



cio investment club

Whitepaper #6

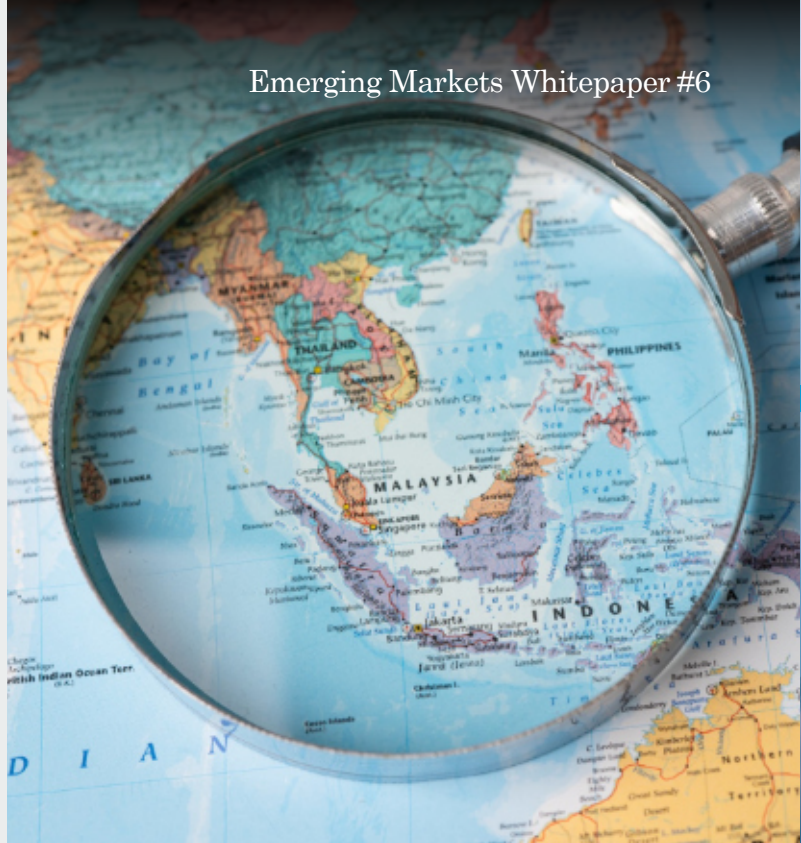
August 2024

Emerging Markets Whitepaper – Emerging Markets have come of age

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Marketing communication

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Introduction

Looking forward, it is a serious doubt that there may be too many humans for the planet to sustain this century. Looking backwards, the last thirty years have seen billions of people lifted out of poverty. Those two points may be connected.



The rise in living standards has much to do with the success of populous countries such as India, China, Indonesia, and Vietnam industrialising. Farmers have become factory workers, replicating a pattern in Western Europe and the U.S. many decades ago. To keep costs down, companies in these rich regions have tended to transfer both light and heavy industry to Emerging Markets, with the irony that their efforts are financed in part by the pension funds of the rich-world workers who lost their jobs as part of the transfer.

The moot question for pension funds and other institutional investors is how much to allocate to Emerging Markets. Many long-term investors have been derisking this century. As such, the additional returns from EM have been overshadowed by concerns about the extra volatility. It pays to stay invested but many rich-world allocators do not demonstrate long-termism. Instead, they retreat periodically – often reactively - from EM and thereby amplify volatility.

There are also some persistent misperceptions such as the default risk versus equivalent debt in other markets, notably the U.S. The latter wins out because of its breadth and familiarity but comparable corporate default rates year by year fluctuate.

Those fluctuations are a great case for allocating patiently EM to diversify sources of return. The question here is whether to use specialists for each region, or even a truly free global manager in bonds or equities. One concern for asset owners is that the best EM managers charge so much in fees that the net return does not justify the effort.

A final matter for discussion brings us back to sustainability. The UN SDGs want to raise basic standards for all humans by 2030. But the Dasgupta Commission on the Economics of Biodiversity reckons that the SDGs are not sustainable, even if we reached them.

