A case for active investment in emerging markets

Attractive valuations, but the ‘free lunch’ is over

The long-term case for faster-growth emerging markets remains intact. With valuations attractive, the case for reviewing allocations is compelling.

However, the drivers of emerging markets are changing, with consequences for the approach investors now take. After a period in 2003-8 when a rare synchronisation of factors made investing straightforward, the heterogeneity of emerging markets has reasserted itself.

Active management of investments is vital as more money is invested indiscriminately at a time when fundamentals are reasserting themselves. Stock-focused investors can take advantage of the opportunities this creates to target cash-generative firms growing their shareholder returns.

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Executive Summary

- The long-term case for allocating to faster-growth emerging market remains intact.
- Attractive valuations make this an opportune time for investors to review allocations.
- The nature of investing in global emerging markets (GEMs) is changing.
- China's economic rebalancing towards consumption has implications for emerging market economies as well as for investors.
- Previously, investors made strong returns by investing indiscriminately in GEMs. This 'free lunch' is likely now over.
- Country, sector and stock selection are likely to be increasingly important as divergences reassert.
- An active approach can avoid the risks inherent in backward-looking indices.
- Investors should play close attention to how active their manager is. In this regard, the 'active expense ratio' is a valuable metric.
- Limiting exposure to capital loss is likely to be key to achieving longer-term outperformance from emerging market equity allocations.

Authors

Nick Armet
Head of Corporate and
Investment Communications,
nick.armet@fil.com

Alex Homan
Investment Director, Global
Emerging Markets
alex.homan@fil.com

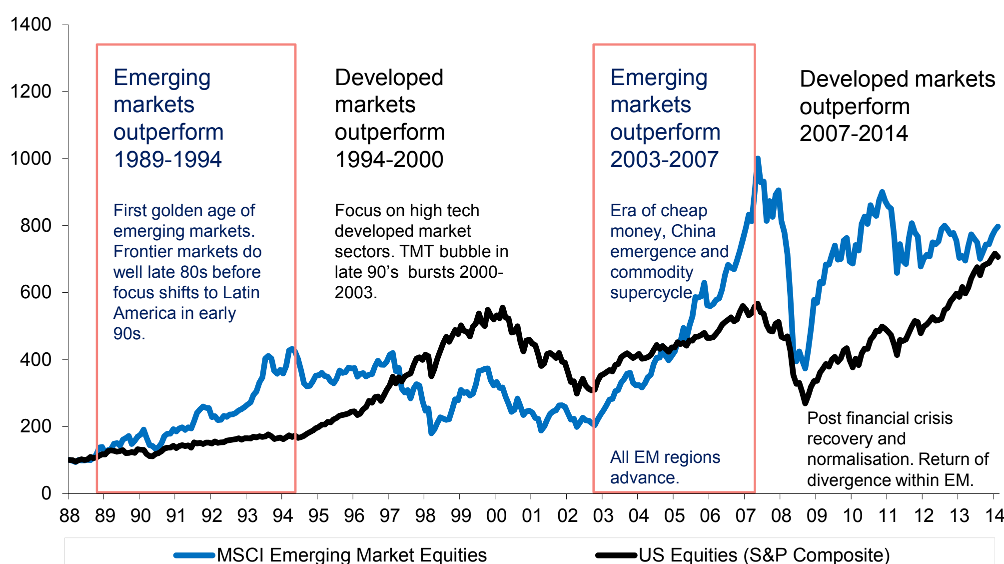
The free lunch is over

There have been distinct periods of emerging market and developed market leadership in recent years (see chart 1). Developed markets have led the way in the post-crisis environment as investors have focused on the strength of the US recovery. Prior to that, the EM led-advance in 2003-8 was remarkable in term of its strength and breadth. By 2007, only three countries in the world suffered negative economic growth as a rising tide lifted all boats. There were three key macro tailwinds behind this prosperous phase:

- **China**: Double-digit Chinese growth provided a strong tailwind for emerging markets exporters, and helped to paint a compelling narrative for investors.
- **Commodities**: The commodity super-cycle driven by China's appetite for resources combined with supply constraints benefited many EM exporters.
- **Liquidity**: The global economy benefited from significant growth in consumption, with much of it fuelled by easy access to credit, which boosted demand for cheaper imported goods from developing markets.

When the latter phase ended, developed markets came under significant pressure from their debt burdens. Investors mistakenly assumed a decoupling was in prospect since most emerging markets had not participated in the credit binge. In reality, the developed world has always been – and will likely remain – a key trading partner for many emerging economies.

Chart 1: Where next for emerging markets?



Source: DataStream, 05.11.2014.

The effects of a weak end market for many emerging markets exporters had a detrimental impact on their earnings growth, dampening optimism that they might be able to escape untouched.

