INVESTMENT

Emerging opportunities

Coronation Fund Managers' Global Emerging Markets Strategy co-manager Suhail Suleman **talks to *European Pensions* about the benefits of direct investment allocation to emerging markets**

Emerging markets (EM) are known for their bouts of volatility. Is the time now right for European pension funds to look to increase their direct allocations to EM, and if so, why?

If you look at emerging markets' contribution to global growth, and how this is represented in their weight in global indices, you will see EMs are under-represented. They should probably be 25-30 per cent of global markets; in reality they are 12-13 per cent. There are reasons for it, such as some larger EM companies having low weights in the global index due to controlling shareholders and obviously the indices look at free floats, not total market cap. So there are some reasons, but it shouldn't be as low as it is.

What we saw a couple of years ago is that developed markets did very well. Global stocks were up a lot from the post-GFC low in early 2009 and although emerging markets did the same for a while they were flat overall for six years from March 2011. So people did not increase their GEM allocations, and because the global stocks had done so well, they ended up being quite underweight emerging markets. Because of the difference in relative performance, you would have had to actively reallocate substantially from global to GEM to stop your relative allocation from falling a lot. Some of this did occur in 2016, where we saw people putting more money into emerging markets and they have been rewarded with good performance since, but we're still not back to anywhere near what we think are the appropriate levels of exposure to emerging markets due to the scale of relative underperformance during the six aforementioned years.

Are there any particular sectors or regions within emerging markets where European institutional investors should focus their attention?

We feel that if what you're after is exposure to long-term compound earnings growth in good businesses, the right way to do it within equity emerging markets is to focus on stocks that are slightly higher up the quality spectrum but are trading at a reasonable valuation.

If you look at our portfolio, it is predominately made up of stocks in industries that we consider to have reasonable barriers to entry, all with a long-term tail wind because of increased penetration. For example, food retailers in Russia, where you have a very fragmented industry with the top player only having 9 per cent market share. If you have a market leader that is growing and consolidating, you could have years of good earnings growth ahead of you and you can buy them on 12-15 times earnings.

The private university education stocks in Brazil, are very attractive from both valuation and long-term growth of the industry. Banking in India, if you are in the private sector banks, it is very attractive because they are so much better run than the public sector banks and collectively only have 30-odd per cent market share between them.

We have got a fair bit in tobacco in the multi-nationals, which we feel have been excessively punished by the market based on recent results and regulatory fears. They trade on 12-13 times earnings and many other staples are on 16-20 times earnings. They have decent dividend yields and will probably be the long-term winners in the shift away from smoking cigarettes towards alternative, less harmful, products.

In the Chinese internet space, we have exposure to some of the names but we do think valuations are slightly high, so we have been reducing. But we do think the long-term drivers for this stock are very powerful. China has leapfrogged many of the market developments that were seen in the West, as far retail infrastructure is concerned. You already have a bigger e-commerce market in absolute dollar terms in China than the US, and you still have 20-30 per cent of the population without internet access, and you have steadily rising incomes and the associated spending that goes with this.

Emerging market investing has become more sophisticated in

recent years, for example with improvements to EM indices. What does this mean for active allocation to EM versus passive?

We think the weight of the global stock in the EM indices is too low, so direct allocation is very important if you want to get EM exposure. As for active versus passive, it is important to know that the index has changed materially over the past 10 years. When we first launched our strategy, in 2008, the index was dominated by state owned businesses, as well as commodity players, particularly in the larger weights. That is less so today. The biggest stocks in the industry today are the tech stocks, such as Samsung Electronics and Taiwan Semiconductor Company. You are getting slightly higher-quality businesses when you go for passive allocation than you did historically.

From an active management perspective, valuation is very important. The reality is most of the stocks I mentioned have run quite hard. In fact, interestingly, we did the sums and almost three-quarters of the total return in EMs has come from four stocks – Alibaba, Tencent, Samsung Electronics and Taiwan Semiconductor Company. That's why you see these companies being so large in the index and trading at higher valuations relative to history. You are reliant on continued earnings of 20-30 per cent for the next five to seven years to justify holding them. That may happen, and we directly or indirectly own all of them, but having 5-7 per cent of your portfolio in each of them is not prudent for a long-term investor when you take valuation into account. If you are a passive investor, you will end up having those sorts of weights. Also, active management is very important in emerging markets because there are some countries that are very underrepresented in the index and are sometimes dominated by single stocks like Petrobras for Brazil or Gazprom for Russia.

While there have been some improvements in the index, there is still this massive tail of very poor businesses in emerging markets. There are very mature telcos, like the ones in China, which are used by the state to develop local technological expertise. If you go anywhere else in the world, your towers and electronic equipment will probably come from the likes of Nokia, Eriksson etc, while in China they are trying to get the local players to do this. This is great for the local manufacturers, but not great for the shareholders of these telos who are paying large amounts of money to fund development of this industry. We are active managers because of what you can find if you are prepared to dig deep, as opposed to what you get in the index.

How do you construct your portfolios to maximise the opportunities of emerging market investment? For instance do you adopt a top-down or bottom-up approach?

We are completely bottom-up focused. We look at companies purely on the basis of the valuation. After all, it's said the best business bought at the wrong price is a bad investment. We have a preference for quality, a preference for above-average businesses, but what we have in our portfolio are a mixture of businesses across the quality spectrum and they are there because of the valuation of comparing the upside against what we think they are worth today. We try to create a portfolio that is not dependent on one particular country or sector – eg we will not have 40 per cent of the portfolio in commodities, as you are then very dependent on the commodities cycle.

We try to create portfolios that will generate alpha in most economic scenario over long periods of time, such as five to 10 years. Looking at the performance over around seven years or longer is appropriate when looking at EMs, as they trade wildly based on short-term news. It is almost impossible to get rid of the volatility within EM, but it does give you the opportunity to buy stocks when they are hit by short-term news while the long-term investment case remains intact.

You mentioned that EM stocks can trade wildly based on short-term news. So it is recommended that investors look beyond the short-term headlines and consider the long-term gains that may arise. What are the benefits of being a long-term investor in emerging markets?

The biggest gain would be that EM will deliver better long-term earnings growth than developed markets. The incomes are growing faster and the industries are more fragmented so it stands to reason that EM businesses will grow at a faster rate than developed market businesses. The challenge is converting this into earnings growth as not all companies will benefit equally. You have companies with 5-10 per cent of market share today that could have 20-40 per cent market share in 10 years. You may make or lose money in the short term, but over a long-term time frame, EM should deliver reasonable absolute return, and in comparison to developed markets.

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