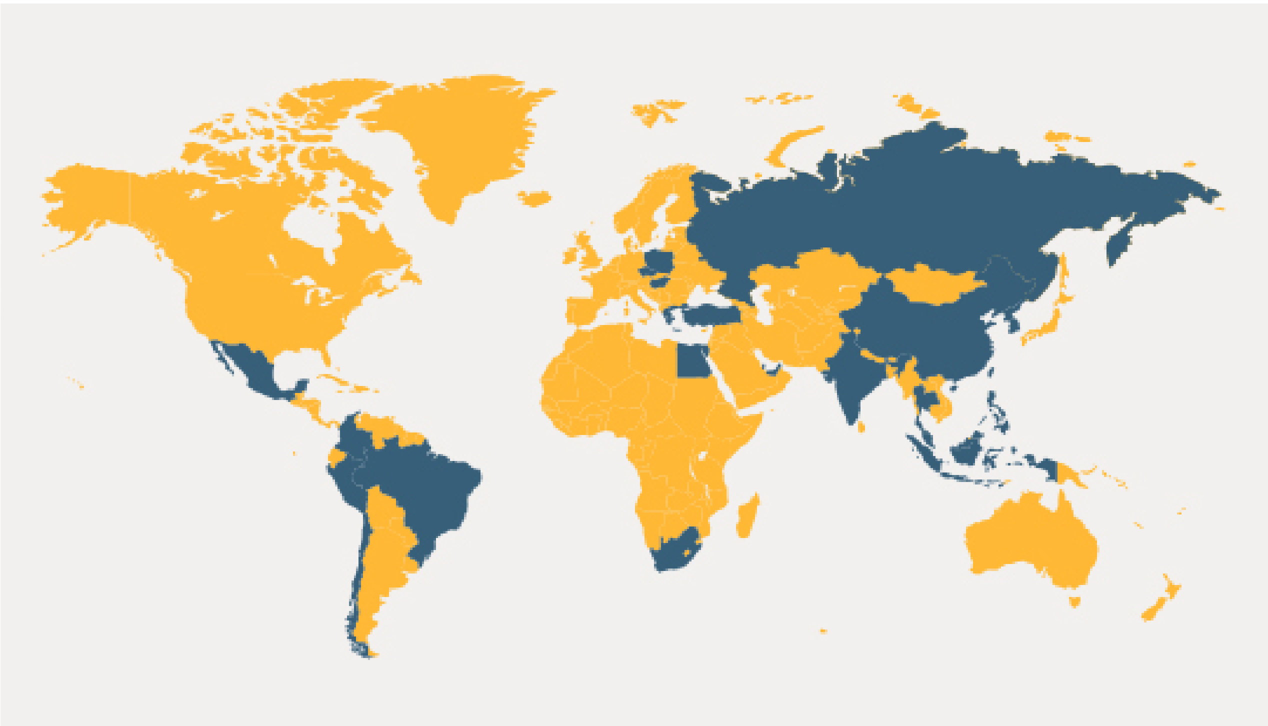
JAN 2022 | BOCCONI STUDENTS ASSET MANAGEMENT CLUB