Figuring out sustainability would be hard enough if the countries of the world were unified in their approach. Instead, political division, war and deglobalisation are trending. Will Emerging Markets maintain a sustainable trajectory as the regions which fostered their industrialisation now put up barriers to their goods and services? Will they be able to afford profound decarbonisation?

Investors in EM need to define their role in these conundrums.



Access

The cio investment club roundtable on Emerging Markets began by asking panelists how they accessed both debt and equity from these countries.

Ian Coulman, CIO of Pool Re, the £7bn reinsurer against terrorist acts to UK commercial property, started by recalling a risk rebalancing exercise away from equities some years ago. Pool Re considered Emerging Market debt alongside High Yield and Bank Loans as three new diversifying sources (It had dismissed distressed debt and convertibles as too equity-like). “We chose Multi-Asset Credit Strategies (MACs) to take advantage of value when it presented itself between asset spaces,” said Coulman. “We recognised that we could have used specialists in each sub-class but then we would have had the challenge of moving money from one to another in time to capture fresh opportunities.” He reckoned it could have taken up to six months for such moves to be effected inhouse, hence the choice of MACs.

Regarding EM equities, Pool Re does not have a specific mandate. It has instead a mandate tracking a Value-Weighted global equities index which includes Emerging Markets.

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There may be fantastic opportunities in Brazilian LC debt, for example...

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Jeremy Cunningham, investment director at Capital Group, asked why investors were passive in Emerging Markets equity. Coulman responded that while he saw little variety in active equity in Developed Markets, the nuances of EM mean that you can find value there. However, for Pool Re, given its allocation, those nuances “do not move the dial”. That is because its total weighting to equities is 10%, meaning roughly just 1% in companies listed on Emerging Markets.

Oriana Mezini, senior investment research consultant at Hymans Robertson, gave another reason: appetite for both EM debt and equity among core clients, UK pension funds, is not as strong as before. “UK defined benefit pension schemes are derisking. When they do choose risk assets, it tends to be on the passive side,” said Mezini. The exception here is the Local Government Pension Scheme (LGPS).

Border to Coast Pensions Partnership is one of the eight pools now managing most LGPS assets. Will Ballard, head of equities at Border to Coast, said that it separates out Hard and Local Currency EM debt within its MACs product. “Hard Currency (HC) is easier because it is effectively the spread over Treasuries and then the credit risk of underlying issuers. With Local Currency (LC), there are a significantly higher number of issuers, domestic factors and foreign exchange that must be included. We try to keep it simple. HC is internally managed. For LC, we believe our external manager is better resourced.”

To decide the relative exposures, Border to Coast has an allocation committee, on which Ballard sits. He described it as a balance when making those decisions. “There may be fantastic opportunities in Brazilian LC debt, for example,” he said. “But I consider that a tactical play. The question we need to tackle is how we get the right long-term exposure.”

The cio investment club roundtable discussed a 50/50 LC/HC blend, building value via the carry rate, not duration risk, and never a strong deviation from the strategic blend.

From a yield perspective, the current differential is 150bps, with HC offering 650 bps versus 800ish bps for LC.

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Corrado Pistarino, is CEO of Foresters' Friendly Society, a £350m investor which currently has no allocation to Emerging Markets. He said one had to strike a balance between complexity and diversification. "Why have one extra line on the balance sheet? Perhaps it is my lack of familiarity with the asset class but what are the risk premia I am trying to capture?"

Cunningham said that 20 years ago there were only around 20 markets in Emerging Markets, and most of those were in Latin America. "They went up and down together," he said.

From a US\$300bn universe, EM has grown to over US\$6trn today, including around 80 countries and in recent years dominated by local currency issuance. "Poland, Mexico and Ghana are all different types of economies at different stages of development," he said. "How they react in different regimes is vastly different even within HC or LC segments."

Responding directly to Pistarino's query on risk premia, Cunningham said that it is no more complicated than credit risk.

