Where next for emerging market equities?

In mid-September, **Tell Media Group**, in co-operation with **Baillie Gifford**, **Robeco** and **East Capital**, invited four Norwegian institutional investors and manager selectors to discuss emerging market equities. Tell Media Group founder **Niklas Tell** and Nordic Fund Selection Journal editor **Caroline Liinanki** moderated the roundtable.

By: Niklas Tell Photo: Christer Salling

The discussion, which was held at The Thief Hotel in Oslo, kicked off with Niklas Tell asking the fund managers at the table to provide their thoughts on emerging market equities after the tougher times the asset class has run into this year.

FABIANA FEDELI: "It was a perfect storm and a few elements that came together. On their own, they would not have hurt the market and would certainly not stop the outperformance over developed market equities. However, put together they were formidable. If you think about the Fed hiking rates, typically that has never been much of a headwind for emerging market equities. Related to this, we had a strong dollar and that hurt some weaker emerging markets. We also had some weakness in earnings relative to expectations. Then, the biggest factor was the concern about trade wars. If you look at fundamentals across emerging markets, it's still fairly solid but the fear that the trade war could escalate created a perfect storm."

NIKLAS TELL: "SO BETTER SAFE THAN SORRY?"

FABIANA FEDELI: "Yes, and that has unfortunately been the case with emerging markets for many years. They are still a beta play."

TIM CAMPBELL: "I think you're right but I also think we must ask the bigger question. Emerging markets have actually underperformed developed markets over the last 30 years in dollar terms and you're voluntarily taking on this extra risk and you haven't been paid the extra return. I think it's fair to ask why we bother with emerging markets at all. I don't want to put myself out of a job but it's an important question to ask. That said, the time when you actually do make money is in situations like the one right now and we're hugely positive on emerging markets at the moment because of all the things Fabiana mentioned. But should we have global emerging market equities as a long-term allocation?"

FABIANA FEDELI: "I think it's wrong to think about emerging markets as being one market because it's not. Different countries present different opportunities and risks."

MAGNUS RIIBER: "I think you're wrong. I think there are some common themes for most emerging markets and those are less developed governance and weaker structures. That's the only reason you should get a premium for investing in these markets. People who start to talk about growth rates and things like that are totally off. You can find all sorts of growth rates across a lot of different assets. The only things that emerging markets have in common is weakness in governments and weakness in corporate governance. That's a risk that you can't diversify away from and therefore a risk you should get compensated for."

FABIANA FEDELI: "Would you then argue that the Taiwanese government and Taiwanese corporates are weaker than the Italian government and Italian companies?"

MAGNUS RIIBER: "You will, of course, have the whole range and Taiwan is probably among the stronger ones. What I mean is that what you seek in emerging markets is the type of risk I mentioned earlier."

GEORG SKARE LUND: "But the headline for emerging markets – the marketing – is that these are the countries of the future. This is where the growth will be as they catch up to developed markets and that's the reason you should invest. I think that's too simplified. Then, on the question if we should be invested at all, I would say yes just because it's such a huge part of the world's economy. Emerging markets represents 60 per cent of the global GDP. I think you should have exposure to that and you could take a broad passive exposure and combine with alpha on top."

GEORG SKARE LUND – STOREBRAND ASSET MANAGEMENT, DMITRIY VLASOV – EAST CAPITAL, MAGNUS RIIBER – OSLO PENSJONSFORSIKRING, CAROLINE LIINANKI – TELL MEDIA GROUP, NIKLAS TELL – TELL MEDIA GROUP, TIM CAMPBELL – BAILLIE GIFFORD, ISABELLE JUILLARD THOMPSEN – GJENSIDIGESTIFTELSEN, FABIANA FEDELI – ROBECO, FREDRIK WILANDER – DNB ASSET MANAGEMENT.

FREDRIK WILANDER: "Also, from an asset allocation point of view, you would need an exceptionally bearish expected return on emerging markets to completely take it out of your portfolio."

DMITRIY VLASOV: "I think what also matters is the distribution of historical returns. There are periods when emerging markets have done exceptionally well and have massively outperformed developed markets. Also, historical performance is less relevant because what was emerging markets 20 years ago is very different from today."

TIM CAMPBELL: "I must come back to your remark about passive exposure. Why passive? You have an index that over time has underperformed developed markets and it's also an index where performance is driven by a very small number of companies. We ran some numbers, looking at performance from 2007 until 2017 and over those ten years, 100 per cent of performance was driven by three companies. Of all the markets in the world, you have to be active in emerging markets because there's so much rubbish that you need to avoid."

