Emerging Markets Allocations – January 2019

The vibrancy and high growth rates of emerging market economies are often alluring for investors looking to add incremental growth and exotica to their portfolios. The high under-lying growth rates, huge population base and a perception that less transparency and analyst attention suggest that these markets are less efficient was the start-point for many fund pitches.

There have been two broad approaches for adding emerging market exposure to segregated portfolios:

i) indirect exposure, by investing in well-run western companies with significant emerging market businesses; or
ii) direct exposure, through ownership of companies based and operating within one or more emerging economies.

Our portfolios have historically had a mix of the two, with the bias being toward the first approach. Our portfolio manager is dedicated to a detailed, bottom-up analysis of each company that it evaluates. This approach is often more challenging when it comes to emerging market issuers, in part because of less access to management, frequently the lower quality of financial information, the reticence of EM management teams (that were not used to that sort of due diligence process), and frankly, less confidence in the quality of corporate governance.

However, the balance has been shifting towards direct exposure over the past decade, as these issues are addressed by more and more management teams in the emerging markets. Client portfolios now have direct exposure to emerging markets at, or slightly above, the MSCI ACWI allocation.

However, and as you are no doubt aware, these elevated growth rates enjoyed by emerging economies have not always translated into elevated total returns for minority investors in emerging markets companies. EMs have had periods of exceptional performance and then periods of under-performance, such as we witnessed in 2018. In addition, volatility has historically been considerably higher than in developed markets, producing unenviable Sharpe ratios (although Bloomberg Markets pointed out last week that short-term volatility in developed markets was currently above that in emerging markets, a very rare event.)

So what changes, other than greater comfort with due diligence processes, give us more comfort with direct EM exposure than was the case historically?

Emerging economies now represent almost two-thirds of total global GDP, while their stock markets represent approximately one-third of global market capitalisation. Key global indices have an even lower allocation to EM, at around 10%. As more China-listed companies are included in indices over the next few years, that figure will rise, but it will still remarkably understate the importance of those economies to global growth.

While emerging economies typically exhibited higher growth rates, their economies were not as large and influential to total global growth as were the developed economies. However, whether it's China, India, southeast Asia or EM as a whole, their absolute scale has become very important, not just their relative growth.

A recent paper from the Brookings Institute estimated that over 90% of the increased spending power of the <u>global</u> middle class will come from China, India and other Asian emerging countries by 2022. In other words, the impact that these economies have on global growth is now impossible to ignore.

Second, the composition of what drives emerging economies is evolving. In boom periods of the past, growth was led by low-cost, export-driven manufacturing, domestic property development typically fueled by cross-border capital flows and resource extraction industries. This led to considerable volatility in EM returns during a business cycle.

However, the less volatile and often domestically-oriented sectors such as healthcare, consumer staples and consumer discretionary sectors are becoming more relevant. In most Asian EMs, the technology sector, *albeit* still export-oriented, is now much more important – *although whether the chip makers and components suppliers have managed to* *reduce cyclicality is currently on trial*. The MSCI EM index now comprises over 40% of technology and consumer sectors.

Third, research focused on the increasing integration of ESG issues (environmental, social and corporate governance) into company analysis and investment decisions has highlighted that this approach is particularly helpful in evaluating risks in the emerging markets. Assuming this is true, and we believe that it is, then the detailed, bottom-up style of investment research (as opposed to the use of passive products) should enhance returns over time, relative to the same impact with respect to developed markets.

Finally, from a relative value perspective, EM currently looks very attractive. While the relative value between EM and DM is somewhat cyclical, the end-of-2018 MSCI EM relative to the MSCI World (normalized to early 2008) is extreme, historically.

As 2019 market outlooks were distributed in the first two weeks of January, it is clear that emerging markets are again very much in the conversation. The large sell-side houses seem about equally divided on the attractiveness of the asset class, informed in large part by their outlook for global growth, the likely strength / weakness of the USD and the likelihood of two or more Fed rate increases during the year.

We do not market or promote any fund products, but if you are interested in more information on how our client exposure to emerging markets is expressed within their segregated accounts, please contact us.

Contact Us:

ChapmanCraig Limited

2507 Tower Two, Lippo Center, 89 Queensway Road, Hong Kong

www.ChapmanCraig.com T: 852 2521 7218 E: Douglas@ChapmanCraig.com