EM investment opportunities

Sandra Haurant explores the wide world of emerging markets equities

Summary

• Emerging markets (EM) equities are a mainstay of pensions investment thanks to the diversification they provide with regard to developed markets.
• The term itself lacks an official definition – instead, it refers to countries that are not yet economically 'advanced' according to the IMF's assessment criteria.
• The sector is huge and covers multiple countries with very different geopolitical circumstances – each unique but with countless interdependencies.
• Autocratic EM regimes have been shown to have poorer outcomes than those with traditional democracies.
• Volatility makes this an area that is less appealing to defined benefit schemes.
• The high number of elections in 2024 has provoked some volatility in EM markets, but the US election will likely have the greatest impact.
• Questions abound over the way in which US policy will affect China; some predict opportunities, while others are more concerned.
• Diversification is one of the benefits of EM equities, and another is the potential for higher growth and greater returns than those on offer from developed market stocks.

Emerging markets (EM) equities are a mainstay of the pension portfolio, providing diversification from developed economies and the potential of greater growth. But what exactly is an 'emerging market', and how does investment in this extensive area benefit pensions?

Defining features

For a term that is so widely used, it is perhaps surprising that there is no official definition of an 'emerging market'. In fact, the International Monetary Fund classifies 39 economies as 'advanced' based on factors like per capita income, exports, and integration into the global

financial system, while the rest of the world is broadly defined as 'emerging markets and developing economies.' And the IMF considers about 40 of those as 'emerging market and middle income.' The diversity of countries on the IMF's list shows just how broad a field this is; it includes Latin American countries such as Argentina, Brazil and Mexico, as well as China, the Philippines, Indonesia and Malaysia, and Hungary and Poland.

"These markets are unique, interconnected, and driven by diverse factors, entirely different to developed markets," says Invesco Asian and emerging market equities fund manager, Charles Bond, who adds that: "Emerging markets boast rising incomes, urbanisation, and favourable demographics, leading to a growing middle-class consumer base."

Diversification is key

While, for pensions, the role of emerging market equities is one of diversification from developed markets, they also provide greater potential for growth and higher returns, argues Tobam deputy CEO, Christophe Roehri. "Looking at the past 14 years, the growth of the leading EM countries has strongly outperformed the growth of the DM countries. The weight of China in the world economy (GDP) went from 9 per cent in 2008 to 18 per cent today." But this is a complex area, says Roehri, who adds: "The performance of EM equities, when measured via the return of market cap indices, has been significantly below developed markets (DM) equities."

China, specifically, he says, strongly underperformed over the same period; a global EM ex-China outperformed a global EM portfolio. "Why? Because of the huge concentration of DM markets driven by the mega cap US performance, and because of the poor performance of stocks listed in or highly exposed to autocratic regimes, like Russia or China, for example."

Indeed, says Roehri: "Long-term asset owners like pension funds should pay attention, monitor, and mitigate their exposure to autocratic regimes."

As such, the sector comes with characteristics that do not always suit pensions. PwC UK head of pensions, Gareth Henty, says: "When it comes to portfolios, emerging market equities can provide diversification and the potential for higher returns, but there is more volatility and risk. Funding level improvements and generally de-risking also means private sector defined benefit schemes hold little emerging markets equities." He adds: "The PPF *Purple Book* shows the average pension scheme now holds less than 20 per cent in equities, and of this, less than one tenth is in emerging market equities. Furthermore, disappointing returns over the past decade has meant, on a risk-adjusted basis, they have not been an attractive investment."

Highs and lows

That volatility has been evident this year. In what are considered to be 'traditional' democracies, more than four billion people have been eligible to vote across the globe in 2024, with EM elections in EM countries providing some surprises and some reassurance. The presidential election in Mexico saw the election of Claudia Sheinbaum. In India, the landslide victory anticipated for Narendra Modi did not happen as foreseen. And South Africa, too, saw a shift in power, with the ANC losing its majority for the first time since 1994.

Markets famously don't like uncertainty, and true to form, volatility followed the votes in each country, but while these three economies sit under the EM umbrella, it's clear that they are vastly different places with potentially divergent futures.