Post-crisis, the QE programmes of central banks encouraged the flow of fresh money into risk assets. However, given the continued underperformance of emerging market equities relative to their developed market peers, EM beneficiaries were more driven by a hunt for yield rather than equity risk. The 2013 taper tantrum put an end to this period of appetite for broad emerging markets risk, particularly in those economies that had begun to over-rely on external sources of funding.

With the prospect of US interest rate rises and the likelihood of a stronger dollar, this should further cement a greater recognition among investors of the need to take a discriminating approach to a diverse EM universe.

Attractive valuations: investors should review allocations

With the focus of global investors having shifted to the US over the past four years as recovery boosted earnings growth relative to that of the emerging world, emerging market valuations have fallen back to historically attractive levels on a range of measures. Indeed, the discount of emerging markets to developed markets on both a price earnings and price to book basis is now as large as it was in 2004 (see charts 2 and 3).

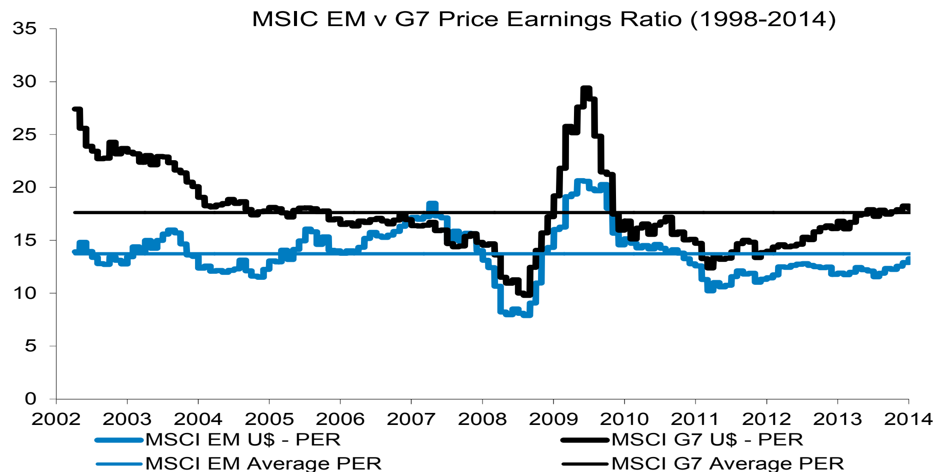
This valuation opportunity makes it an opportune time to review allocations to emerging markets. The asset class tends to be under-represented in many institutional investor portfolios, partly due to the persistence of home bias, despite the accepted wisdom of international diversification.

To frame the level of exposure to EM equities in a global context, the following views make interesting reading:

- **Global GDP approach**: emerging markets now account for 50% of global GDP.
- **Global market cap approach**: EM companies make up 23% of global market cap.
- **Benchmark market-cap approach**: MSCI AC World Index has a 13% weight in emerging markets.

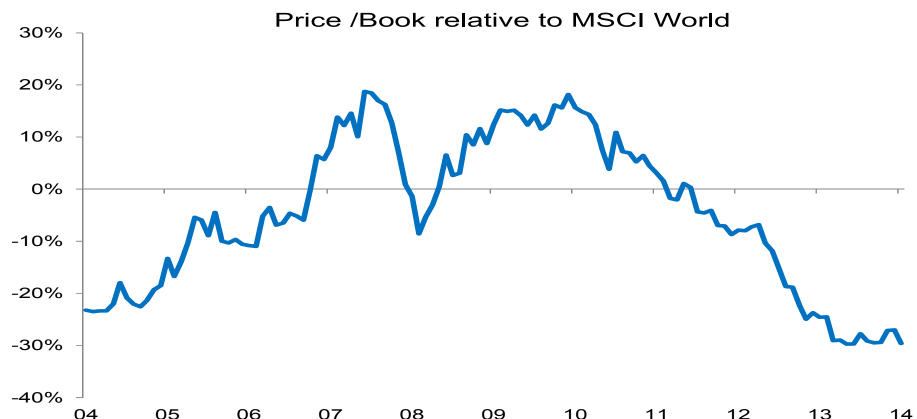
Emerging markets have a lower proportion of free float reflecting their lower liquidity, so the benchmark-cap approach under-represents the importance of emerging markets in the global economy. For investors with a strong aversion to illiquidity, the benchmark-cap approach may still be most appropriate. However, longer-term investors prepared to accept some illiquidity for faster economic growth and potentially higher returns should gravitate towards the other approaches.

