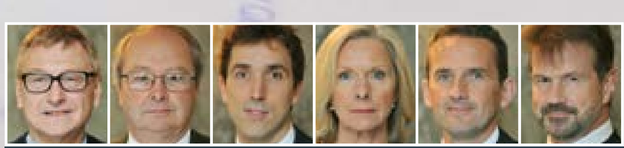
Emerging markets

Short-term pain, long-term gain



David Ayrton | Andrew Cheseldine | James Jackson
Kathryn Langridge | Ross Teverson | Stuart Trow

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Emerging markets: Short-term pain, long-term gain

Investors seduced by the impressive growth forecasts for emerging market economies should prepare themselves for a bumpy ride.

Global consumption is predicted to double to £64trn between 2013 and 2025, according to McKinsey. The consultancy adds that half of this growth in demand for goods and services is expected to come from developing nations.

Younger populations and rising urbanisation are just two reasons for such a forecast and underpins the investment case for emerging market companies. Yet the countries they operate from are no strangers to volatility and, as I write, they are having another wobble.

Argentina's debt woes are rarely out of the business pages and Turkey has been struggling under the strain of huge foreign currency borrowings and inflation marching towards 20%. Add to that South Africa surprising many by entering recession as well as fears of further sanctions against Russia and investors are getting a little jittery about their emerging market holdings. News that China will have to pay higher taxes if it wants to sell some of its goods in the US has not helped fund managers in their attempts to ease such fears.

These concerns are understandable. Many emerging market companies are young and, therefore, riskier. But there are signs of maturity. Some companies have strong balance sheets and rising earnings as directors ignore the noise around the political situation in other emerging countries and focus on serving the favourable demographics in these regions.

This has led to emerging markets' output no longer being focused on commodities. Technology, healthcare and leisure are growing industries as companies not only target the local middle classes, but developed market customers too.

There are, however, justifiable concerns over liquidity, especially when it comes to fixed income. Corporate governance is another issue, but, as we explore on *pages 26-29*, there are signs of improvement.

So emerging markets and bad news do not make comfortable bedfellows, but long-term investors should not be too concerned by short-term turbulence. As long as the investment case has not changed, it could be an example of volatility being your friend and take advantage of improving valuations.

If the forecasts for emerging markets prove correct, can pension schemes hungry for growth really afford not to have any exposure to the asset class?

Investors may have to ignore the short-term pains in order to collect the potential long-term gains.

Mark Dunne
Editor, *portfolio institutional*

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James Jackson

"There is always going to be noise in emerging markets, whether it's politics, trade or rising rates."

James Jackson, Aon

PI: Argentina's economy never seems to be out of the headlines and Turkey's has its specific problems, but now South Africa has gone into recession, which has surprised some people. Is that a sign that there is a deeper problem in emerging markets?

James Jackson: There is always going to be noise in emerging markets, whether it's politics, trade or rising rates. For us, however, it is a strategic asset class that should be held long term.

The long-term investment case is still intact with drivers such as favourable demographics, urbanisation and rising consumption remaining in place, which makes us think that it can out-perform over a full cycle.

Andrew Cheseldine: The point of investing in emerging markets is that as a long-term asset class it is expected to do better than more mature markets. You get diversification, including of currency, so why would you suddenly come out?

The rationale for going into emerging markets has not changed. There might be specific countries that you want to avoid, so don't be passive, but that's about it.

Kathryn Langridge: I would largely agree with that. There is plenty of negativity about emerging markets at the moment. You mentioned Argentina and Turkey; they are largely architects of their own misfortunes.

There are headwinds this year that emerging markets did not face last year, but growth, which is central to the long-term investment case, and earnings remain in place this year and into next year.

More particularly, from an equity point-of-view, there are compelling opportunities at the stock level. That is where you are seeing genuine growth companies, often with innovative technologies and often large scale, able to take advantage of changing demographics.

PI: What conversations are you having with your investors about this turbulence?

Langridge: My investors are largely long-term and see through the short-term impact of some pretty large macro events that are inter-playing with local concerns in specific markets. But you cannot escape the fact that we are dealing with an environment of a stronger dollar and higher rates, which pose threats to the most vulnerable emerging markets, via liquidity strains and higher funding costs. So there are some big picture macro issues, but that will not derail the long-term investment case.

Ross Teverson: It is impossible for clients not to be concerned about what a stronger dollar means for emerging markets. There is also no getting away from concerns that what has happened in Turkey and Argentina may have some knock-on impact.

It is true that most clients are long term. They appreciate that there is a structural case for the asset class that we have talked about.

Generally speaking, fundamentals are more robust than they have been during previous periods of market weakness. Looking at standalone stocks and seeing, for example, that on aggregate earnings continued to grow at a double-digit rate during the first half and recognising that many emerging market companies have stronger balance sheets than their developed market peers is reassuring for long-term investors that there is still a good reason to be in emerging markets.

Jackson: The active management point is an important one. Argentina and Turkey have been mentioned. Argentina is not even in the emerging markets benchmark and Turkey is a very small component of it. These aren't countries that you have to own.

There is probably an assumption that all emerging markets are the same, but the reality is that they are a heterogeneous group of countries; and whether you want to cut them by valuation, growth or stage of development or any other measure. They are different, they are fragmented and there are opportunities within that for an active manager.

Langridge: The problem is that during this period of risk aversion, there is very little differentiation made between individual emerging markets. That is exactly the point at which an active manager can get interested because it is exposing some enormous opportunities that arise from a wave of risk aversion which is inappropriate at the company level and often market by market.

Teverson: Indiscriminate selling of stocks right across the markets because of a broader headline issue is something that creates opportunities for active managers to make long-term investments that will bear fruit.

Langridge: Collectively, emerging markets have strengthened their financial and economic resilience since the global financial crisis. Ross referred to the recovery in the structure of corporate EM, and those are the underlying principles here. What you do also have is a number of economies where pressure has become more evident with higher interest rates. That creates higher funding costs. So South Africa has its problems. Argentina and Turkey have problems. Brazil has problems. We are facing an uncertain election in Brazil and none of the principal candidates appear to be offering any clear solution to address the country's profound fiscal problems.

