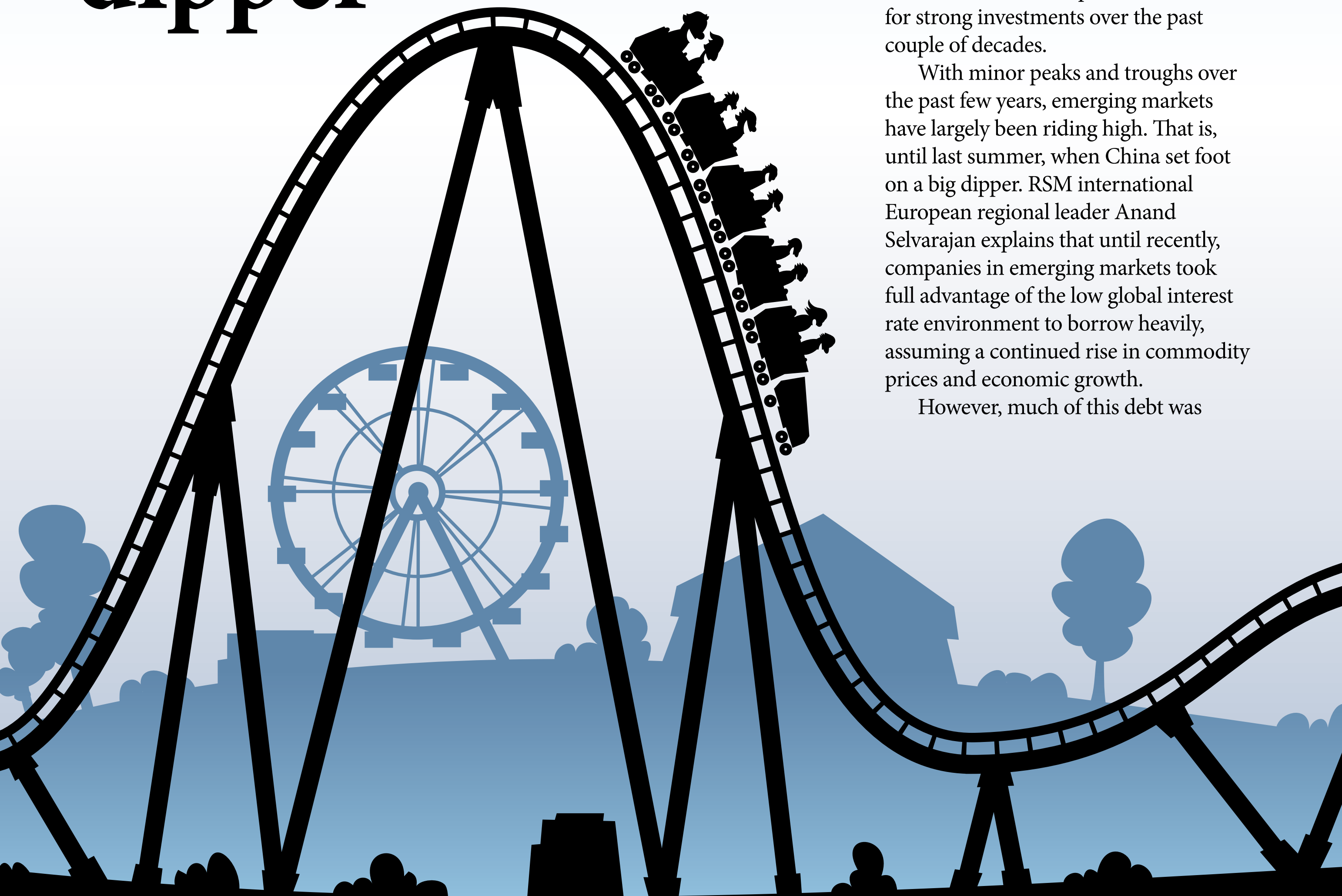
Summary

- Emerging markets have transformed the way investors allocate their capital, offering faster growth than developed economies.
- However, the recent slowdown in China has had repercussions across the world and left investors feeling wary of emerging markets.
- Despite this, pension funds are still advised to include emerging markets as part of a diversified portfolio.
- The advice is to work with good, active managers investors know and trust.

China: The big dipper

China, the 'epicentre' of the emerging markets, has suffered a slowdown that has rocked the rest of the emerging markets; Natalie Tuck asks whether they are a rollercoaster worth riding



The emerging markets have transformed the way investors allocate their capital; their growing economies, rising middle class and cheap labour have made for strong investments over the past couple of decades.