Pistarino replied that he was more attracted to LC than HC for diversification purposes. He asked Cunningham what the size of Capital Group's EMD team was. "What's your edge?"

Cunningham replied "If I was on the other side of the table, that is what I would be asking too. Given the size of the EMD universe and the fact that economies are at different stages of development, we believe it is important to have a specialised team of analysts and traders each with designated coverage. Equally important is having specialist EMD risk analysts."

Cunningham warned against passive – "or else you risk getting stuck in distressed situations such as we saw recently in Sri Lanka."

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Skills Gap

The cio investment club turned back to EM equity. Ballard explained that Border to Coast has separated their approach to Emerging Markets into two parts. The internal investment team covers EM ex China whilst they have two external managers focussing just on China. Because of the complexity of that country, having external resources made sense. “At this stage we believe that our partner funds are better served by gaining access to external expertise for China rather than solely relying on our team up in Leeds,” explained Ballard.



Søren Sørensen, senior portfolio manager at Russell Investments, said its EM equity strategy is composed of a diversified mix of active strategies. Each manager needs to be differentiated against the benchmark and against the other managers on dimensions including investment style, process, and regional capabilities. Multi-manager provides a “single-line-item” solution to this complex asset class.

Mezini said that China or ex China was a question with multiple factors in the underlying economics. “EM ex China is still dependent on China,” she remarked.

“When we think about China in EM debt,” said Cunningham, “it’s important economically but plays a defensive role in an EMD portfolio. You can buy China bonds if you want to derisk, where before you bought US Treasuries.

Cunningham said that if Trump gets elected for a second term as U.S. president, then there is a higher probability of increased protectionism. This raises the risk that Chinese money may flow out of U.S. Treasuries.

Ballard questioned whether we had that with Japan decades ago. “Yes, and elsewhere,” replied Cunningham. “Reducing risk is relative to the other constituents of the portfolio.”

Mahtani asked about exposure to China in Border to Coast’s current allocation.

Ballard replied that it was ‘bang on’ benchmark. “We worry about some of the structural issues in the economy and there is a tendency to ‘extend and

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on all the measures we look at, there is no denying that China is very cheap

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pretend’ rather than deal with the underlying issue,” he said. “But our three-year view on China is positive as on all the measures we look at, there is no denying that China is very cheap.”

Regarding the woes of the property sector in China, Ballard noted that local authorities got part of their money from land sales. That is a big incentive to keep the status quo.

Sørensen said there has been a dramatic sentiment shift from China to India within EM. “It’s amazing how things have changed over three years. We have a smaller specialist that predominantly does the private enterprise side of the Chinese economy. It’s been a difficult journey in recent years – in terms of beta and alpha – as China has propped up state-owned enterprises during the sell-off over the past three years.”

Russell has nevertheless retained the specialist manager, and while the top down is uncertain, believes some Chinese businesses are currently under-appreciated: “It is a very deep market given all the issues,” he said.



The role of Russell is to combine managers from a diverse spectrum. Sørensen noted that EM is a very diverse opportunity set geographically and from a sector standpoint. He gave the example that very different skills are required of contrarian managers in Latin America hunting for Value in Brazil, compared to identifying the next compound growth idea in India or Taiwan.

Pistarino returned to the dilemma of complexity versus benefit. Given the employment of different managers in a multi-manager portfolio, he noted that the asset owner gets diversity but has to engage with those moving parts.

“I can see EM as a tactical play but on a strategic basis, then over the next 10-15 years I have to deal with the vagaries of this market.”

Sørensen replied that employing different managers should lower risk, making the journey more palatable rather than more aggressive. He did suggest that “in some respects, it is easier to have conviction on the trajectory ten years into the future than the very near term”. The dollar and the US market’s outperformance compared to EM has historically moved in cycles and would eventually diminish. “There is a strong case for a contrarian view on EM if you are patient.”

