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EMERGING MARKETS

roundtable

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DISCUSSION: EMERGING MARKETS

Favourable demographics and an abundance of natural resources mean that emerging markets (EM) are expected to outgrow the global economy this year at 3.7% compared to 2.9%, according to the IMF. With corporate earnings under pressure in the developed world, emerging economies look attractive, especially with central banks being further along their tightening cycle and China re-opening after axing its strict Covid restrictions. Yet there are issues. Eight countries in Asia are responsible for 45% of the world's greenhouse gas emissions, making them a huge ESG risk. So how are pension funds and insurers with net-zero commitments navigating these markets? *portfolio institutional* sat down with those investing in the emerging world to find out.

What do emerging market assets bring to portfolios?

Bola Tobun: Diversification and enhanced returns. It allows you to enjoy the growth of emerging market economies. But there is limited transparency on the ethics and governance of companies. The ESG credentials vary significantly in this region, making it difficult for us to increase its allocation.

Where are investors looking for quality, growth and value?

Nick Payne: Across the universe, there's always quality, there's always growth and there's always value.

India is popular in terms of growth and quality, and deservedly so. Investors like India because there is a long runway of multi-decade growth.

Other markets are more mature, so you will potentially look at value or dividend generation. There is something for everyone, because it is such a big, diverse universe.

Padmesh Shukla: EM is a promising story. In equities, the multiples are down 40% from their peak, on a relative basis versus the US. Fixed income is also interesting.

On ESG, we are investing in EM renewables. If we are lucky, we will probably make 7% in developed markets on a good day. There is a clear narrative around EM and infrastructure, but there is a spectrum in terms of quality, the political system and stability. You have to be careful where you are fishing.

I'm quite bullish on EM. Asia, as always, offers the most interesting opportunity set, followed by Latin America and then there is Africa and its urbanisation story that is not even a footnote in our portfolios today. Looking ahead five to 10 years, it is a diverse and interesting opportunity set.

What is Border to Coast's emerging market investment strategy?

Will Ballard: Focusing on the equity part, we have done something a little unusual. China dominates when people are looking to invest in emerging markets, so we have separated the mandate into China and emerging market ex-China.

When allocating capital, you have to look at it over five, 10, 20 years and we see China being a dominant force within emerging markets, so to manage that we have separated it.

If you are looking at emerging markets ex-China, Brazil becomes more relevant. Brazil was quick to raise interest rates and they could be starting to come down, while inflation is more under control.

You start to think more about your local allocations and the smaller markets start to become more relevant. It gives you an opportunity to delve down to find better opportunities.

Vanessa, what investment ideas have you had from looking at emerging markets?

Vanessa Zhao: A lot of interest has been in China's growth stocks, which are quality companies with good fundamentals and promising growth trajectories. But in the past three or four years, non-fundamental elements are affecting China, like geopolitical risks and trading bans from the US. Within China itself, there is a lot of policy reform. Common prosperity is affecting the education sector, healthcare and automation. We watch policy within the country closely because it changes where we play in the long run.

We tend to focus on quality players that have a tailwind from local or central governments and less exposure to those non-fundamental elements. These are in areas like carbon neutralisations, automation and semi-conductors.

Oriana, what do your clients want to know about emerging markets?

Oriana Mezini: We often get questions around active versus passive. For gaining exposure to emerging markets, we believe in active management. These markets are less efficient so there's more opportunity for alpha. Governance is an important issue as is geopolitics, so we prefer active managers. I assess asset managers and their investment processes. They must have ESG integrated into their investment decision making. It is a must, not just in emerging markets, but across the whole spectrum.

If you have a remit to cut emissions from your portfolio and you want emerging market exposure, do you have to go active?

Lorant Porkolab: We have seen a significant growth in ESG index-based strategies focusing on emerging markets. Somewhat simplistically, if an ESG index excludes brown companies with weak environmental credentials or the bad boys not willing to comply with common ESG disclosures and standards, then by going passive you can achieve a considerable positive ESG tilt in your portfolio at a reasonable cost. But is this passive investment or an active one in disguise? Of course, this passive approach is far from perfect, and the closer stewardship and engagement by an active manager can deliver more substantial ESG benefits in the long term.

Shukla: Bad boys is an unhelpful label. Risk perception matters in EM markets

India will not be the new China.

Will Ballard
Head of equities
Border to Coast

for trustees and I would be careful how we define some of these companies, which are in an index for a reason. We invest in EM commodity exporters because without their products there is no net-zero transition.