EMERGING MARKETS OUTLOOK



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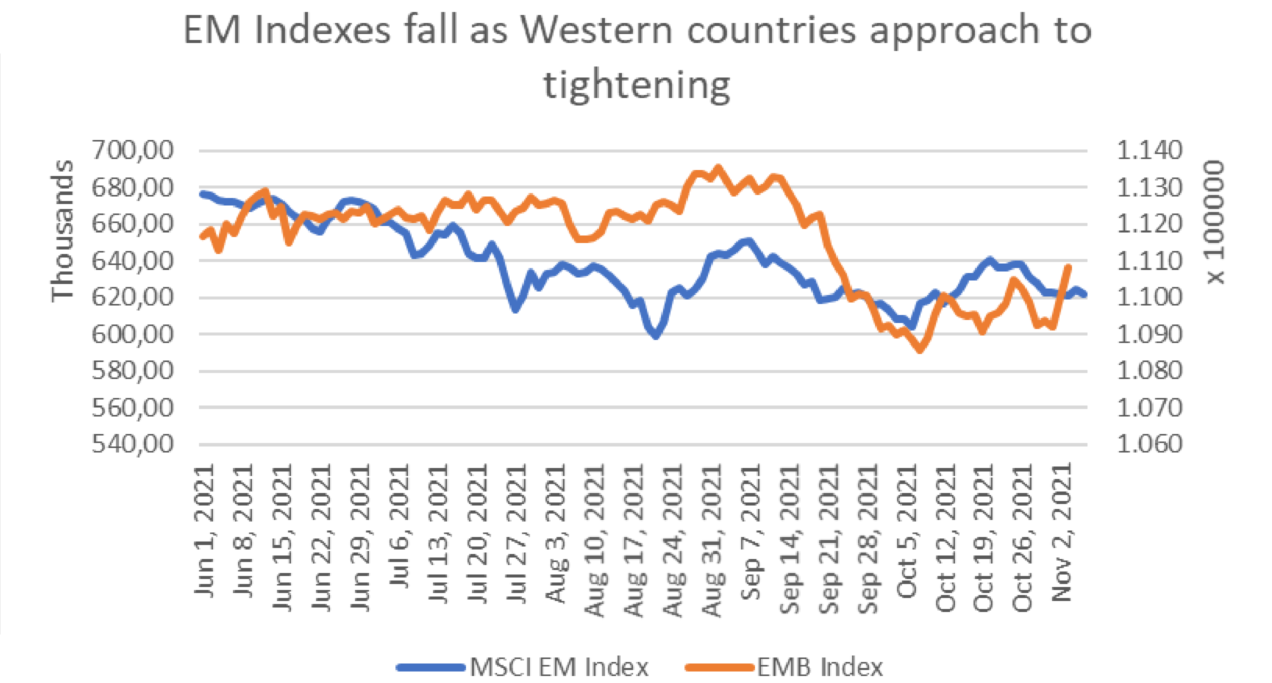
OVERVIEW

Emerging Market's countries often have rather unstable governments and economies which are, in addition, highly dependent on a few industries. Much of the volatility is due to the great relevance that volatile goods (food and energy prices) have on the consumer price index baskets. These countries frequently experience high levels of inflation, deflation, or currency devaluations and all this political, social, and economic instability contributes to bringing about volatility in financial markets.

Developing economies are subject to changes in developed market economies; in particular, they are exposed to their central banks' monetary policy decisions. Since the 2008 Financial Crisis, Western countries have enacted numerous expansive programs which released great amounts of liquidity into the economy. The lower interest rates in these countries divert investors to more profitable securities in EM causing an appreciation of the local currencies and, consequently, a contraction of exports, harming the economy. In response to this, EM central banks could follow the Western policies, but the resulting depreciation has often proved to create wider problems.

We may consider the current macro situation to better look at this issue. As a consequence of the pandemic, Western countries implemented economic stimuli, but, following the concerns on inflation, central banks are now heading towards tightening policies, which will likely weaken EM's currencies, possibly worsening inflation.