Cunningham said from an EMD perspective, we are now at an inflection point. He suggested that a couple

of years of good performance are needed to make people increasingly comfortable with the asset class.

“Three-quarters of EMD is rated Investment Grade,” he said. “It’s a high quality asset class, which is not the common perception as many think of it as predominantly sub investment.”

He then remarked on the big trends of redistribution of economic activity away from China and decarbonisation. “Given we are unlikely to reach total-isolation policies, the question is: who will be the major beneficiaries?”

Sørensen agreed that EMs are trading more with each other. “It might look like deglobalisation but that could be the view from DMs,” he said. “Look at how many Electric Vehicles Brazil is importing from China.”

Mezini noted that not just finished products but supply chains can potentially be re-routed.

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Early to India

Within EM equities, India has been a star performer in recent years. In EM debt, the country has been harder to access. For reasons of capital control, it has not been included in the standard JP Morgan index. But Capital Group had facilitated access and held 8-9% of its EMD strategy in LC India sovereign debt until recently.

Cunningham noted that now that India is coming into the JP Morgan benchmark index, his colleagues feel that the “inclusion boost” is already somewhat in the price. Capital’s EMD strategy, which has held India local currency sovereigns for almost 10 years, has therefore reduced exposure to 1-2%.

Ballard pointed out that debt investors do not get access to the growth story. Equity does, while bondholders just get repaid.

Cunningham partially agreed. He noted that while the majority of EM debt is issued by states, 5-6% of Capital Group’s blended EMD strategy was in corporate issues.

Capital Group also has a multi-asset EM fund, which was developed as a solution for clients attracted to the long-term growth offered by Emerging Markets but put off by the volatility inherent in Emerging Market equity investing.

Pistarino noted that from the perspective of an insurer, he preferred the multi-asset option. Sam Mahtani, an independent consultant and former EM manager, said that it could be best to invest in both EM equity alongside EM debt.

Mezini asked Cunningham how Capital Group thinks in terms of risk management, for example the off-benchmark allocation to India.

“There are lots of moving parts,” replied Cunningham. “We have a team of dedicated risk experts who take the EMD portfolio and disaggregate the risk. EMD is such a broad asset class with a variety of instruments: sovereign, quasi sovereign, corporate, nominal and inflation linked bonds. Each of these bring a set of risks that vary significantly and therefore need to be understood before being included into a portfolio. Specialist risk analysts are more readily equipped to identify where anomalies lie in portfolios. Having them embedded within the investment process ensures portfolio managers have real time understanding of which risk factors are driving the portfolio. This allows portfolio managers to accurately reflect their investment views in the portfolio and to adapt efficiently when investment views evolve and change over time.”

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We have a team of dedicated risk experts who take the EMD portfolio and disaggregate the risk.

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Politics

The cio investment club roundtable closed on the issues of politics and engagement. Mezini noted that active EM equity managers had got caught out holding Quality Russian stocks following the invasion of Ukraine and subsequent embargoes.



Mahtani noted that the invasion pushed geopolitical risks up the agenda of investors to become their number one issue at that time. “It’s very challenging to build geopolitical shocks like this into an investment framework,” he said.

“But it does show the importance of country risk, said Ballard. “You need to have policies.” He said Border to Coast tracked investment flows coming and going, and how they were influenced by reforms.

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EMs do not fall like dominos in a crisis...

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Cunningham noted that flows do not just involve governments. Egypt’s recent support package from the UAE triggered further money from the IMF, resulting in Egypt getting US\$35bn. He noted that the presence of the IMF adds further scrutiny to how the UAE funds are deployed and increases the probability that the monies will be utilised in a productive economic manner. “We can’t influence the Egyptian government as minority bondholders but we can follow the IMF criteria to keep them on the right path,” he said.

Mahtani asked about state investment in companies, notably China. He noted that the private education sector in China was effectively shut down a few years ago.

“There has always been this divide in EM between state-owned enterprises and the private sector,” observed Ballard. He pondered, however, whether any company in China is truly private.”