The G should be an important focus of ESG analysis because a well-governed company will probably be a well-engaged company. We have to work on and look beyond perceptions as investors build lasting and generic high-risk premiums and mental barriers live on the back off few bad experiences – Argentina, for example.

Tobun: It depends on the manager. The carbon exposure of London CIV's emerging market portfolio was high as the manager invested heavily in carbon-intensive companies.

When this manager was changed due to performance issues, the portfolio's carbon exposure reduced significantly. This is because the new manager incorporated their in-house philosophy into the mandate. And the incumbent manager delivered better performance than the previous manager.

This demonstrated that one can incorporate the desired ESG criteria and still earn a better risk-adjusted return.

Ballard: We are talking more and more these days about the difference between greening the world and greening your portfolio. This is not just an emerging market issue.

Anglo American, for example, has improved its green credentials by making a commitment, under guidance from their shareholders, to exit thermal coal. They spun out these assets by listing Thungela on the stock market. The portfolios which hold Anglo American have become greener as their carbon footprint has reduced, but Thungela is still producing thermal coal and has a similar carbon footprint.

Tobun: You must remember the need of scheme members, which is not just about making the world a better place, as important this is. At the end of the day, the primary objective of the fund is to have enough money to pay pensions as they fall due. This can be a difficult balancing act for the trustees.

Zhao: In emerging markets, active managers are a better choice for investors than a passive ESG index. There are a couple of important issues. One is the quality of ESG ratings, which are not comprehensive or consistent.

When I started as an analyst 13 years ago there were only a handful of funds that did ESG analysis and engagement. But the methodologies they used were different. The third party ESG analysis providers spoke to companies approximately every two years.

Things may have improved in that they have hired more people and speak with companies more regularly. But a score can stay outdated with companies being punished for events that happened five or six years ago.

Another issue is now that ESG is popular and attracts a lot of capital, funds have developed their own ESG methodology and scores, which are not consistent across the industry either.

But companies are improving their disclosures as ESG has become more and more important for investors and regulators. For example, there is a famous internet company I engaged with 13 years ago, which is now completely different in that they have a dedicated ESG team working on their disclosures.

You can only find these details from many companies through good long-term direct engagement. If you only read a Sustainalytics or MSCI ESG report, it may not include all the improvement in details, and can potentially lead to exclusion.

Payne: Our experience echoes that. We are always careful in recommending anyone to buy a passive ESG product because you are effectively contracting out a huge part of the investment decision. You would be shocked at the level of basic errors in those providers, such as which sector a company is classified in. They have one analyst covering hundreds of stocks and not in any great depth.

If you buy a passive product, you are effectively sub-contracting that position out. You have no influence, whereas an active manager does.

Also, it is a myth that in emerging markets ESG is more challenging. The reality is that they are not as good at reporting it. We often find, particularly when talking to smaller companies, that the better gov-

erned companies are more advanced in either doing it or willing to listen. They ask us what they need to report on, they are taking action and mapping things out. But because it is not mapped in a way that Sustainalytics or MSCI wants to see it, they are making a reporting error.

We have found it valuable to guide them on what milestones and roadmaps investors want to see.

Shukla: It is important not to have a blanket view of these things. The most bang for your buck from emerging market companies comes out of engagement. It is not that they don't want to do it, it is trying to understand what the protocol and process is.

You lose that if you decide to leave the table by not investing because the ESG score happens to be poor. It reinforces the point that active management is important and engagement is super important part of that process.

Ballard: We have done a lot of work on this. There appears to be a correlation between the size of a company and its ESG score as well as the number of interactions it has with the ESG rating agency. That tells me two things. Firstly, companies need more guidance on what ratings agencies want to see and how it needs to be presented. Secondly, the ratings agencies are looking at thousands of data points, so unless you are a huge organisation with an incredibly well-staffed investor relations team, it is hard for you to provide all the data needed.

Tobun: Fund managers need institutions like the credit rating agencies to create an ESG standard template to enable us to have comparable measures. Currently, there is no credibility or consistency in the ESG data we are receiving.

Payne: You could go the other way. In this space, there is a desire for false precision. Everybody likes a label, everyone likes AAA, BB, CC, but in the real world analysing and owning companies is not like that. There are grey areas about countries, geopolitics and companies' interpretations of goals, but everyone is driven by a desire to stick a AAA label on it and off we go.

Porkolab: There is a huge oversimplification in a single ESG score when there are hundreds of factors to consider. There is no consistency or standardisation, and aggregating, for instance, climate and social factors by washing them together can easily hide important characteristics.

