

SPECIAL
REPORT:
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MARKETS

The Emerging Catch-up Game

EMERGING MARKETS HAVE GONE FROM NICHE TO MAINSTREAM, BUT MOST INVESTORS' EXPOSURE STILL LAGS THE NEW WORLD ECONOMIC ORDER.

By Julie Segal

ILLUSTRATION BY LARA TOMLIN



JEROME BOOTH, HEAD OF RESEARCH at \$33 billion-in-assets Ashmore Investment Management in London, was having lunch in Munich last month with a large German institutional investor who was crowing about changes he had made to his

portfolio. After years of hearing Booth preach about the need to dramatically increase exposure to emerging-markets economies, the investor excitedly announced that he had shifted his conservative stance and doubled his allocation — to 10 percent. Unimpressed, Booth deadpanned, “So you’re still comfortable with 90 percent in the crash zone?”

Many institutional investors are fundamentally rethinking their approach to emerging markets. Attracted by the powerful growth of economies in countries such as China, India and Brazil, investors have been putting more of their money in these markets. The debacle in Greece, concerns about the future of the euro and worries about debt levels in developed countries are providing more reasons for investors to shift their weightings. Fund managers increasingly regard emerging markets as a core part of their portfolios rather than a high-risk sector that they can flit into and out of tactically in an effort to boost yield, says Allan Conway, head of emerging-markets equities at Schroder Investment Management. The London-based fund manager has \$24 billion of its \$255 billion in assets in emerging markets.

GE Asset Management’s Ralph Layman (clockwise from left), PIMCO’s Ramin Toloui and Schroders’ Allan Conway are leading the charge into emerging markets

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As part of this shift, many investors are setting their own allocation targets for emerging markets and using specialist managers with extensive footprints in these regions to build up positions, instead of leaving the job in the hands of generalist global managers. Larger institutions are expanding their direct presence in emerging markets while others are using exchange-traded funds as a low-cost means of increasing their exposure. Investors are diversifying within the emerging-markets space, moving beyond basic equities to put their money in fixed-income securities, private equity and infrastructure investments. And they're moving further afield into frontier markets in places like Africa, seeking higher returns. According to a survey of large, mostly U.S. institutional investors published by Bank of America Merrill Lynch late last year, emerging-markets equities are the most desirable asset class, with 42 percent of respondents planning to add to their positions over the next 12 months. By contrast, 39 percent said they were planning to reduce their exposure to large-cap U.S. equities during the same period.

Yet for all of the recent changes, most U.S. and European investors are still woefully underweight in their emerging-markets holdings. "People understand the emerging markets are a big opportunity," says Richard Titherington, CIO and head of the emerging-markets equity team at \$1.2 trillion-in-assets JPMorgan Asset Management in London. "But the average pension fund thinks it is overweight at 5 percent. They need to dramatically rethink that and go to 20 percent." According to the BofA Merrill Lynch survey, U.S. institutional investors' allocations to emerging-markets equities range from 2 to 15 percent and average between 3 and 5 percent. The \$50.1 billion Virginia Retirement System has a weighting of 5 percent, the \$22.9 billion Connecticut Retirement Plans and Trust Funds has 4 percent, and Boeing Co.'s \$71 billion defined benefit plan has 2 percent.

Emerging markets constitute 13 percent of the MSCI all country world index, so by that measure, most Western institutional investors are indeed underweight. But some analysts regard the MSCI weighting as excessively low. The index firm bases its weightings on the free float of shares in a given market; many emerging-markets companies have only a modest percentage of their shares in public hands, with the bulk still held by controlling families or governments. "Why should the somewhat arbitrary and fairly static rules of an index provider define useful investment allocations?" asks Ashmore's Booth. He contends that investors should have a 50 percent exposure, which equals the emerging markets' share of global economic output based on purchasing-power parity. "That's if they're neutral, not bullish," he says.

Julian Thompson, an emerging-markets specialist at \$97 billion Threadneedle Asset Management in London, says the developed world's underfunded pension plans, trying to operate in countries with aging populations, need to take advantage of the growth that young people with rising incomes in the emerging world will provide.