Sørensen turned towards new advances in technology. He noted that some EMs had the opportunity to leapfrog DM because they were not saddled with redundant infrastructure. “There is a growing middle class, and EM consumers have jumped straight to online banking and e-commerce on their smart

phones. So it’s a real opportunity for growth,” he said, “especially the ‘winner-takes-all’ model.”

Ballard observed that some DMs are now more indebted on the GDP-to-state debt ratio than EMs.

Pistarino countered that countries such as France or Italy have deep pools of domestic saving whereas as EMs do not. “Those domestic savings are there in times of crisis,” he said.

Cunningham reiterated that with LC being the most popular form of issuance, there is no longer high levels of contagion. “EMs do not fall like dominos in a crisis,” he said.

On sustainable investing, Coulman said that dialogue between asset managers and issuers is critical: “We expect all our managers to report back on their engagement.”

Mezini said that for Hymans, across all EM managers, sustainability is a key criterion.

She added that Quality Growth companies tend to be away from polluted sectors.

Mahtani urged investors keen on sustainability to do their own research rather than rely solely on third-party agencies. “Read the reports these companies publish,” he said.

Ballard called for relative judgements. “India and China are still improving their people’s standards of living. Factor that into your assessment,” he said. “Adjust your demands in terms of a just transition. Otherwise, they will be unrealistic.”

Cunningham said that Capital Group employees, on debt and equity, held over 20,000 meetings with companies and issuers last year. He was sanguine that these engagements have an impact on the EM sovereign asset class. He accepted that direct influence on sovereign issuers by bondholders was limited per se, but collectively would have a positive effect because the messages on ESG were now coming from all corners of the asset management industry.



Participants



Søren Sørensen

CFA, Senior Portfolio Manager, Russell Investments

Søren is a member of Russell Investments' Emerging Markets Equities team and manages Global Emerging Markets equity funds. Aside from selecting subadvisors and managing portfolio exposures, Søren conducts regular reviews of funded managers and participates in the research of broader manager universes and the firm's proprietary investment capabilities.

Prior to joining Russell Investments in 2008, Søren worked for two years at Kirstein A/S a Copenhagen based investment consultant.

Søren holds a Masters in Finance from Copenhagen Business School and a CEMS Masters in International Business (MIB) from Wirtschaftsuniversität Wien.



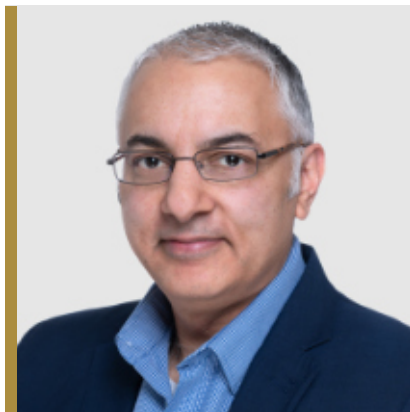
Oriana Mezini

Senior Investment Research Consultant, Hymans Robertson

Oriana leads the global equity manager research responsible for selecting global equity and global emerging markets managers across different investment styles and approaches. Prior to Hymans Robertson, Oriana has worked as a fund researcher and portfolio manager for large global asset managers and private banks. She has also covered real estate and fixed income funds during her career.

She holds the Chartered Financial Analyst (CFA), Chartered Alternative Investment Analyst (CAIA), Investment Management Certificate (IMC) and the CFA ESG Certificate.





Sam Mahtani

Director, Alpha ESG Consulting Ltd

Sam has a total of over thirty years of investment experience and is the founder of Alpha ESG Consulting Ltd, an Independent Sustainability and Investment Advisory firm, helping charities, foundations, and fund management firms with their approach to investing sustainably.

He is an Advisory Board Member for the government backed 'Be the Business' board scheme helping advise and mentor small business entrepreneurs in the UK. He also sits on the investment committee of a leading animal welfare charity in the UK.

Sam is an Associate of the Institute of Financial Services and a member of the CFA Society in the UK.



