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Emerging Market Equities Whitepaper

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Welcome to CAMRADATA's Emerging Market Equities Whitepaper

Investors in Emerging Markets (EM) are unlikely to get another supercycle, but they could do with a boost. The first decade of this century was marked by euphoria for industrialisation by emerging economies and the commodity producers that enabled their great leap forward. Most of that trade took place in or between Asia and Latin America.

But the supercycle diminished and so did equity returns from these regions. An investor who swapped EM equities in 2011 for U.S. large caps would have handsomely outperformed over the two decades.

In the first years of the third decade, even China, the star of EM economies if not EM investing, has waned. The EM equity index has been reliant (mostly) on India to drag performance along.

Acknowledgment of the effects of COVID and subsequent inflation is in order. But there are still exogenous risks out there. The question for investors is how robust they feel EM companies are in an unsettled world. Is Taiwan's manufacturing base secure from Chinese invasion? Are Chinese real estate companies safe from stricter bank covenants? Which Indian stocks are not overpriced? Will Mexico remain free of Trumpist meddling?

Historically, EM equity managers have made the case that companies which can succeed in harsher domestic environments (Turkey has experienced inflation above 20% for years) are tough competitors on the global stage. Until these countries have pools of domestic savings as deep as Developed Markets, however, there remain worries about their cost of capital. Take a look at the close correlation between EM equity markets and the value of the dollar.

It might be nice to wish away that link as merely the prejudice of Developed Markets investors but perhaps it is actually a reflection of globalisation and the pre-eminent status of the US dollar.

This CAMRADATA Emerging Markets whitepaper will seek to discover how asset allocators and managers cope with these issues; what sort of diversification can help mitigate volatility caused by macro-economic factors; and where the much-needed boost to EM companies might present itself.

Meet the Team

Natasha Silva
Managing Director, Client Relations

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Sarah Northwood
Marketing and Events Coordinator

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Emerging Market Equities Roundtable

The CAMRADATA Emerging Market Equities Roundtable took place in at the end of 2024

The 2024 CAMRADATA Emerging Markets equities roundtable began with the likely effects of Donald Trump's return to the White House on trade and markets globally. Jorry Nøddekaer, portfolio manager of Polar Capital's Emerging Stars strategy, said that the stand-out fact from the first Trump regime was that Emerging Markets (EMs) equities outperformed the Russell 2000. "EMs had a decent growth environment until COVID. Trump talked down Mexico in 2016. Then in 2017 there was a big trade deal between the two nations and Mexico was arguably one of the best-performing EM in FX, debt and equities."

Nøddekaer said it would not be much of a surprise if in this term Trump cut a deal with China. But he added that there also clear negatives from the policies stated by Trump. One was the effect on supply-side sales given many of the announced policies during the campaign will contract the supply-side of the economy. The lack of clear visibility on policy is of course not helpful. "Stagflationary policies over the medium term bring less structural growth over the long term," warned Nøddekaer.

He said that championing small government was all well and good but the US's demographics and culture were against easy efficiency gains. Higher tariffs and blocks on immigration – even if smaller in practice than rhetoric - would be inflationary, which makes it harder for the Treasury to reduce interest rates. That means EM central banks in turn would be less likely to cut rates.

Nøddekaer contrasted the flexibility of labour in EM. "We see a lot of round-tripping, where semi-finished items from China goes to the likes of Hanoi, and then get exported to the rest of the world, including USA, with a "Made in Vietnam" banner. China is escaping tariffs but also redistributing the workload. We think it is highly likely that something like half the industrial estates in North Vietnam are used by Chinese

> ***"Emerging Markets are included in our global equities allocation and are part of our strategic weights reported to the regulator; thus we are more concerned with managing the active risk and generating excess return against the ACWI index."***

companies exploiting "Made in Vietnam" labels."

The CAMRADATA panel turned to the asset allocators and consultants to ask how they approach EM. Sonia Bluzmanis, head of research, external equities at Australia's Rest Super, which has in total over AUS$80bn assets under management, said that asset allocation is driven by CPI plus objectives while the active risk budgets are influenced by the regulator, which sets a performance benchmark using strategic weights and cap-weighted indices. To pass and maintain a licence, the Super funds must outperform a threshold below this benchmark.

