Summary
- After a rough 2018, emerging markets are seeing an uptick.
- Investment in this space is less about geography and more about sectors, particularly technology.
- Emerging markets are not homogenous, and should not be treated as such.

Flexing its muscles

After a disastrous 2018, emerging markets have seen an uptick in the first quarter of this year. But where within emerging markets are pension funds placing their money, how are funds evolving, and how should funds should preparing for the future? Peter Carvill reports

If you were an emerging market, 2018 was not a good year for you. A wave of international crises, fears, and narrowly-averted catastrophes on the global stage led to Bloomberg, in December, calling emerging market performances 'floundering' and 'turbulent'.

However, the news did not appear to be all bad, given that, "while the currencies, stocks and local-currency bonds of developing economies are all heading for their worst year since 2015, they have rebounded from lows in the past few months".

After a backdrop of a US-China trade war, potential war between the US and North Korea, the Brexit squeeze, the Kim-Trump meeting, political corruption in Malaysia, domestic troubles in Turkey, sanctions imposed on Russia, the murder of Jamal Khashoggi, political upheaval in Venezuela, and the rise of populism in Latin America, things had begun to improve.

As Lazard Asset Management wrote in Outlook on Emerging Markets, published in April: "Emerging markets equities rebounded in the first quarter after declining significantly in 2018, due mostly to a stabilizing US dollar, perceived progress in US–China trade talks, and recovering oil prices."

If 2018 was a rough year for emerging markets, it was a reversal of the steady growth that had characterised the sector since 1990. Between then and 2002, real GDP growth in this space averaged 4 per cent per year, compared to 2.5 per cent in advanced markets.

This had jumped between 2002 and 2012, in growth fuelled by China's expansion, to 6 per cent. Between 2013 and 2018, this slowed to 4.4 per cent; however, this still outpaced the GDP growths of the EU and the US. According to World Bank statistics, this was 2.456 per cent for the former in 2017 and 2.217 per cent for the latter.

A brighter future

Despite the tribulations of 2018, the outlook is bright. In March, Swiss Re released Emerging Markets: The Silver Lining Amid a Challenging Outlook. The authors said: "Emerging markets will remain the growth engine of the global economy over the next decade and as part of that, we expect the shift of economic power from west to east to continue.

Our projections indicate that together, the emerging economies will account for 60 per cent of global growth in 10 years' time. The seven largest emerging markets will contribute up to 42 per cent of global growth, and China alone 27 per cent."

The same report states: "In spite of current macro adversity, emerging markets remain in a favourable economic position, especially vis-à-vis advanced markets."

Lazard Asset Management's head of emerging markets, James Donald, acknowledges that 2018 was a difficult year. He says: "It was dominated, to a large degree, by macro-economic and political events. Along with the sanctions on Russia and the strife in Turkey, the strong dollar was putting pressure on every currency. There was also a major effect during H2 from the US' higher tariffs, particularly on Chinese exports.

Given that, I'm not surprised to see markets up now. Given it was only Q1, the increase was more than I expected."

Pension funds, with their vast assets, have long invested in emerging markets. In September, Willis Towers Watson estimated that the 15.1 per cent increase in AUM by the world's top 300 pension funds in 2017 was driven by the growth of pension funds in this area.

Donald's perspective on pension funds and their investments in this space is that the interest is not delineated by geography, but is instead focused on areas such as technology. "This is," he says, "because it tends to be a big sector. Tech tends to be a big part of their investments. There's some huge Chinese and Korean internet companies."

RWC Partners' co-head of emerging and frontier markets James Johnstone expands on this point, linking it with the commodities that emerging markets have traditionally been associated with. "In the old days," he says, "back in the nineties and the first decade of this century, emerging markets were closely linked to commodities, particularly if you look at their rise and the growth of China.

"With the emerging markets of 2019, nearly 85 per cent of those markets import oil. They should have lost their relationship with commodities. Nearly a third of index in emerging markets is now involved in tech. You've got fantastic Chinese companies that are at the cutting edge of the tech world. I think that when oil prices fall, this will be a boon for China and India."

All change

Johnstone's colleague, head of business development, Tord Stallvik, says that the approach taken by funds investing in this space will probably change, although he adds that it is difficult to make a definitive statement on this. He says that the typical fund approach is driven by target assets.

"If you have the emerging markets index as your benchmark, it becomes risky for the pension fund to do the things that a crossover portfolio would do. The irony, of course, is that the risk in that case is the risk that your performance differs from that of the emerging market index. What we hope they'd be thinking about is the return they'd make if they didn't go into smaller emerging markets and therefore miss out on the returns from those fast growing markets."

Stallvik questions what funds will do as China's economy and market continues to grow, and whether that will cause the country to be allocated separately. It will, he says, be interesting to see what it means for emerging market mandates if funds do go down that road.

One change that has been apparent, according to Newton Investment Management's chief commercial officer, Justin Lyne, is that funds and other individual investors have been looking with closer attention to the ethical and sustainability targets and characteristics of their investments. He says that he has seen more questions posed about carbon footprints, water usage, and diversity. "In emerging markets," he adds, "people are more attuned to the natural world the opportunities it offers, particularly in the focus on ESG."

This closely relates to the idea of governance, and how companies in the emerging economies regulate themselves and the methods taken by their local governments to oversee them. Quite often, in these countries, such measures are a work in progress. When asked about this, Donald says that Lazard Asset Management does extensive testing through questionnaires and the results often impact the valuations given. The impact, he says, is "significant".

"The devil is in the detail," Donald says. "We've been discounting for governance for the last two decades. The lesson we've learned in that time is that every company is different, and their governance is more sensitive to what they do than to the regulations in place. With this type of thing, you have to look at everything on an individual basis and understand the intent of the people in charge."

Different characteristics

It is important to remember that emerging market countries are not homogenous. There are differences in regulation, social mores, levels of corruption, workers' rights, and limits in foreign investment. One issue that has a great impact on this sector is the level of state intervention in the domestic economy. "We believe," says Lyne, "that being the minority shareholder in a company where you're at the whim of political interests is not a good place to be. We try not to have exposure in those areas".

The future, for now, seems to be bright, with experts making the case for increased investment by pension funds. Lyne says: "Pension schemes are going to look at the intrinsic growth opportunities and make individual allocations to individual markets. From there, it comes down to their point of view. It's also the point when I think we'll see the interesting conversation between active and passive management. If there's a risk budget and a cost budget, a lot of schemes are going to be making allocations to emerging markets."

Written by Peter Carvill, a freelance journalist

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