Chart 2: Valuations: EM v DM price earnings



Source: DataStream, 05.11.2014

Chart 3: Attractive valuations: EM discount price to book



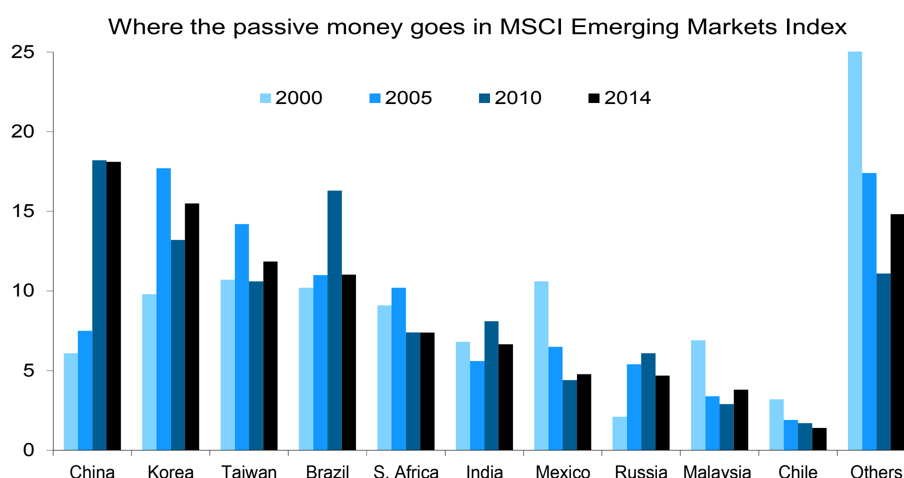
Source: DataStream, 30.09.2014

EM indices: better reflection of past success than future potential

While a 'free lunch' may have been available previously this decade – allowing indiscriminate investment to prosper – it is clear that ***the 'free lunch' is over*** and a more discriminating approach to EM investing is warranted, just as it was prior to the 2003-8 phase. EM economies and companies are likely to be increasingly be driven by their own internal engines of growth as well as their willingness to embrace structural reform. Philosophically, this means allocating to companies with sound fundamentals and corporate governance structures that operate in sound economies that can provide a tailwind to growth, rather than simply allocating to emerging market countries, sectors and stocks purely on the basis of size.

As chart 4 shows, the composition of emerging market indices has changed considerably over the last decade. The growth of certain large markets has resulted in a greater degree of concentration in the MSCI EM Index than was present at the start of the decade. In 2000, investing in the index meant allocating across a broad spread of countries. Investors who bought the index in 2000 benefited from growing exposure to strongly performing winners. Nowadays, investing in the index means allocating large portions to countries like China (18%) and Brazil (11%) – two of the best-performing countries of the boom period (2003-8), whose rates of economic growth have slowed measurably since.[1] The growing index weights of the 'top 4' have had the effect of reducing exposure to other emerging countries. This concentration presents a challenge to passive investors, while active investors can weight exposures based on forward-looking fundamental research.

Chart 4: Changing shape of emerging market indices



The 'top 4' countries (China, Brazil, South Korea and Taiwan) account for over 56% of the index.
The five largest companies in China, Brazil, Russia and India all account for over 30% of their respective MSCI indices. For comparison, the top 5 stocks in the US account for less than 10%.

Source: MSCI, 31.07.2014

Economic rebalancing: shifting drivers in emerging markets

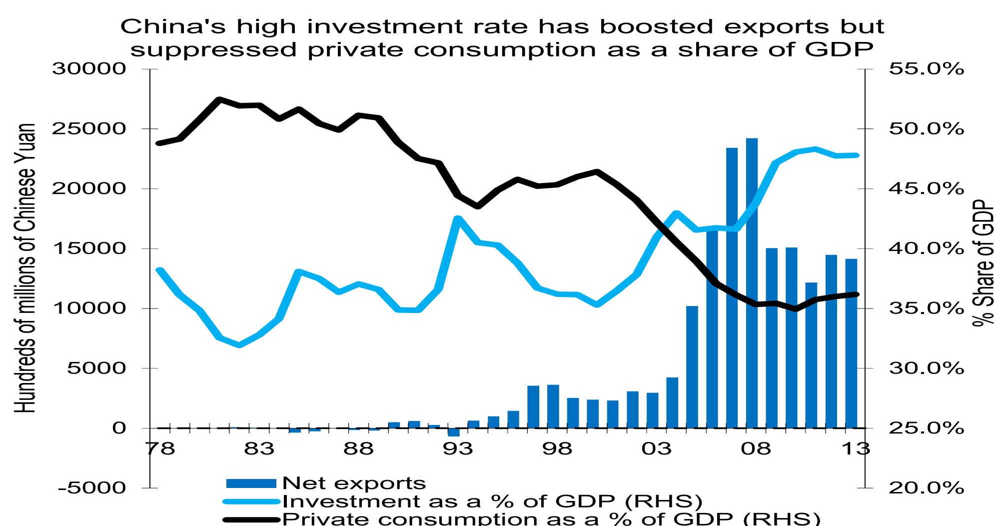
Economic development in emerging economies continues apace. On average, they continue to deliver faster economic growth rates than the developed world. However, economic growth is not uniform across the developing world – some parts of the emerging world are slowing, while other parts are accelerating. Moreover, the quality of the different growth models in emerging markets is as worthy a consideration as the marginal rate of growth. Some markets continue to emerge positively, embracing structural reforms as in the case of China and India. On the other hand, there are those at risk of 'submerging' under the weight of weakening commodity prices as in the case of Russia, or as a result of excessively populist government policy as has been the case in Brazil.