So there are a number of markets that have problems, but collectively emerging markets are in a much stronger position than they were five or six years ago.

PI: Are the demographics in emerging markets creating stronger companies?

Teverson: Absolutely. The demographics are quite remarkable in some frontier markets. Kenya and Nigeria, for example, have a median population age of around 20. If you can identify a strong company in a market which has that demographic tailwind, such as a strong banking franchise, then that creates an excellent long-term opportunity.

Stuart Trow: Where there is more of a contagion issue is in the debt markets. There's no secondary liquidity because the nature of the credit markets has changed since the crisis. Basically, unless you are a first mover to get out of a position you are going to be stuck with it.

There are some strong fundamentals in equities but fundamentally the debt equation, not just in emerging markets but globally, has changed. For all the volatility we have seen in emerging markets and certain other sectors, we have not seen much of a movement in US treasuries. They have had their quietest quarter for decades. We haven't seen a panicked rush into gold either. Things have changed. Perhaps developed market equities are the new flight-to-quality – the Amazons, the Apples – because they have been growing fast at precisely the time when money has been coming off the table from emerging markets.

Cheseldine: One of the interesting things about the quality stocks just mentioned is that they sell an awful lot into emerging markets. So you are getting the emerging market exposure via a developed country.

PI: David, why is the National Union of Journalists Pension Scheme looking at gaining some emerging market exposure?

David Ayrton: Pension schemes, particularly defined benefit (DB) schemes, need growth and therefore we are forced to consider investing in emerging markets. But there are the concerns of volatility and of the unknown.

I was talking with a fellow lay trustee yesterday and he said: "If we went into emerging markets now we might be zigging when we should be zagging, when before we were zagging when we should have been zigging." In other words, is this the wrong time?

The primary concern around that question is that we cannot see emerging market investments in isolation. We can only see it in relation to the developed markets.

What a lot of lay people are looking at is the question of the protectionist stance that has been adopted by the US.

At the moment, we see apparently surging markets in the US, so should this zig or zag be based now on more advanced markets, primarily the US. The associated concern with that, of course, is that if the US continues its protectionist stance is that going to be met with retaliatory tariff positions, particularly by China?

The Chinese thus far have taken a cautious approach so as not to upset the US. As China finds its feet more as an economic and political power, is there a danger that we move into a trade war which could negatively impact the US?

Teverson: It is impossible for anybody to have visibility on when we are going to pass the peak of trade war concerns. It may be right now. There is an awful lot of negative news-flow around trade and protectionism. It is anyone's guess as to whether that gets better or worse.

What we can say is that there is a lot of concern around trade already reflected in asset prices. If you look at the price-to-earnings discount that emerging markets trade at relative to developed markets, it is as wide as it has been in the past decade. A lot is priced in already. Of course, there are plenty of scenarios we can envisage where trade fears begin to subside because a lot of what Trump's doing is probably positioning ahead of mid-term elections.

Policymakers, whether on the Chinese or the US side, realise that it is not in anyone's interest to disrupt trade too much. We can see with Mexico that despite some quite radical things being said, it looks like there is just a slight tweaking of the relationship between the US and Mexico rather than a wholesale re-write.

Cheseldine: If you exclude China from emerging markets, what proportionate effect do trade wars have on the rest of emerging markets versus the rest of developed markets? It seems to me that the arguments Trump is picking are more with developed markets than with emerging markets. In theory, therefore, emerging markets could profit from Trump.

Teverson: A lot of emerging market companies are increasingly generating revenue from within emerging markets. So you are seeing greater intra-regional trade. It is quite hard to quantify the secondary effects

of US protectionism and how that impacts consumer confidence and capital flows. It is hard to come to a conclusion as to whether emerging or developed markets are more vulnerable.

Langridge: What you are also going to see are more diversified supply chains, not just centred in China. It's important to understand that there has been a substantial shift, certainly among major emerging economies, to rebalance away from export dependency and create self-sustaining drivers of domestic growth. In China, for example, 52% of GDP is now derived from domestic drivers of growth. That is a major shift over the past 15 years or so.

Jackson: If you look at the direct impact of trade on listed companies in China, there's actually a low proportion of their revenue coming from the US. It is about 1% to 2%, compared to around 20% for Europe.

Langridge: Two-thirds of the top 25 exporters in China are multi-nationals and most of those are US companies. So, as Ross described, there are complex secondary effects that are concealed beneath the trade war headline.

Teverson: It is fair to say that China is moving in the right direction in terms of unfair trade practices. So it is conceivable that Trump can declare a victory in that some things have improved and we can move on.

Langridge: Another aspect of this is that Chinese companies as a result will also be working to improve their competitiveness through increased automation and moving up the value added supply chain, for example. There are many responses to trade wars that actually can have positive long-term effects.

PI: We hear a lot about the high levels of debt that Chinese companies are carrying, is that why you don't invest in Chinese banks, Ross?

Teverson: Levels of debt in China are high and it is difficult to have good visibility on true asset quality of these banks. Chinese banks appear to be attractively valued, so there is some concern in the price, but it is that visibility on asset quality that concerns us.

Having said that, China is beginning to do some of the right things to address the systemic risks that are arising from such high levels of debt. The jury's still out as to whether China grows out of those debt problems gradually or whether we have to go through an episode where there is some adjustment.

Trow: Chinese banks have been cheap for a long time, so it's almost more a case of the Chinese market as a whole is moving towards the banks, rather than the other way round in the past 12 to 18 months.

Teverson: Part of the reason valuations are low is because not only are there asset quality risks that could eat away at earnings in the coming years, there is also the risk of net interest margins compressing as well. So even if over time deposits and loans continue to grow, there may be relatively short earnings growth in those banks with the dual pressures of asset quality and margin.

Trow: It's not completely dissimilar to the European banks. I'm not suggesting it's exactly the same, but European banks are struggling in terms of profitability and momentum. It is difficult to see where they generate profits and it is the same for the Chinese banks. That is the one area where the lack of transparency and visibility is a real problem. If you have a problem in your financial sector, that always leaves an element of doubt.