GEORG SKARE LUND: "But mathematically, that's why you should buy the entire market because I don't think anyone would be able to pick the exact right companies. If you make a concentrated portfolio, you will have a big risk of underperforming. I'm not saying that you should only do passive though."

TIM CAMPBELL: "Even if you're just able to avoid the very worst, you're likely to outperform and I think that anyone who does their fundamental research would be able to do that."

GEORG SKARE LUND: "However, the portion of active managers outperforming the benchmark in emerging markets is not greater than in developed markets."

FABIANA FEDELI: "That's true but the amount of outperformance is much higher. If you chose the right asset manager, you will get more bang for your buck."

GEORG SKARE LUND: "But that's true on the downside as well so if you select the wrong manager, it will hurt more in emerging markets."

ISABELLE JUILLARD THOMPSEN: "When we talk about active versus passive, I think your arguments, Magnus, about ESG and governance speaks to more active management. I think you have to do your due diligence when investing in emerging markets. You must assess the national and corporate frameworks and the governance structures. We're long-term investors and we want to have exposure to emerging markets and we would like to get that through active management."

FABIANA FEDELI: "I agree with you and country allocation and ESG are key elements in our investment philosophy. Engagement is also important because a lot of companies frankly need some help. Some also come to us and ask for advice. That's a huge potential in order to create more alpha in emerging markets."

NIKLAS TELL: "COMING BACK TO THE ACTIVE VERSUS PASSIVE DEBATE AND ALSO THE FOCUS ON ESG. GEORG, I KNOW THAT YOU'RE HUGELY FOCUSED ON ESG – HOW DO YOU SQUARE THE PASSIVE EXPOSURE WITH ESG CRITERIA?

GEORG SKARE LUND: "We think it's possible to run a passive emerging markets strategy with a high sustainability profile. That's no problem. The real question would be on engagement because if you spread your investments across some 1100 companies, you can't really engage to the same degree when you're a smaller owner."

GEORG SKARE LUND
Storebrand Asset Management
Head of fund selection at Storebrand Asset Management. He joined the company as a management trainee in 1996 and came to the fund selection unit in 2005.

MAGNUS RIIBER
Oslo Pensjonsforsikring
Senior portfolio manager at Oslo Pensjonsforsikring (OPF). Prior to joining OPF earlier this year, he spent ten years as a portfolio manager at KLP Asset Management. He has also worked as a senior portfolio manager at Storebrand.

MAGNUS RIIBER: "I'm no ESG expert but I find it strange that there's such a huge price difference between countries and companies that score well on ESG and the others. I'm afraid we pay too much today. If you own something in Russia and Putin does something strange, that company would be punished - but the risks were there before something happened."

GEORG SKARE LUND: "So you think ESG is too much backward-looking?"

MAGNUS RIIBER: "Not only backward-looking but we also don't price the risk correctly. Take Gazprom. It's Russia and fossil fuel and trade at three times the earnings. Even if the government steals half of the dividends for all future, it still provides a better return than any windfarm in Europe."

FABIANA FEDELI: "I believe you have to distinguish between real value and value traps because emerging markets is full of value traps. I would give the example of a large oil company that had big oil spills and the public opinion against them. We worked with them to improve their health and safety and now they're much better. That said, there are some companies that are beyond salvation and where engagement doesn't help."

FREDRIK WILANDER: "I think what you say, Magnus, is that if you have an ESG process in place and you're evaluating a company where there are latent risks, but where nothing has come out publicly, it's not yet in the price. Then, when something happens, the price drops but the ESG characteristics haven't really changed. The ESG score should be the same but the price has dropped 20 per cent. What should you do? That's a difficult question and I assume the answer will depend on if the ESG score is linked to the target price or if you simply don't invest if the ESG score is too bad."

GEORG SKARE LUND: "I think it comes down to why you do ESG in the first place. If it's to guard yourself from reputational risks, then you're encouraged to stay away from specific companies. But then you're on the wrong foot. You should do it because you want to make the world a better place and to reduce the risk of the portfolio. If that's your motivation, you shouldn't be concerned about what happened in the past but rather focus on what's likely to happen going forward."

DMITRIY VLASOV: "Another reason is, of course, to create better returns and good companies from an ESG standpoint should outperform over the longer term."

CAROLINE LIINANKI: "DO YOU NEED A DIFFERENT ESG POLICY FOR EMERGING MARKETS COMPARED WITH DEVELOPED MARKETS?"

TIM CAMPBELL: "You need to take into account that they're on a totally different development path."

