ASSET ALLOCATION

Niche areas that offer significant potential

Emerging markets could well prove to be the engine of global growth in coming years, and the asset class is full of possibilities for investors. Joanna Terret, product investment specialist, GEM at SWIP, takes a look at some of the opportunities on offer

Over the past 25 years there has been a sizeable shift in world market capitalisation – away from the traditional developed markets such as the United States, Europe and Japan towards the rapidly-growing emerging markets.

This shift is vividly reflected in MSCI All-Countries World index. In 1987, just 1 per cent of its weighting was in emerging markets; by 2007, the proportion had grown to 11 per cent. Growth rates in the emerging economies continue to outstrip their developed-market counterparts; some commentators predict that within the next decade some emerging market economies will have become bigger than many in the developed world. This should ultimately be reflected in terms of their stock market capitalisations.

Intuitively, one would expect emerging markets to continue to be the engine of global growth. While the developed markets' labour force is set to grow by just two million in the next 20 years, those of the so-called BRIC countries (Brazil, Russia, India and China) are forecast to grow by more than 250m (see figure 1).

Investors need to start to adapt to this new reality. Yet, as the events of the past few months have illustrated, doing so requires nerve and imagination. In a bear market scenario such as the one we are experiencing, emerging markets are vulnerable to macroeconomic factors: exchange rate fluctuations, volatility in commodity prices, political turmoil, and speculative panics, as the past year has illustrated so dramatically.

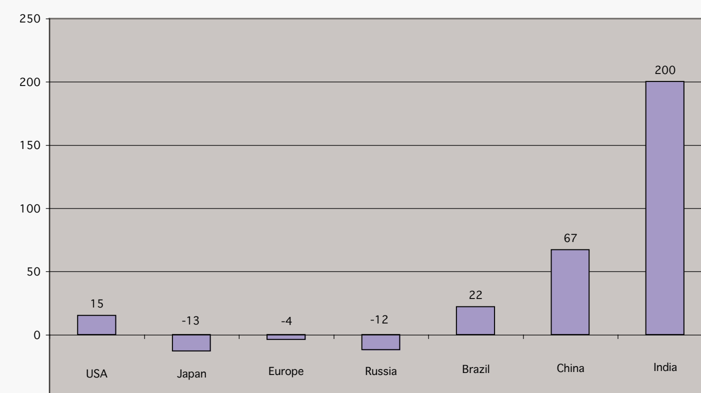
Emerging markets were not alone in suffering a significant setback as the credit crunch began to take hold. Increased risk aversion meant investors flooded out of riskier investments into the relative safety of government bonds. Decoupling – the proposition that emerging markets were becoming largely immune to shifts in the developed economy – looked all but dead in the water.

Was the shift overdone? The recent resurgence in emerging markets seems to indicate it was. Perhaps the notion that the emerging world is much more export-orientated than its developed counterpart has been overstated – that, in fact, emerging "beta" is lower than is commonly perceived. Despite a huge reduction in global trade, markets such as China continue to grow much more quickly than the rest of the global economy.

However, the emerging-markets universe is anything but homogeneous; apart from China, one of the world's major consumers of raw materials, it also includes countries whose economies are driven by the production of commodities such as Brazil, Russia and Chile. What unites them all is their superior rates of growth relative to developed countries. That makes an allocation to these markets increasingly important.

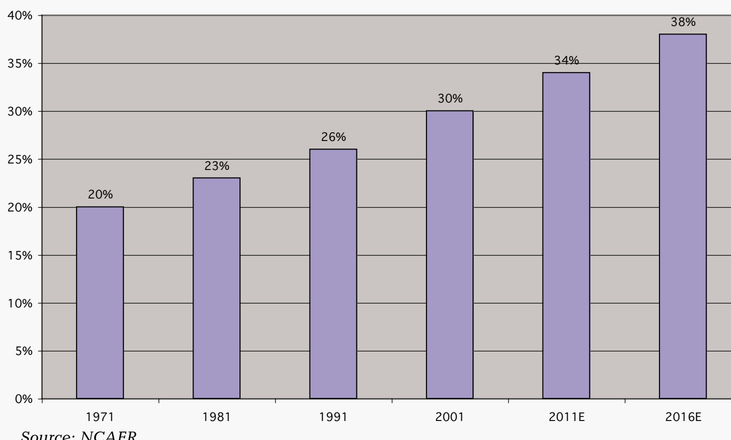
The fundamental factors underpinning emerging markets' success remain in place. The asset class generally has strong foreign exchange reserves, low corporate debt and high household savings. There is also a clear trend towards urbanisation in the developing world, driving infrastructure programmes. Back in 1971, just one-fifth of India's population lived in towns and cities. By 2016, that proportion is expected to have doubled (see figure 2).