One of the things that's striking since the financial crisis, is that if you look at global stocks, they massively out-performed emerging markets, but the one region that's moved in parallel with emerging markets has largely been Europe. So both of them, for a long time, have been the next thing to happen and neither of them has actually caught fire.

PI: Transparency is a big issue. How would you describe the level of governance in emerging markets?

Trow: It varies from market to market. Again, you look at Chinese GDP numbers, they come out on the button every quarter and they don't look credible because there's no volatility in them. If they don't look credible it makes you wonder what is behind them. Maybe I'm being over-sceptical about that, but then you have Turkey where the economic bureau has quite a good reputation and people are slightly fearful that maybe political pressures might alter that. As things are at the moment, they seem quite open and transparent, relatively speaking.


Ross Teverson

"Commodities have become much less important to emerging markets. That is a change that perhaps isn't recognised enough."

Ross Teverson, Jupiter Asset Management

PI: When you are doing your research, is there much independently-audited data that you can turn to?

Langridge: The key to successful emerging markets investing from an equity perspective is knowing your company from the inside out and doing your homework. You can identify through qualitative and quantitative analysis good quality companies with high returns on capital, with reasonable environmental, social and governance standards. The data is there. Often you need to be quite shrewd as to how you assess that data, but in broad terms, transparency across emerging markets has improved dramatically from the early days of my career in the 1980s where you had to roll your sleeves up and ask questions yourself because the data wasn't there.

One of the turning points in terms of improvements in governance, transparency and disclosure came post the Asian financial crisis, when it became clear that the best quality companies were going to be able to attract capital and the worst were not. You have to conform to high international standards and corporate governance to attract capital. So that was something of an inflection point.

PI: If you come across a company where you are concerned about its transparency, would that put you off investing or would you work with management to improve standards?

Langridge: If I can't build conviction about the integrity of the company in which I'm contemplating investing, I won't invest. Where there are red flags, you investigate them until you can build that degree of conviction. It is important to understand where there is an alignment of shareholder interest. It is vital to invest in companies that act with integrity, and where as a minority shareholder, your interests are not going to be compromised.

Investing in emerging markets does bring additional risks, but those risks are not insurmountable. A good quality investor is going to ensure that those risks are moderated to the extent that it's possible to do so.

Jackson: Within emerging markets it's interesting that governance and ESG is not something that managers are doing because it's currently popular. It is something that they have done for a long time because it clearly adds value.

We are doing work on China A-shares at the moment, and as a proxy, if you look at the difference between state-owned versus privately-held companies, there is a vast level of outperformance from 5% to 10% p.a. over the last five years.

Teverson: Part of the reason there has been a big improvement is because active managers have been putting pressure on companies for a long time to improve transparency. To the point that Kathryn made about management alignment, we do see more companies recognising that management needs to be incentivised with long term equity-based compensation rather than being set key performance indicators like revenue growth that may not have anything to do with creating value for shareholders.

"There is a strong long-term investment case to be made about emerging markets, but for now there are global challenges that have to be worked through."
Kathryn Langridge, Manulife Asset Management

Kathryn Langridge

Taiwan has come a particularly long way. When I went there for the first time in 2000, companies were giving away free bonus shares to employees, which if they had been properly accounted for would have completely wiped out a whole year's net income. The picture today is completely different. Accounting standards are much stricter in Taiwan, in line with international standards. The Taiwan Stock Exchange comes to London to meet investors to get advice as to what they can do to improve governance standards. To be honest, there is not a huge amount of advice they need because the standards in Taiwan are now pretty much up there with the best developed market standards.

Korea has more challenges, but even with Samsung Electronics, where in the past people have been quite concerned about governance, what you see there now is a clear shareholder return policy. You can see a route to some of that large cash pile sitting on its balance sheet gradually being returned to shareholders. So there have been improvements.

Langridge: In general, across emerging markets accounting standards have improved. In most cases they conform to global standards.

Trow: What you are seeing is that the corporates are putting pressure on governments to tidy up their acts.

Langridge: They recognise that it's to their advantage. Their cost of capital will be reduced.

Cheseldine: It is also to their advantage, of course, because if you are doing things right and your competitor down the road isn't, you have a short-term advantage.

Ayrton: We have certain standards because we want relative surety for our investors when colleagues are managing funds. Is there a danger that we could miss opportunities by being too stringent in terms of transparency when new markets open. For example, infrastructure development through China's Belt and Road initiative? What are the advantages of diversifying a little bit from our stringency on transparency?

Langridge: The disadvantage is that you lose your investment. So it's absolutely vital to do your homework to understand that there is an alignment of interest between the majority and minority shareholders. Then you can go wherever you can find companies that conform to good investment criteria.

The Belt and Road initiative will undoubtedly open up new investment opportunities in some of the frontier markets, but unless you have high confidence in the quality of the business that you are investing in you are not acting in the best interest of your stakeholders.

Teverson: There are some well run businesses in what are challenging markets from a political and economic risk perspective. Sometimes those can be the highest return opportunities.

So in Pakistan, which is probably the most significant beneficiary of the type of investment you are talking about, if you have the right management team then there's certainly an opportunity from that Chinese investment. Likewise from a number of African countries that are starting to benefit from this Chinese commitment.

Langridge: What that points to is the range of investment opportunity, and that comes back to the original investment case for emerging markets, which is based around growth opportunities in new parts of the world that investors are not fully aware of. That is our job, as emerging markets specialists, to identify those opportunities.

PI: What opportunities has current volatility created in terms of sectors?

Teverson: Some of the most compelling opportunities from a valuation perspective are in IT hardware, particularly semi-conductors. You have companies that historically operated in a competitive, cyclical business, and there's still some cyclicality there, but that has been massively reduced by memory chip production becoming an oligopoly. If you look at valuations of those companies, they are being valued as though they are still deeply cyclical. As I mentioned earlier, Samsung has a cash pile. That cash pile is equal to 30% of its market cap and it is trading on a mid-single digit multiple at a time when the dividend is rising. So there are definitely opportunities within IT hardware to invest in companies that offer significant future returns.

