**Summary**
- Emerging markets are between frontier and developed markets.
- Pension funds are increasingly turning towards EM in search of diversification and better returns.
- Fixed income/debt and equities both appeal for different reasons.
- In both, hard or local currency decisions play a part: with equities, one can combine views on equity and currency risk since performance is likely to correlate. On fixed income, hard and local currencies carry different risks and advantages.
- Decisions on whether to invest region by region or with a more global approach are important.
- ESG is increasingly playing a large part in investment decisions, and this can have a significant impact on the regions being invested in.
- Choosing managers who can navigate their way around the granular aspects or the global view, whichever is relevant, is essential.

# Broadening horizons

**Sandra Haurant explores why pension fund are increasingly investing in emerging markets, and the different ways that they are doing so**

In the quest for better returns, pension schemes have long been broadening their horizons. "One of the biggest trends that we have seen in the UK pension market is the continued push to enhance the investment process across schemes of all sizes," says, Goldman Sachs Asset Management's head of the global portfolio solutions group for EMEA and Asia-Pacific, Shoqat Bunglawala. "With many schemes finding themselves in tough positions following interest rate movements over the past few years, trustees and sponsors are looking at how they can work their assets harder to try and close the funding gap."

There is a balance to strike between risks and rewards, and increasingly, says Bunglawala, pension schemes have diversified away from traditional portfolio mixes. "Our research into the pension schemes of FTSE 350 companies shows that, since 2011, on average, schemes have decreased their allocation to equities by around 16 per cent, while only adding around 8 per cent to fixed income." The rest, he says, goes to innovative diversifying strategies, adding: "Anecdotally, we have seen allocations to emerging market (EM) assets, both debt and equity, increase due to this trend, as schemes move away from traditional global equity exposures and seek to access the EM growth story and productivity catch-up dynamics demonstrated in markets."

### Emergence of asset classes

The coining of the term 'emerging markets' is credited to the international investment analyst Antoine van Agtmael, and dates back to the early 1980s. As the *FT Lexicon* says: "Emerging markets sit between developed markets – for example, the US, the UK, core European countries and Japan – and 'frontier markets' which are even less developed than emerging markets."

For pension funds, in many ways a shift towards EM seems to make sense. "Over the long term, pension funds we speak to aim to have a larger proportion of their assets in EM, as they seek to participate in the long-term domestic demand story," says Fiera Capital's UK CIO and director, Julian Mayo, who leads on the Global EM fund. "Emerging and frontier countries account for over 80 per cent of the world's population and 50 per cent of the world economy. They are adjusting for purchasing power, and are growing at a 5 per cent rate, whereas the rest of us in the 20 per cent are only growing at 2 per cent."

Returns have been broadly positive over the past year. J.P. Morgan Asset Management's EM debt investment specialist, Zsolt Papp, says: "If I take the past 12 months until the end of January, we had very strong positive returns both on equity and fixed income sides." But, he adds: "Particularly on the debt side, EM debt was considered quite highly valued. What we have seen since, and which was really more pronounced in May and June, is a quite significant correction, particularly on debt. From a purely tactical perspective, entering EM debt now is probably a much more attractive proposition than it was six to 12 months ago."

Pension schemes access EM through both equity and fixed income routes, and within a portfolio both have their advantages and risks. "Each schemes' situation is unique, and their allocation to these asset classes will be defined by their risk appetite and other, scheme specific, constraints. Each emerging asset class offers access in a unique way. EM equity provides access to local companies in EM countries, which may benefit from the increase in domestic consumption as well as exports." Bunglawala adds that, in Goldman Sach's view, the opportunities in these regions cannot be fully captured by developed market companies serving these regions, and says: "These equities tend to offer higher returns over the long run than their developed market piers."

**Hard vs local currency**

On the fixed income side, debt is issued in either hard currency (US dollars) or local currency, and both have inherent risks, Bunglawala explains: "EM local currency debt offers returns that tend to be driven by sovereign risk, such as GDP growth, fiscal policy, ability or intent to return capital, monetary policy, inflation, and foreign exchange." However, he says that while local currency debt can provide diversification through emerging market fiscal and monetary outlooks, it tends to be sensitive to the fluctuations in developed market rates, which means it may underperform when these rise quickly. "Compared to their local counterparts, hard currency debt generally exhibits higher interest rate risk, lower credit quality, lower volatility and less currency risk," says Bunglawala.

"The local/hard currency decision is an important one, and investors should take into account that the volatility of local-pay EM debt is almost twice that of dollar-pay debt," agrees Payden & Rygel's managing principal, Kristin Ceva. "For local-pay EM debt, investors take exposure to both local yield and currency moves. Dollar-pay EM debt trades at a spread to US treasuries, so total return is comprised of both spread changes and US treasury movements." But, she adds, it need not be exclusive: "Many pension funds that want a broad exposure to EM debt have chosen to take a blended approach which allows for exposure to both of these asset classes."

When it comes to equities, currency has a different impact, as Cambridge Associates' managing director, Himanshu Chaturvedi, says: "It is a widely held view, and has been empirically true, that you see currencies and the underlying local currency assets moving the same way. So people tend not to hedge, because by expressing a view on the underlying asset, you have to have a view that you are at least neutral if not positive on the currency."

There are differences, too, in the way schemes approach equities and debt in the EM sphere. Chaturvedi recommends a granular approach to investing in equities, looking at each region on its merits rather than taking a blanket approach. "Asian economies are very different to Latin economies and EMEA economies, and it's going to be hard to find teams equally good in all of those regions," he says. "As a pension fund, you have a critical mass of assets and you should try to allocate on a regional basis. Even within regions, we have sub regions."

Meanwhile, according to Ceva, EM debt requires a more global approach. "There are now over 70 countries in the EM fixed income universe, across Latin America, Asia and Central and Eastern Europe, the Middle East and Africa (CEEMEA), so taking a global approach allows for diversified exposure across regions and countries."

**Responsibility and investment**

In both instances, it's essential to select managers who are able to provide the relevant expertise. And this is equally important when it comes to environmental, social and governance (ESG) issues. Investing in EM can have a significant impact on a region's development, and pension funds are increasingly interested in socially responsibly investment. The *Financial Times* reported in November 2017 that six out of 10 investors were planning to increase their allocations to responsible investments over the next three years.

Chaturvedi says he is certainly seeing evidence of this among pension funds: "ESG has gathered pace in the last year, helped along by a regulator who is supportive. Trustees themselves express their beliefs in how assets are allocated, and the landscape is providing more options with respect to products you can allocate; you don't feel you are compromising on returns."

And Payden & Rygel is also seeing an increasing emphasis on social decisions. "ESG considerations are embedded in our EM sovereign investment process, and are given an explicit weight and score in our country scorecard," says Ceva. "These factors influence a country's path toward or away from sustainable, productive growth over time. We look closely at factors such as rule of law, corruption, transparency, social stability and potential for structural reform."

Of course, investing in EM, whether through equity or debt, requires care. "The addition of such asset classes needs to be done in a thoughtful way to ensure the appropriate risk posture for the scheme is maintained while gaining access to these higher volatility assets," says Bunglawala. Making the right decisions and choosing the right manager is essential to getting the most out investing in these markets as they make their way upwards to become a more developed, stable economies.

**Written by Sandra Haurant, a freelance journalist**