FABIANA FEDELI: "We have something we call materiality framework where we look at which ESG factors could have a material impact on the company. The factors are fairly similar between emerging markets and developed markets but the importance differs. In developed markets, innovation is very important. In emerging markets, at this point in time, it's still corporate governance."

CAROLINE LIINANKI: "HOW DO YOU DEAL WITH THESE DIFFERENCES AS AN INVESTOR? I ASSUME THAT YOU WOULD LIKE TO HAVE THE SAME POLICY ACROSS YOUR PORTFOLIO."

MAGNUS RIIBER: "I don't think you can have the same policy. You basically decide to change policy the moment you decide to invest in a particular country. If you've chosen to invest in a country that's not democratic and where there's corruption, that means you've decided to relax some of your policies. You can

have the same target of where you would like things to be but you will have to accept a lower threshold in order to find companies to invest in."

FABIANA FEDELI: "I think that also means that you will have a bigger impact. We have engaged with a company in Latin America, which was very corrupt. We contributed to the appointment of two independent directors on the board and to change the chairman of the board and the CEO. I prefer doing that instead of just saying that this company is corrupt. Also, in that process you do create alpha as you improve the operational efficiency of the company."

ISABELLE JUILLARD THOMPSEN: "But you need the same consistent framework to assess risks and decide what you're comfortable with."

NIKLAS TELL: "BUT I GUESS IT'S THE CHANGE THAT IS IMPORTANT?"

FABIANA FEDELI: "Absolutely, the delta is important and that's what creates value."

NIKLAS TELL: "WHAT ABOUT ESG DATA - IN GENERAL AND IN EMERGING MARKETS?"

FABIANA FEDELI: "You need to take some of these rankings with a pinch of salt. One of the elements everyone looks at with regards to corporate governance in emerging markets but also in developed markets is the percentage of ownership of the main investor in the company. Well, there is a difference if that investor is a retail family that has owned the company for 50 years or if it's an oligarch in Russia. I would feel better if the retail family owned 40 per cent of a company than an oligarch owning 12 per cent. We all talk about rankings but we really need to look at and interpret the underlying data."

DMITRIY VLASOV: "I think most active managers do that. We have a robust and fairly comprehensive process to assess ESG and then it's very well incorporated in the investment decision-making process. The large positions where we take the most risk have to be above certain thresholds so there's no compromise there."

NIKLAS TELL: "IF YOU LOOK BACK AT THE ASSET CLASS – WHAT ARE THE MAIN THINGS THAT HAVE CHANGED AND WHEN LOOKING AHEAD, WHAT DO YOU FORESEE?"

FREDRIK WILANDER: "In terms of what has changed it's clearly China, the importance of Asia and the importance of the technology sector. Going forward, the inclusion of China A-shares will, of course, be very important. The question of global emerging markets versus regional exposure is a tough one for us because as of today, we don't have a strategic or tactical view on regions. One reason is simply because we don't have the resources to do that. We have a team of five managing the tactical asset allocation portfolios and we need to look after a lot of asset classes already. We have a global emerging market exposure and we therefore need to find a manager who can do that regional allocation for us, but this might change going forward."

TIM CAMPBELL: "It makes sense. Local managers tend to outperform their local benchmarks but then you tend to lose it all on asset allocation. We speak to a lot of clients in the US and they pick individual managers because they're impressed with the relative performance. But then they're stuck with a Brazilian manager at times when you don't want to have anything in Brazil."

FABIANA FEDELI: "I think you need to look for managers that do country allocation and make sure that the allocation actually changes over time. Being in emerging markets mean that you're exposed to markets in constant development. Things will change and transform and you should therefore be able to gain exposure, through a global emerging market fund, to the countries that makes the most sense."

ISABELLE JUILLARD THOMPSEN
Gjensidigestiftelsen
Portfolio manager at Gjensidigestiftelsen, responsible for equity investments and total portfolio management. Prior to joining the foundation, she was a senior analyst at Norges Bank Investment Management for more than four years. She has also worked as senior investment manager for alternative investments and head of hedge fund investments at Storebrand.

FREDRIK WILANDER
DNB Asset Management
Head of allocation & selection at DNB Asset Management. Prior to joining DNB in 2015 he held various roles at Nordea Wealth Management/Asset Management since 2007, including chief investment strategist and head of asset allocation as well as fixed income director.

ISABELLE JUILLARD THOMPSEN: "We allocate to global managers for the same reason as Fredrik mentioned. We're fairly small and we have no local expertise and no edge in timing regional markets. We would rather find a good global manager that can do that regional allocation for us."

MAGNUS RIIBER: "We also have a global allocation and I think the most important thing is to identify the 'personality' of the manager because they tend to stick to that over time. A growth-oriented manager tends to stay that way."