Langridge: The interesting aspect about those companies is that they represent a new source of global corporate leadership. They have differentiated technology, leadership and scale and are key parts of a

global supply chain which has emerged in the past 20 years.

Trow: One of the problems for emerging markets in general, which makes it difficult to pick opportunities, is that the whole game has changed. It seems like we haven't got a safety net anymore. In crises in the late 1990s, the IMF could always be prevailed upon to come with a new unprecedented "whatever-it-takes" type policy. Next time around I'm not sure that will be possible. So if somebody gets in trouble, they are going to stay in trouble. It is going to be difficult to dig themselves out. You might get a situation, certainly from a debt perspective, where you don't sell what is distressed; you sell what you can, as we saw during the financial crisis. That is how contagion could spread to areas where it really shouldn't be, but it's more of a liquidity issue.

When there were problems in Malaysia, Thailand and Mexico in the past, the IMF broke its rules to deliver a package that was big enough to be convincing. I'm not sure that, with a Trump presidency, anybody's going to be brave enough to try and sell that to sceptical US politicians.

Certainly Trump does not have the statesmanship to say: "Look, this is what we need to do. This needs to get done." Arguably, you could say that Argentina was a bit of that because we have a package on the table, but it certainly isn't a decisive package.

For the last few decades, we have been in a position where what has always been required is a decisive package, whether it's the eurozone sovereign crisis, the global financial crisis or the smatterings of emerging market crises we have had.

Cheseldine: It's not just Trump because Europe has its own problems. How are they going to cope

without the UK and its income? I cannot see the European Central Bank rushing to bail out Greece if it went wrong again.

Trow: And Europe, for all its wealth and power, geopolitically punches below its weight, which is not helpful for trying to sort out ancillary problems for Turkey, for example. The EU, being the local domestic power, you would have hoped that it would engage a bit more constructively with Turkey, and that's not really happened.

Ayrton: This Turkey question, is it primarily a political question in relation to the Turks' relationship with the United States? If that is the case, are we not in a position where the Chinese and therefore the broader emerging markets can take advantage of the US and the EU's failure to accommodate the Turks and other parts of the world in a similar way?

Langridge: There's no doubt from a geopolitical perspective that the Chinese will be playing a powerful hand and will be making new alliances as a result of perceived weaknesses, however engendered. In terms of Turkey's economic problems, they are architects of their own downfall. They have persistently stimulated the economy through rapid credit growth. They have twin deficits, both fiscal and current account, fuelled by external borrowing and short-term capital flows. That has been aggravated by a policy response in which President Erdogan has undermined the credibility of the central bank. He's gone for growth and allowed inflation, which has resulted in the currency collapsing. That sharp depreciation and huge foreign exchange indebtedness further aggravates banking problems and may drive the country into recession.

Stuart Trow

"What you are seeing is that the corporates are putting pressure on governments to tidy up their acts."

Stuart Trow, European Bank for Reconstruction & Development

Trow: To some extent they have been victims of their prior success. A lot of the hard currency borrowing, particularly in dollars, has been because it's cheaper to raise foreign currency borrowing than it is to borrow at home. So it's not necessarily that people need hard currency funding, it's that that's the cheapest way of doing it. Now that the credibility of the Turkish authorities has been diminished, they are left in a situation where access to refinance their hard currency borrowings is just not there.

The whole thing only staggered on for as long as it did because people had faith in the Turkish capital markets. They have quite well developed capital markets, but it's taken a lot to drag them down to the level that they are now.

Cheseldine: If China is buying influence by lending cheap money, and we have already accepted that China is massively indebted, where is it going to get the money to lend at a cheap rate to Turkey or somewhere else in the longer term? Historically, it's been the US. It is difficult to see how people are going to lend at 5% to China so that China can lend cheaper somewhere else. It doesn't make sense.

Teverson: On quite a few of these investments that China is making, their overall long-term return will be quite good, actually. You may hear of a Chinese development bank offering loans at 3% and 4% to build infrastructure, but Chinese contractors are involved. The long-term returns on some of those infrastructure projects will be high and the Chinese will be taking a part of that return. So they are perhaps more rational allocators of capital to overseas projects than people think.

PI: Going back to the stock level. Are emerging markets just about technology companies and commodities?

Teverson: Commodities have become much less important to emerging markets. That is a change that perhaps isn't recognised enough. There are some interesting sectors developing. Healthcare, for example, is a tiny part of the emerging market index, so if you went via the passive route you would get little exposure to healthcare. But from a stock pickers perspective there are a number of opportunities, whether it be in hospitals or in emerging pharmaceutical names. Companies on the pharmaceutical side benefit from a relatively low cost base and a domestic market that is growing much faster than domestic markets are in developed countries. Healthcare is going to become increasingly relevant within emerging markets.

Cheseldine: I always worry how much of it is 'chicken and egg' in that a lot of countries with substantial commodity resources are the ones with the most political volatility. Venezuela has lots of commodities, but I don't see anyone jumping to invest there at the moment.

Teverson: It's a sad fact that there is almost an inverse correlation between the amount of commodities that a country is able to produce and their level of governance. The less resource rich a country is the better its economic institutions are. We have seen that time and time again.

Jackson: There remains a perception that emerging markets are a commodity play, but that has changed over the last 10 to 15 years. It is no longer about fixed asset investment and export from China, and that has manifested itself within the index. Five or six years ago, energy and commodities were around 30% of the index, now it is down to around 15%. In its place has come information technology, which is up to about 27%.

Trow: Going back to what Ross was saying, healthcare is the ideal way of leveraging a move to a middle class. A lot of commodity countries are going the other way, exporting their middle classes either downwards or outwards.

Langridge: It's not just healthcare. There are many other aspects of consumer spending that represent growth opportunities in, for example, leisure, tourism, education, the development of new brands, and, of course, savings products. So there are many potentially highly lucrative areas that will develop rapidly with the growth of an affluent middle class and new consumer habits.

