

Emerging wealth

Capturing the long-term growth dynamics of the emerging markets

There is no doubt that emerging markets continue to grow in importance in the context of a global economy, but investment solutions in this area are not simple. Over a number of years Watson Wyatt has spent a considerable amount of resource examining the key economic drivers behind the emergence of the structural growth phenomenon taking place in countries such as China and India. Our findings highlighted the complexity many pension funds face when trying to address a portfolio allocation in this area.

Like many other advisors we acknowledge the shifts in economic power from West to East but finding a route of investment that captures this long term trend is multi-faceted and requires consideration of many factors, none more so than governance. Before we tackle the issue of implementation we need to first consider the long-term drivers behind the secular shifts in economic strength.

- Strong expected future productivity and economic growth.
- Strong economic fundamentals; with many emerging nations holding large foreign exchange reserves and experiencing large trade surpluses.

Our rationale for expecting strong future economic growth in emerging markets is summarised as follows:

- The ongoing shift in focus from agriculture to industry and services.
- Favourable demographics (growth in the labour force, particularly relative to developed markets).
- Globalisation, in particular the integration of China and India into global trade has significantly increased the supply of inexpensive labour.
- An increasingly conducive environment for Foreign Direct Investment.
- Deepening capital markets.
- High rates of investment and the adoption of technology has improved efficiency.
- Trade with other emerging economies (as opposed to the US consumer) is increasingly important.

By way of contrast, a number of developed markets (for example the US, which is typically the largest regional exposure within most fund's international equity exposure) exhibit significant current account deficits and unfavourable demographics due to an ageing population. These factors, coupled with a large public and private sector debt overhang, may lead to a weaker economic outlook in the near term as households and governments seek to deleverage and save more. In spite of emerging markets' historic higher risk relative to developed markets, they represent a diversifying opportunity for some of these risks.

developed country levels. Throughout this 'catch up period' emerging economies have the opportunity to grow at higher rates than developed markets.

For emerging markets to achieve this high growth 'convergence path' with developed markets a number of conditions for growth must be achieved:

- Economic factors – stable monetary and fiscal objectives, and inflation-targeting are important policy choices and support long-term investment inflows. From an external perspective, integration into the global economy (that is, trade and

- Political conditions – a robust legal system based on the rule of law and democratic government are most conducive to strong future economic growth.

Consequently, while the underlying structural growth drivers are powerful, there are a number of ways in which countries could fail to deliver on their growth prospects. As such, it is important that clients monitor these conditions for adverse changes and consider a diversified exposure to the long term growth drivers.

While we believe that broad based investments in the most favourable economies and across the capital structure is most appropriate a number of factors can prevent such an approach. For example, the legal framework present in some target markets prohibits investments in certain asset classes or there is a lack of suitable investment products due to prohibitive fees and poor vehicle structures. We are also of the belief that the starting point for gaining exposure to emerging economies should be via asset classes that are correlated to the macro trends, liquid, higher capacity, with relatively lower transactions costs and manager fees. As such we concluded that a broad based methodology for investing in the emerging economies should start with equities, debt and currency. However, we note that there may be factors (for example deficiencies in existing indices or the specific nature of the market) that mean that an active approach is still preferable in certain asset classes.

Other asset classes (for example private equity and real estate) are highly heterogenous in nature and implementation in these asset classes will largely be an 'alpha play' rather than offering a long-term link to secular economic changes. Here,

“ We believe that emerging market economies will continue to grow strongly, due to a mix of rising productivity, economic and financial reforms, and favourable demographics. ”

On a GDP basis, the emerging world is dominated by the BRIC economies (Brazil, Russia, India and China). Over the last decade, emerging markets (especially China and India) have shown growth rates well in excess of developed countries, consistent with the arguments presented previously. We believe that emerging market economies will continue to grow strongly, due to a mix of rising productivity, economic and financial reforms, and favourable demographics. It is a widely held view that emerging market productivity levels, particularly in Asia ex Japan, will eventually converge to

capital flows) as well as gradual capital account liberalisation are also important drivers of long-run growth.

- Human capital – education is an important factor in supporting rapid GDP growth, by providing a flow of skilled workers to meet increasing trend demand as an economy grows.
- Technological capabilities – adoption of new technology is a key driver of improvements in capital efficiency (that is, increasing the amount of GDP output per unit of capital deployed).

fund governance levels are key and will dictate the complexity of the implementation route taken.

So why did we conclude this? Emerging market equities seem like an obvious choice as part of an investment proposal, however, this is not necessarily the case. There is little concrete evidence of a close relationship between equity returns and long-term real GDP growth. The primary reason for this is that the equity price paid for future growth has a critical bearing on future equity returns. In addition, high economic growth may accrue to labour (higher wages) rather than capital, non-listed companies (which may subsequently list as emerging capital markets expand) may benefit most, or demand patterns may favour foreign multinational companies. Ultimately, for economies experiencing high economic growth and high returns on physical capital, and subject to valuations, we do believe their equity markets can deliver relative outperformance. As such, we think emerging market equities should be an important part of an institutional fund's allocation. Timing of entry and benchmark design or manager selection are key considerations.