Ian Coulman

Chief Investment Officer, Pool Re

Ian has been Pool Re's Chief Investment Officer since joining in 2011. As CIO he is responsible for the development and implementation of investment strategy, strategic asset allocation and the monitoring of the range of managers through whom Pool Re invests.

Prior to joining Pool Re as CIO, Ian fulfilled a number of senior investment roles with Butterfield Bank in Bermuda and AIG in London, Boston and Tokyo. Ian began his investment career with the private Swiss bank Lombard Odier.



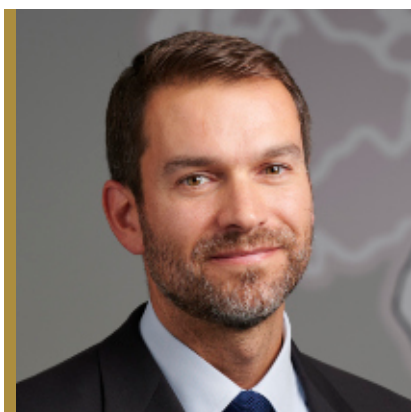


Corrado Pistarino

Chief Investment Officer, Foresters Friendly Society

Corrado has over 25 years' experience in investment banking, asset management and insurance. He is CIO and Chair of the Climate Risk Forum at Foresters Friendly Society.

Corrado holds a degree in Physics from Turin University and a Master in Finance from London Business School.



Will Ballard

Head of Investments, Border to Coast Pensions Partnership

Will leads Border to Coast's equity investment team. He joined the LGPS pool in 2022 and has 23 years' investment experience, having previously worked for Aviva Investors where he was Head of Emerging Market Equities.

Prior to joining Aviva in 2009, Will worked at the Royal Bank of Canada and Henderson Global Investors.

He is a CFA Charter holder and a Cambridge University graduate.





Jeremy J.W. Cunningham

Investment Director, Capital Group

Jeremy has 37 years of industry experience and has been with Capital Group for eight years.

Prior to joining Capital, Jeremy worked as head of EMEA fixed income business development at Alliance Bernstein. Before that he was head of product management at Schroders. Earlier in his career he was a fixed income portfolio manager at INVESCO, J.P. Morgan Fleming and Merrill Lynch.

He holds the Chartered Financial Analyst® designation.



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In attendance



Brendan Maton (Moderator)

Director, Crayford Ash

Brendan Maton has been covering pensions and investments as a journalist for almost thirty years. He began his career at FT Business before going independent in 2003. Since then, he has chaired roundtables, moderated investor conferences and hosted the IPE channel of sponsored webcasts. He still writes on pensions and investments for IPE as well as freelancing for a host of organisations.



Shannon Gaughan

Director, UK & Ireland Institutional, Capital Group

Shannon Gaughan is a director for UK & Ireland Institutional at Capital Group. She has seven years of industry experience and has been with Capital Group for three years. Prior to joining Capital, Shannon worked as a sales and relationship manager at FX Connect. Before that, she worked in sales and business development at State Street Global Exchange. Shannon holds a bachelor's degree in global business from Dublin City University and a bachelor's degree in international business with a concentration in finance from Northeastern University in Boston. She also holds the Investment Management Certificate.



Sean Thompson

Founder & Director, cio investment club

Sean has 38 years of experience working in London's financial services sector and the insurance market. After 10 years as Managing Director of CAMRADATA, Sean launched the cio investment club on 1st January 2024.

The cio investment club's mission is to become the voice of chief investment officers and investment professionals at institutional firms. To help achieve this the club hosts events throughout the year that educate and inform, whilst providing thought-provoking content to its members.



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The voice of chief investment officers and investment professionals at institutional firms

The cio investment club hosts events throughout the year helping to educate and inform, whilst providing thought-provoking content to our members ... and so much more:

- Data-driven insights
- Intelligent research
- Roundtables
- Investment Breakfasts/Lunches
- Peer-to-Peer Discussions
- Conferences



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