With strong economic growth, emerging market equities were supposed to be a one-way ticket up. But it’s not a short flight.

By Craig Sebastiano
It’s been a rough few years for emerging markets. While developed market indexes have mainly been on the rise during that time, emerging market indexes have declined.

Take 2013 as a prime example. The Nikkei jumped more than 50%, the S&P 500 posted a 30% gain, and even the S&P/TSX Composite Index rose nearly 10%. Meanwhile, markets in Brazil, China and Russia all declined.

Emerging markets are viewed as a growth story because those countries’ economies are growing faster than more developed economies. The International Monetary Fund (IMF) predicts that emerging market economies—such as China and Mexico—will grow, on average, by 5.1% this year compared with an average of 2.2% for advanced economies, such as Canada, the U.S. and Germany.

“I think the long-term case is quite compelling in terms of growth prospects in emerging markets and growth, for example, of middle-class consumers in those countries,” says David Zanutto, an investment consultant with Mercer Investment Consulting.

Business-class Seats

The growth of the middle class is often cited as the reason why emerging markets are so attractive. EY (formerly Ernst & Young) notes that there were more than 1.8 billion people in the middle class worldwide just five years ago. By 2030, this number is expected to jump to nearly 4.9 billion.

The majority of that growth will be in the Asia-Pacific region, where the middle-class population is forecast to increase sixfold. While the growth in Central and South America, Africa and the Middle East won’t be as large, it will still more than double. In Europe and North America, the middle-class population will stay about the same.

“We’ve never seen in the history of the world what we’re going through now, with a large part of the global population with the potential to move, or actually moving, into a greater consumerism,” says Brian Drainville, an institutional portfolio manager with Pyramis Global Advisors. “That has been, and remains, the main underpinning of the emerging market story.”

There are 21 countries that make up the MSCI Emerging Markets Index, which represents 11% of the world’s stock market capitalization—up from less than 1% in 1988. “It’s really a significant part of global markets,” explains Karen Umland, a senior portfolio manager with Dimensional Fund Advisors. “For clients, there is an opportunity for diversification to go into emerging markets.”

Although adding exposure to emerging markets helps to diversify a plan sponsor’s portfolio, it hasn’t done this so well lately. However, that could change due to valuation. The Institute of International Finance notes that overall emerging markets equity valuation has declined to a low level. The forward price-earnings (PE) ratio is about nine—below the long-term average of about 11 and much lower than developed markets, which have a forward PE ratio of 15.

Top 10 Emerging Markets Managers

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<tr>
<th>Company</th>
<th>2013 CPA</th>
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<tr>
<td>1</td>
<td>J.P. Morgan Asset Management (Canada)</td>
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<tr>
<td>2</td>
<td>Aberdeen Asset Management PLC</td>
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<tr>
<td>3</td>
<td>UBS Global Asset Management (Canada) Inc.</td>
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<td>4</td>
<td>Vontobel Asset Management, Inc.</td>
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<td>5</td>
<td>Baillie Gifford Overseas Ltd.</td>
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<td>Wellington Management Company, LLP</td>
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<td>8</td>
<td>BNY/Mellon Asset Management Ltd.</td>
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<td>9</td>
<td>Lazard Asset Management LLC</td>
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<td>10</td>
<td>Investec Asset Management Ltd.</td>
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Top 10 Total: $10,447.0

Notes: Figures in this report are based on responses provided by the survey participants. Benefits Canada assumes no responsibility for the accuracy of the data provided. All totals are subject to a +/- variance due to rounding.

Source: Based on Canadian pension assets allocated to emerging market investments per the Canadian Institutional Investment Network’s fall 2013 money manager survey.
Fasten Your Seatbelts

While there are many positive aspects to investing in this space, there are also negative ones, such as volatility. An example occurred recently, when Russian troops marched into the Ukraine’s Crimean peninsula. That sent Russia’s MICEX index down nearly 11% in a day and had a negative effect on other emerging markets, too.

Plan sponsors need to be aware of these risks. “If they’re the type of plan sponsor that can’t live with a reasonable amount of volatility and can't live with a longer-term investment horizon, this is not the asset class for them,” says James Donald, head of the emerging markets group with Lazard Asset Management. “It actually is the perfect asset class for them not to be in.” He adds that these types of investors often get in when the volatility has decreased and just before things get worse—which is often exactly the wrong time.