Debt should also be a component part of a wider emerging allocation. The case for investing in emerging market debt rests on the long term improvement in the economic fundamentals of emerging countries which should lead to improved credit quality, lower yields on emerging market bonds, appreciation of emerging market currencies and improved liquidity of emerging market debt. In order to capture both credit risk and currency appreciation we are of the view that both local and hard currency debt investments should be present in a portfolio of investments. The key characteristics of emerging market debt indices

suggest that some form of active management is essential given the limited number of issuers (which emphasises the need to manage security specific risk), bias of market cap indices towards structurally weak countries and the ongoing development of debt markets which may present opportunities. We recommend emerging debt strategies contain a significant skill component.

We also believe that clients should have exposure to a long-term dynamic basket of emerging market currencies, funded in a diverse basket of overvalued G4 currencies – that is yen, US dollars, euro, sterling. We think this provides direct long-term exposure to higher relative productivity growth in emerging countries and world rebalancing themes. To manage currencies dynamically requires an assessment of the main medium-term fundamental drivers of exchange rates. One of our favoured investment approaches buys (for the long-term) those emerging currencies with the most robust structural fundamentals (mainly Asian currencies), while actively managing nearer term macroeconomic risks.

There are potentially strong cases for many other more illiquid asset classes – for example private equity, infrastructure and real estate. However, there are some specific challenges that mean allocations have to be more opportunistic in nature. In addition, the complexity of these investments ensures that governance levels need to be high. Outlined below are some of the key issues for consideration in other potentially attractive asset classes.

Real Estate

Property is reasonably correlated with GDP growth, which presents a

good economic case for real estate. However, markets (by geography and sector) are highly heterogeneous, with some markets relatively immature. Consequently, security and manager selection are critical.

Private Equity

Many managers have skill-sets that entrepreneurs and management teams value highly and therefore they are well positioned to generate returns by helping portfolio businesses develop and grow. We have a preference for growth capital over buyouts as we believe this is a purer way of playing the emerging growth theme.

Infrastructure

There is a strong case for high levels of spending by emerging countries on new infrastructure projects. However, the firm believes that there will be a wide range of outcomes for foreign, private providers of capital. Some investors may choose to access infrastructure through the indirect exposure of developed and local market equities and others will seek, and benefit, from more direct forms of investment.

Hedge Funds

Managers have significant flexibility and are therefore able to opportunistically take advantage of a variety of market inefficiencies. As such, they can be well positioned to play many themes prevalent in emerging markets in order to generate returns for investors. With the availability of so many different strategies and the immaturity of the hedge fund universe, we believe a skilled fund of funds can offer a compelling trade-off between the extra fees involved and the selection expertise which is paramount in emerging markets hedge funds.

Frontier emerging markets

Differing accounting standards and patchy analyst coverage results in limited transparency and comparability across geographies. As a result the lack of quality data would appear to impact the effectiveness of quantitative investment strategies, but equally can provide benefits to fundamentally driven managers that can expend resource on research to exploit inefficiencies and mitigate exposure to potential fraud. As such our preference would be the use of active management in this asset class. In addition, many products are managed close to Frontier market indices which are inherently biased towards the Gulf States (for example United Arab Emirates, Kuwait, Qatar) which, in our opinion, do not offer many of the economic and demographic attractions in other areas.

In conclusion

We believe that there are strong arguments for a positive long term outlook for select emerging economies. However, the extent to which different countries are leveraged to the key elements of the emerging market growth 'story' varies materially and needs to be factored into investment decisions.

In addition, we believe that there are a number of medium term factors that provide further support to expectations of stronger growth in emerging economies relative to developed economies. Developed economies (especially the US) are experiencing a relatively slow growth recovery, due to the need for the private sector to deleverage and for households to save more. In contrast, emerging economies which did not participate in the credit boom and have high surpluses (especially

China and China-linked countries) are experiencing a more normal, cyclical recovery in growth.

The long term outlook for emerging economies should have a positive impact on the outlook for emerging market related investments across the capital structure and in particular emerging market equities, debt and currencies. Importantly these are the asset classes where exposure to the macroeconomic dynamics can be most readily obtained.

Further information

No action should be taken on the basis of any article without seeking specific advice. If you would like to discuss any of the areas covered in more detail, please contact your usual Watson Wyatt consultant.

watsonwyatt.com

Emerging Wealth

© Watson Wyatt Worldwide November 2009
Ref: 2009-INV-AP1105