PI: Russia is in the headlines again. What would more sanctions on Russia mean for markets?

Langridge: The key vulnerability for Russia at this point is more sanctions, although it's quite hard to see what more powerful sanctions could be levied. One possibility could be newly issued state debt.

Russia is always a cheap market, and it's cheap at the moment because of sanctions. If you were to put sanctions to one side, Russia has a current account surplus and inflation is low. Policy in Russia has been moderate, targeting low inflation and fiscal constraint. So at a macro level, Russia is actually doing many of the right things and because of sanctions Russia has become more resilient to global conditions and more dependent on their own domestic drivers of growth.

The best quality companies in Russia have improved shareholder-centric governance than they had in the past when it was pitifully poor. There are a selective number of good companies in Russia that are generating high levels of free cash-flow, are reinvesting in their future growth and returning cash to shareholders.

It is not all bleak in Russia, but there are huge problems and I certainly wouldn't give the country a blanket seal of approval. You have got to be highly specific. You have got to know what you are investing in.

Trow: The other positive for Russia is that there's not been a political will internationally to make sanctions tough enough to not be able to be circumvented. When we had the last round of sanctions earlier in the year, I thought: "Wow, that's a big deal." Actually, they changed ownership structures to move away from the particular named oligarchs and things recovered pretty rapidly.

Teverson: With those sanctions, it quickly became apparent that if you stop foreign investors from owning shares in a certain company then the people you hurt the most are the foreign investors that then dump their stock and it gets bought up cheaply by Chinese and Russian investors.

So if you look at what is currently being suggested in terms of potential sanctions, there doesn't appear


David Ayrton

“Pension schemes, particularly defined benefit (DB) schemes, need growth and therefore we are forced to consider investing in emerging markets.”
David Ayrton, National Union of Journalists Pensions Scheme

to be anything of that nature being discussed, yet what is reflected in share prices is a fear that there will be something that is materially negative for holders of Sberbank’s equity, for example.

Going back to the observations we made on trade, it is hard to say exactly how that will pan out, but what we do know is a lot of concerns are already priced into stocks and that is true of this sanctions risk, as well.

PI: Volatility is high and companies are stronger than they were, so what is your outlook for emerging markets?

Langridge: There is a strong long-term investment case to be made about emerging markets, but for now there are global challenges that have to be worked through. We have moved from a period of extreme euphoria to extreme negativity. That is the point at which your interest in the long-term investment case for emerging markets ought to be raised, given the opportunity to gain exposure to industry leading companies that will generate strong returns at an opportune entry price. The long-term investment case is intact, but short term there are challenges that will be worked through.

Cheseldine: The strategic asset allocation case is still there, as it has been for a number of years. A long-term investment makes a lot of sense.

Trow: At the same time, the global macro overlay is that there is going to be less and less liquidity with central banks taking money off the table. On a net basis they are going to be reducing balance sheets, probably from the middle of next year and the European Central Bank is probably stopping later this year. That is going to have a major impact.

We saw earlier in the year with the volatility trades where people were unable to get out of positions, and they were structured around ETFs. I'm not saying ETFs are inherently dangerous, but with emerging market debt, for example, ETFs imply a liquidity that's really not there. These stories could run further than the fundamental analysis suggests. That's what concerns me.

Ayrton: During the swing from euphoria to negativity, is there an opportunity for investors to move in and buy at cheap prices as panic selling takes place?

Langridge: That's exactly the phase we are moving into. It is impossible to know how long this opportunity will persist for because there are considerable problems to work through. So we are not trying to call a bottom to emerging markets. We are saying there is an interesting entry opportunity.

Teverson: One of the key things to come out of this conversation is that while in the press emerging markets are often talked about as a collective group of investments that should move in the same direction, if you look at the underlying fundamentals, there are some huge differences across that emerging market universe. When you see indiscriminate selling across the asset class, it has to create opportunities in individual companies that are very strong.

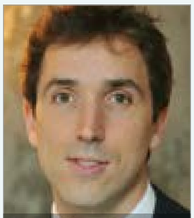
"The point of investing in emerging markets is that as a long-term asset class it is expected to do better than more mature markets."

Andrew Cheseldine, Capital Cranfield Pension Trustees

Andrew Cheseldine

Making the case for emerging market equities

James Jackson, senior equity manager researcher, Aon
Derry Pickford, asset allocation specialist, Aon


James Jackson

We believe that emerging market equities should be a strategic part of client portfolios and are best expressed via unconstrained active investment managers.

We feel that the strategic thesis for emerging markets remains largely in-tact, with on-the-whole positive demographics, rising numbers of urban consumers and strong growth. Last year, emerging market equities were the stand-out asset class. However, year to date performance has been disappointing. We believe there are two main narratives as to what is the ultimate cause of this underperformance of emerging market equities. One is China's vulnerability to the US-China trade war. The other is emerging markets' vulnerability to a stronger US dollar/higher US interest rate environment.

Sentiment is also being undermined by bad news stories emanating from Turkey and Argentina. However, the former is a tiny part of the MSCI Emerging Markets index (just 0.5%) and the latter is not part of it at all. Even if the situation was to deteriorate much further, the direct impact would be small.

Our base case is that emerging markets will recover some of the lost ground and, therefore, we think investors who are at or below benchmark should use the recent weakness as an opportunity to build-up to modest overweight positions.

Sluggish emerging market performance is often associated with US dollar strength and the recent under-performance has been no different. Recent negative news-flow on emerging markets is more of an emerging market debt issue than an emerging market equity one.

Equities are a different asset class to emerging market government debt, with much higher exposures to China, South Korea and Taiwan. These countries are less vulnerable to tighter dollar liquidity which has impacted other emerging markets.

We believe that trade skirmishes are likely to be with us for at least another two years. Although this will be a headwind for emerging markets, we think markets are not pricing the breakdown in international co-operation consistently. Developed markets are under-reacting and some emerging markets, China in particular, are overreacting.

We think that the Chinese equity market may be over-estimating the sensitivity of listed Chinese companies to the problem as listed companies actually have little in the way of US sales.

