

# EMERGING *opportunities*

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## IMPROVING FUNDAMENTALS OFFER A WINDOW OF OPPORTUNITY FOR INVESTORS WHO WANT TO TAKE A LONG RIDE ON THE EMERGING MARKETS WAVE.

Investors often dismiss emerging markets as a risky roller-coaster ride of booms and busts, where hot money jumps in hoping to make quick returns.

The past 10 years have reinforced that prejudice. After surging five-fold from March 2003 to their October 2007 peak, emerging market equities crashed more than 60 per cent when the global financial crisis hit. A dizzying 140 per cent rally followed. And then nothing. They have stalled and drifted for the last five years, underperforming developed markets. The index now trades almost 20 per cent off its last peak in April 2011.

Many investors withdrew or lost interest.

But improving economic fundamentals and attractive valuations are now providing a rare window of opportunity for investors to make allocations to emerging markets, which can boost long-term portfolio performance and diversification.

“It’s a good time to gain long-term exposure,” Charles Stodart, investment specialist at Zurich, says.

### EXPOSURE TO LONG-TERM GROWTH

Emerging markets include 23 countries spread across Asia, the Americas, Europe, the Middle East and Africa, incorporating the BRIC countries (Brazil, Russia, India and China) as well as several smaller nations, such as Poland, Peru and Taiwan.

Emerging markets comprise about 12 per cent of global stocks, based on the MSCI All Country World Index (ACWI). That suggests investors should have 10 to 15 per cent of their global equities allocated to emerging markets.

But Steven Sweeney, emerging markets manager of research at Lonsec, says global investors are underweight emerging markets, with typical exposure of about 5 to 8 per cent.

The volatility witnessed in the past 10 years and throughout history is no doubt to blame. Emerging markets have suffered sell-offs during periods of market stress, such as the Russian default of 1998 and the 1997 Asian financial crisis.

“When the outlook for global growth is relatively

buoyant, investors are positive on the asset class and increase flows,” Sweeney says. “But when there are clouds on the economy and poor sentiment, investors repatriate capital and look elsewhere.”

To benefit from the higher long-term economic growth than in developed markets, Stodart argues that clients should form a long-term holding of emerging markets in their portfolios, rather than trying to time the market.

The International Monetary Fund is forecasting GDP growth over the next five years of 5 per cent a year. “That’s not as high as you’ve seen in the past, but double what is expected from developed markets,” Stodart says.

Higher economic growth should flow through to higher equities returns (though not all research reaches that conclusion). While emerging markets have underperformed over the last five years, the longer-term picture is different. Stodart cites data going back over a 20-year period, from 1998, that shows emerging markets returned 6.5 per cent a year – well above the 4.5 per cent of developed markets.

Sweeney believes investors in emerging markets can expect to achieve returns of 8-10 per cent a year over a seven-year cycle. “That compares relatively well with other equity classes, albeit with hard drawdowns on the way,” he says.

Emerging markets also have diversification benefits for a portfolio. The correlation between emerging markets and developed markets has historically been about 0.60, based on index monthly returns from January 1999 to April 2017 in Australian dollars over rolling five-year periods, Stodart says. “That implies that the return profile of emerging markets can deviate materially from developed markets.”

A perception that commodities, resources and energy dominate emerging markets has reinforced the prejudice against them. Sweeney notes, however, that about 70 per cent of the emerging markets benchmark is in technology, finance and consumer companies.

Stodart says the role of dividends in emerging markets has also been underappreciated. From 2000, about 40 per cent of emerging market returns have come from dividends. About 90 per cent of companies in the emerging markets benchmark pay dividends. This “can dampen some volatility inherent in emerging markets,” he says.

Stodart also notes that a focus on dividends in emerging markets can help address corporate governance concerns. “Dividend yield can be a leading indicator





for good corporate governance,” he says, “typically highlighting strong business models, sustainable cashflow generation and minority shareholder-friendly management.”

Lonsec recognises emerging markets are a high-risk asset class and, therefore, prefers a measured approach, but Sweeney says Lonsec believes investors should have 10 to 20 per cent of their global equities allocation in emerging markets. (Stodart agrees with a 10 to 20 per cent allocation.)