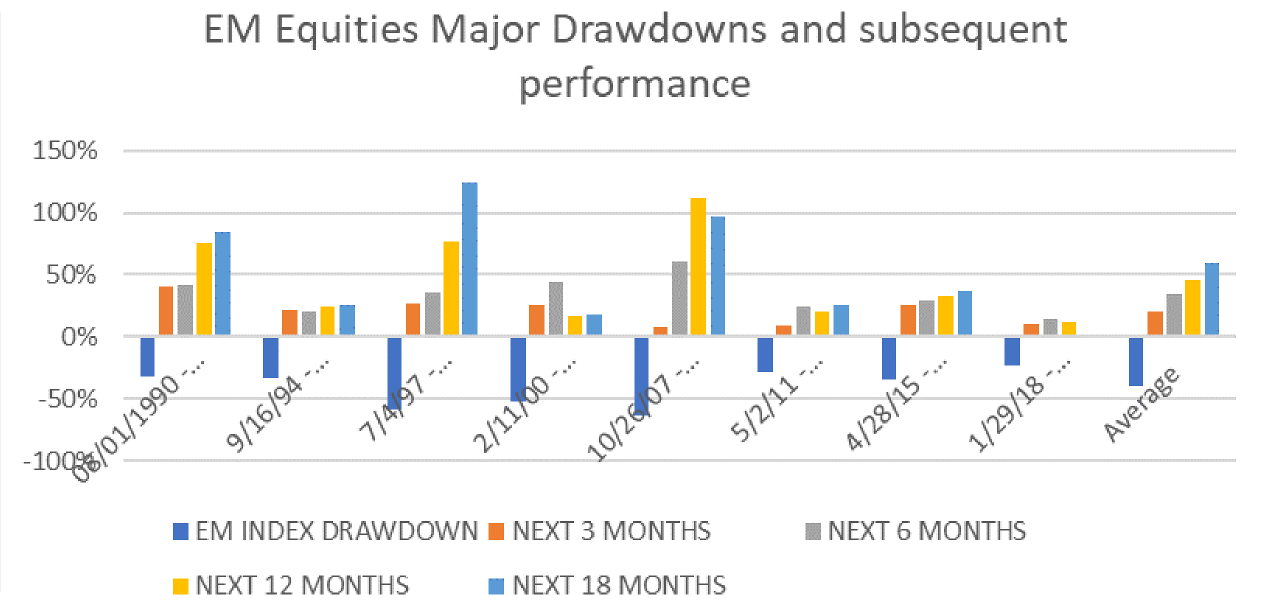
A correspondent tapering in EM could be devastating as the risk of stagflation approaches (only countries like Russia and Nigeria which benefit from energy inflation are able to keep up, but would suffer from a sudden downturn). Countries like Brazil, Hungary and Mexico are tightened in a harsh environment: their attempts to hike interest rates up are necessary not to lose control of inflation but, on the other hand, they constrain growth, which represents a major bedrock for many EM's asset classes - investors often expect EM to grow faster than developed ones and are therefore willing to accept the higher risk these entail. Therefore, the emerging markets' attractiveness is questioned. The graph below shows that investors have already been moving money away from EM.

Conversely, Turkey and South Africa have cut their rates, neglecting inflation, which might prove an even worse strategy. Ignoring tightening measures in developed economies could lead to a depreciation of EM's currencies - a drastic consequence of that is the increase in the value of foreign currency-denominated debt, with the possibility of defaults looming, a phenomenon that is common across developing economies. In this respect, Turkey faces accentuated risk since it has one of the highest FX debt exposures in the world (80.7% to GDP).

All these factors may impact the possibility of steady and consistent growth in these countries, contributing to even higher uncertainty and risk than what we see in developed ones. In the next section we are going to discuss some alternatives to approach this issue.

ADDRESSING VOLATILITY AND UNCERTAINTY IN EMERGING MARKETS

The historic performance of EM is characterized by several drawdowns, all followed by sharp and substantial rebounds. Therefore, it is key for asset managers to find ways to overcome volatility and exploit the opportunities that these markets offer.



An important approach may be the adoption of long-term stewardship: a form of shareholder activism where the investors engage with the company to encourage good corporate governance. The type of company most suitable for this purpose is the family-run business. The reason is that these owners care about the long-term perspective of their business and can steward the company through generations bringing long-term value.

The need for stewardship comes also as investors are increasingly giving importance to environmental, social and governance issues. According to a survey by Accenture Asset Management, 93% of asset managers said they were looking to upgrade their stewardship approach in the subsequent years.

Nonetheless, this strategy needs careful implementation, since it still has many barriers. Data standardization and global access to them are key points which this approach has to deal with. Also, cultural, social and language barriers are to be considered an obstacle along the path if the aim is to obtain integrated stewardship.

Let's now consider the strategy of WisdomTree Emerging Markets Ex-State-Owned Enterprises ETF (XSOE) which, as the name suggests, tracks the investment results of emerging market companies that are not state-owned. In particular, more than a third of its weight is allocated to Chinese stocks. According to the fund's managers, non-SOEs are inclined to maximize shareholder value instead of bending to government interest; they are more efficient, and, thanks to a strong governance, they are able to outperform in a dynamic competitive environment.

Actually, this year XSOE has underperformed the MSCI Emerging Market Index which represents large and mid-cap companies across 27 EM countries, but this trend is expected to be short-lived as it depends on regulatory concerns from China and the increase in commodity prices; typically, these periods have been sharply reversed.

Indeed, over the past three years, XSOE grew by 55.4% against 38.3% by the MSCI Emerging Markets Index. Additionally, over the same period, despite annualized volatilities of both indices being close to each other, XSOE's largest drop was 150 basis points less than that of the MSCI index. XSOE beating developing markets indexes happened quite regularly recently: in the last six years, XSOE beat the MSCI EM Index in four of them. Therefore, a more focused approach seems to pay off on account of its selective nature which enables it to perform better than an index does.