"Emerging Markets are included in our global equities allocation and are part of our strategic weights reported to the regulator; thus we are more concerned with managing the active risk and generating excess return against the ACWI index," said Bluzmanis. "While we can take country risk, we prefer excess return to be driven by stock selection."

She added that Rest Super takes risk but is very deliberate where that risk is taken.

Danny Nilsson, manager – investments at pension fund consultancy, Isio asked whether Super funds can afford to take significant bets away from the index.

Bluzmanis replied that in general they had dialled back the risk. "There is less tolerance nowadays." Rest Super, however, appoints specialist active managers.

Oli Wayne, head of investment research at institutional investor consultancy, Redington, asked whether Rest Super was set up as core passive with some active or enhanced index satellites.

Bluzmanis replied that all those levers were used. "We have low-risk systematic and high-octane approaches and most global equity managers have ACWI benchmarks, while some are developed only," she said. "The inhouse team rebalances, however, depending on how underlying portfolios are faring and how comfortable they are with the composition of active risk."

Wayne said the approach was interesting given that the UK is moving towards the Australian (and Canadian) pension megafunds model. He queried the impact of the short-term performance benchmarking process on the quality of investment decision-making given the potential incentives to hug regulatory benchmarks and the path dependency introduced to the manager selection process.

Redington doesn't have fixed asset allocation weights but the equity model portfolio has been consistently overweight EM by 10-20% compared to the MSCI ACWI index. Wayne said that the rationale for that overweight has been a mixture of top-down and bottom-up views

EM has been very attractive from an active, bottom-up management perspective over the last six to seven years.

"We don't believe in passive EM," said Wayne. "We look for active fundamental and quantitative managers

targeting very specific market inefficiencies"

Nilsson pointed out, however, that trustees and clients look at asset class returns. "They say: 'We have been hearing about favourable demographics and growing GDP in EMs for the last 15-20 years. Why has the DM index outperformed?' Trustees are looking at level of returns."

Wayne agreed that EM beta has been a headwind. Redington's EM Equity composite comprising four active managers has generated +4.5% annualised excess returns over the last six years which has been a great outcome from an active management perspective. However, this hasn't made up for the underperformance of the EM beta at an asset allocation level.

He remained positive that looking forward, EM was still attractive: "We remain overweight EM compared to global market cap-weighted indices which have become increasingly concentrated towards DM," said Wayne.

Steve Sawyer, manager researcher at wealth manager, Capital Generation Partners, echoed Wayne's perspective that there is alpha available and findable in this asset class. According to Sawyer, as a selector, there is a route to picking good managers, but your clients must be able to tolerate medium term line-item underperformance to stay the course. "If you are willing to invest and look over long horizons, there is a cohort of EM managers that I have regularly invested with over my career which have all delivered meaningful net of fee alpha, but in nearly every case, they have experienced a difficult 3-5 year period." At Capital Generation Partners, we use passive and active allocations to express our investment views, but this does not mean we are necessarily targeting betas or are beholden to a Strategic Asset Allocation – many of our clients have inflation plus targets which mean that betas must earn a place in portfolios.

"We also have to be cognisant that whilst we have the benefit of stable, patient capital, liquidity needs can come at inopportune times and so the decision to be active or passive isn't always just about total return." In terms of underlying manager combinations, Sawyer suggested that there was a variety of valid approaches depending on risk appetite and the wider opportunity set for capital. "Capital Generation Partners is prepared to invest with managers with strong convictions and high alpha potential. One of invested managers began life as a long/short strategy and adapted this process to long-only. To this day, it is prepared to go to zero allocation in large constituent countries and we support this." Sawyer summarised that today Capital Generation has a full position in EM, although we are always seeking entry-points to add exposure.

At Isio, Nilsson said the team work off a Capital Markets Assumption framework covering c. 45 asset classes. Within the subsequent Strategic Asset Alloction (SAA), he said that EM equities sit pretty well from a risk-return perspective. That then gets built into an efficient frontier with volatility target constraints.