China is now a consumption-driven economy and India will go down that same path.

Nick Payne
Investment manager, global emerging market equities
Jupiter Asset Management

Credibility and reliability are also important considerations. Who is auditing the information? Who is checking and confirming the metrics? Are we just taking them at face value?

Ballard: There is movement. On carbon footprints, for example, there are standards. It is happening, but it is the beginning.

Shukla: Everyone knows what we expect from a company when it comes to the E in ESG. The question is whether it's being measured and reported in a timely and accurate manner?

On governance, most people understand what it means to be a well-governed company. But each country has its socio-cultural context and practices, which means they will be slightly behind, or may take a different slant on governance than what a classic Anglo Saxon model may profess.

On the S, where do we start? What is acceptable in our home market might be outdated in Sweden, for example. That to me is the hardest part and is where most of the debate tends to happen.

Porkolab: In principle, there is no significant difference between emerging markets and developed markets when considering ESG factors. But in some of these areas, in particular those related to social or governance issues, the reasons for weaker or different ESG credentials of emerging market companies could lie deeper and are related to political or cultural factors. Developing an understanding of these factors and how they may develop over time is equally important from the perspective of an investor based in a developed market.

Even with engagement, making a significant and relatively quick improvement in the S and G areas when investing in companies in China or India is far more challenging than in Germany or the US.

Shukla: But in developed markets there are countries equally challenged on this. The diversity of the E, S and G practices between Italy and Sweden, for example, may probably be the same as between the UK and India.

If you do not invest in emerging markets, then you do not have the influence to force positive change.

Oriana Mezini
Senior investment research consultant
Hymans Robertson

We have learned to live with these variations in western markets. This is another example of how labelling is unhelpful as differences exist everywhere.

Porkolab: It is fair to say that the variation regarding ESG credentials in emerging markets is significantly higher than in the developed universe. Therefore, there are more challenges when it comes to reporting, engaging and making change happen.

I am not saying this is a reason not to invest, but we have to recognise that emerging markets are a less homogeneous universe. We have to be a long-term patient investor and cope with these challenges.

Payne: Otherwise, we end up looking through a UK-centric lens. We get recommendations to vote against directors who have been on a board for 15 years, but they have been on the board for 15 years because it's culturally normal in India.

Then there are instances where we have been asked to vote against something we believe is sensible. For example, we had a Brazilian company that was making a transition from the original owners to professional management. They offered a 10-year remuneration glidepath, which we thought was excellent, but we were asked to vote against that because it was too long.

Porkolab: Is this a fundamental question or problem in the way we look at these things, in particular ESG factors? Namely, assessing them from a UK or European investor perspective and evaluating them through that lens?

Payne: If we use a UK or European framework when looking at a company in India or China, we can all understand the relevance of rotating boards and explain that to those companies. But they often come back with it being a good idea to have someone with 20 years of industry experience on the board to give them a view of what it is like in good times and bad.

There is a huge oversimplification in a single ESG score when there are hundreds of factors to consider.

Lorant Porkolab
Trustee director
Law Debenture

Porkolab: When it comes to pension schemes, trustees need to consider their fiduciary responsibilities, namely of what pension scheme members may expect from them regarding investment decisions, including those in emerging market companies.

Trustees have to decide if they can and want to accept these cultural differences, potentially resulting in lower ESG scores, or exclude such companies or countries from their investment portfolios, which could reduce the diversification benefits and potential returns.

Zhao: It is difficult to compare the ESG practices of an emerging market company with those of a counterpart in the developed world. If you compare them based on a UK, US or European framework, then you may find emerging market companies score much lower. I wonder whether it would also be helpful to only compare the ESG practices of emerging market companies with emerging market companies, as one reference point to indicate the ESG progress in emerging markets over the years.

Another issue to consider is how a company's ESG practices have evolved because emerging markets have changed so much. China today is different from China 15 years ago. How many companies have become giants during that time, like

Alibaba? Assessing a company's ESG practices over time can be helpful.

Porkolab: This is a valid point, but if we apply different standards and criteria in different territories, then we lose some objectivity. If we give up using a consistent methodology for comparing emerging market companies with those in developed markets, whether it's for ESG or other factors, are we not compromising too much and risking of making sub-optimal investment choices and decisions? Are we saying that Vietnamese companies should only be benchmarked against Vietnamese companies?

Ballard: There are clear differences when it comes to government requirements. When assessing a company, it is not wrong to start with what you believe to be the best possible standards, which may not necessarily be in your personal geography. But you must acknowledge any difference, know why that gap exists and understand the direction of travel.