This leads us to consider another kind of strategy, still based on a long-term term and growth-oriented approach, where the successful selection of securities is fundamental. The Guardian Emerging Markets Equity Series I fund takes a concentrated approach focusing on only 25 stocks and holding them for about five years. The difference with the MSCI Emerging Markets Index is evident: the benchmark has about 1400 stocks. The fund, following its long-term strategy, focuses on sectors such as consumer discretionary and information technology.

Joris Nathanson, who oversees this fund, suggests that, in the past, investing in Emerging Markets has been driven by macroeconomic aspects and by the developments of specific countries. The consequence was strong trend cyclicality, resulting from huge investment in activities whose growth was sustained by economic cycles. Instead, Nathanson's fund looks at companies with sustainable growth through the cycle. This means focusing on quality companies that generate sustainable margins and significant cash flow. In this view, the companies to avoid are those with low margins, heavy on capital expenditures and less concerned about ESG.

The meticulous choice of the companies has its roots in two assumptions: first, only a few companies have managed to turn growth into shareholder value. Second, it is more effective to concentrate on a small number of high-quality companies able to deliver shareholder value by trying to buy them at the right price. As Nathanson reports, "it's a strategy of focusing on the best of the best", which he believes to mitigate risk. Over three and five-year periods, the fund returned an annualized 10.76% and 8.07%, significantly outperforming the MSCI Index (8.33% and 6.53%).

There is another strategy we should take into consideration, which is the one advocated by Dan Rasmussen, CIO of the asset management firm Verdad Advisers. Dan analysed financial markets' behaviour throughout EM's crisis that took place from 1987 on (71 crises in the 18 most tradeable EM). These recurrent and constant crises meant decades of underperformance for buy-and-hold investors and were often caused by excessively bullish investors who flooded EM with capital, leading them to crack from unsustainable growth or from negative macroeconomic effects. The rapidity with which the markets were flooded was the same with which capitals are pulled out when crises come, magnifying the effects.

However, Rasmussen finds that excess returns could be obtained "providing capital when no one else does", i.e., when the market cracks. This approach is called "crisis investing" and has historically beaten the S&P500.

It consists of a three-part strategy focusing on EM large value stocks, EM sovereign debt and U.S. sovereign debt. The process is the following: holding EM stocks for two years immediately after a global crisis, holding EM debt for two years after a crisis idiosyncratic to aR country or region and holding US debt when the portfolio is not invested in either of the above.

The analysis shows that this strategy returned 16% annualized between 1993 and 2020 against 4.7% of the MSCI EM Index and 9.5% of the S&P500 over the same period. Also, the analysis of volatility proves to be encouraging, with a maximum drawdown of 19% against 51% for the S&P500.

These are some winning strategies that may be adopted by asset managers to overperform and tackle volatility in Emerging Markets. We might point that a long-term focus is the starting point for a successful performance. Moreover, these strategies often involve a selective and concentrated approach for investment process, which enables investors to rely on companies with greater long-run potential. Finally, a contrarian attitude during periods of turmoil has also proved to yield superior performance.

