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New frontiers: tapping emerging market returns

Investors have been challenged by higher realised short-term volatility of returns in emerging markets equities. Clearway Capital Solutions managing director **Dennis Mothoneos** 01 argues that seemingly obvious strategies relying upon large companies or targeting household names are not necessarily optimal for investing in emerging market equities.

Institutional investors have been increasingly attracted to emerging markets equities by the prospect of deriving higher long-term returns. Generally, this belief has been underpinned by comparatively faster growth rates, and improving governance and capital management.

Also, increasing consumption, sound macroeconomic policies and intermittently attractive valuations have been important. Until it was recognised that correlations with the developed markets had risen, implementation of this view had been relatively simple; build an exposure to companies such as Petrobras and Gazprom in the BRICs; and perhaps, companies such as Samsung in smaller Asian Tiger economies.

However, investors have also been challenged by higher realised short-term volatility of returns; particularly during crises, generated by an array of risks which are less prevalent, or non-existent, in developed markets. Uncertain free cash flow and discount rates, oscillating investor flows in often thinly traded markets and broader geopolitical issues create complex feedback loops that occasionally send investors dashing towards the safety of developed markets or even cash.

Consequently, rather than opt for using dedicated emerging market strategies, some investors have pursued three alternative approaches.

The first consists of selecting developed market strategies with a direct exposure to emerging market companies – ordinarily ranging from 5% to 20%. This approach is implemented by an off-benchmark allocation or in reference to the MSCI All Country World Index (ACWI), an index consisting of developed and emerging markets. Investors adhering to this approach believe developed and emerging markets are converging rapidly, or converged already; therefore, emerging market equities should be regarded as an integral part of a global equity allocation.

Some investors prefer a supposedly safer route; selecting developed market strategies that invest in companies such as Standard Chartered, SABMiller and The Swatch Group which generate a significant part of their revenues from emerging markets. The underlying assumption is that they are subject to developed market regulatory oversight, disclosure requirements and accounting standards.

In addition, there is a third approach somewhat related to the above, consisting of using

index or exchange traded fund (ETF) products. Recently, index/ETF manufacturers have launched offerings incorporating techniques to ostensibly make exposure to emerging markets more compelling. Generally, these passive products filter constituents from developed and emerging market indices based on whether they derive a material percentage of their revenues from emerging markets rather than where it is incorporated or listed.

Of course, many investors have opted for different permutations of these approaches, sometimes in combination with dedicated emerging market strategies. Regardless of the mix, they are based on a belief that an investor can benefit in some indeterminate proportion from the perceived safety of the developed world and the outsized returns possible from emerging markets.

There are several problems with these presuppositions. Regarding the first approach, many developed market managers tend to manage substantial amounts of capital, limiting them to the largest and most heavily researched BRIC companies. These are often managed directly or indirectly by the state; and therefore, managed for political expediency rather than for shareholders. Also, they typically export orientated, relying on developed market economic strength, rather than local demand. The unintended consequence of this approach is that investors are exposed to sources of developed market political risk or economic growth rather than risk more correlated with the underlying economies.

Moreover, more 'pure' emerging market companies are increasingly found outside of the BRICS, in less well-known countries such as South Africa, Mexico, Turkey and Indonesia, and in consumer-orientated and healthcare sectors. These companies are smaller and trade less often, making it difficult for managers with large portfolios to hold sufficient exposure to contribute meaningfully to returns. Furthermore, many of the less-researched and lowly correlated opportunities in frontier markets would be even more inaccessible to these managers.

Another problem is that developed market managers consider opportunities based on industry sectors, with country and currency factors being largely secondary considerations. However, country factors and currency move-

ments retain explanatory power in emerging markets. Managers should only ignore these risks at their own peril.

With the second and third approaches, one problem is that few developed world companies are actually driven by their exposures to emerging markets – only a small number such as Standard Chartered and SABMiller derive more than half of their earnings from emerging markets. It is still debatable whether their emerging market exposures are an important factor. Most shareholders on their registries are from developed markets; and will invariably, due to the lower information costs, evaluate companies in reference to other developed market companies and macroeconomic data.

Additionally, the supposed benefits of developed market management are potentially negated by overly aggressive expansion and facilitated by poorly designed compensation structures, in countries they habitually fail to understand. As domestic businesses are often preferred by locals, locally listed subsidiaries are possibly a better option. Again, these companies tend to be smaller and trade less often.

There is also a problem with the availability of data. Because data tends to be patchy, index providers mostly rely on revenue to ascertain emerging market exposure but earnings or assets might be more important determinates. Also, identifying companies that generate a large part of their revenues from emerging markets can be difficult as more than half of the S&P 500 companies do not report their earnings by country.

On the whole, a common belief underpinning the above approaches is that expected economic growth and equity returns are highly correlated. However, although seemingly counterintuitive, a number of empirical studies suggest there is at best, a weak link between economic growth and equity returns. Emerging market equities are influenced by a myriad of variables that are sometimes unrelated to economic growth.

The problems identified above suggest that investors hoping to directly harvest emerging market returns, should continue to employ capacity constrained, dedicated emerging market managers that seek the most under-researched companies deriving a sizeable proportion of their earnings from smaller emerging, and even frontier market, countries and sectors. **FS**



The quote

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