Investors consider more flexible approaches to emerging markets

Asset owners have lowered their exposure to emerging markets after a decade of underperformance and are increasingly considering country-specific mandates for both risk control and return enhancement, according to a panel at the annual Frontier conference.

Geopolitical considerations and divergent performance of the two largest emerging market countries, China and India, have underlined the shift with investors now specifically considering emerging market ex-China allocations.

James Gunn, Head of Equities, Frontier Advisors, said it was dominating client discussions, but few had moved past the conceptual stage.

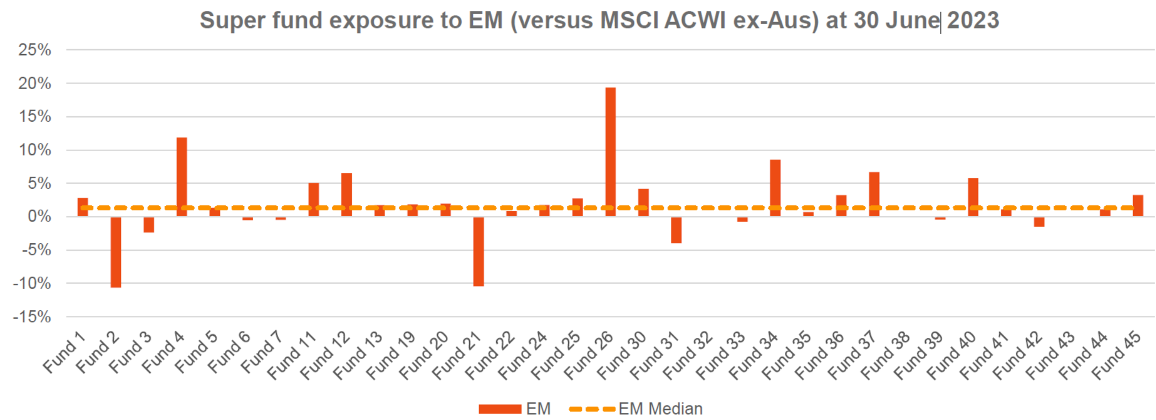
“I think in the US it's quite different where there are not necessarily the same benchmarking issues and there's absolutely some specific sovereign considerations for particular pension funds.”

Dominique d’Avrincourt, Head of Equities at TelstraSuper said the fund had considered funding a separate India mandate but instead decided to give an emerging market manager a 35 per cent leeway to invest in India, which has more attractive demographic and economic tailwinds than China.

“The only reason is the size of our fund,” she said.

She said emerging market investors needed an absolute return mindset to invest in the sector and should not pay performance fees relative to the benchmark. However, Telstra Super still had exposure to China because of benchmark risk.

This more flexible approach comes as overall Australian asset owner allocations to emerging markets have declined, although on average they remain slightly above the benchmark. Frontier maintains a forward-looking conviction that an active, dedicated exposure to emerging markets can be return-enhancing and provide diversification benefits.



Source: eVestment, Frontier, Portfolio Holdings Disclosure

China versus India

The performance of Chinese and Indian equities has diverged materially in recent years, along with a narrowing of their respective index weights.

Patrick Russel, Director, Portfolio Manager/Analyst, Northcape said successful emerging markets investing required selecting exceptional businesses while also managing sovereign risk.

“If you're not managing or integrating the sovereign risk, you can lose it all, and a classic example might be Russia. You can invest in quite good business there but then you've lost all your money from a significant sovereign risk breach.”

Northcape's average discount rate for its 'most preferred countries' ranges between 9 and 12 per cent and for its 'least preferred' countries, which currently includes China, significantly higher discount rates are used. In the case of Russia, Northcape was using a discount rate of over 30% when it was included in the EM asset class. As such the manager held no Russia equities when they collapsed immediately after the country invaded Ukraine.

"That's what you've got to do in this asset class. Frankly, it's a contact sport. You have to think defence and then you get the gold."

China's debt-to-GDP was a 'galloping train' while India's debt-to-GDP was declining. Demographics represents another stark contrast with India seeing an influx of young, skilled workers entering the labour force.

"There's a big chunk going into the golden period of household formation – that's 24 to 45 – that's when you get maximum voltage and consumption. That's when an economy really starts to put on the afterburners."

He said these economic shifts would help the Indian mortgage market grow 15 to 20 per cent over the next two decades.

"Over ten years ago, we had more invested in China than India – however, over the years, that started to change, and we now have a substantially larger exposure to India. We've built our exposure to South Korea, partly due to improvements in corporate governance and the growth in the semiconductor industry there. We've upweighted to markets like Indonesia, to some extent, and Taiwan has improved."

TelstraSuper's d'Avrincourt said she had recently visited India where she saw massive construction underway in Mumbai.

"There's a very, very strong private enterprise culture in India and I was very impressed by the entrepreneurial mindset. The businesses that I met all came out very strongly focused on not only improving societal outcomes for India and Indian people in general, but they had a very, very strong focus on return on invested capital.

"I think that's a key difference between India and China. China is very focused on growth and India is very focused on return on investor capital, which is a preferred metric of mine."

She also said China was not a long-term investment given risks including corporate governance. Any short-term opportunities in China could be exploited via futures or ETFs rather than members' capital, while India was a long-term play.

Frontier believes it's important for investors to be monitoring their underlying EM exposures and associated risk contributions to ensure they are intentional – particularly as it pertains to major markets like China and India. Our preferred approach for most investors at this stage is to continue to allocate to EM under a single umbrella, with the potential for making standalone allocations. But we are also supportive of some investors considering alternative approaches to portfolio construction in EM, particularly where they wish to express a specific country view. For example, idiosyncratic factors (including geopolitical risk considerations) have naturally meant more investors are potentially looking to express a separate view on China. This could be for risk control; return enhancement; exposure management; portfolio completion; or a combination.

If you'd like to discuss this further, please contact your Frontier consultant or speak with any member of our equities research team.