Not all global emerging markets ARE PRECIOUS

Written by: Joseph Fekete, Clearway Capital Solutions managing director

Clearway Capital Solutions' Joseph Fekete looks at how institutional investors are approaching the way they benchmark their global emerging market equities portfolio.

Although benchmarks are necessary for performance measurement purposes, institutional investors question whether they are always the most effective risk-management tool. In certain asset sectors, some investors are only using benchmarks for historical comparison purposes and are appointing managers who disregard them entirely in managing portfolios.

Active and enhanced managers deviate from benchmarks on the basis that market inefficiencies create potential to generate alpha. Some perceive that potential may be generated as a result of inefficiencies or biases in the market benchmarks themselves. Strategies predicated on the latter view have been variously described as alternative beta, beta-prime and better beta.

Other managers espouse a benchmark-unaware approach. Such managers opine that not only are benchmarks biased, but the concept itself is flawed, at least in certain markets, and therefore they should be ignored. They still reference market benchmarks for reporting purposes but they confidently anticipate outperforming these benchmarks over the long term. These managers tend to consider risk in an absolute, rather than a relative, sense.

Some investors believe such an approach may be rather more relevant in markets where, among other things, the chances of holding securities that ultimately become valueless are much higher, the incidence of extreme events is higher, the divergence in performance among sub-sectors may be pronounced, there may be difficulty exiting illiquid positions, or there is a lack of appropriate hedging instruments to defray some of the marked macro risks. In a volatile environment investors may be more comfortable holding absolute rather than benchmark-relative risk positions.

Global emerging market (GEM) equities are an obvious example. Many investors believe long-term risk-adjusted return expectations for GEMs now exceed those of the developed markets. Reflecting this, many institutional investors have adopted strategic allocations to these markets. Despite the positive outlook, investors finding themselves overweight in GEMs are tending to bring their positions back to a strategic weight. Investors who are close to their strategic weights seem comfortable holding those positions, while those who have not yet allocated are contemplating the best way to build a position in these markets (dollar-cost averaging is one approach being considered to mitigate risk in the current environment).

Institutional investors seem more cautious than concerned with the extent of the recent outperformance of emerging markets. However, they also recognise the push into these markets has been somewhat lacking in discrimination, with significant capital flowing via passive strategies such as retail-dominated exchange-traded funds. In the developed markets, greater depth and a preponderance of active managers mean large passive flows can be more readily absorbed. This is a rather more significant issue in GEM equities where the market is thinner and passive capital flows tend to push up prices across stocks, sectors, countries and regions irrespective of their relative attractiveness.

Given the size of the markets in which they invest, active GEM managers screen out many stocks using a number of criteria familiar to developed market managers. This provides the opportunity to find stocks with attractive fundamentals that are nowhere near as well researched as their developed market counterparts. More so than developed markets, however, GEMs are influenced by macro-economic

and political considerations. Their economies may be less diversified than their developed market counterparts (possibly driven by commodity prices and/or an overly insular focus), investment flows may be relatively large compared to their market capitalisations, and their economic systems may be more reliant on state influence or patronage than market forces.

Therefore, it is important active managers consider not only the fundamental attractiveness, or otherwise, of specific stocks but also macro-economic and political factors. Passive managers, and active managers operating within tight constraints, are limited in terms of the extent to which their portfolios are able to incorporate stock-specific and macro themes. However, benchmark-agnostic managers adopt a more concentrated and conviction-driven approach and can avoid altogether stocks, sectors, countries, regions and even themes they might otherwise be required to have some exposure to.

Nonetheless, investors can be reluctant to go too far out on a limb and appreciate that managers don't always get it right. Given the potential for divergence across the GEMs, some institutional investors have adopted a modified core and satellite approach to them. They have chosen conviction-driven, benchmark-agnostic managers for a significant proportion of their exposure, but have also allocated to more broadly diversified approaches, thus ensuring they have some exposure to each of the countries, sectors and stocks comprising their benchmark. ❇

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