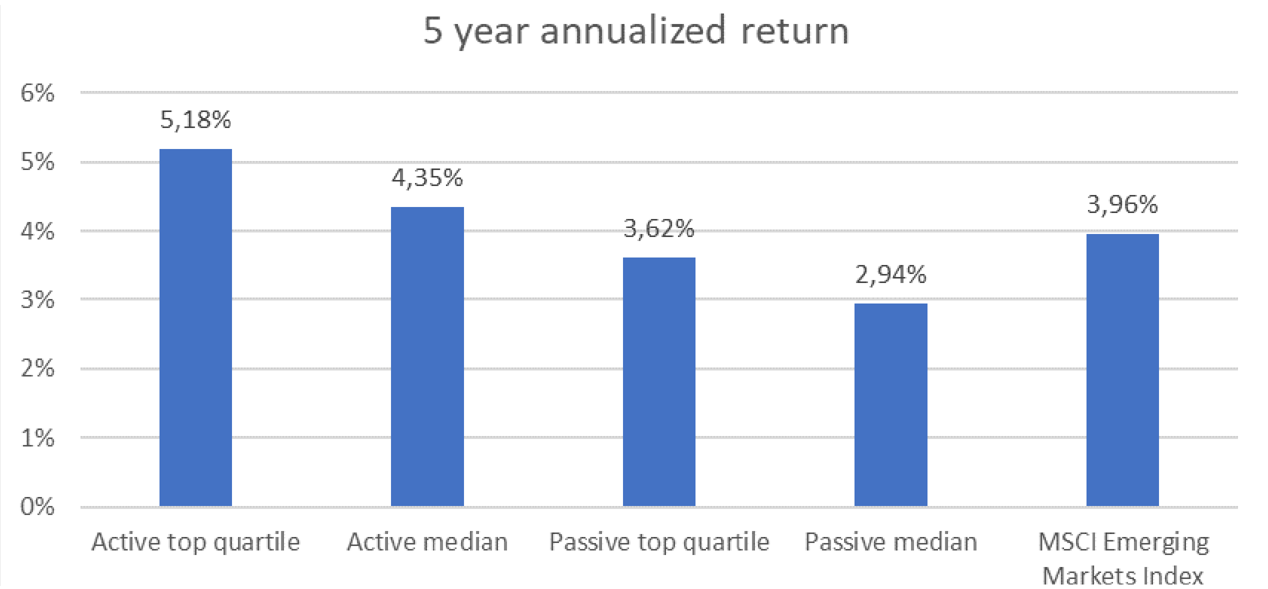
FROM PASSIVE TO ACTIVE INVESTING IN EMERGING MARKETS

Many fund managers have been increasingly investing in Emerging Markets over the last 30 years. This sector has shown high growth potential over the last few years and is looking to continue this impressive momentum. However, one question posed by various investors and analysts is whether to approach these markets using active or passive investing.

Over the years, investors have long preferred to use passive investing as a way to access emerging markets. But, although it may seem safer to invest in large-cap stocks or EM index funds in such an unpredictable market, some asset managers would argue that active investing is a far better alternative.

This is the case of Makena Capital, which does not invest in index funds in Emerging Markets. Instead, they capitalize on inefficiencies across countries such as Brazil, Russia, and India, using active management. Their approach consists of hiring long-only managers with in-depth knowledge of the companies they invest in rather than following the market trends. Asset Management firm Lord Abbett states that fundamental research is crucial in EM country selections such that their active managers allocate much of their resources towards this integral step.

The firm also acknowledged that travelling to EM countries and “establishing strong relationships with the local banks, policymakers, and country experts” were essential to “leverage” the knowledge, networking, and “access to financial and technical data” that these groups can provide.



Copley Fund Research found interesting data using a sample of 222 actively managed global emerging market equities funds with a combined $350 billion in assets under management. Their findings support the claims made by the previous firms, since over the five-year period ending December 2019, around two-thirds of active managers outperformed the passive products that most investors can access, net of institutional management fees. This is a good example of the potential upside that active approaches can provide over passive ones in emerging markets. However, active investing comes with a cost. Firstly, the ability to research the valuable EM opportunities and the time devoted to networking in those countries take up a considerable amount of time and is not always cost-efficient. Additionally, active investing often comes with a much higher risk than passive investing such as in ETFs due to their high volatility. Nonetheless, there exist techniques that can help mitigate the risks in active funding in addition to the plethora of information a firm can get if investing properly.

Furthermore, a disadvantage of passive products such as ETFs is that they will track the index even under conditions of imminent turbulence. A good example could be Venezuela's recent economic turmoil. While its finances were starting to weaken in mid-2014 due to the significant declines in oil prices, "the country continued to issue more and more debt at higher coupon rates". Venezuela made up 13% of the J.P. Morgan Emerging Market Bond Index Global (EMBIG) at its highest and has since dropped to about 1% of the index. If investors used passive strategies that included bonds from the Venezuelan government, investors could be incurring huge losses of value on these investments. As such, it is fundamental to actively seek information about countries with geopolitical tensions to minimize risks and in turn, decrease the probability of negative returns.