Mezini: If you do not invest in emerging markets, then you do not have the influence to force positive change.

Ballard: Exactly. It comes back to Bola's point about the perception that investing in emerging markets is a greater risk. That could be true, but I'm not sure because there are lots of risks in developed markets.

Shukla: We have talked a lot about ESG, but I am keen to understand why we allocate to EM because there is a higher hurdle in terms of understanding these markets. For all this extra pain, there has to be extra reward. But ESG has moved the hurdle higher for institutional investors to allocate capital.

Tobun: ESG is not the only consideration, but it is a major factor nowadays. People tended to ignore it, but now there are pressure groups and lawsuits out there for companies that are behaving badly, so ESG integration into investment philosophy has to be a priority.

Local government pension schemes see ESG as a reputational risk, so we try to ensure we don't get negative publicity by investing in organisations with bad ethics.

The most bang for your buck from emerging market companies comes out of engagement.

Padmesh Shukla
Chief investment officer
Transport for London Pension Fund

Porkolab: I don't disagree, but, from a fiduciary responsibility point of view, there are more than ESG factors to consider when making investment decisions on behalf of scheme members.

The big question is whether the primary focus should be on financial considerations, because that's what matters when it comes to paying members' pensions, or if the non-financial considerations should receive an equal weight, as these will make the world a better place and may also affect the outcome for members in the long run?

Payne: We mostly get feedback on diversification and growth.

On diversification, the correlation of the European markets with the S&P500 has been around 0.8 over the past two decades. Most emerging markets are 0.5 lower, with some a little higher, like Taiwan, due to the inter-connected nature of electronics, and Hong Kong because of the dollar peg. Individual markets like Colombia, Saudi Arabia and Indonesia are around 0.3.

That brings us to growth. A lot of investors equate that faster GDP growth automatically turns into faster earnings growth, which automatically turns into higher share prices. It doesn't. The problem is many people have not realised that turning a growth environment, like India and Indonesia, into return per share, return on capital or return on equity is challenging.

We look at three quarters of the emerging universe and it does not beat a 10% cost of capital, which is a reasonable hurdle.

That exists for a couple of reasons. It's the structural makeup of the indices as there are more commodity markets. Oil companies and miners are not high return on capital businesses, they are price taking businesses which are dependent on the price of iron ore. It is the same in developed markets but the allocation in EM indices is higher than in Europe and the US.

The other reason is shareholder capitalism. The US is one of the world's best performing markets, even though its economy is growing at 2% or 3%, because companies turn growth into a higher return on equity. They are focused on shareholder value, not getting big for the sake of being big.

Shukla: Does this lead you to a certain style if you want to hit 10% because everything is either state owned, family owned or a combination thereof, leaving only a small subset?

Payne: That is why you should buy quality businesses. There is a higher component of state-owned enterprises in emerging markets, which is why we exclude oil companies because you cannot engage with them. The state is only interested in maximising the profitability of the geological gift they have been given.

The universe will look the way it does until shareholders get more demanding in asking for management to grow a sustainable business and maximise returns.

We often find that this is secondary or tertiary as an objective. It is rare that we meet management teams who understand what return on invested capital is.

Shukla: If I compare the index today versus 10 years ago, it is much more dynamic with new economy companies. There is so much more to choose from compared to 10 or 20 years ago.

Ballard: What was interesting is that you gave two options: value or growth, and Nick picked quality. That speaks quite strongly to what is going on in emerging markets, which is you don't want the state-owned enterprises, you don't necessarily want the highest growth companies, you want the companies which can consistently deliver high returns. They have strong brands and can generate high sustainable returns over the long run.

Payne: That is the best way of capturing that GDP growth.

Ballard: This is different from the previous perception, which was: go to emerging markets purely for growth.

There is a little more maturity now. Growth is slowing in emerging markets and there is volatility, so we need to invest in companies that can survive the tough times and come out stronger. It's about persistence.

Could we go back to China? What impact will the end of the zero-Covid restrictions make?

Zhao: China had a different approach to Covid. It was strict in the beginning and then they civilized the situation while the West opened up. China was catching up, but by the beginning of this year, around 80% of the country was infected.

Now they have recovered. In Q1 people returned to work and resumed other activities. In Q2, domestic traffic is almost at the pre-Covid level, but consumption needs to catch up.