While China remains key to the health of emerging markets, inevitably, it is unlikely to sustain the same level of impact its rapid emergence had during the last decade. Average rates of Chinese growth have slowed from the double-digit levels they hit in the mid-2000s to 7-8% annually as the

economy rebalances from an investment-driven manufacturing export model to one more reliant on domestic consumption. This rebalancing will also have implications for other economies beyond China, particularly those who benefited from supplying it with raw materials during its investment phase. The growth and investment rates of manufacturing economies like Japan, Taiwan and South Korea all eased back when their per capita incomes reached China's current level ($5,000).

Indeed, a defining feature of the Chinese economy has been its high investment rate. As chart 5 shows, China's investment rate moved above c.45% in 2011, partly due to post-crisis stimulus.[2] The scale and duration of this level of investment is unprecedented. Furthermore, it is expected that investment will fall back from this high watermark as marginal returns on capital diminish and labour market dynamics change. As wages rise in China, other emerging market economies are likely to be beneficiaries of a repositioning of labour-intensive manufacturing activity away from coastal China, particularly some of the less advanced Asian economies.

Chart 5: China: Investment's share of GDP to fall



Source: DataStream, EIU, CNBS, latest available data as at.05.11.2014

China: New versus old

- The new economy sectors such as internet stocks, consumption and gaming stocks have prospered in recent years while the commodity-related, old industry stocks have lagged.
- The Chinese government remains focused on the transition to a more consumption-led economy, but we have also seen growing focus on reforms to state owned enterprises.
- The Chinese market can offer investors access to both long-term growth and tactical value plays – the market is increasingly a stock-picker's game.

The super-cycle is over – 'back to normal' means 'back to diversity'

China's investment-driven growth model, coupled with ample liquidity and a weak dollar, had a significant impact on incremental demand for many commodities during the last decade. In fact, China's appetite for industrial metals and fossil fuels was at the centre of a ***commodity super-cycle*** that created significant 'China dependency" for many commodity exporters. In 2011, China accounted for 50% of global demand for coal, 41% of aluminium, 40% of copper, 30% of rice, and 11% of oil. Incredibly, China's contribution to incremental copper consumption during 2002-2011 was over 100%; increases in supply were being driven solely by Chinese demand.

Nowadays, weakening Chinese demand is a risk to commodity prices, which may have ongoing consequences for certain emerging markets like Chile and Brazil which have significant exposure to metal exports at both the economic and equity market level.

Other emerging markets will prosper, however. As a net commodity importer, India is a beneficiary of falling commodity prices. In addition, if the structural reforms promised by the new Modi regime materialise, then India is in position to benefit from a significant improvement in its economic situation,

presenting a tailwind for companies operating in an increasingly confident and business-friendly environment.

In Sub-Saharan Africa, many economies are benefiting from independent structural growth drivers in the shape of growing urbanisation and consumption. In Latin America, Mexico is potentially a beneficiary of a resurgent US; its wage competitiveness, infrastructure, and close ties to its northern neighbour are all in its favour. However, to identify the winners and losers investors must be prepared to undertake comprehensive analysis that drills down to the stock level.

Emerging markets: more than just faster growth

Investing successfully in emerging markets is about more than simple economic growth. Over the medium-to-longer term, there does appear to be a relationship between economic growth and stock market performance. This is what makes emerging markets an attractive long-term investment as their market capitalisations rise to reflect their growing share of global GDP. However, the link between economic growth and stock market performance is not straightforward. A host of other factors such as company fundamentals, valuations, macroeconomic and regulatory conditions, corporate governance and investors' expectations all play their part. This complexity demands a diversified, stock-picking approach to emerging markets that focuses on a range of bottom-up factors over a simplistic focus on economic growth rates.

Renewed focus on specific risk

We are seeing renewed focus on a range of emerging market-specific risks leading to divergent stock performance:

- Competitive pressures, where new entrants seeking to achieve a dominant position are more interested in gaining market share than maximising margins
- Uncertain and unstable regulatory environments
- Political uncertainties such as government instability or the introduction of populist policies
- Inconsistent treatment of property rights, physical and intellectual
- Weak corporate governance, less transparent accounting policies or unfair treatment of minority shareholders

The importance of good governance

Issues such as capital discipline, dividend policy, strategic management capability and corporate governance are critical considerations for EM investors in the post-financial crisis world. Active managers adopting a bottom-up stock selection approach look to invest in businesses that are able to maintain superior returns on their assets, and who pass those returns onto their minority shareholders through capital appreciation or dividend payments.

Strategically important companies can carry higher political risk; for example energy companies can suffer political interference to subsidise fuel costs for domestic consumers. Government constraints on domestic pricing and aggressive taxation of energy profits impact both Petrobras and Gazprom.