In the past, there have been a number of currency crises among different emerging markets currencies, such as the Asian Financial Crisis in 1997. And the worry hasn't waned over the years, says Zanutto. “Currency devaluation still remains a concern for investors.”

Also, not all countries respect contract rights or property rights, and there’s the risk of nationalization—when a government takes over private assets—in some countries, notes Janet Rabovsky, director of investment consulting services with Towers Watson. “Some of the developing countries have very good fiscal management policies, but not all do. There are so many things that can go wrong.”

Cross-check

There’s also the risk of country-specific investing. Economic growth doesn’t always translate into a rise in equities. Although most emerging markets economies are set to outperform most developed markets this year, not all will do so. For example, the IMF predicts that both the U.S. and U.K. economies will perform better than those of Russia and Brazil as a boom in commodities slows.
Targeted exposure to specific countries can result in an allocation that’s different from the overall market. For example, more than half of the MSCI Russia Index is weighted toward the energy sector, and two companies—Gazprom and Lukoil—make up approximately 37% of the index. On the other hand, South Korea is very tech-heavy. IT accounts for nearly two-fifths of the index, with Samsung making up about one-quarter of the total index. “So you have very different compositions in the makeup of the countries in the emerging market indices,” says Thomas Leventhorpe, a managing director and client portfolio manager with J.P. Morgan Asset Management.

Consultants and money managers tend to agree that emerging market investing should focus on specific equities and not countries. Some companies that have high capital expenditures and that aren’t shareholder friendly are best left alone, they recommend. Also, companies based in emerging markets that compete globally may lack pricing power and might not be able to deliver the growth investors expect.

“Emerging markets are like America in the 1950s,” says Peter Newell, managing director at Vontobel Asset Management. “What could you have invested in and held in your portfolio for 30 years and received a positive compounding effect on your portfolio? Coca-Cola, PepsiCo, Procter & Gamble, Wrigley, Anheuser-Busch, IBM, Nabisco and many other iconic brands. They never disappointed, and they never imploded, because the demand for their products grew as the demographics in America grew. That’s what we think is the dynamic of the emerging markets: companies that are domestically oriented and taking advantage of tremendous middle-class consumption.”

**Time to Board?**

While the economic outlook for emerging markets is mostly positive, there is still trepidation about investing in, or increasing the equity allocation to, that area. “Clearly, when the headlines have been as negative as they have been, people are much more wary about making investment decisions because they see a lot
of negativity,” Leventhorpe explains. “People are generally more willing to buy things when the news is very good and unwilling to buy things when the news is very bad.”

Drainville suggests that plan sponsors expand the money manager’s mandate to allow for investing in emerging markets. “Having a broad mandate allows you to sidestep the potential pitfalls you may have because of heavy dominance in certain countries.” This will also allow plan sponsors to get used to the different risk/return characteristics.

It takes a disciplined approach to invest in emerging markets, and plan sponsors should be aware that things can turn negatively very quickly. “An appropriate allocation that you can stick with over time, and that makes sense for the overall portfolio’s goals and risk profile, is important to consider,” says Umland.

Plan sponsors need to consider a number of aspects before investing—such as what their time horizon is, how much risk they want to take, whether they’ll expand their mandate or hire another money manager and how this fits into their overall investment strategy—and ensure that the pension committee and management discuss them before moving ahead.

“I think everyone buys into the fact that emerging markets should be able to provide great profitability,” Rabovsky explains. “But how are you going to do this? The question is simple, but I don’t think the answers are.”

Craig Sebastiano is associate editor of BenefitsCanada.com.
craig.sebastiano@rci.rogers.com

THE FINAL FRONTIER

Frontier markets are a subset of emerging markets. The frontier market countries usually have a much lower GDP per capita. For example, Brazil (an emerging market) had a GDP per capita of US$11,340 in 2012, while the GDP per capita of Ghana (a frontier market) was US$1,605. Compared to a developed country like Canada, both are quite small. GDP per capita here in 2012 was US$52,219.

“In general, frontier markets tend to be more rudimentary economies,” explains James Donald, head of the emerging markets group with Lazard. “Some of the more early-stage economies are frontier, whereas some of the more mature economies are emerging.”

Other differences include risk and a lack of liquidity, adds Peter Newell, managing director at Vontobel Asset Management. “When the negative volatility comes, it’ll be hard to sell these stocks.”