US sales for MSCI China constituents average just 2.2% of total sales compared to 20% for MSCI Europe. As the local Chinese A-share market liberalises and the 'partial inclusion factor' (an adjustment made to the market capitalisation when deciding the weighting in the index) on A-shares is increased, China's share in the index will increase further and, therefore, is likely to be a larger driver of return.

We think emerging market equities are now close to the bottom in relative performance terms versus developed markets. Whilst there is the potential for more downside, from either a big escalation of trade tensions, more pessimism about the global economic cycle or another surge in the US dollar, we think these risks are now largely priced in and further falls would represent an overshoot of fair value.

Whilst idiosyncratic risks remain, with certain countries such as Turkey creating concerns, we think that (with the exception of Asia) it is difficult for specific country factors to create broader contagion to the whole emerging market equity universe.

Access to the asset class

There is a tendency to treat all emerging markets as a homogenous group – countries with high economic potential but with higher risk and weak governance. While there are some common factors across the group of countries, this assessment masks significant variation between countries by most measures – population demographics, currency vulnerability, political regime and stage of economic development to name but a few.

Resultantly we should acknowledge that the average return for emerging market equities will disguise a wide range of performance. We also think that a lot of the additional volatility from emerging market equities tends to be these markets overshooting fundamentals. In light of this, where governance structures and time horizons permit, we believe clients' best route of access into emerging markets are from our most unconstrained and nimble managers, and those most able to express their views.

We favour managers that can meaningfully allocate to areas of highest conviction, often most aligned to the thesis of emerging market investing, irrespective of benchmark allocation; China A-Shares represent one such present area.

In the current market environment, we consequently favour managers focused on more domestically-exposed, high-quality companies, where profitability is driven by strong return on capital rather than financial engineering, particularly if it is driven by high levels of foreign-currency denominated debt.

What has the market missed?

Ross Teverson, head of strategy, emerging markets, Jupiter Asset Management

Global markets never stand still, and the world is changing every day – but are investors anchored on old information and missing potential opportunities? *Ross Teverson*, head of strategy, emerging markets, outlines why a focus on change is central to his team's investment process.

In Jupiter's emerging markets team our investment philosophy is centred on the search for under-appreciated change. This is because we believe that markets are inherently inefficient, overlooking the impact of change on a company's fortunes.

This inefficiency is due to persistent market characteristics, including a tendency for investors to become anchored on a historic perception of the company or its share price, herding around a relatively narrow range of stocks and short-termism that causes investors to miss the positive long-term changes that are taking place.

Identifying change

The sort of changes we look for can be classified into three categories. The first is structural, where there is significant long-term change such as rising penetration of a company's products or services. The second is industry change, when an industry is becoming more consolidated or seeing improved pricing power. Finally, we also look for company-specific change, which could be down to capital management or a new product offering.

When we have identified a change that is taking place, we try to determine if that change is reflected in the share price. We do this by comparing our own expectations for the stock to sell-side models, analysing the valuation relative to the market and historic averages. Finally, it is important that we can identify a catalyst for why any under-appreciated change for a company will become more recognised by the market.

Third-party company research on emerging market stocks, particularly outside the large caps, can be scarce and poor in quality. This creates a significant opportunity for us to get on the ground, research and visit companies to give ourselves a better understanding than the market of what is changing in a company's outlook.

Investing through volatility

Changing situations are often disruptive, but they create opportunities for some companies to thrive. It is no coincidence that the Mandarin character for crisis is made up of the characters "risk" and "opportunity".

Investing in emerging markets will always be a relatively high-risk endeavour, but there are a number of approaches we take to mitigate risks and diversify on a relative basis in the Jupiter Emerging Markets strategy, which we believe differentiates us from many of our peers.

Emerging markets indices tend to be heavily skewed towards large cap companies and with high concentrations in a handful of countries and industry sectors, but we are comfortable building portfolios that look different to the benchmark.

This is most clearly evident in our strategy's unconstrained approach, as we are free to invest in the most promising multi-cap opportunities, with a higher proportion of small and mid-cap stocks than would be typical for an emerging markets fund. In our view, this is a structural positive, given the long-term out-performance of mid and small-sized companies in emerging markets, which we believe can be explained by the higher growth potential and higher levels of management equity ownership.

Being benchmark agnostic is also reflected in our willingness to explore opportunities in frontier markets, such as, for example, in Georgia, Kenya and Nigeria. The favourable demographics and, in some cases, fast-growing economies of certain frontier markets have created a multi-year tailwind, ideal conditions for structural change. Additionally, frontier markets exhibit a low correlation to some of the larger emerging markets, not least China, which aids risk management by offering diversification.

Volatility and risk, whatever their source, are naturally important for us to manage. For long-term investors, however, the short-term fluctuations of markets should be of little concern, and the volatility of emerging markets is, in fact, an effect of the pace and magnitude of change that happens there.

Encouraging a contrarian mindset

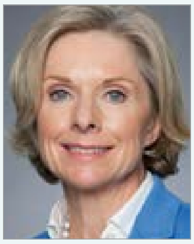
You might notice that there were few terms I did not use when describing our strategy, such as "value", "growth" or even "quality". That is because under-appreciated change can be found in any part of the market, and in any kind of stock. Our focus is on identifying materially under-appreciated change for a company, and where there are catalysts that we believe will focus the market's attention on what is improving for a business.

This discipline tends to steer us away from universally-liked stocks and encourages a contrarian approach to stock-picking, as well as a forward-looking analysis of each stock. We believe that over the long-term this strategy can result in superior relative returns.

JUPITER

Emerging market winners in an age of disruption – Companies not countries

By Kathryn Langridge and Philip Ehrmann, Senior Portfolio Managers, Manulife Asset Management



Emerging markets (EM) have been beset this year by growing concerns over the impact of the developing trade war and the prospect of further increases in US interest rates. While it's all too easy to become absorbed by day-to-day influences, one should remember that EM is home to well-managed companies that are benefitting from the profound structural changes taking place in their own backyards.