With minor peaks and troughs over the past few years, emerging markets have largely been riding high. That is, until last summer, when China set foot on a big dipper. RSM international European regional leader Anand Selvarajan explains that until recently, companies in emerging markets took full advantage of the low global interest rate environment to borrow heavily, assuming a continued rise in commodity prices and economic growth.

However, much of this debt was

fuelled by China's stellar and strong demand for commodities, he says. According to the IMF, emerging markets now have an accumulated debt of $18 trillion (£12.6 trillion), four times that of the value in 2004. China's slowdown last summer, and the speed at which it happened, has taken both emerging and developed markets off guard, adds Selvarajan.

The repercussion of China's slowdown have been significant for other emerging markets because they have become increasingly 'synchronised' in how they act, says Sanlam Private Wealth senior equity analyst William Ball, reflecting their "enhanced integration in global trade and capital flows" with China at the 'epicentre' of this.

"China is not only a large market in and of itself, it is also an important trading partner of many emerging market economies. When China slows, risk of slowing growth throughout the emerging markets increases," Acadian senior portfolio manager Asha Mehta explains.

China's impact can be seen on the share price of the MSCI Emerging Market Index, which fell by around 25 per cent from its peak of $1,065.62 in 2015 on 27 April to $794.14 on 31 December 2015. Since then the index has suffered even more, falling as low as 692.76 on 20 January 2016.

Though it is not only China that has suffered. As China is a key player on emerging market indices, the effects will have been felt by investors. It is important to remember though that emerging markets make up a heterogeneous group, and returns on individual markets vary greatly.

For example, Ashburton Investments fund manager Simon Finch notes that investors who have bought a global emerging market product over the past five years will have invested in countries such as Russia and Brazil, which have lost 57 per cent and 78 per cent over that time period.

A sweet spot

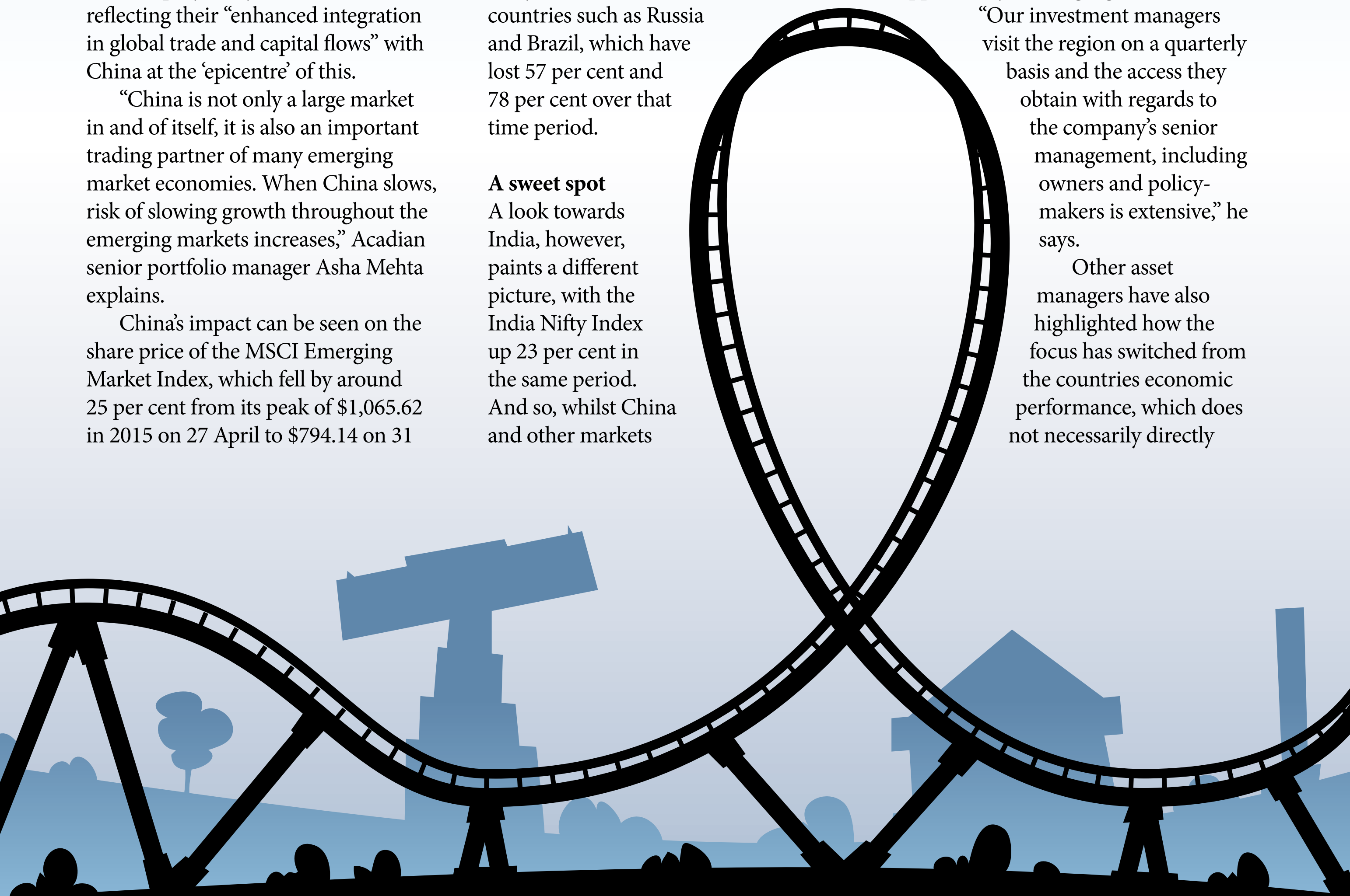
A look towards India, however, paints a different picture, with the India Nifty Index up 23 per cent in the same period. And so, whilst China and other markets suffer a slowdown, investors refer to India as a 'standout country' that's hit its 'sweet spot'.