#### STRENGTHENING FUNDAMENTALS

Just as investors began to lose interest, emerging markets sprang to life again last year, rising almost 12 per cent in \$A terms in calendar 2016. They're now up almost 22 per cent in the 12 months to the end of April, outperforming the MSCI World Index. They bounced back from a tough final quarter amid concerns about the impact of the Trump presidency and potential trade wars between the US and China and Mexico, and the risks of higher US interest rates and a higher US dollar.

Emerging market economic fundamentals are starting to improve, or at least stabilise. After years of downgrades, earnings were upgraded last year. Exporters are gaining from a pick-up in global growth and many countries are starting to benefit from economic reform.

China, which has a 27 per cent weighting in key emerging market indices, has stabilised growth at 6.5 per cent, and the banking sector recently saw the first quarter-over-quarter decline in non-performing loans in five years.

There are also positive signs in Indonesia, Brazil and India.

Risks do remain, however, including major geopolitical risks around Russia and North Korea.

In a basket of 23 countries, some will always be struggling, Sweeney says. Turkey, in the grip of the increasingly oppressive Erdogan regime, was the poorest performer in 2016. South Africa is also grappling with high unemployment and disruption from electricity shortages.

Corporate governance in emerging markets can also fall short of the developed world, though Sweeney says there have been strong gains in recent years.

#### VALUE

Emerging markets also offer value.

Despite the recent rally, the forward price-earnings multiple on emerging markets was 12.5 times at the end of April, which compares favourably with developed markets, on 17.2 times. That indicates higher expected returns from emerging markets over the long term.

The combination of fundamentals and value provides a solid entry point to gain exposure through direct shares, exchange-traded funds, country-specific funds and ETFs, or dedicated active emerging markets managers.

Stodart argues that buying direct shares in emerging markets is a challenge for individual investors, given the need to understand different economic cycles and development stages, as well as accounting standards. But Nimalan Govender, portfolio manager at Morningstar, advocates direct stakes in emerging-market companies. He believes Australian investors mistakenly view emerging markets as a homogenous block, and he's wary of passive exposure through a single broad-based ETF, given the oversized Asian – and particularly Chinese – weighting in indices that might not be suitable for certain investors.

Govender says Australian investors should be looking to craft a customised solution and buy into specific countries and higher quality companies at attractive valuations. There are opportunities, he says, in the likes of emerging European countries, despite the obvious risks those countries face.

Investors can gain passive emerging-market exposure via Vanguard and iShares ETFs, but Sweeney argues that investors are usually better off choosing a well-managed active investment strategy. There is general agreement that the inefficiencies of emerging markets allow a skilled manager to generate alpha in the asset class.

Emerging markets can have similar performance characteristics to small-cap companies, Sweeney says. The lack of coverage means active managers have odds in their favour to add value. He notes there are more than 5000 companies listed on the Bombay Stock Exchange, a large swathe of which are not covered by brokers and investor research.

Active managers can also better manage risks, including minimising exposure to companies with poor corporate governance.

#### STAYING THE COURSE

Some investors have exposure to emerging markets through developed market managers, but Sweeney says he prefers dedicated emerging market managers.

Stodart says that given the long-term benefits of emerging markets in a portfolio, the biggest risk is not being in emerging markets at the right time. That means staying the course through inevitable volatility. So he recommends that investors find a strategy that allows them to hold for the long term.

One way is through dividends. The Zurich Investments Emerging Markets Equity Fund, for example, focuses on emerging market companies that pay attractive and sustainable dividends, which offer the growth potential of emerging markets but with lower levels of volatility through a market cycle. “This lower level of volatility can provide a core ‘through the market cycle’ solution for investors that would prefer not to time the market,” Stodart says.

Investors are starting to rediscover emerging markets again. Money started to flow in late last year and the inflows continued into the start of 2017. With more investors eyeing off the asset class, the opportunity to get set in emerging markets at attractive prices may not last for long. ■