

Summary

- Emerging markets tend to be middle- to upper-middle income countries with relatively fluid capital markets, robust regulation and minimal barriers to currency exchange.
- Sitting between developed and frontier markets, they include a vast range of territories and provide diversification and differentiation within a pension portfolio.
- However, just as the developed markets indices are overweight in tech and particularly AI stocks, so EM indices are dominated by the suppliers of memory chips and other elements supplying those companies.
- EM equities and EM bonds can sit together in a portfolio and bring quite different benefits to a pension fund.
- The sector has been resilient over the past year despite political and economic unrest around the globe and will continue to provide opportunities for pension funds in the future.

The term emerging markets (EM) encompasses an eclectic mix of territories around the globe, from Turkey to Brazil and Poland to Indonesia and beyond. The likes of MSCI and FTSE decide which countries make it onto their EM indices. But how do pension portfolios invest in this varied sector, and how these burgeoning markets are holding up in an increasingly turbulent world?

Defining markets

“There are three broad classifications used in investment,” explains Coronation Fund Managers EM portfolio manager, Suhail Suleman. Developed markets – for example the United States, UK and most of Western Europe, among many others – have strong financial markets, legal protections and a highly developed regulatory environment. Crucially, says Suleman: “These have a large and liquid

Searching the EM landscape

Sandra Haurant considers how and why pension funds can invest in the varied area of emerging markets

capital market and generally also have a fully convertible, freely floating currency with little in the form of exchange controls or intervention.” Frontier markets, at the other end of the scale, are the smallest investable economies around, with small capital markets, lower liquidity and often greater restrictions on currency exchange. Examples on the MSCI FM list include Burkina Faso and Vietnam.

EM sits somewhere in between these, and the indices include middle to upper-middle income countries that meet certain core criteria. Suleman explains: “You’ve got to have reasonably well-developed capital markets. You’ve got to have reasonable liquidity, a reasonable range of stocks to invest in. You’re going to have reasonable regulation. And you’re going to have currency that’s reasonably freely convertible, particularly for foreign investors.”

Suleman cites South Africa, India and China, where foreign investors can bring money in and out “quite easily without restrictions”, but the locals face limits on the amount of currency they can take offshore. “Those are emerging markets because foreigners generally can enter the market and when they want to take profit, they can get their money out,” says Suleman.



Differentiation and diversification

For pensions investors, EM brings a variety of benefits. “Investors find themselves in a world where there’s really a scarcity of diversifiers,” says Global Evolution senior macro and allocation strategist, Witold Bahrke. While in the past, fixed income in the form of corporate bonds or US treasury bonds might have provided diversifiers to equity risk, he says, debt correlates so closely with equities today that the desired balance can no longer be struck. “We are in a world with heightened geopolitical risk, elevated inflation uncertainty, and potentially more central bank-induced volatility, where all you need is really diversification. But there is a dearth diversification out there,” says Bahrke.

This is where EM equities can be useful. It’s not just about the broad range of sectors to be found in these markets, but also about their stage of development. Take banking, says Suleman. “In the developed world, banking is effectively like a utility now. Everyone has a bank account, and if you look at what we call credit penetration, the total credit that a society has, whether it’s home loans, car loans, credit cards, it’s very large,” he explains. “When we go to emerging markets, that penetration is very low. Almost no one has a home loan, hardly anyone has a car loan, because they are very early on in those development curves. A lot of people will have bank

accounts, but credit isn't that prevalent, and it's because they're going through that phase that developed countries went through 100 years ago."

It's a similar story for food retail, he adds. "In EM countries, 15 per cent of *[food retail]* is 'formal' *[i.e. in supermarkets]* and 85 per cent is informal, and that's all those small little stores that you see which are run by a shopkeeper and there are always benefits with that, but from a competitive standpoint, they will be not able to compete with the purchasing power on the scale of large retail. And, and so that 15 per cent will grow to 20, 30, 40 per cent over the coming years and decades. That's a long earnings runway growth for those sorts of companies."

Another of EM's attractions is its ability to withstand economic and political turbulence, says People's Partnership co-head of equities, Lara Rodriguez San Cipriano. "I think that there's something about the relative resilience that you can see in many emerging market economies in comparison to previous cycles."

And the same goes for EM debt (EMD), according to Bahrke. "If I had said at the beginning of the year we would have an Iran war, we would have several *[rate]* hikes by the Federal Reserve [...] If I had described that kind of a market environment, then most of the knee jerk reaction from investors would have been 'hands off EMD'. But here we are with EMD performing in line with or even better than most."

Indeed, Ninety One co-head of emerging market sovereign and FX, Grant Webster, adds: "EM corporate debt also behaves distinctly to emerging market equities. Equities chase capital growth, are driven by earnings and pay dividends of 2–2.5 per cent; corporate bonds yield around 6 per cent, earned as a spread over Treasuries. In a sell-off, that Treasury component rallies as equities fall, cushioning bondholders even as spreads widen." As such, Webster says:

"Owning both is not doubling up on EM risk; it is one of the more reliable ways to improve a portfolio's risk-adjusted return."

The concentration problem

However, EM equities cannot escape one of today's biggest investment issues: concentration risk. Just as the developed markets indices are dominated by US tech giants, so the EM markets are dominated by their suppliers. It's an unprecedented landscape, says Suleman: "What's really happened is that it's created this huge demand for stuff that is made in Korea and Taiwan in particular." Indeed, he says, the "big beneficiaries of the 'AI-related spend' that's originating in the West" have been Taiwan Semiconductor Manufacturing Company (TSMC), and the South Korean memory chip makers SK Hynix and Samsung. As such, the diversification that investors seek is offset by an overreliance on one single industry – artificial intelligence.

"Emerging markets are interesting from a long-term, bottom-up perspective"

However, there are ways to move beyond that risk, argues Marathon Asset Management analyst, emerging markets, Laura Fyfe: "Emerging markets are interesting from a long-term, bottom-up perspective. Global equity capital has, broadly, neglected emerging markets and then more recently been directed towards the tech heavy Asian markets."

But, Fyfe adds: "Marathon's capital cycle approach, which considers supply side dynamics, steers us away from high return businesses where returns are potentially unsustainable."

"There are compelling opportunities across Latin America, for example, in overlooked companies where years of underinvestment and shrinking capacity

are repairing returns, and valuations appear attractive based on undemanding assumptions. These companies, often found in relatively unloved industries such as materials, real estate and telecoms, offer excellent prospects for investors with a long-term commitment to the emerging markets asset class."

Rodriguez San Cipriano argues that it can be helpful to think of EM as bringing something quite different to the table. "You can't really see EM as a hedge, for example, against secretary risk," she says. "But it is a source of differentiated long-term returns."

Future focus

There are challenges for EM, but in a fragmented asset class there will always be winners and losers. "A lot of the AI supply chain comes from emerging markets," says Rodriguez San Cipriano. "And we need to keep an eye on what's happening with regional conflict, geopolitical tension. All of these are going to have quite big implications on capital flows across emerging markets and therefore on valuations."

Nonetheless, the world's markets keep evolving and, says Webster, that leads to greater opportunities: "It is important for investors to also consider smaller 'frontier' markets. Today's frontier markets can be tomorrow's emerging markets." He adds: "Under-researched and largely absent from mainstream investment portfolios, these markets offer some of the highest real (inflation-adjusted) yields available and are driven by domestic reform rather than global sentiment – making them powerful diversifiers in portfolios. Investors who spot the countries that are poised to grow out of the frontier category into the emerging market one can position themselves to benefit from price moves as these markets enter emerging market indices."

Written by Sandra Haurant, a freelance journalist