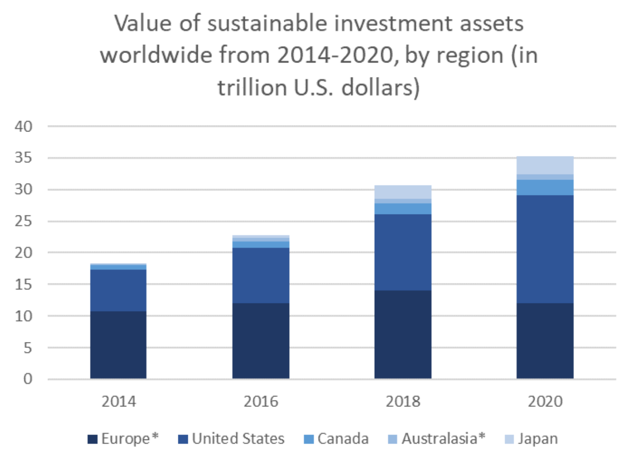
Stewart Investors have been investing in Emerging Markets since 1992 and have since then been using Bottom-up approaches due to the market diversity. This is an active investing strategy that focuses on the micro attributes of a company. They have over 1500 meetings with management teams to fully comprehend the business they are backing, and to create strong relationships with the owners and stakeholders to prevent being backstabbed or at a disadvantage. Moreover, these investors mentioned there being environmental and social goals for family-owned businesses which gives the Asset Management funds incentive to invest in.

A report made by Lyxor ETF revealed that in Emerging Market equities, active strategies were rewarded with $5.4 billion of inflows in Q1 of 2019 vs a $500 million outflow for passive strategies. As such, there has been a perceived incentive to switch to active investing. Both Makena Capital and Lord Abbett agree that it is essential for a firm investing in EM to create a bond with international banks and government officials, in order to obtain pertinent information about the risks involved. Both believe it is primordial to stay in contact with the local stakeholders as well as local experts.

Thus, as seen from these examples, moving to an active strategy for investing in Emerging Markets has many benefits such as social, environmental, and most importantly, increased financial growth. Although passive investing is less time-consuming and apparently less risky, if executed well, active investing rewards have a strong potential to outweigh those of passive investing.

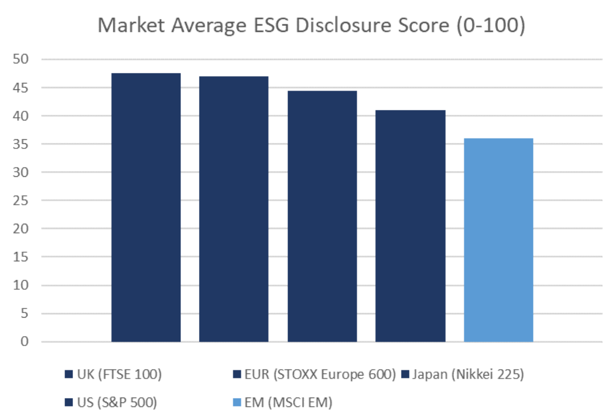
THE ESG GAP: CONSTRAINT OR OPPORTUNITY?

Addressing sustainability issues has become a global necessity, and investment professionals have been increasingly willing to either use their capital to directly fight climate change or, at least, to consider ESG factors in their portfolios. It is expected that ESG compliance and disclosure (ESGC&D) will, over the long-term, contribute to mitigating firm-specific risks of compliant firms, allowing them to meet the demands of a broader range of stakeholders and access a larger investor base, ultimately lowering its cost of capital, which in turn may translate into improved economic performance.



The interiorization, by global investors, of the viability of achieving the twin goals – generating a positive impact without giving away on financial returns – has been contributing to the growth of the so-called Impact Investing, an emerging asset class entailing $715 billion in assets under management, and boosting ESG assets, which are expected to exceed $140.5 trillion in AUM by 2025.

However, companies in Emerging Markets have long been lagging behind those in developed regions when it comes to efforts concerning ESG, often being left behind by asset managers looking to ESG goals when investing their capital. Is this lag constraining the attractiveness of Emerging Markets for investors?



In many of these markets, companies are not legally forced to comply with as many ESG practices and disclosure as their peers in developed economies do. Furthermore, when available, information is often inefficient and not credible, and compliance itself has very low standards. As a result, independent ESG research providers are limited in the quantity and quality of the data they can deliver, complicating the job for ESG equity investors, which must run proprietary research if they want to thoroughly assess companies and their practices towards the environment, society and their governance. If not able to deal with this, investors must either accept higher uncertainty or turn to developed economies to allocate their 'green' capital.