Nilsson said further that Isio had two blocks: Core EM or regional style beta. Because of the risk-reduction path of many of Isio's pension fund clients, the majority of EM exposure is obtained via Core global emerging market managers. "We have a slightly above benchmark exposure to EM, driven by asset allocation levels because SAA drives the majority of returns," he said.

Mark Udeh, manager researcher for Phoenix, the UK's largest manager of retirement savings, concurred that allocations are driven by the chosen SAA.

He noted that Phoenix was currently searching for an EM manager with more of a Core-type exposure, which could then be blended with a lesser element providing differentiated returns. The goal is to dampen cyclicality by diminishing any style bias.

"We are looking for a fundamental manager that can allocate across the full universe without a style bias."

"What do you mean by Core?" Wayne asked Udeh. "Outputs or inputs?"

Bluzmanis agreed that Core was a loosely defined term.

Udeh replied that Core was weighted towards Large Caps and neither Growth nor Value but the sweet spot in the middle. He said that Phoenix was not short-term in its thinking. "We benefit from having a closed book. We understand the cyclicality of the market. The manager should be rotational."

Nøddekaer sought clarification: "Does that mean moving into Growth and Value? What if they miss it?"

Take The A-Train

The CAMRADATA panel discussion then turned towards China. Wayne said that Redington thinks a lot about China A shares because the market has a relatively low correlation to other equity markets and most EM active managers do not take advantage of them. "Most tend to focus on US or Hong Kong

"Sawyer said that selectors have a role to educate clients on risks and a duty to champion weighting appropriate to their risk appetite. He said that if clients are seriously risk-averse, then an honest conversation is needed about the type of EM allocation that is right for them."

listings," he said, "but the A share market is very liquid, very deep and very inefficient. We pick systematic managers who capture shorter-term trends to accompany onshore fundamental managers with longer time horizons".

Nøddekaer said that the Polar Capital EM team is active in A-shares and Hong Kong. But right now he questioned the seeming consensus that China is very cheap, as many of the better companies in the A-share market still trade at very high multipliers. "We can for sure find some good companies with good management teams and business models," he said. "But even after a long period of underperformance in this market, one still has to look carefully at valuation levels."

Wayne did not agree on the valuation point but Aalok Sathe, quantitative analyst in Artemis' SmartGARP strategy team, did. He said: "In 2023 we were long China. Lots of managers were out of the A-shares market. There are some very good companies headquartered there and it was a larger proportion of our alpha contribution."

Wayne said that there were now "many good-quality companies that have got cheaper and cheaper, particularly in the mid-cap space."

He added, however, that many Redington clients are stuck on a more profound question: In the EM sphere, is China investable? The question has been triggered by memories of being forced to divest or leave assets in Russia following its invasion of Ukraine. What happens if China invades Taiwan?

Wayne admitted that the answer was difficult: "Were an investor to remove China from the EM equity index, you are left with a serious exposure to Taiwan, whose predicament is likely to have caused the divestment from China."

Polar Capital has an EM ex-China strategy. Nøddekaer said it was created for clients who did want to move their capital out of China.

Sathe said: "You can take exposure across different regions but it comes down to the construction of the portfolio. We had positions in Russia but because of diversification, the sanctions had very little effect on the portfolio. Our construction meant that the value of seven Russian names got written down to zero but we outperformed that year.

Participants at the CAMRADATA roundtable nevertheless agreed that China is a different magnitude to Russia in capital markets.

Sawyer said that selectors have a role to educate clients on risks and a duty to champion weighting appropriate to their risk appetite. He said that if clients are seriously risk-averse, then an honest conversation is needed about the type of EM allocation that is right for them.

Bluzmanis said that while it might seem like spending a disproportionate amount of time on China, the country it is "super important". In her opinion, a mandate exclusion of the highest emitter of green-house gases and the second most populous nation on Earth seemed very short-sighted and reactionary. "Things can turn quickly," she said. "We in the West don't always understand. We don't always know the answer. On the ground in China there are stories of positive change."