The government wants to see how the re-opening will play out by itself without big monetary stimulus but has kept some tools behind in case the economy needs a boost. What happens next will be interesting. The re-opening effect will last for maybe three quarters but what will then sustain and support the recovery and drive company revenue growth.

Shukla: It looks like China is becoming a binary issue. There is strong economic case, but because of the geopolitical concerns, should we invest or not?

Zhao: Apart from the fundamentals, in the past 18 to 24 months, you see people discount China based on geopolitical concerns like the relationship with the US and the news around Taiwan. That will not be completely removed anytime soon.

Porkolab: The removal of the zero-Covid restrictions will have a considerable positive impact, just as introducing them had a negative impact.

The binary point regarding investment in China mentioned earlier is interesting. No doubt, there are lots of companies with great potentials in China, but how do you overlay and factor in the considerable geopolitical risk?

Similarly, some would argue that certain country specific ESG factors, such as human rights issues, should also affect your view of how much you allocate to China, especially if you have carved it out of the EM universe.

Ballard: Questions around a discount are almost impossible to answer. What you can look at is the revenue being generated in China, which is lower than in 2018. Earnings are incredibly depressed as well. There is a lot of capacity out there and when things pick up, you do not necessarily need to invest more capital to grow. The operational leverage which could come through is significant.

Valuation does not necessarily give you a trigger point to get into something, but it can give you a measure of the additional returns you could get when economic activity picks up.

It is difficult to compare the ESG practices of an emerging market company with those of a counterpart in the developed world.

Vanessa Zhao
Portfolio manager
Candriam

Payne: There is a huge margin of safety in China. To put this into context, Ping An, China's largest privately owned insurer, traded on 10 times earnings prior to Covid. Today, it is on around five times. The question for us is, will it return to 10 times earnings, or, because of geopolitics, is it now an eight times multiple stock in the medium term?

It is undervalued and earnings are depressed, so there is plenty of runway to make attractive returns. The medium-term question is, do we put a 10 or a 20 on it and how do we quantify that discount because China may or may not be getting a more difficult place to invest because of President Xi's attitude to private businesses.

To what extent does the desire for more control compress free market entrepreneurialism. Xi has reiterated his support for the private sector because it is 80% of jobs in China. The new model coming out is of common prosperity: don't be an island with your wealth. Get rich but share.

There is no credibility or consistency in the ESG data we are receiving.

Bola Tobun
Treasury and pensions manager
London Borough of Harrow

Shukla: A lot of institutional money is looking for a credible home. With China's geopolitical risks, could and should India be the new China as the next big destination for global institutional capital? It is democratic and there is attractive demographic story.

Mezini: The macro is important, but it is about investing in those companies being run in the best interests of its shareholders, especially from the perspective of a foreign investor. These are some of the factors that active managers consider when selecting companies to invest in whether India or elsewhere in EM.

Porkolab: All the positive developments in China happened while we were going through a strong globalisation stage. This has changed, and we are seeing much stronger anti-globalisation trends and political mindsets across the globe, and this may also affect the way forward for India in terms of economic developments compared to China in the previous decades.

Ballard: What you say is true. The world is not where it was when China joined the World Trade Organisation. The journey they took to become the manufacturing engine of the world – bringing in low cost labour, producing goods that people did not know they wanted at incredibly low prices and the proliferation of global supply chains – cannot be done again.

We are now seeing onshoring. People are worried about who they are relying on to get their goods. They are thinking about how to automate production at home. Perhaps we are in a different phase when it comes to the global economy.

I am not saying the Chinese model is necessarily dead, but I wonder whether we are at a stage where going through that journey again is not possible. It has to be a different journey.

Payne: India is a deep, rich market of investment opportunity. The current administration is reaping the benefits of the reforms they sowed a few years ago – like the goods and service tax – which were quite painful and politically unpopular.

India has had a big drive on digitalisation and a credible central bank with strong institutions and rule of law. But it is not an easy place to invest as it is idiosyncratic and has world-class bureaucracy.

It is India's to lose. In other words, it requires a huge global shock, such as an oil price spike or their politicians to mess it up.

Shukla: It is quite an inward focused, consumption driven market. That is where the diversification story comes in with it not being entirely dependent on exports.

Ballard: India will not be the new China. India will always be India and it will have a different development path.

Shukla: If globalisation has peaked and economies become more inward looking, then that is generally bad for emerging markets, particularly the ones with a strong goods export tilt.

Payne: That is bad for different countries. Will is right: the 2000 and 2010 decade is not going to be repeated and nether is the Chinese model of building bridges to nowhere. China is now a consumption-driven economy and India will go down that same path.