Anyone who had a big position in emerging-markets stocks should have enjoyed strong performance in recent years. The MSCI emerging

markets index produced annualized returns of 7.61 percent over the ten years through June 1, compared with an annual average return of -1.26 percent for the Standard & Poor's 500 index over the same period. Some individual markets produced spectacular returns. Among the so-called BRIC countries, for instance, the Shanghai Stock Exchange composite index rose 133 percent from 2000 through 2009, the Bombay Stock Exchange's Sensex index advanced 249 percent, São Paulo's Bovespa gained 301 percent, and Moscow's RTS index surged 863 percent. Even in more-recent periods, when developed markets have bounced back strongly, most emerging markets have done even better. The MSCI emerging markets index returned 53.91 percent in the 12 months ended April 30, compared with a 38.84 percent return for the S&P 500.

Can emerging markets continue to outperform? Although some investors worry about the risk of a setback after such gains, current valuations are not excessive. The emerging-markets segment of the MSCI all country world index was trading last month on a 12-month forward earnings multiple of about 11.2, slightly above that segment's ten-year average of 10.9. By comparison, MSCI's developed markets were trading at an earnings multiple of 12.9, below their ten-year average of 16. "Emerging markets are not worryingly expensive or bubbly, but they are closer to fair value," says Kevin Gardiner, head of investment strategy for Europe, the Middle East and Africa at \$241 billion-in-assets Barclays Wealth in London.

One of the more aggressive emerging-markets investors is Ralph Layman, CIO of public equities at GE Asset Management, a Stamford, Connecticut-based outfit that manages \$120 billion in assets for General Electric Co.'s pension fund, GE-affiliated insurance companies and third parties. Layman began looking at the sector in the 1980s, when he was a portfolio manager at

Templeton, Galbraith & Hansberger and Sir John Templeton and Thomas Hansberger asked him to research the feasibility of investing in emerging markets. (Templeton ended up hiring Mark Mobius in 1987 to manage one of the first emerging-markets funds.)

Indexes such as MSCI's may reflect the current share of the global equity market that publicly available emerging-markets stocks represent, but Layman contends that they almost certainly understate the share that these markets will have in the future. It's that future weighting that investors should anticipate, he explains, using a hockey metaphor. "Like Wayne Gretzky said, 'You skate to where the puck is going, not where it's been.' It's the same concept with the index," he says.

Layman is doing just that with the \$43 billion General Electric Pension Trust. The pension fund's combined allocation to China and India is roughly halfway between the countries' 25 percent weighting in the MSCI emerging markets index and their 68 percent weighting in a customized model designed by Layman that includes shares held by governments and local shares, such as Chinese A shares, that are not available to most foreign investors. GE is also in the process of eliminating the pension fund's home-country bias by shifting toward an equal weighting of U.S.



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— Ralph Layman
GE Asset Management



and non-U.S. equities in its portfolio. “Our thought process on asset allocation is fairly unique,” Layman says. “In presenting it to some peer groups, there was a high degree of skepticism.”

GE is also building up its staff in emerging markets to better identify the local companies that will benefit from the growth of domestic consumption in these economies. The firm has recently taken on new investment professionals in Shanghai and Singapore, is opening an office in Brazil and is considering opening one in India. “We see the developed world as needing to save more and consume less,” Layman says. “It’s the opposite in the emerging markets. As consumers start to consume more, whether in health care, education or retail, regional and localized services will be great growth vehicles.”

Goldman Sachs Asset Management is pursuing a similar strategy. The firm, which manages \$840 billion, has tripled the number of investment professionals it has in emerging markets, to 30, and has opened offices in Brazil, China and India. In the next 20 years, Goldman believes, some 2 billion people in the emerging markets will cross the income threshold of \$5,000 a year, the point at which people begin to buy discretionary consumer goods such as mobile phones. “Even if it ends up being half that at 1 billion people, the impact is enormous,” says Donald Gervais, global head of fundamental equity product management at GSAM in New York.

The Universities Superannuation Scheme, which manages £29.9 billion (\$43.4 billion) in pension fund money for U.K. university employees, has added three emerging-markets specialists to its team and aims to raise its allocation to emerging markets to 7.5 percent from 5 percent by the end of this year, with emerging-markets equities reaching 12 percent of the fund’s overall equity position. Previously, USS put roughly half of its equity holdings in the U.K. and invested in emerging-markets equities only on a capitalization-weighted basis as part of its non-U.K. regional mandates.

