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Opalesque Exclusive: Thematic approach is favoured among emerging market equity strategies

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As emerging markets (EMs) economies continue to grow, many fund managers think one of the best investment bets could be in EM equities. Two managers explained their rationale for investing in EM equities at the Jetfin conference "BRIC 2010" in Geneva a couple of weeks ago.

Valartis: Commodities, infrastructure and domestic consumption
There is a strong investment case for emerging markets, according to Valartis Group AG, a Geneva-headquartered asset and wealth manager with CHF6bn ($5.5bn) in AuM.

First of all, EMs are an attractive alternative to developed markets. Indeed the later's deficits and outstanding debt are too large and central banks' balance sheet expansion and printing is debasing currencies, making the USD's status as a reserve currency questionable, and seeing SWFs and EM central banks diversifying reserves.

The investment case is supported by growing intra EM trade and domestic growth. Low interest rates are pushing global investors up the risk curve and out of developed markets, and EMs provide good exposure to hard assets, value and growth.

"Commodities, infrastructure and consumers are our main themes," said Tim McCarthy, who manages three successful EM mutual funds at Valartis.

"EMs have to refocus their economy on domestic consumption," he continued. "That's where we find it on the upside. In fact there are now 109 million households earning more that $100,000 p.a. in EMs, compared to 110 million households in the U.S."

However, EMs' equity markets are not for the faint-hearted: BRIC (Brazil, Russia, India, China) for example saw their equity markets fall significantly in the later part of 2008. In the last 36 months, Brazil fell -59.92% peak to trough, then rallied 134%, and is almost fully recovered; Russia fell the most, -79.90% peak to trough and is still 38% below its peak; India fell 61%, rebounded 114%, and is now just 15% below its peak; China peaked in Oct-07, fell 72% to trough in Nov-08, up 80% from trough and is still almost 50% below peak.

GEM equities suffered from fund outflows of $50bn in 2008 but $83bn went back in last year. But EMEA (Europe, Middle East, Africa) has had cumulative net outflows since July 2006, and now

China has outflows.

According to Valartis, China and India currently look expensive and Russia looks cheap on almost any metric. "Within BRICs, Russia stands out for value-focused funds," said McCarthy.

Political and economic risk has declined and returned to pre-crisis levels, but the accuracy of risk perceptions is still questionable.

McCarthy believes that perceptions of corruption interfere with market valuations. He is confident about a lesser geopolitical risk in Russia, especially in light of new relations between Obama and Medledev, and a warmer and symbiotic relationship between Russia and China, as well as more growth-creating trade, encouraged by a calmer geopolitical climate.

The macro outlook is rather promising: the top 10 EMs have a collective GDP equal to 21% of global GDP and 88% of US GDP. BRICs are expected to exceed US GDP in 6 years under current growth rates, or 9 years if China slows down to 9% - as indeed, China's ability to sustain such high growth without inflation seems incredible. And EMs' consumption now exceeds US's. Furthermore, BRIC currencies should be in demand due to higher growth and interest rates.

On the assumption that this year, oil prices average $70/bbl, there will be no attack on Iran or other catastrophes, CDS spreads tighten a further 25 to 50 bps, there are not dramatic rate hikes, Russian policy rates decline to 7.5%, Russian mortgages and inflation decline, U.S. rate hikes to 50bps and the China/US currency dispute is resolved - then Valartis expects the following equity market returns for 2010: Brazil 20 to 25%; Russia 26 to 32%; India 6 to 12%; and China 12 to 18%.

Carmignac: Brazil real estate, Indian consumers, themes
Didier Saint-Georges, member of the Investment Committee at Carmignac Gestion, a Paris-based asset manager with Eur33bn in AuM, thinks that a big global rebalancing is a reality. The challenge in the coming 5 to 10 years, for EMs, will be to reinvent and find growth. Carmignac currently finds more opportunities in India (in which it is overweight) and then China.

There have been inflation scares, he said. But the situation in Brazil is under control - as there is inflation but also steady interest rates. There is also a big shortfall in housing. The government will create 1 million new homes, but that will not be enough. So in the coming years, a lot of real estate investments will be in demand.

Inflation in India is not so well controlled, as the central bank, not ahead of the curve, recently hiked interest rates. India's long-term perspective can be seen through the age pyramid, which shows that its working population (aged between 20 and 50) will be much bigger in the coming 10 years. Consumer demand and demographics are therefore in favour of India, and in a medium-term perspective, India is in an interesting position.

In China, there is the real estate bubble issue. Public debt is now at 50% of GDP and household debt 16% of GDP (compared to 90% for the U.S. and 60% for Europe). Saint-Georges thinks that

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the existing China real estate market is not overleveraged and so there is no huge downside risk.

Saint-Georges believes that, with regards to valuation numbers in EMs, there are a "lot of hidden ideas behind the figures, as for example, the average PE is influenced by resources stocks." He also thinks that value investing is tricky in EMs, as there may be big discrepancies depending on the sectors one invests in.

So it is best to look at themes and find the best players or opportunities in global rebalancing.

As for absolute returns, as EMs are becoming more efficient, easy opportunities in inefficiencies and arbitrage are not there so much any more. Also, model-based investing and quantitative investment got hurt during the crisis, so, he concluded, "it is better for returns to be roughly right than very scientifically wrong."

Interest in EMs by U.S. investors has burgeoned over the past two years, said financial-planning.com. Nearly half of the 1,300 alternative investors surveyed by Brighton House Associates in the fourth quarter said they were interested in hedge funds following global macro trends because of the strategy's broad economic approach and highly liquid structure.

But it is good to bear in mind however, that not all financiers agree on the EM opportunity. Economists at a UK bank called Standard Chartered recently said that surging flows of capital from the west into emerging economies threaten asset-price bubbles that could trigger a new phase to the global financial crisis, The Guardian reported. They also warned that urgent action was needed to address the potentially destabilising impact of "hot money" attracted by stronger growth and higher interest rates.

See yesterday's **Opalesque Exclusive: Some macro strategies in emerging market investing**
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