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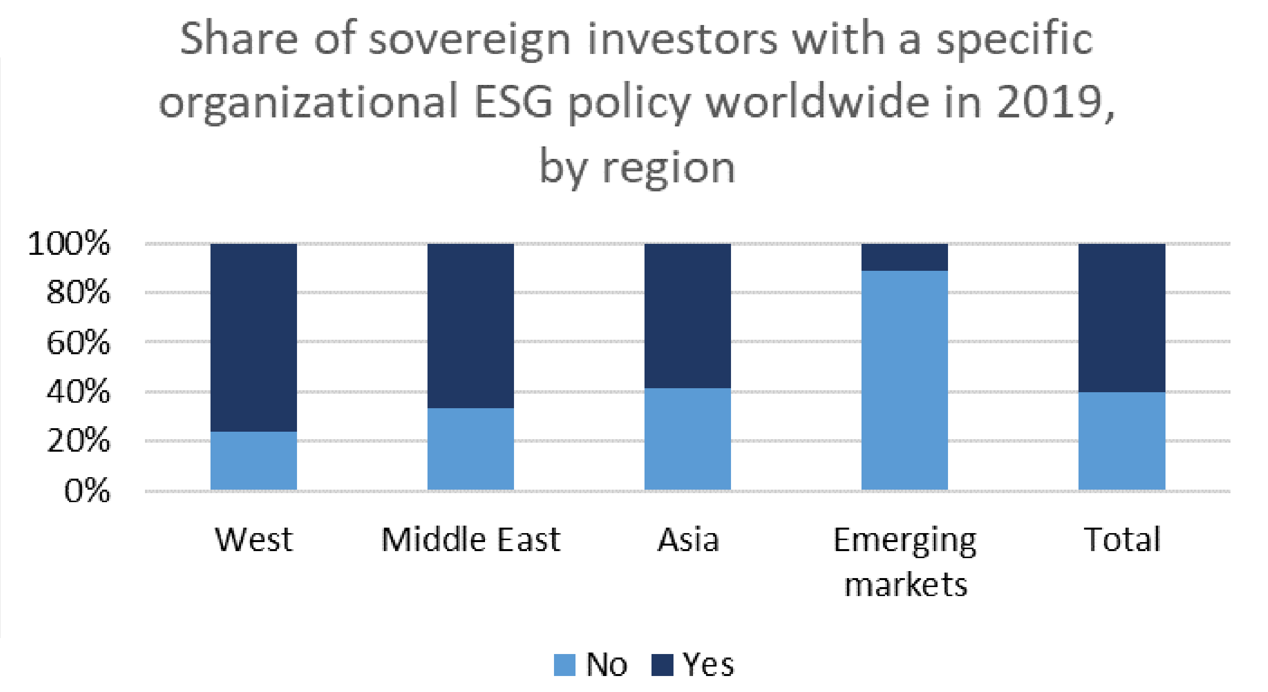
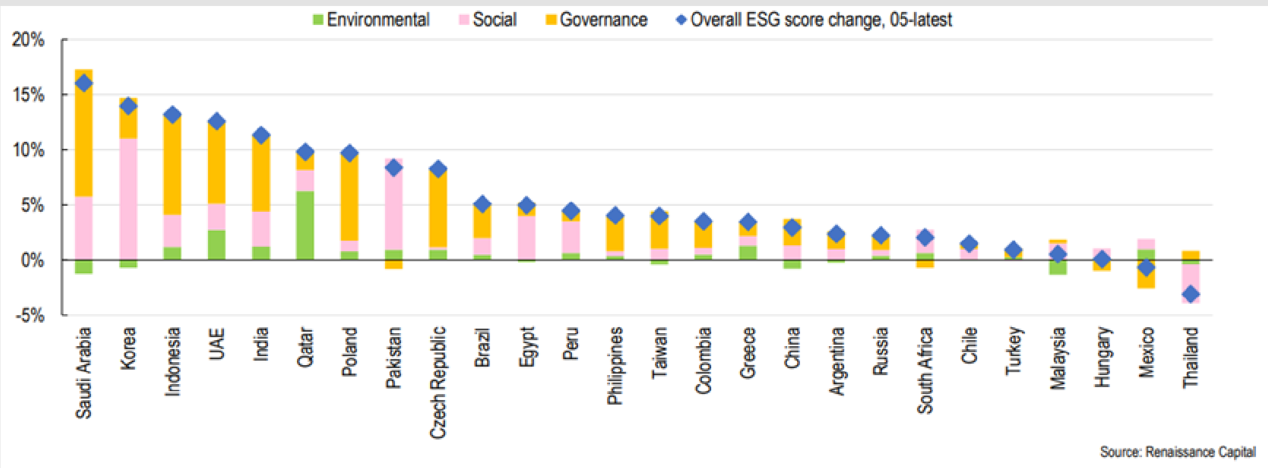
However, this gap has been narrowed by a variety of factors. First, notwithstanding the inaction we find among investors in EM, international investors have been pushing companies all around the world to comply with demanding ESG standards and to disclose the initiatives they have in place to address climate issues. This pressure has been leading companies in EM to catch up and to increasingly incorporate ESG efforts as part of their corporate strategy.