It's the economy, stupid

On the Communist Party (CCP), Nøddekaer said that Xi Jinping managed to get loyal people behind him. However, Nøddekaer reckoned that sentiment for the Party within the private sector was extremely low. "When we travel in China, key business leaders say

they are dissatisfied with Xi," he said. "We get indications that business leader groups and former political leaders want the economy in better shape."Nøddekaer reckoned that Foreign Direct Investment had gone to zero and key companies were moving overseas. "Youth unemployment is likely above 20%," he noted. "Every generation wants to grow more prosperous. But will 600m people rise into the middle class over the next ten years? I doubt it."

His sense was that Xi was realising the build-up of political pressure. Hence the recent mantras of 'no more regulation' and 'just hire some people'.

Finally, Nøddekaer noted that Taiwan is a very difficult topic for business people in China. "You cannot go against the CCP and its agenda," he said. "But the geo-political tension it creates is clearly costing on the bottom line."

Sathe said: "From our perspective, we are overweight China and underweight India. Right now 39% of our top-decile opportunities are in China. We see earnings revisions starting to matter in EM tech when trading on discount. There are deep valuation gaps but the numbers are strong from the likes of Asus. Leading indicators are bottoming out."

Sathe said with that kind of momentum, revisions are coming followed by reversion. He pointed to differences in the current three-month earnings revisions for MSCI China versus MSCI India.

"Fundamental losses are moving at the same rate," Sathe continued. You have 'growth darlings' like Colgate-Palmolive India failing to sustain multiples. It suffered a 40% downtrade last month."

On the Artemis quant model, said earnings revision had over 20 years been the strongest factor. Hence the double-weighting ascribed to earnings revisions over the other eight factors.

Sawyer asked if the strategy had a static or dynamic weighting system. Sathe replied that if you trade a dynamic system, that creates churn. You don't stabilise the system. "Our system is tested to see if thresholds are in place," he said. "Then you end up visiting interesting parts of the market as the model tilts based on dispersion."

He gave the example of mid-caps. "There were areas even in India last year where we found strong winners such as Indus Towers.

Closing fees

The CAMRADATA roundtable finished on the important issue of fees. Nilsson noted various fee constraints, such as on default funds in the UK's auto-enrolment pension market, meant "pretty sharp" deals.

The panel agreed that fee pressure was driving greater allocations to passive in DC.

"It's a discussion about the Core," said Wayne. "Everyone is looking for that strong and steady outperformance without drawdowns." But he described such a scenario as 'nirvana' that turns out to be a mirage after you are invested. "In order to invest in EM or any other market you must be able to tolerate periods of poor performance," he said. He queried why anyone would allocate to EM if they required a smooth ride.

"Rather than move to passive for EM, for clients with a low tolerance for relative risk, we think active systematic strategies with tightly controlled risk budgets are a great option. These approaches tend to be relatively low cost and typically have higher information ratios at lower levels of active risk," Wayne concluded.

Roundtable Participants

Aalok Sathe

Analyst, Artemis' SmartGARP equities team

Personal Profile

Aalok is a quantitative analyst in Artemis' SmartGARP equities team. He has a bachelor's degree in mathematics and a master's degree in management from University College London. From 2011, he worked as a quantitative analyst at Hinde Capital, developing and managing a number of factor-driven investment strategies.

Before joining Artemis, meanwhile, he worked as a quantitative analyst for Aviva Investors, where he helped to integrate ESG factors in their stock-screening process. Aalok joined Artemis in 2021.

Company Profile

Artemis is a leading UK-based fund manager, offering a range of active equity and fixed income strategies which invest in the UK, Europe, the US and globally.

Established in 1997, our expertise lies in security selection and conviction investing, implemented by experienced, focused investment teams with significant expertise in their chosen disciplines.

Jorry Nøddekær

Head of Emerging Markets & Asia team and Lead Fund Manager, Polar Capital Emerging Market Stars Fund

Personal Profile

Jorry joined Polar Capital in June 2018 to set up the Polar Capital emerging markets franchise. Prior to joining Polar Capital, Jorry worked at various firms including Nordea Investment Management, Danske Capital, F&C Investment Management, New Star Asset Management and BankInvest Asset Management. Jorry studied at Aarhus University in Denmark where he gained an MSc in economics and finance.