Figure 1: Projected labour force growth by 2030 (in millions)



Source: Economist Intelligence Unit

Figure 2: The pace of Indian urbanisation



Source: NCAER

These massive amounts being spent on infrastructure are helping to refocus demand towards domestic, rather than foreign, economies. Could it be that emerging markets are, after all, in a much stronger position to withstand the current setbacks to global growth?

The sharp upswing in the fortunes of emerging markets is welcome. At the same time, it serves to underline that the potentially spectacular rewards from the asset class carry big risks: namely, their vulnerability to a variety of macroeconomic factors.

At SWIP, we are bottom-up investors; we focus on how a company generates its cash earnings, and on how these earnings will grow. We believe superior performance can be achieved by actively managing portfolios constructed exclusively from stocks where the underlying company's longer-term growth prospects are not reflected in its current stock price. By understanding how a company generates its earnings and carefully forecasting how these will grow over the long term, we believe we can identify a firm's inherent value.

However, investors in emerging markets cannot ignore the particular forces that macroeconomic factors exert on emerging market companies. Emerging-market movements can be heavily influenced by flows of liquidity in and out of the asset class, and in extreme conditions such as those witnessed over the latter part of 2008, fundamentals tend to be ignored. Economic policies and macroeconomic statistics take on an enormous significance – indeed, sometimes it seems the macro elements are all the market cares about.

Our investment approach makes allowance for the importance of macroeconomic factors, and we view macro as a source of risk rather than a source of alpha. Political (in)stability, currency volatility, commodity prices or economic policies all must be taken into account.

As emerging markets grow and become more intensively researched, the opportunities to exploit valuation anomalies are likely to reduce. So, while the argument for core emerging markets remains solid, SWIP has sought to widen the investment opportunity set by identifying a number of niche areas with significant upside potential. These are: emerging-markets infrastructure, smaller companies and Latin America.

INFRASTRUCTURE

As a sector, infrastructure is less sensitive to economic downturn, but it also offers exposure to long-term growth and new sources of return. It has been feted as one of the major investment themes of the coming decade.

Infrastructure represents the necessities of life, facilities without which no modern country can function. Roads, water and sewage, power stations, railways, ports and airports, housing and schools are crucial for the efficient production of capital and consumer goods. They provide the framework for the efficient and ongoing development of a country.

With rapid population growth and an increasing tendency towards urbanisation, the strains on infrastructure will become acute unless spending continues to grow. Estimates by Merrill Lynch indicate that governments in the world's developing nations will spend more than $2,200bn (€1,535bn) over the next three years to build and upgrade their economies.

There are clear signs that this expenditure is already taking place. Last year, China embarked upon a $585bn fiscal stimulation package in an effort to ward off recessionary conditions, largely focusing on infrastructure and consumer spending. In Brazil, the government has embarked on a three-year "Growth Acceleration Project", a $200bn plan to modernise the road network, power plants and ports.

Emerging markets' banks are in relatively good shape compared to their developed market counterparts. That, combined with high consumer savings and low consumer debt, reinforces the urbanisation theme. As figure 3 illustrates, mortgage loans as a percentage of GDP are low in the BRIC countries, demonstrating the potential for a massive upsurge in home ownership.

With liquidity remaining scarce, companies around the world are reining in their expansion plans for the tough times ahead. But in the case of infrastructure investment, the key differentiating element is state backing. More than 70 per cent of emerging-

market infrastructure projects are backed by government spending, which means low exposure to the global business cycle.