NIKLAS TELL: "TIM, AS WE STARTED THE DISCUSSION, YOU SAID THAT EMERGING MARKETS HAVE UNDERPERFORMED OVER THE LONG TERM. HOWEVER, FABIANA ALSO HIGHLIGHTED THE FACT THAT EMERGING MARKETS ARE CONSTANTLY CHANGING. IS IT FAIR TO COMPARE EMERGING MARKETS TODAY TO WHAT IT WAS HISTORICALLY?"

TIM CAMPBELL: "You're right – today it's all about China. That dominates everything today."

FREDRIK WILANDER: "And that will be the important question for emerging market managers to get right. You have had some emerging market managers that caught this China/technology trend spot on some ten years ago and they've produced fantastic returns from that. The question then, especially if you're a thematic manager, is what the next big trend will be."

NIKLAS TELL: "GIVEN THE IMPORTANCE AND GROWTH OF CHINA – SHOULD YOU HAVE A SEPARATE MANDATE FOR CHINA?"

MAGNUS RIIBER: "From a size point of view, that would be a natural development."

DMITRIY VLASOV: "China is a huge market and it has everything that you need for a standalone country allocation. It has a long list of excellent companies and A-shares alone are 3600 companies. If you look at the roadmap of inclusion, then China could become 40 per cent of the emerging market index."

FABIANA FEDELI: "I think you make a great point. The situation right now is a bit misleading as index providers don't recognise the size of China within the world and within emerging markets – right now China is some 3 per cent of the MSCI All Countries index. Even if you don't believe in emerging markets, you would want to put money there because of its size in the world."

CAROLINE LIINANKI: "EVEN WITHOUT A SEPARATE CHINA ALLOCATION, HAS THERE BEEN REASON TO HAVE A SECOND LOOK AT EXISTING MANAGERS TO MAKE SURE THEY'RE ON TOP OF CHINA?"

FREDRIK WILANDER: "Absolutely. If you have a global emerging market mandate, you should evaluate your manager's coverage of A-shares, for example, and if they can handle it from an operational point of view."

ISABELLE JUILLARD THOMPSEN: "I think the understanding of the legal framework around A-shares compared to Chinese companies listed in the US through VIE structures is very important. VIEs don't give you direct ownership of underlying companies while A-shares give you direct access."

TIM CAMPBELL: "Yes, maybe everyone will have a separate A-shares strategy in ten or 15 years' time but let's not forget that this is the one legal casino in China. It fluctuates so wildly and there are periods when you probably don't want to have any exposure."

CAROLINE LIINANKI: "DMITRIY, DO YOU AGREE ABOUT THE VOLATILITY?"

DMITRIY VLASOV: "It's a statement of a fact but we're also focusing more on this volatility now that the market is down. People are not that concerned when markets double. It's a reflection of the state of the market, which is still dominated by retail investors. That's the issue and it presents challenges. The good thing is that it's local capital and the downside is that it's retail. The government is aware of this and all initiatives that are coming through are geared at introducing more long-term capital into the market."

NIKLAS TELL: "BUT THIS MUST AT THE SAME TIME BE A PERFECT ENVIRONMENT IF YOU'RE A PROFESSIONAL STOCK PICKER AS THE VOLATILITY WILL SURELY THROW UP OPPORTUNITIES."

DMITRIY VLASOV: "Yes, and that's one reason why you shouldn't seek exposure through ETFs."

GEORG SKARE LUND: "I would argue that you should have a blend of passive and active because the dispersion is so big and if you don't do your manager selection well, you risk going with an active manager that get it totally wrong. The result of that could be that your investment committee comes to the conclusion that you should avoid exposure to emerging markets all together, which would be wrong. A broad exposure through a passive strategy would mute that risk."

CAROLINE LIINANKI: "HOW IMPORTANT IS IT FOR A FUND MANAGER TO BE PRESENT IN THE LOCAL MARKET AND HAS THAT CHANGED OVER TIME?"

MAGNUS RIIBER: "I think that depends on how advanced the economy and market is. As economies and markets become more developed and transparent, the less important it becomes to be local."

TIM CAMPBELL: "I also think it depends on your timeframe. If you're slightly shorter term, then quarterly earnings releases and the noise around that matters. But if you're looking to hold something for five to ten years, then being local is less important."

FREDRIK WILANDER: "It absolutely depends on the strategy. Is it a deep fundamental, bottom-up strategy or a quant strategy? Is it a global or regional/country mandate? If it's a global, fundamental strategy, then I do think it's important to be on the ground and potentially also speak the language but where that global team sits would be of less relevance."