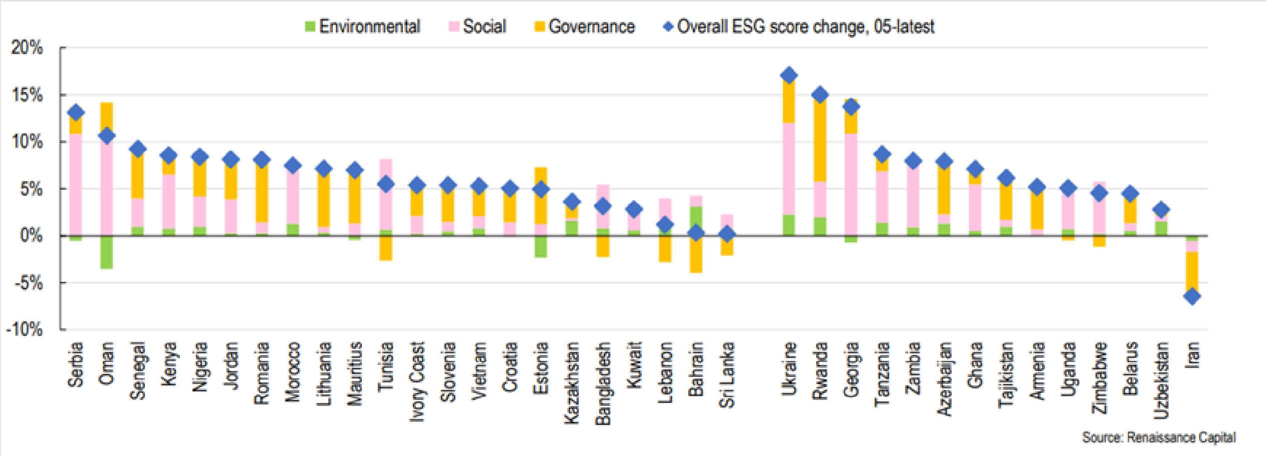


Second, legal frameworks in many emerging economies have been evolving, and so did their legal requirements regarding ESG disclosure, which have been moving from a purely voluntary to a “comply or explain” framework. Third, globalization and higher than ever interconnection between economies, societies and markets across the globe have been creating greater influence and pressure from companies in developed markets over their peers in emerging ones, which feel forced to adapt themselves in order to remain competitive when accessing global capital.

Additionally, and to the surprise of many, the pandemic has also accelerated the adoption of some of those efforts by these companies. Many of them operate in very poor countries, whose societies face problems that are non-existing in richer countries.

This often creates the feeling that they must also contribute to the social wellness of those societies and provide solutions to problems that would be addressed by governments in developed countries. Some have recently stepped in to provide social care, support in setting up testing centres and provide medical equipment for covid patients, therefore accentuating the ‘S’ in their ESG efforts.





It is true that ESG has been foremost a Developed Word's phenomenon, and a lot needs to be done by EM's companies regarding ESGC&D. However, with ESG assets and Impact Investing gaining volume, international investors increasing their pressure over these companies, and as they interiorize the benefits of ESG initiatives over their economic performance, this gap is likely to underlie a potential catch-up movement that will support the growth of Emerging Markets, rather than representing a constrain on their opportunities scope.