Battle hardened multinational corporations (MNCs) are active in many of today's fastest-growing consumer discretionary industries and have previously been viewed as an easy way to invest in EM countries. However, the MNCs have become increasingly challenged with the emergence of "local" EM competitors, keen to capture the high growth and profits to be found in these rapidly changing areas of their economies. Significantly, we're beginning to see EM companies that are no longer content to compete and succeed at home and are applying their knowledge and skills to expand into developed markets.

It should be stressed that these trends are in their infancy. Indeed, to succeed, EM companies and established developed-market companies require a similar combination of factors relating to resources – financial, physical and managerial. However, EM companies often have the added advantage of learning from what has played out in the past, known as the "second mover advantage". In addition, successful EM companies typically possess operational leverage with respect to the scale and growing marketplaces available to them, and they have fewer legacy issues relating to past capital investment and planning constraints. Many have adopted new technologies and processes more rapidly and at lower cost than their established developed-market peers; the best companies we're meeting with now spend as much on research and development as their first world counterparts.

These trends are playing out in key global growth industries where we see attractive opportunities:

– **Technology**—Several Asian companies that have traditionally been low-cost component suppliers have emerged as innovation leaders in fields such as smartphones and industrial robotics. One example is Taiwan Semiconductor Manufacturing (TSMC), the world's largest dedicated independent semiconductor foundry. The company has established itself as a pre-eminent manufacturer, as evidenced by Apple's selection of TSMC to make the core processor chip for iPhones. It has consistently invested in leading-edge manufacturing capacity, and a strong focus on capital allocation has yielded consistently strong margins relative to those of its peers.

- **Logistics & Ecommerce** — Reductions in supply chain barriers across EM have increased efficiency in the movement of goods, opening new markets to potential consumers. One company driving these trends is Naspers, a South Africa-based communication, entertainment, gaming and ecommerce provider. This multinational corporation was an early investor in Tencent, China's leading gaming and social media company, and it has built a portfolio of businesses with leading positions in classified advertising, ecommerce and gaming across Africa, India, Russia and Brazil. After a period of extensive investment, management is now focusing on achieving scale across its ecommerce businesses.

- **Leisure & Tourism** — Economy hotel chains have emerged in countries as diverse as Mexico, India and China, and ticketing for trains, airplanes and buses has been transformed from cash payment to online experiences using smartphones and cashless systems. One leader in this field is Ctrip, China's leading online reservation and ticketing agency. The company has expanded into international markets as it has followed the growing numbers of Chinese tourists traveling abroad. Ctrip's business is structurally attractive, with high barriers to entry and high returns, and the company's profitability is beginning to approach that achieved by more mature Western peers such as US-based Priceline, with which Ctrip has a commercial partnership.

As EM investors, we view these trends as sources of compelling investment opportunities, and a growing number of EM companies are demonstrating sustainable, quality growth – in financial terms and in regard to environmental, social and governance practices. Amid the disruptive forces that are transforming EM economies today, stock selection at the company level is key.

EM governance: Breaking through

Those pushing for better corporate governance in emerging markets report some progress, but, as *Mark Dunne* discovers, there is still a lot of work to do.

As a codename, Operation Car Wash sounds a little dull. Yet the ongoing four-year investigation into Brazil's national oil company has generated enough drama to fill a Hollywood blockbuster.

What started as an investigation into money laundering at Petrobras has put executives and politicians behind bars and even toppled the country's then president as details of a deeper scandal emerged.

The probe uncovered allegations that billions of dollars were diverted from the company's accounts to executives and members of the ruling political parties, while bribes are reported to have been the deciding factor in awarding contracts by the oil giant.

Lawsuits from investors who bought shares in New York and São Paulo soon followed to claim back their losses.

The scandal has heightened concerns among risk-adverse developed-world investors about the quality of corporate governance and transparency standards across emerging markets.

Investing is about trust. Investors are backing the people running a business, not just what is written in an annual report. Investors want senior management to be responsible for the performance of the business, provide clear, accurate and timely information on its financial health and operations as well as treat minority shareholders fairly.

Companies judged to have a track record of higher governance standards are better positioned to withstand market shocks, the International Monetary Fund (IMF) claims. Its Global Financial Stability Report published in 2016 found that moving to the upper end from the lower end of its governance index reduces the impact of global shocks on emerging market firms by an average of 50%.

It is not just about cutting risk. Adopting strong governance practices could also help boost performance. Indeed, the MSCI EM ESG Leaders index improved by 40.9% in 2017, which slightly bettered the 37.7% gain recorded by the MSCI Emerging Markets index.

These figures will make good reading for those with a long-term investment horizon, who choose to ignore the noise surrounding rising inflation, rate rises or even improving share prices to instead seek companies with robust governance structures, more sustainable profit growth and a lower cost of capital.

Of course, corporate governance failings are not limited to developing nation companies.

Don't forget that in Germany, Europe's largest economy, car-maker Volkswagen received huge fines and an executive was jailed over software that tricked tests into believing that its diesel cars were complying with emission regulations.

And who could forget energy giant Enron, which went bust in 2001 despite having $63.4bn of assets in what was at the time the US' largest corporate bankruptcy. Hiding billions of dollars of debt and losses from investors was blamed.

The issue for many is that despite its failings, governance in the developed world is still seen as more robust than that of emerging market companies.

"There are a lot of standards in emerging markets which are not in line with the other regions," says Lucia Meloni, a SRI and corporate governance analyst at Candriam Investors.

GOOD, THE BAD AND THE UGLY

Governance is at the top of the agenda for professional investors. Rob Marshall-Lee, who leads Newton Investment Management's emerging markets and Asian equities team, says that governance is critical to the firm's investment decisions.

Calvert, a responsible investor that is part of Eaton Vance with around $1bn (£763.5m) invested in emerging market equities, always has a minimum governance weighting of 20% in its modelling. "It is likely the most important point of analysis," chief executive John Streur says. "Everything starts with governance."

Candriam, meanwhile, has a filter for assessing governance. "If a company has poor governance it is not going to be in our emerging market universe," Meloni explains.