One prudent way in which active investors can access well-governed growth opportunities is to invest in the emerging market affiliates of western multinationals. Affiliates enjoy undiluted exposure to rapid EM consumption growth, but also benefit from the established corporate governance structures of their parents. Another useful approach is to consider stocks with attractive dividend yields and dividend payment records, where a material portion of total shareholder return is consistently returned to investors in the form of cash.

The value of active management in emerging markets

Emerging markets are widely accepted to be less efficient than developed stock markets. They are also comparatively under-researched. These factors coupled with greater incidence of risks augur for an active approach. Nevertheless, the macro-driven nature of performance over the last decade has seen strong inflows into passive funds. This higher proportion of indiscriminately invested money in cap-weighted indices (which entail concentration and momentum risks) actually gives active

managers further opportunity to outperform by taking fundamentally driven views against components of the index.

Strong relative performance in certain parts of a stock market can push valuations to expensive levels, sowing the seeds of subsequent underperformance. This is a big problem for investors in passive, market weighted indices which are inherently momentum-driven. As chart 6 shows, the MSCI BRIC index performed strongly until mid-2007 by which time it was valued at a premium to developed markets. However, this proved to be a high watermark, with the BRICs subsequently underperforming as valuations moved back to historic norms. Active investors with a systematic valuation approach look to lock in gains after shares have outperformed strongly and valuations hit target levels. This allows them to avoid momentum reversals by shifting their exposure to more undervalued stocks. This is a critical distinction: active managers have a forward-looking bias, whereas passive funds invest in backward-looking indices that favour markets and stocks that have already performed well.

Another problem with passive investing that active investors can avoid is the fact that the indiscriminate allocation of money by market weight can result in large investments being made in stocks purely on account of their larger size, regardless of their fundamentals. A passive investment in various emerging market indices can result in big investments in certain energy, banks and industrial commodity companies like Petrobras (see chart 7).

Chart 6: The problem with passive: momentum reverses

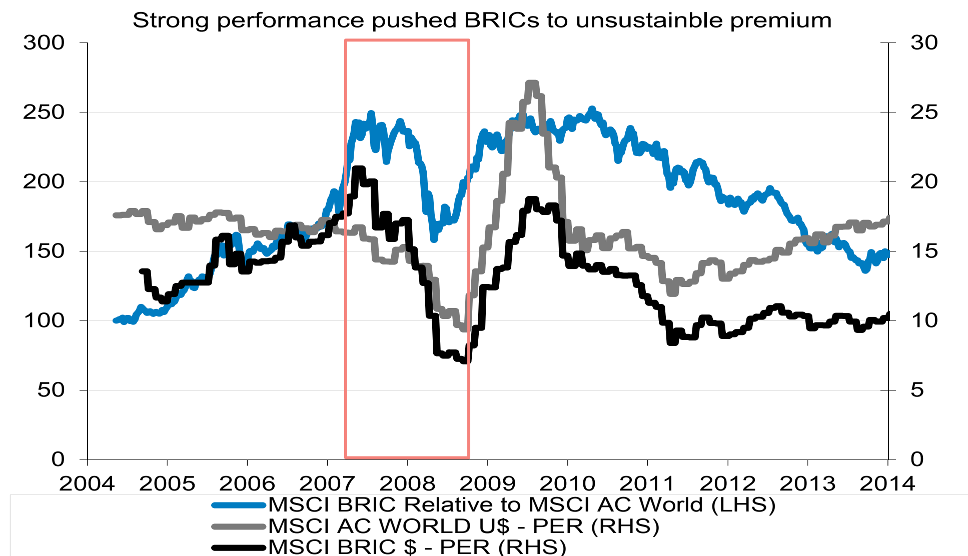
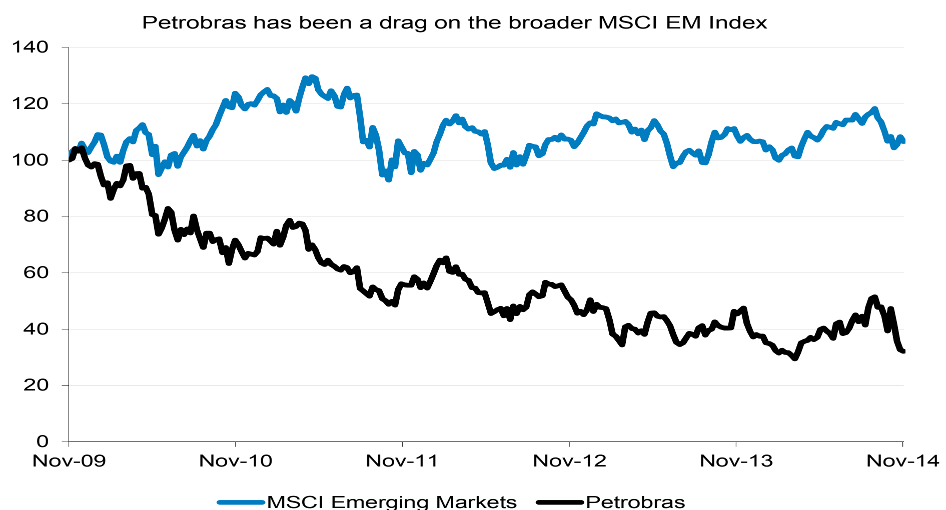