SMALL-CAP

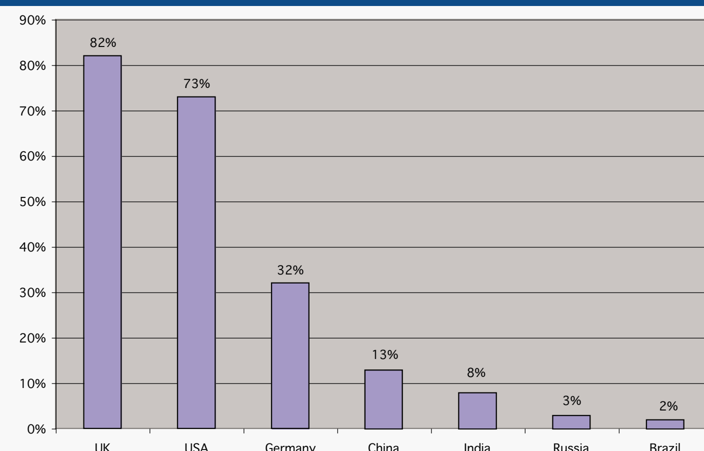
Smaller companies, too, are well placed to benefit from the upsurge in government investment. Emerging-market small caps stand to become big beneficiaries of government stimulus spending because much of it is directed towards local businesses.

The introduction in June 2008 of the MSCI Emerging Markets Small Cap index cast light on some of the fastest-growing companies in the world. The separate smaller companies index has helped emerging-market smaller companies to be recognised as an asset class in their own right.

The small cap index was created to deepen MSCI's equity coverage, and comprises roughly 1,600 stocks. This is a significant expansion compared to the existing large-cap-dominated standard index, and provides the potential for higher returns from companies the market has under-researched and undervalued. The typical market capitalisation range of firms in the MSCI Emerging Markets Small Cap index is between $50m and $1.5bn. Companies in this range represent a very different investment proposition to standard index companies.

The emerging-markets small cap universe is more evenly balanced across sectors than the standard MSCI Emerging Markets index, which is dominated by energy and financial stocks. The domestic bias of the small cap sector is evident in the industry weightings of the small cap index, with a 30 per cent weighting in the consumer sector (compared to 11 per cent in the standard emerging-markets index) and 19 per cent in infrastructure (compared to 8 per cent in the standard index). With no single company or sector having a dominant weighting, success in this segment of the market requires the services of experienced and research-driven stock-pickers who can identify the winners.

Figure 3: Mortgage penetration: mortgage loans as a percentage of GDP



Source: MF IFS, Central Bank Data, Banc of America Securities - Merrill Lynch

AN OVERLOOKED REGION

One subset of the emerging markets universe – Latin America – merits closer scrutiny. Investors who put money into core emerging markets often only receive exposure to a narrow part of this diverse region. With many funds focused on the BRIC economies, they may be missing a trick.

Latin America has a favourable demography: the region has a larger population than either Europe or the US, one that is generally well-educated and with an average age of less than 30. Its infrastructure is generally sound. Political stability in the region has improved appreciably, with the spread of democracy nurturing a climate of economic stability and fiscal and monetary prudence.

But the ace in the hole for Latin America may be its natural resources: notably iron ore in Brazil and copper in Chile. The typical Latin American company – and, notably, its banking sector – is unencumbered with the levels of debts and toxic assets that have plagued its western counterparts.

CONCLUSION

Emerging markets suffered from significant levels of volatility over the past year. With investors taking fright as the economic slowdown began to intensify, a "flight to safety" resulted in an en masse desertion from the asset class into government bonds. However, this outflow was fairly short-lived; as investors came to recognise the strengths of emerging markets and have returned with a vengeance.

Scottish Widows Investment Partnership (SWIP) delivers active, research-driven investment management with world-class service and guidance to institutions and individuals around the world. SWIP is a core division within Lloyds Banking Group and one of the largest asset managers in Europe. SWIP's competitive edge lies in its active, research-driven approach to investing. Our core capabilities include UK and European Equities, Fixed Interest, Property and Global Emerging Markets and we offer a broad range of investment strategies suitable for varying risk/return requirements. Today, we manage over €97 bn worth of assets for a diverse range of clients. Our specialist investment teams combine the benefits of focused expertise and accountability with a shared global research platform.