It appears that these filters are identifying companies with higher investor relations standards as some directors in emerging market companies are making more of an effort to be shareholder-friendly. Yet there is some way to go before it stands on par with the codes and practices common throughout the developed world.

Streur says that some larger emerging market companies are doing a good job of discussing non-financial risk with shareholders, although this is "not a uniform practice across the market".

Tapan Datta, Aon's head of asset allocation, points to more independent directors and board members with fixed tenures as one area where there has been an improvement. "The issue is that the improvements come off a base that is still not ideal," he adds. "What we take comfort from is that the trend is moving in the right direction."

Datta names the financial crisis of 2008 as a catalyst driving improvements in corporate governance in some of these markets. However, Meloni has not seen an immediate response to the governance failures at Petrobras.

HOPES AND DREAMS

Other areas that global investors would like to see improvements in include the treatment of minority shareholders, especially as most of the largest companies in the emerging markets are government controlled.

Streur wants to see greater transparency and disclosure of financial and non-financial data, particularly risk-orientated data. "That is going to be important for companies in emerging markets to attract a global investor base," he adds.

Legal & General Investment Management's (LGIM) corporate governance manager, Jeannette Andrews, puts the availability of more English-language corporate documentation as one change she would like to see. "This is the language of corporate business," she adds. "Improving company reporting on governance, environmental and social aspects in English and in a timely way will certainly be important to develop a culture of investor stewardship in these markets."

Meloni adds that emerging markets also trail North America and Europe in gender diversity. "We need to improve the Corporate Governance Code, legislation and regulation," she adds. "We are still behind, but I'm confident that in five to 10 years we are going to see a big improvement."

It is not just reforming the composition and independence of company boards that is important to boost transparency. For Meloni, this has to go further to include the audit committee.

"The remuneration system has to be transparent," she says. "At the moment we do not have full information about it. Sometimes we don't know how the variable remuneration is fixed, so we don't have a clear view on this. So the remuneration data has to be enhanced.

"There is a lot of improvement needed," she adds.

DIFFERENT STROKES

The key to unlocking better governance in these markets could depend on the quality of a country's government. Reform is on some government agendas but not others.

The Petrobras scandal in Brazil led to political change, which is welcome as the government was embedded in the scandal. But this has not proved to be a silver bullet as the new government does not appear to be free from allegations of corruption. So it is not the clean break those protesting on the streets of Brazil had hoped for.

"What the car wash scandal has shown is just how deeply imbedded the corruption was in that society, which is a function of the weakness of the government over a prolonged period of time," Marshall-Lee says.

He adds that he is seeing corruption resulting from weak government in other emerging markets, but points out that there are other countries where leadership is rapidly improving.

India is an example. Prime Minister Narendra Modi was elected on an anti-corruption ticket. This has resulted in the introduction of innovations to improve transparency and fairness, such as the bidding for government contracts being staged online.

There is external pressure on emerging markets from investors and organisations such as the International Monetary Fund (IMF) to ensure that governments and regulators are pushing best practice. Initiatives have included pushing corporate governance guidelines and codes. These efforts might be having the desired effect.

"Regulators are now better informed, are more active in terms of seeking out better corporate governance codes," Datta says. "In general, the financial system is better regulated than it was, particularly pre-financial crisis. Corporate governance is part of that improvement in the way that financial regulation improved post-crisis."

Improvements that Newton is seeing include a Korean company that intends to start taking investor calls in English. The investor is also engaging with a company to ensure child labour is not used in its supply chain.

Some companies are taking these things on board. "There are others who couldn't give two hoots, to be frank. Those will be companies that we don't invest in," Marshall-Lee says.

CODES OF HONOUR

The preferred route by governments and regulators to improve the landscape for investors has been to introduce or overhaul stewardship and governance codes.

Asia is one region that has introduced tighter regulation. Malaysia, the Philippines and Korea are just three countries that have strengthened their corporate governance rules, while China is reported to be revising the corporate governance code it introduced in 2001.

MSCI's vice president of ESG research, Michael Cheng, says that there is corporate governance momentum in emerging markets, especially in Asia. "In emerging markets they simply came to the realisation that when they provide more market access to global investors they also have to meet global investors' expectations on corporate governance.

"That is a good dynamic that hopefully will put governance development in emerging markets on a more global stage," he adds.

Cheng concedes that this is not a perfect solution to the problem, but he is optimistic. "There is a lot of work to be done, but the fact that these stewardship codes have been put in place highlights the dynamic that emerging markets realise that you have when you are providing market access to global investors," he adds. "So that is the start of the conversation."

Cathrine De Coninck-Lopez, head of ESG at Invesco Perpetual, agrees that corporate governance in Asia has been on an improving trend, but says that developments in China are more nuanced.

"Most importantly, at the big state-owned enterprise level, there have been significant management changes due to a drive against corruption and bribery, spearheaded by President Xi Jinping. Similarly, some of these entities have been proactive in improving consideration for minority shareholders in the form of more efficient uses of capital."

She adds that at the same time, big tech firms continue to operate under majority control and variable interest entity structures, giving limited rights for minority shareholders.

"While some of these have not abused this position, others have arguably been less considerate," De Coninck-Lopez says. "This highlights that the way to address the risk-adjusted view associated with poor corporate governance, or the opportunities associated with improving corporate governance, are best identified through fundamental analysis."

In conclusion, Cheng describes the level of disclosure in emerging markets as a work in progress.

"It takes two to tango," he adds. "So from the perspective of global investors and also from the issuer's perspective, this is something that is good to work on."

The issue with emerging markets is that it is as diverse as any other economic region, stretching from Latin America to Asia via Africa. Each has its various governance challenges. In Asia, for instance, there is a dominance of family-controlled companies. "Whether it is the state or families with controlling interests, their influence, although on the wane, is still an issue with emerging markets," Datta explains.

So, despite making progress, there's still work to do to avoid another Petrobras.

"In emerging markets they simply came to the realisation that when they provide more market access to global investors they also have to meet global investors' expectations on corporate governance."

Michael Cheng, MSCI

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