FABIANA FEDELI: "I think we're asking the wrong question. It's not a matter of being located in these countries but rather having experience and expertise. If you're travelling there once every month or if you're actually sitting there is irrelevant."

NIKLAS TELL: "WE'VE TALKED ABOUT HOW CHINA INFLUENCES OTHER MARKETS BUT IS CHINA ALSO AFFECTED BY OTHERS?"

DMITRIY VLASOV: "Of course and this year is a good example as we have the trade conflict with the US. It obviously affects China and also other emerging markets."

NIKLAS TELL: "WOULD YOU SAY THAT POLITICS AND MACRO ARE MORE OR LESS IMPORTANT FOR EMERGING MARKETS TODAY?"

TIM CAMPBELL: "The interplay between politics, macro and company fundamentals is what makes the job fun. It's never only been about bottom-up stock-picking."

GEORG SKARE LUND: "But maybe the importance of macro and politics is more apparent today."

FREDRIK WILANDER: "I think what has changed is that it's not politics and macro versus the market but politics versus macro today. I recently talked to an EMD manager, which had

ROUNDTABLE – EM EQUITIES, OSLO

TIM CAMPBELL
Baillie Gifford
Chair of the emerging markets product group at Baillie Gifford. He joined the company in 1999 and worked as an investment manager in the emerging markets equity team before moving to the clients department in 2007.

FABIANA FEDELI
Robeco
Head of global fundamental equities and portfolio manager in the emerging markets equities team at Robeco. Prior to her current role, she was the lead portfolio manager on the Asia ex Japan equity fund at Pioneer Asset Management.

DMITRIY VLASOV
East Capital
Portfolio manager and an advisor on the China A-shares strategy and mandates. He joined East Capital in 2007 as head of real estate research in Moscow. In 2011, he started in the Asia team as a senior analyst and was promoted to portfolio manager in 2013.

hired more political analysts than macro economists recently. The argument was that it doesn't matter how well you forecast the inflation in Turkey if you don't have a view on what Erdogan will do over the next two months."

GEORG SKARE LUND: "So if we agree that politics and macro matters a lot in emerging markets, should we give you managers more freedom to do country allocation?"

FABIANA FEDELI: "Yes, I think you should, if you have faith in your manager."

GEORG SKARE LUND: "I'm sceptical. Even if it matters, it doesn't mean that you have skill in predicting the future political development. How many foresaw the election of Trump or the results from the Brexit vote?"

FREDRIK WILANDER: "To me, it depends on the asset class but it also depends on how many bets you want to matter in the portfolio. Big top-down calls can easily wipe out all other bets in the portfolio. If you have a 15 per cent overweight to Latin America, you will have to have exceptional outperformance from your stock-picking if Latin America goes down the drain. Maybe you don't want your alpha contribution to come from just one source."

NIKLAS TELL: "WE HAVE TALKED ABOUT THE FACT THAT MARKETS HAVE COME DOWN THIS YEAR AND WE HAVE TOUCHED ON TRADE WARS. WHAT DO YOU SEE AS THE BIGGEST RISKS TODAY?"

TIM CAMPBELL: "If I take a long-term view, the biggest risk to the asset class would be that there are a lot of emerging countries that never manage to emerge because of structure and governance. When you look at the asset class, you have to be very selective. There will be a huge amount of opportunities within the asset class but there are a lot of things that are going backwards at the moment."

FREDRIK WILANDER: "What our tactical allocation team has been looking a lot on recently is the build-up of dollar debt in the system. Is it a debt bubble or not and if it's a debt bubble will it develop into a debt crisis?"

FABIANA FEDELI: "I think the biggest risk in emerging markets is the same that you have with a teenager growing up. There will be some issues along the way. At some point, things might not go as smoothly as you expected. It's really growing pains that could arise."

FREDRIK WILANDER: "Another interesting question is, of course, the growth versus value one, which is something you can spend hours thinking about."

MAGNUS RIIBER: "I think the value versus growth cycle is different in emerging markets as it's less driven by the rate cycle and that it's more about improvements in governments and governance. If you see improvements there, you will see a revaluation of companies such as Gazprom."

NIKLAS TELL: "WHAT ABOUT RISKS IN CHINA?"

DMITRIY VLASOV: "I think the trade conflict is the obvious one. That said, tariffs are discounted by the market and their impact might not turn out to be as bad for the real economy as the valuations indicates. The risk in China since 2009 is the increasing level of debt. The government tried to curb that earlier this year but the timing was wrong so that's not a priority any longer. It's still a risk, of course."