“Now we can independently weight emerging markets on a strategic basis,” says chief investment officer Roger Gray. “The old architecture for creating EM exposure was creating too little, and it was not comprehensive.” Already, Gray is making changes based on his view of individual markets. USS is overweight in Asia — India in particular — because of the strength of the economic recovery and trade links with developed markets. The fund is underweight in Brazil because it regards valuations there as lofty and believes volatility is likely to increase ahead of October’s presidential election.

For some investors, the increased focus on emerging markets is leading to greater diversification rather than just a ramping up of equity holdings. That’s the case with the University of Michigan’s \$7 billion endowment, the seventh-largest such fund in the U.S. CIO Erik Lundberg asserts that most investors’ focus on listed equities explains the sharp run-up in emerging-markets stocks since early 2009, but says that move may have gotten ahead of reality. “Emerging markets have better growth prospects, but that growth doesn’t always translate to the bottom line,” he says.

Lundberg has increased Michigan’s investments in long-short equity, real estate and venture capital within the endowment’s 12 percent emerging-markets allocation. Twenty percent of Michigan’s venture capital investments are in emerging markets, as are 15 percent of its private equity positions and 10 percent of its real estate holdings.

GLG Partners, a \$24 billion London-based hedge fund, tries to get some of its emerging-markets exposure through Western companies that are geared to growth in those markets. Daniel Geber, portfolio manager of GLG’s international small-cap and midcap strategies,

says that Western luxury companies are benefiting from robust demand among wealthy Chinese for established luxury brands. “Local players can’t yet replicate the cachet of a Swiss-made watch,” says Geber.

Although many larger investors have been building up their in-house expertise on emerging markets, that isn’t a practical option for most smaller managers. For them, and for many big outfits as well, a growing number of passive investment options can do the trick. Northern Trust Global Investments, with \$647 billion in assets, started offering broad emerging-markets index strategies in 2005. Over the 12 months ended March 31, assets in these indexes have grown by more than 90 percent, not including returns, to just more than \$10 billion. Northern Trust has also been offering more-targeted indexes in the emerging-markets space. The company introduced a small-cap emerging-markets index in December 2008, and it plans to offer a frontier markets index fund. Gregory Behar, a senior investment strategist on Northern Trust’s global quantitative management team in Chicago, says 25 percent of new investments in emerging markets were indexed as of October 2009, up from just 10 percent in January 2007. “Investors are using low-cost beta products to get to the proper allocation, and they are finding active managers to add a bit of alpha,” he says.

Exchange-traded funds are also attracting a significant share of the emerging-markets flows. Gregory Ho, president of \$2 billion Spring Mountain Capital in New York, sees ETFs as the most efficient way to navigate emerging markets, which are highly sensitive to macroeconomic, geopolitical and technical factors. “We asked active managers in 2008 why they didn’t pare their exposure if they saw where the world was headed,” Ho says. “They felt they didn’t have the capability to anticipate macro factors. They were stock pickers.”

Fixed-income markets are another fast-growing area of diversification. For many institutions, modern emerging-markets investing started with the introduction of Brady bonds to alleviate the Latin American debt crisis in the late 1980s and early 1990s, but such opportunities have waned in recent years as many developing countries have slashed their debts and investors have focused on equities. U.S. pension funds have an average of only 2 percent of their holdings in emerging-markets bonds, for example. With the developed world now quaking under boatloads of debt, however, the low level of leverage in emerging markets is making many fund managers salivate at bond prospects there. Flows into emerging-markets bond funds hit a record \$31 billion this year as of last month, according to JPMorgan Chase & Co. With net issuance of emerging-markets sovereign bonds just \$13 billion so far this year, the flow of money has pushed down yields. In April, Russia issued \$2 billion of five-year notes priced to yield a narrow spread of 125 basis points over U.S. Treasuries and \$3.5 billion of ten-year notes at a spread of 135 basis points.

“In domestic portfolios, everyone recognizes that you should have a mix of bonds and equities,” says Ramin Toloui, an emerging-markets portfolio manager at Pacific Investment Management Co. in Newport Beach, California. “A similar logic should be applied to emerging-markets portfolios.” PIMCO expects equities to underperform in coming years and emerging-markets currencies and bonds to continue to gain. “In this context, a broad 50-50 split between EM equities and EM fixed income is a more appropriate balance for many portfolios,” says Toloui.