Chart 7: The problem with passive: stock concentrations



Source: DataStream, MSCI, 05.11.2014

Research from the Bank of International Settlements (BIS) indicates there is in fact greater evidence in emerging markets that "the concentrated use of benchmarks and co-movement of investor flows can generate correlated investment patterns that exacerbate price movements".[3] The reason is that emerging markets represented in the index tend to be heavily influenced by passive money (ETFs). Investments also tend to be highly pro-cyclical – with fund flows increasing when share prices are rising and reversing when share prices are declining. This is the opposite of what long-term investors should be doing. With valuations attractive, there is scope for such investors to build positions at an attractive valuation point that is likely to enhance compound growth potential over the longer term.

How active is your active manager?

We have seen there are supportive conditions for active management to add value within emerging markets over investment cycles. However, one key question that comes to mind is '*how to identify a better than average active manager?'* As outlined in our recent Perspective 'A Return to Active Investing'[4], academic research by Martijn Cremers and Antti Petajisto suggests this is largely driven by the level of activeness in the portfolio. Not only do truly active managers tend to outperform after fees, they also tend to do so persistently. One technique that has helped to identify these managers is looking at how active they are, how much they charge and how well they have performed in the past.

To ascertain how active a fund manager is, we can look at how different they are from the benchmark index. This can be measured using a measure such as **'active share'** (or 'active money'), which is the sum of all of a manager's overweight positions plus cash, expressed as a percentage of the portfolio's net assets. It is a measure of how much the portfolio's composition differs from that of the index (i.e. how active the fund is).

'Active expense ratio' takes the approach a step further and is a measure of how active a fund is relative to its cost. The measure provides a useful way for investors to identify those active managers who are both genuinely active and also good value for money on that basis[5]. Skilled portfolio managers who operate with high active money combined with reasonable fees (resulting in a low active expense ratio) have the best scope to outperform after fees (see table 1 below).

Table 1: How active is your manager?

	Ongoing Charges Figure (OCF)	*Active money*	*Active expense ratio*
Emerging markets sector average*	1.79	0.56	2.65
Fidelity Funds Emerging Markets Fund	**1.98**	**0.87**	**2.17**

Source: Morningstar Offshore GIFS Global Emerging Markets Equity. Latest available data as at end October 2014. The passive expense ratio is assumed to be 0.70. Reporting share class used is that defined as primary by Morningstar (not the institutional share class). Active expense ratio = Passive expense ratio + (Portfolio expense ratio - Passive expense ratio/Portfolio active money).

A simple focus on fees takes no account of how active the fund is in determining whether it is value for money. **Active expense ratio** considers how much active management you get for your money. The lower the active expense ratio, the better.

Active strategy: focus on consumption

Active managers have the ability to focus their firepower on stocks that benefit from powerful structural tailwinds over the longer term. Emerging market consumption continues to present a vast, multi-decade opportunity. Food and beverage consumption could see powerful structural growth, outstripping production in many in markets thanks to population growth creating opportunities in agriculture, fertilisers, food producers and retailers. The changing composition of diets as incomes rise will also drive increases in meat and dairy consumption. Significant growth potential exists in automobile markets where car ownership levels are often a fraction of developed country levels.

Stock highlights

TaTa Motors: considerable scope to grow its earnings given low levels of automobile penetration in its principal target markets and a beneficiary of an improving outlook for the Indian stock market after the election of reform-minded Narendra Modi.

China Mengniu Dairy: Chinese dairy company that is benefiting from a shift to protein-rich diets among domestic consumers. China's per person milk consumption is only 25% of the world, illustrating the massive potential for growth.

Active strategy: focus on emerging technology & media winners

Despite recent fast growth, internet usage in China, and other emerging markets economies is still significantly below western levels. The estimated penetration rate of 39% in China is still less than half the c.90% penetration rates commonplace in countries like the US and the UK.[6] This huge scope for growth will serve as a powerful demand driver for established Chinese players such as Tencent and Baidu.

Stock highlights

Netease: A Chinese internet company that operates the popular 163.com portal; in particular, it is a leading provider of online gaming with several popular titles. Mobile gaming and online lottery offer significant earnings growth potential in the Chinese market.

Bitauto: Market leader in terms of on-line advertising for new car sales in China, with aspirations to become a key player in the development of the second-hand market.