This is a thought shared by RBC Global Asset Management, institutional portfolio manager, emerging market equities Nicole Vettise, who says they have a "preference for India" because of reforms, which hope to drive future economic growth.

Companies in India have also been praised for their 'high quality', and it is this which may be driving investments in the country. Finch explains that Indian equity markets have 100 years of trading, supported by a strong legal doctrine.

"Our investment managers visit the region on a quarterly basis and the access they obtain with regards to the company's senior management, including owners and policy-makers is extensive," he says.

Other asset managers have also highlighted how the focus has switched from the countries economic performance, which does not necessarily directly



correlate to investment performance, to instead assessing the strength of the companies within the countries.

"In more recent times, company characteristics have impacted returns in emerging markets more than country dynamics," says Mehta.

Pension funds

Despite the current turmoil, the sentiment among investors is emerging markets still have a place in pension fund portfolios. Today's buzz phrases such as 'search for yield,' 'search for growth,' and 'new normal,' are about diversification and emerging markets are key to it.

Finch explains that all these terms are "relevant to the pensions market today," as since the global financial crisis, investors and pension schemes have seen interest rates go to zero and in some examples into negative territory.

"A diversified pension portfolio will need to have an element of growth, particularly for those individuals with a longer time to pensionable age as savings rates are at historical lows," he explains.

Therefore, investors recommend including emerging markets within their portfolios to achieve this diversification. Vettise says emerging markets provide some "much-needed risk diversification within the equity component of an overall portfolio".

Pension funds can also take advantage of the recent market weakness in areas such as China, as they can offer investors an improved entry point to benefit from a renewed effort with regards to reform measures in the coming quarters.

Furthermore, the attraction of emerging markets is not limited to exploiting its weaknesses as there are also benefits over developed markets. Mehta says that growth in the emerging markets still continues to outpace the developed markets. Vettise too, adds that they offer "favourable demographics, a growing middle class and under-penetration of services such as banking".

Where to invest?

Pension funds looking to invest in emerging markets are advised by Finch to "cautiously enter equity markets such as India and China, with a focus on solid stock picking, and large cap stocks".

"As the year unfolds we may see earnings recoveries across sectors in these markets, which should further aid a recovery from the opening year lows," he says.

Looking outside of Asia, Mehta recommends emerging European locations such as Poland and Turkey. "Poland is a beneficiary of the lower oil price environment and is attractively valued. In Turkey, positive signals include the depreciated exchange rate and relatively limited market risk," Mehta explains.

However, the consensus coming across from asset managers is that with the high volatility in the emerging market economies, pension funds should seek out an active manager that they know and trust.

"Expectations are that volatility and breadth of market moves will be under close scrutiny in 2016, and thus we would advocate investors to seek out active investment managers that have consistently been in the top two quartiles over the long-term in the chose markets," Finch says.

It is important to remember though that when investing in emerging markets, pension funds should be thinking about long-term gains. As Vettise says, there remains many headwinds in emerging markets making it impossible to forecast the short term. "Our role is to pick strong companies in emerging market economies that we believe will outperform over the long term," she adds.

Written by Natalie Tuck