investment Management for Latin America. Nomura manage the product in London and in this way investors can enjoy the benefits of three specialist managers, but deal only with one.”

in emerging markets and that this percentage is rising.”

Recent research from Intersec Research and Greenwich Associates supports the fact that there is a similar trend in the US. However, it is wo at these allocations are well below the levels indicated by GEM’s weight in global indices, which suggests that current allocations could easily double if institutions wanted to match global benchmarks.

Da Silva and his team at Nomura are optimistic going forward on emerging markets as an asset class, despite recent market turmoil.

“Emerging markets have been affected by the recent global market pullbacks and in recent weeks have fallen more sharply than their developed counterparts,” da Silva agrees.

“Despite this however 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