"Although India's election brought short-term volatility, it ultimately ended with a Modi victory and a strong signal of market-friendly economic continuity. The recent budget announcement was also a notable positive and it seems India continues on its unique path of profitable growth," says Global X ETFs head of EM strategy, Malcolm Dorson. "Mexico's election brought more volatility; Sheinbaum's victory was not a surprise, but the amount of power her party gained in congress and the senate gave investors pause over potential judiciary reform and increasing government intervention in the private sector. South Africa's election outcome was seen as a strong market positive."

Overall, says Dorson: "Despite many elections, 'higher for longer' rate rhetoric, and a strong USD, EM assets have performed well this year, which signals strong structural dynamics and less reliance on elections and central bank speculation."

Spheres of influence

The ballot with arguably the greatest potential to impact EM markets is due to play out soon in the United States. "The impending US election is creating uncertainty for markets, including global emerging markets. A key driver is the US-China relationship and how this will be impacted by the next president," says Eastspring Investments client portfolio manager, equities, Sam Bentley. "The US is the largest trade partner for China, which accounts for over 25 per cent of the MSCI EM index."

But Bentley argues that, while trade tariffs and embargoes could impact certain EM stocks, others may be "attractively valued" and largely unaffected by the US election outcome. He adds: "While the outcome of the election is uncertain, and even more so since the announcements of change in Democratic candidate, retaining process discipline is key to capturing any opportunities this might throw up."

At the time of writing, the polls are showing Kamala Harris and Donald Trump to be neck and neck, so making forecasts based on likely outcomes at this stage is close to impossible. Indeed, says

Bond: “As we saw in 2016, even if you did correctly predict the result, the market can go in the opposite direction of what might be expected. This is without even considering the unpredictability of decisions that could be made by the new president.”

But what is striking, nonetheless, says Roehri, “is the bi-partisan aspect of the criticism and proposed actions against the Chinese regime”. Both Republicans and Democrats plan to increase tariffs aimed at stemming Chinese domination. “The tone of the Democrats has somewhat converged towards the Trump administration’s offensive posture that prevailed before Biden’s,” says Roehri.

Pinpointing potential

The US election outcome may be tough to call, but there are suggestions that parts of the EM equities area will react positively, whatever happens, says Bentley: “Over the next 12 months, we will pass through the US election cycle and into an interest rate cutting cycle,” he says. “Lower uncertainty, lower interest rates and a weaker US dollar can be structurally supportive for emerging market equities. We see earnings delivery improving across emerging markets driven by investment in real infrastructure, decarbonisation and supply chain diversification, supported by the attractive valuation on offer in these traditional value names and sectors.”

But within the wide world of EM equities, countries promising potential and those providing concern are constantly evolving. Bond says: “We seek opportunities in undervalued market areas, where overly negative reactions create attractive entry points. For example, in China, pessimism has led to significant undervaluation. Entrenched negativity, such as the ‘Korea discount’ due to corporate governance concerns and geopolitical tensions, also presents opportunities.”

Improvements in Korean corporate governance and dividend payments could create “chances to invest in solid companies with good balance sheets and potential for shareholder returns,” he says. “The portfolio includes manufacturers of semiconductors, electronics, autos, and companies in the EV battery supply chain.”

Meanwhile, at Tobam, Roehri says: “We have set up a quarterly committee with internal and external geopolitical experts in order to assess the country risk of the countries that are within what we call the grey zone, meaning when our quantitatively driven assessment of the authoritarian exposure places them in the zone just above exclusions from our investment universe.” The ‘grey zone’ include the likes of Hong Kong, Sri Lanka, India, Peru, he says. And while Bond sees potential in China, Roehri is perhaps more reticent: “On a market cap weighted basis and weights of influence, the three areas of concerns we have are: China, China and China.”

The term emerging markets equities encompasses a broad spread of diverse economies at different stages of development and with varied interdependencies, and different regimes offer quite different outlooks. While the world assesses the results of recent waves of elections and prepares for the next big one, this sector may continue to provide diversification and plenty of potential for pensions, but its propensity for volatility and uncertainty are clear caveats.

Written by Sandra Haurant, a freelance journalist