A break in the clouds

Lynn Strongin Dodds discovers how pension fund investors are looking to emerging markets as bright spots within challenging market conditions

Summary

- Geopolitical tensions are hanging over emerging markets but they are long-term plays that add value to UK pension funds, especially in the prolonged low interest rate environment.
- Passive investing via ETFs has been a popular way to gain access, but fund managers argue active management is better in such a diverse and heterogenous universe.
- The benefits are diversification and higher yielding returns but investors have to carefully look at the underlying themes and how they align with their particular requirements.

Emerging markets may have started the year with a boom, but the US' ongoing trade tensions with China and Mexico and the more recent sabre rattling with Iran have cast a pall. However, UK pension funds are taking the long view and are increasingly looking at these countries for new prospects amidst the uncertainty over Brexit and the persistent low interest rate environment.

These views are reflected globally in a recent poll conducted by the Institute of International Finance. It showed that although emerging market funds have suffered over $5 trillion of outflows since Donald Trump toughened his stance against Chinese imports on 6 May, net positions in EM assets were over $30 billion for the year to date.

Separately, a new report by Templeton Emerging Markets Investment Trust (TEMIT), which examined investor mindsets towards emerging markets, finds that UK investors were optimistic. After three months of negative growth, as well as the prolonged uncertainty over Brexit, they saw emerging markets as one of the brighter spots. One in three, or 33 per cent, of UK-based investors expected returns for these countries to be higher this year than they were in 2018, which is twice as high of those that believe the UK markets will turn in a stronger performance.

Despite the positive view, only half of UK investors have assets in emerging markets. "There are still some outdated perceptions about these markets, which has meant that investors have missed out on attractive opportunities," says Franklin Templeton portfolio manager of the TEMIT, Andrew Ness. He adds that there has been a fundamental shift, with many countries in much better financial shape than their developed peers, while companies have improved their corporate governance by, for example, distributing dividends to minority shareholders.

Diversity and innovation

To date, emerging markets account for about 60 per cent of global growth and over 50 per cent of GDP, but equally as important their economies are no longer dominated by agriculture and cheap manufacturing. They are now home to some of the most innovative companies and their populations, particularly in Asia, have more money in their pockets to spend. In 2000, the middle classes living in these countries accounted for only about 4 per cent of the world's population, but by 2030 that is expected to jump to 15 per cent, with China projected to overtake the US next year and India to follow in 2021.

The growth and consumer spending trends are only two parts of the investment equation though. "Diversity of exposure is also important because emerging markets can be immune to shocks that occur in developed markets," says Jupiter Asset Management head of strategy, global emerging markets Ross Teverson. "We saw that with Brexit. They were not impacted when UK markets went down."

Of course, a broad-brush investment style cannot be applied. Mirabaud Asset Management head of emerging markets market debt, Daniel Moreno, points out that these countries are at different stages of development and investors need to understand the underlying trends impacting each of them. He splits emerging markets into three groups, starting with those at the more advanced stage, such as the Czech Republic, Hungary and Poland in Central Europe, as well as South Korea and Taiwan in Asia, and Chile in Latin America. The second group belongs to those in the middle to high end, including Brazil, Mexico and Turkey, while last but not least are the frontier markets, which are progressing but have a much longer way to catch up.

Access

Accessing the markets will vary depending on a pension fund's specific requirements but passive investing has been gaining momentum across the asset class spectrum. Globally, figures from financial data provider EPFR show that over a 16-month period through mid-April, ETFs specialising in emerging market equities garnered a significant $84 billion in inflows. The majority or 80 per cent though went to companies in just five countries – China, South Korea, India, Brazil and Taiwan.

This concentration is why many fund managers advocate a more active approach. "One of the problems on the equity front is that three-quarters of the MSCI Emerging Market index is large caps and more than 30 per cent is skewed towards China," says Teverson. "We believe it is a poor representation of the small to mid-cap sector, as well as the frontier markets. There is, for example, only a very minimal exposure to small caps and no exposure to frontier markets through ETFs, which means investors miss out on some of the strongest structural growth stories of the world today."

Using a bottom-up approach, Teverson points to well-run banks in Nigeria and Pakistan that have better aligned management and minority shareholder interests as well as "tech enabling companies that are part of the biggest technology themes playing out globally. These include South Korea's Hynix, which manufactures memory chips that are used in cloud-based, artificial intelligence and autonomous driving technologies".

Ness sees appealing opportunities in semiconductors, as well as e-commerce, particularly in China, Brazil and Russia where penetration levels are still low. "We are also interested in hardware suppliers that enable cloud computing and data, mobile banking, high performance and the internet of things," he adds. "In general, we think emerging markets are relatively better positioned to benefit from disruptive technology because they have shared infrastructures, unlike the developed markets."

A dynamic approach is considered even more essential for investing in emerging market debt (EMD). "One of the issues is that there is a real lack of liquidity in fixed income and the rise of ETFs has been very dangerous from that perspective," says Moreno. "Investors have been forced to sell and buy at the wrong time, which has exacerbated the situation."

The asset class has in fact come back thanks to the Federal Reserve's more dovish stance and the stubbornly low interest rates, which has translated into $13 trillion of fixed income sitting on negative yields. Research from J.P. Morgan shows that sovereign debt with stable currencies and economies returned 8.6 per cent this year through 5 June, while hard currency corporate debt was up 7 per cent over the same period.

Overall, the EMD space comprises roughly $11.7 trillion with local currency bonds accounting for the lion share – $8.4 trillion. The remainder is in hard currency – mostly dollar – denominated bonds with about half in investment grade instruments.

Typically, UK long-only pension funds have opted for a standalone blended approach that combines the two categories, although increasingly schemes are slotting their EMD portion into a multi-asset credit solution or a mix debt and equity portfolio. "One of the problems with a blended approach is that the returns have been disappointing," says Bluebay Asset Management institutional portfolio manager, emerging market debt, Claudio Da Gama Rose, adding that the volatility of the local currencies can eat into the performance.

"We believe in an unconstrained approach because the emerging market debt universe consists of 80 countries, different economies and spreads," he adds. "It is important to have the flexibility and ability to move away from the benchmark to manage the downside and generate returns."

Da Gama Rose says that BlueBay focuses on high conviction stories and over the past two years has invested in short-dated local currencies in frontier markets, which are not represented in any conventional benchmark but have a long-term structural reform narrative to tell. It has also taken advantage of Gulf Cooperation Council (GCC) countries, recently entering the J.P. Morgan emerging market indices, with Qatar being its country of choice on the more liquid investment grade end.

Legal & General Investment Management head of EM credit Uday Patnaik also sees interesting opportunities in dollar-denominated sovereign and quasi-sovereign debt in Qatar, Kuwait and even Saudi Arabia, as well as the more speculative end of the market. "We like countries such as Senegal and Nigeria, which is relatively reasonably stable, and Argentina, which has high yields, but the outlook will depend on the results of the election in October. In general, EMD is a growing asset class and offers investors a geographically diverse world with many attractive sector and regional plays."

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