Active strategy: focus on African growth potential

Active managers have the benefit of being able to take a forward-looking view on the economies and stocks they believe are likely to surpass investor expectations over the next decade. Many economies in Sub-Saharan Africa are endowed with a wealth of natural resources and are benefiting from industrialisation and urbanisation. This gives them the capacity to sustain fast growth rates from a low base. Many countries enjoy favourable demographics; large, young populations with low dependency ratios. Low-cost labour can provide a competitive advantage over other markets, while the demographic dividend provides a strong foundation for growth in consumption. The scope for further product penetration is huge, yet competition is often less intense than is the case in other markets. This offers companies the opportunity to achieve strong margins, returns on capital and compounding earnings growth that supports the provision of attractive shareholder returns over time.

South African equities can provide investors with an important gateway to Sub-Saharan Africa through companies that have built on their South African domestic successes to establish broader distribution footprints across Southern Africa. In some cases, this can result in more than a 10-fold increase in the size of their potential consumer base. For instance, **Shoprite** has successfully expanded its supermarket brand across 16 African countries, compounding the proceeds of a return on equity in excess of 30% to deliver total returns that equate to multiples of shareholders' initial investments over the last 25 years. Meanwhile, telecom and payTV companies such as **MTN** and **Naspers** have extended their networks into Sub-Saharan African countries, benefiting from the rapid uptake of mobile telephony and TV subscription services. In the year 2000, despite its population, Nigeria had about 550,000 telephones; today, there are over 90 million mobile subscribers. African mobile network operators such as Kenya's Safaricom are now providing financial services via their customers' mobile handsets, reducing the need for physical banking infrastructure.

Stock highlights

AVI: South African FMCG business that distributes food, clothing and personal care products across Southern Africa, leveraging the distribution of well-recognised brands across an increasingly large potential marketplace.

Naspers: Pan-African payTV business experiencing strong user growth in under-penetrated African markets; it also benefits from stakes in a selection of internet content providers with operations across much of the developing world.

Conclusion

Investors must always try to look forward, and avoid the temptation to use recent history as a roadmap. While the emerging markets continue to offer a range of attractive structural growth opportunities, they are becoming more heterogeneous in nature. This loss of commonality is in turn forcing investors to become more discriminating than before.

The drivers that supported the synchronised growth of emerging markets and their brief mistreatment as a 'homogenous' bloc are fading. In particular, it is a mistake to believe that the knock-on effects of China's rebalancing process will be a negative for all emerging markets. It will simply create greater differentiation between winners and losers. The heterogeneity of emerging markets will once again come to the fore, rendering terms like BRICs outmoded for investors who want dynamic exposures to a range of fast-growing companies.

This is an opportune time to review allocations to the asset class. Emerging market valuations are now attractive both relative to their own history and also when compared to developed markets (see appendix).

Investors should also give careful consideration to how they invest in emerging markets. With passive emerging market approaches allocating money according to size, investors risk receiving significant exposure to stocks in a number of the economies most exposed to the impact of economic rebalancing, as well as a good degree of concentration risk at both the country and stock level. Thus, taking an active and forward-looking approach is likely to be a prudent decision when considering emerging market equities, going forward.

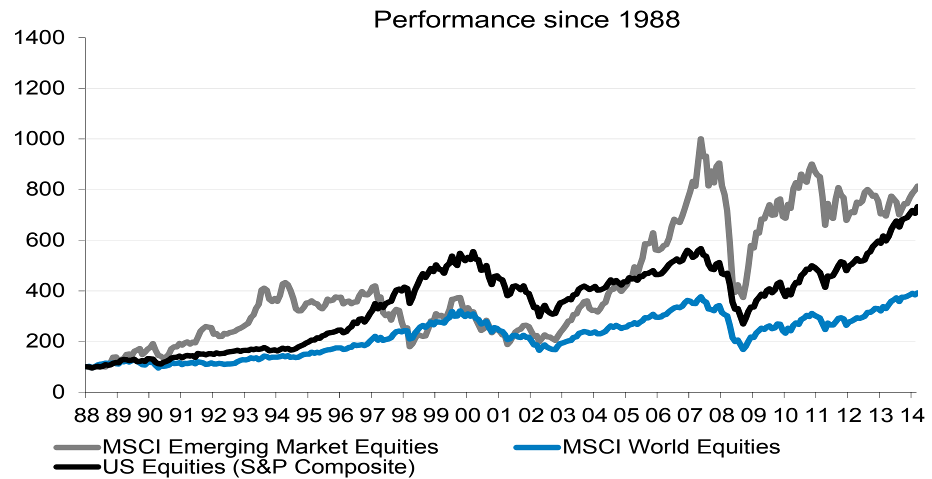
Similarly, investors should pay attention to the investment style of their manager:

- Can they weather 'down periods'?
- Do they focus on quality, well governed growth or growth at all costs?
- Do they actually deliver an appropriate level of portfolio activity for the fees that you pay them?

Those asset managers with a proven ability to take account of important qualitative and bottom-up factors such as corporate governance, ownership structure and management strategy and importantly who are focused on avoiding the weakest of stocks as well as owning those with the best compounding potential should also be those best placed to serve their investors over the next decade.