PIMCO contends that most fixed-income indexes, just like equity indexes, have a bias toward developed countries. “The industrial-

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ized countries have more debt relative to GDP, so if an index is market-cap-weighted, you'll be investing in countries with lots of debt," Toloui notes. To counter that feature, PIMCO last year introduced the Global Advantage Bond Index, which bases a country's weighting on its GDP. The index gives a 30 percent weighting to emerging-markets debt, compared with just 4.5 percent for the Barclays global aggregate index. "It's a big change in thinking about one's bond allocation," Toloui says. PIMCO had attracted more than \$2 billion in funds tied to the new index as of March.

Cristina Panait, senior emerging-markets debt strategist at Payden & Rygel in Los Angeles, says stronger fundamentals are feeding the interest in emerging-markets debt. In 1993 less than 10 percent of emerging-markets debt was rated investment-grade. Today the figure is 50 percent.

IF EMERGING MARKETS HAVE BE-come mainstream for many investors, then frontier markets—countries at an early stage of development—are the new emerging markets. As Schroders' Conway puts it, they are "preemerging." He adds, "Now that investors are becoming increasingly comfortable with emerging markets, the appetite is to be a bit more adventurous." In September 2007, Schroders launched a Middle East fund, which currently has \$300 million. The firm plans to introduce a frontier markets fund in the near future. Schroders is focusing its expansion effort on Abu Dhabi, Egypt, Kazakhstan, Kuwait, Qatar, Saudi Arabia and Vietnam. There are challenges to growing in these areas, Conway acknowledges. Most of the frontier markets have poor liquidity because of a lack of well-developed exchanges and well-capitalized intermediaries. That makes it difficult to put large amounts of money to work and to sell positions.

USS's Gray says the pension plan's expanding emerging-markets allocation includes a long-term commitment to investments in Africa and the Middle East. USS has

built a position in Saudi Arabia, focusing on holdings in mobile telephony, food companies and banks, because it expects that the country's young population will drive the growth of a consumer market.

Frontier markets have been largely untouched by the flow of ETF money into the emerging markets, leaving valuations much lower and the upside much greater, says William Browder, founder and CEO of London-based Hermitage Capital Management. Browder rose to prominence as the biggest foreign investor in Russia a decade ago, but since he was denied reentry to Russia in 2005, he has increasingly focused Hermitage's investments on frontier markets, where he currently invests 20 percent of the fund's \$800 million in assets. "The biggest stocks in the emerging markets received the lion's share of ETF money in an undifferentiated way," Browder says. "One wants to buy the stocks and the countries that other people had ignored." Browder recently made investments in Nigerian banks that

insurance policies in the oil and gas and aviation industries be placed with local insurers.

Development Partners International, a London-based firm that advises a €270 million (\$332 million) private equity fund that focuses on Africa, favors investments that stand to benefit from a growing middle class, says CEO Runa Alam. DPI recently invested in a payroll deduction company, Letshego Holdings, that loans money to employees of large companies and government entities. The company is growing 25 to 40 percent a year and faces few competitors because banks in the region prefer not to lend to lower-income people.

Interest in emerging markets appears set to intensify, from the nascent economies of Africa to the fast-industrializing countries of Asia. The road may be bumpy, though, and investors need to remain alert to risks. Many emerging equity markets fell sharply in recent weeks, reflecting fears of a wider economic fallout from the European sovereign debt crisis. "Our markets can still be

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—Kevin Gardiner, Barclays Wealth

were selling at 4 times earnings and 50 percent of book value. At the top of the market in 2007, he says, those same banks were trading at 4 times book value.

Hurley Doddy, co-CEO of Emerging Capital Partners in Washington, whose private equity funds have a ten-year track record of making more than 50 investments in Africa, says the firm sees opportunities now in telecommunications, financial services and commodities. ECP has an investment in Nigeria's Continental Reinsurance. The firm regards insurance as an attractive sector because Nigerian businesses are underinsured and the country requires that at least 30 percent of

whipsawed by the flow coming from the developed investor markets," says Ray Jovanovich, Asia chief investment officer at Amundi, a newly created asset management partnership between Crédit Agricole and Société Générale that manages \$845 billion.

Peter Adamson, former CIO of the Eli and Edythe Broad Foundation who this month will begin managing the money of talk-show host and producer Oprah Winfrey, was keeping 50 percent of the foundation's global equity portfolio in emerging markets but staying in liquid securities to be able to make quick portfolio changes. Adamson's view: "We want to stay close to the exits." ●●

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