Company Profile

Polar Capital is a multi-boutique active manager. Since incorporation in 2001, the company has grown steadily and now has 14 autonomous investment teams. The business is structured to allow teams to focus on their portfolios while a best-in-class operational structure works on everything else.

Polar Capital offers a range of strategies that includes single country, regional and global mandates as well as thematic portfolios. The capacity of strategies is managed to enhance and protect performance. Polar Capital is listed on the UK stock market and has offices globally.

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Roundtable Participants

Steve Sawyer

Investment Research Director

Personal Profile

Steve is an Investment Research Director at Capital Generation Partners focusing on manager selection. He has 15 years of industry experience. Before joining CapGen in November 2023, Steve was Global Head of Public Equities, Manager Selection at BlackRock.

Prior to that, he was a Manager Selection analyst for a large UK pensions consultant, focusing on public equities and infrastructure.

Steve is a qualified actuary, holds CAIA level 1 and has a degree in Pure Mathematics from the University of Essex.

Daniel Nilsson

Senior Investment Research Analyst

Personal Profile

Daniel is a Senior Investment Research Analyst covering equities at Isio. He has over 8 years' experience across all asset classes, with a background in multi-asset portfolio management. Previously he was an Investment Research Analyst at Morningstar covering emerging markets, UK Income and global small cap strategies.

Mark Udeh, CFA

Manager Research Analyst

Personal Profile

Mark Udeh is a Manager Research Analyst, in the Phoenix Group Manager Research & Selection Team. He is responsible for new Fund Manager selection & performance monitoring across geographies covering both Private & Public Markets.

Mark joined Phoenix in June 2023 after spending 5 years at Mobius Life, working most recently as an Investment Solutions Analyst. Prior to joining Mobius, he was at Sumitomo Mitsui Trust Banking Group. Mark earned a BSc in Financial Economics from the University of Kent & he is a CFA Charterholder.

Oliver Wayne

Managing Director

Personal Profile

Oliver is responsible for Redington's research, selection and monitoring of public equity managers. He joined Redington in September 2016 from Willis Towers Watson where he led the firm's research on UK and European public equity managers.

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Roundtable Participants

Sonia Bluzmanis

Head of Research, External Equities

Personal Profile

Sonia is the Head of Research, External Equities at REST, based in London. Sonia joined REST from BT Investment Group in May 2021, initially to take on the role of Head of Global Equities, with responsibility for managing REST's 20Bil+ global equities asset class, the fund's largest asset class by funds under management. In 2022 Sonia relocated to London and was promoted to Head of Research, External Equities to lead the equity research program, providing advice on manager selection and construction, and market insights.

With over 17 years' experience in investment management, Sonia has held senior roles specialising in investment research, fund manager selection and portfolio construction in several major financial institutions. Sonia holds a Bachelor of Commerce and a Bachelor of Arts (Asian Studies), with majors in Finance, Economics and Chinese (Mandarin) from Curtin University in Western Australia and holds the Certified Investment Management Analyst (CIMA) designation.

Established in 1988, REST is among the largest superannuation funds in Australia by membership, with approximately 1.9 million members and almost AU$90 billion in assets under management.

Moderator

Brendan Maton

Freelance Journalist

Personal Profile

A highly experienced financial journalist with an expansive network of contacts in the UK and across Europe. Brendan has written about pension schemes and national welfare systems from Finland to Greece for 18 years and understands the retirement savings industry in each European country.

Brendan has interviewed EU commissioners and national ministers; central bankers; pension scheme heads; insurance chief executives; chief investment officers; actuaries; union officials; professional and lay trustees.He worked at Financial Times Business for eight years, finally as editor-in-chief of all international pensions titles.

Brendan has spent the last ten years as a freelancer for a number of publications, including Financial Times, Responsible Investor, Nordic region pensions news and IPE. He is also Chief webcast host for IPE.

Brendan has acted as conference chair for Financial News, the UK National Association of Pension Funds, Dutch Investment Professionals Association (VBA), Corestone, Insight Investment, Marcus Evans, Robeco Asset Management, Sustainable Asset Management (SAM), Towers Watson.

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