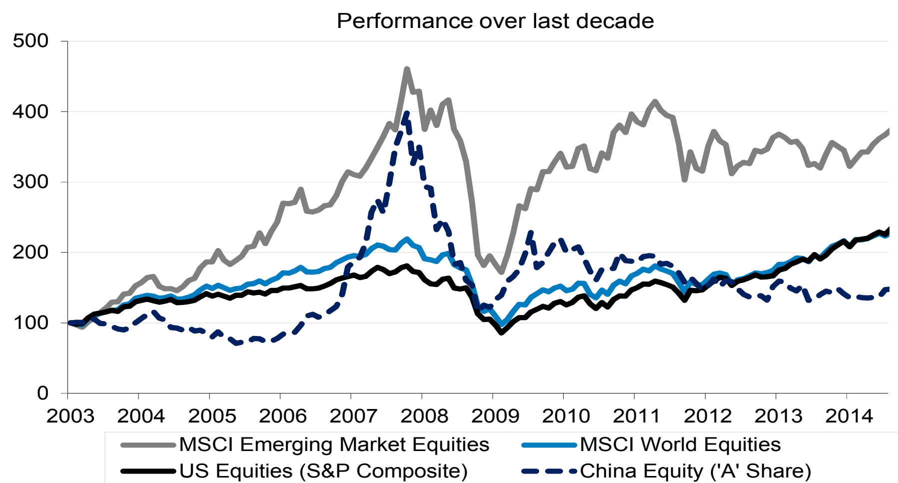
Appendix: additional charts

1. Long-term performance



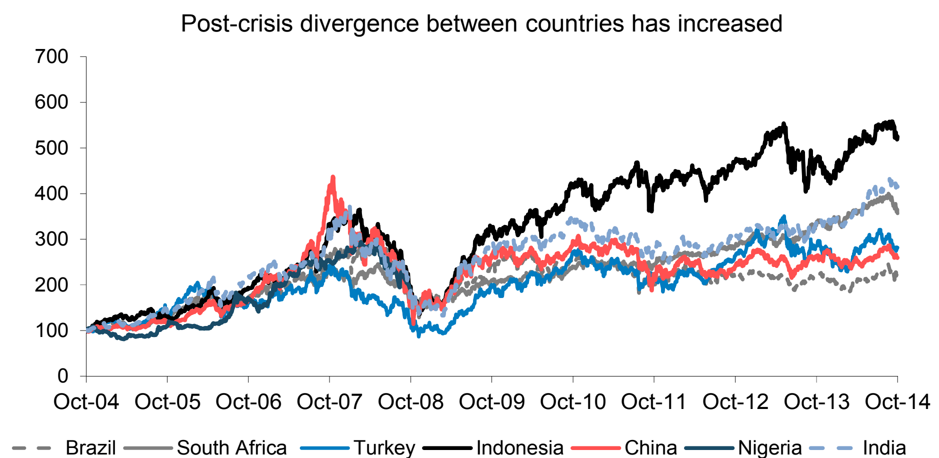
Source: DataStream, 30.09.14

2. Increased regional divergence



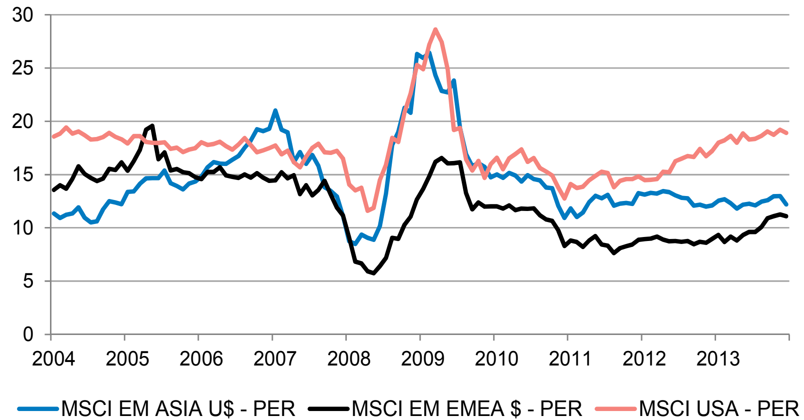
Source: DataStream, 30.09.14

3. Increased divergence between countries



Source: DataStream, 30.09.14

4. Emerging markets are attractively valued



Source: DataStream, 05.10.14

Notes

1. IMF World Economic Outlook (April 2014) and MSCI as at 31.07.14.

2. Chinese National Statistics Bureau.

3. Bank of International Settlements BIS Quarterly Review, September 2014 'International banking and finance developments.

4. 'The Return to Active Investing', Perspectives, Fidelity Worldwide Investment, May 2014.

5. Miller, R.M. (2007) "Measuring the true cost of active management", Journal of Investment Management, 5(1). Note Miller's analysis is confined to US large cap stocks.

6. European Economic Intelligence Unit 2012.

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