

All about emerging markets investing

Expert David da Silva answers all your questions

WHAT IS EXACTLY IS MEANT BY INVESTING IN EMERGING MARKETS?

From an investment perspective, we consider emerging markets to be all markets outside the developed economies (predominantly the US, Canada, the largest European economies, Japan and Australia). These are often classified by the major index providers into emerging market indices, however these listings invariably only capture the top stock markets in terms of liquidity and turnover. There are many other markets which don't meet the minimum requirements for index representation but contain investible opportunities. In general, emerging markets tend to be rapidly expanding economies, albeit that they are starting from a low base, and are characterised by low, but rising, levels of GDP per capita.

WHAT IS THE DIFFERENCE BETWEEN INVESTING IN NON-EMERGING MARKETS? IS IT MORE RISKY?

Emerging markets tend to exhibit greater volatility than developed markets. However strong returns on long term risk adjusted basis have justified their inclusion in investment portfolios. In addition, emerging markets offer diversification benefits for investors in developed markets.

IS INVESTING IN EM SOMETHING TRUSTEES SHOULD CONSIDER AS A SHORT-TERM OR LONG-TERM STRATEGY AND WHY?

We would advocate that investing in emerging markets is a long term strategy. About 80% of the world's population resides in emerging countries, while their share of global GDP is still very low at less than 40%, according to figures released last year by the Economist and the IMF. We view that this imbalance will be addressed going forward, as developing countries embrace market friendly policies, improve fiscal and corporate governance, increase education and skills levels and participate more in

global trade. As a consequence we see that they will constitute an increasing share of global GDP, and this will be accompanied by increasing weight in global indices. From our experience many institutional investors are structurally underweight emerging markets and, as this improves to a more representative level, we foresee an increase in the demand for emerging stocks. So we see strong long term reasons for emerging market investment both from a fundamental and a technical viewpoint.

WHAT SORT OF PENSION FUNDS IS EM INVESTING MOST SUITABLE FOR? (IE WELL FUNDED OR IN DEFICIT, STRONG SPONSOR OR WEAK SPONSOR, PRIVATE SECTOR OR LOCAL AUTHORITY)

A pension fund that invests in the emerging markets should be able to bear a greater volatility than that in developed markets. This translates to an investment time horizon of at least 5-10 years; over this period, the portfolio should be able to deliver enough return to compensate for the volatility. Having said this, the declining correlation between emerging markets and the rest of the world could make them suitable for diversification purposes, reducing the risk of the total portfolio of the pension fund. We believe that an investment across emerging markets globally, rather than single countries/regions can yield more diversification benefits for the investor.

WHAT ARE THE DIFFERENT WAYS OF GOING ABOUT INVESTING IN EM?

When investing in emerging markets you could invest directly into companies listed on local stock markets. You could hire a global emerging markets manager, or alternatively, given the diversity of these markets, you could consider hiring regional specialists to cover the three main regions: Emerging Asia, EMEA (Emerging Europe, Middle East and Africa) and Latin America. Other alternatives are to opt for specific country exposures, sometimes combined into BRIC(S) (Brazil,

Russia, India, China and South Africa) funds, however, we consider that there is a risk that these funds focus on the most popular markets and might ultimately miss opportunities from newly developing economies where the returns might be greater. Finally, one can go passive but we believe this means missing most of the opportunities that can be exploited by active managers.

IS NOW A GOOD TIME TO INVEST IN EM FOR THE FIRST TIME?

We view emerging market investing as a long term strategy and we consider that now remains a good time to invest. Emerging markets in general have strong balance sheets and healthy corporate earnings growth, although it is true that valuations have risen over the past few years, we believe that long term valuations are still reasonable given the growth advantage. In addition emerging markets as a share of global indices have been increasing and we expect this trend to continue, providing a long term technical support for new flows into the asset class. To put this in context, in the MSCI All Country World Index for example, emerging countries have a weight of around 11%. This compares with Japan at 9%, as an example.

WHAT QUESTIONS SHOULD I ASK A PROSPECTIVE EM INVESTMENT MANAGER?

Managing a global emerging market mandate is a challenge for any manager. This is on account of the complexity and diversity of the markets included in the universe. For example in the MSCI EM Index there are 27 countries spread across three distinct regional groupings with their own languages, cultures and political considerations. Acknowledging this, we believe that a global mandate is best handled by a combination of regional specialists. The following are key issues to consider when selecting an emerging market manager. Do they have proven emerging markets experience? Do they have sufficient resource to cover the markets and stocks adequately? Do they have appropriate regional and global coverage?



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