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Emerging Markets Seminar

Coming of Age

13th September 2018

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Welcome to

CAMRADATA's Emerging Markets Seminar 2018

Emerging markets are coming under strain - but the challenges faced by these economies are not likely to be their undoing.

The fact is that trade wars, the stronger dollar and rising interest rates should not derail emerging markets from being indisputably one of the strongest long-term investment themes of the past decade, or the next one. Yet warnings of volatility do make it necessary to re-consider how emerging market assets fit into a portfolio.

That's what this CAMRADATA seminar is about. Drawing on expertise of portfolio managers across equities, bonds, multi-asset and quant, we will aim to:

- Remind ourselves why emerging markets made sense in the first place
- Ask if those reasons remain robust under the weight of current concerns
- And consider how ongoing volatility might present opportunities.

Emerging market specialists remind investors that these markets are not homogeneous. Interest rates do not move in tandem; the dollar impact is different between one country and another; some economies are net importers, some are net exporters. The fact is there is much diversity in emerging markets.

That's why the challenges above - coupled with those of anti-globalisation and China's late-stage economic cycle - do not mean one outcome for emerging market assets. It may not be time to sell, but it is time to rethink.

Agenda

8.30 **Registration and Breakfast**

9.00 **Welcome**
Sean Thompson, Managing Director, CAMRADATA

9.10 **Emerging Markets Equities - Long Term Growth Opportunities**
Neal Smith, Emerging Markets Portfolio Manager, Denker Capital

9.40 **The Economist Overview**
Dr. Jan Dehn, Head of Research and Member of Investment Committee, Ashmore Group Investment Management Limited

10.10 **Emerging Markets - A framework for decomposing and understanding manager styles in EMD Local Currency**
Nick Samouilhan, Multi-Asset Solutions Strategist, T Rowe Price

10.40 **Trends in Emerging Markets**
Romil Patel, Senior Staff Writer, Funds Global MENA

11.00 **Coffee**

11.20 **Emerging Markets - A Quant Approach**
Arup Datta, MBA, CFA, Senior Vice President, Head of Team, Mackenzie Global Quantitative Team

11.50 **Emerging Markets - Isolation vs Globalisation**
Fiona Rintoul, Editor at Large, Funds Europe, interviews Michael Reynal, CIO, Sophus Capital

12:20 **China - The Mega Emerging Country - what are the new opportunities?**
Panel Discussion, Chaired by Alan Chalmers, Publisher, Funds Europe, Funds Global Asia and Funds Global MENA

12.50 **Conclusion & Summary**
Sean Thompson, Managing Director, CAMRADATA

13.00 **Lunch**

14.30 **Close**

Speaker

Bios

Neal Smith

Emerging Markets Portfolio Manager

After completing his articles at BDO Spencer Steward, in 2001 Neal started his investment career at Alliance Bernstein (South Africa) as an emerging markets equity analyst. In 2005 he moved to their London office where he co-managed a $2bn international portfolio for institutional & retail clients which was particularly active in emerging markets. In 2007 he joined GLG Partners in London, a large European hedge fund, to manage a global sector equity long/short fund with a large emerging market exposure.

Two years later he moved on to Carlson Capital as an equity research analyst. After moving back to Cape Town in 2012, Neal joined the Denker Capital business as an equity analyst and became a portfolio manager after two years. He launched the SIM Global Emerging Markets Fund in 2015.

Arup Datta

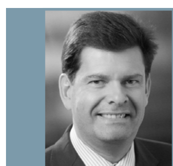
Senior Vice President and Head of Global Quantitative Equity

Arup heads the Mackenzie Global Quantitative Equity Team which provides quantitative investment capabilities in Global and Emerging Markets equities.

Arup has 25 years of experience in quantitative equity investing. Between 1992 and 2012 he was a Quantitative Analyst, Portfolio Manager, Director of US and Director of Portfolio Management with Man Numeric, where he managed capacity-constrained equity strategies (traditional long only, active extension and hedge funds) in all capitalization strata and regions of the world. In 2012, Arup founded Agriya Investors, a firm focused on global equities, which eventually became the global/international arm of AJO. As Chief Investment Officer - International, Arup launched capacity-constrained equity strategies in emerging and developed markets.

Arup joined Mackenzie in September 2017 to head the Global Quantitative Equity Team. Arup has a Bachelor of Technology degree in Electrical Engineering from the Indian Institute of Technology in Kanpur, India, and earned an MBA with distinction from the Johnson School of Management at Cornell University. He is a CFA charterholder.

Bios



Michael Reynal

Chief Investment Officer

Michael's career began in London in 1990 at Barclays de Zoete Wedd, where he helped establish one of the early Latin American equity teams in Europe. In 1993, he was hired by Banque Paribas to run their incipient New York-based Latin America and EEMEA desk. During his time on the sell side, Reynal travelled extensively across Latin America and Eastern Europe, and witnessed the Mexican, Brazilian, Russian and Asian crises first-hand. In 1999, after business school, Michael moved to the buy side, and joined Wafra Investments in New York with an emphasis on Latin America, Eastern Europe and the Balkans.

In 2001, he joined Principal Global Investors, where he ran the Emerging Markets team for eleven years combining quantitative and fundamental research to manage global emerging market portfolios, Asian portfolios and dedicated China portfolios. At the end of 2012, Michael and team joined RS Investments, which was subsequently acquired by Victory Capital Management in 2016 and re-branded Sophus Capital.

Today, Sophus adheres to the same philosophy and process, integrating quantitative signals with fundamental insights. The portfolio managers and analysts are spread around the world, with offices in Des Moines, London, Singapore and Hong Kong.

Nick Samouilhan

Solutions Strategist

Nick Samouilhan is a solution strategist in the Multi-Asset Division of T. Rowe Price. Nick and his colleagues in multi-asset solutions engage clients and prospects in Europe, the Middle East, and Africa in consultative discussions to identify how T. Rowe Price can best meet their investment needs and objectives through a research-led application of the firm's broad equity, fixed income, and asset allocation investment capabilities.

He has nine years of investment experience and prior to joining T. Rowe Price in 2017, Nick was a senior portfolio manager at Aviva Investors, managing a range of total return, absolute return, and multi-asset income funds. Prior to that, he worked at Investec Asset Management, focusing on quantitative asset allocation models and manager research. He began his career as an academic at the University of Cape Town.

Speaker

Bios

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Alan Chalmers
Publisher

Alan is a qualified chartered accountant, involved in publishing for 20 years. He co-founded Funds Europe in 2002 while he was managing director of Union Press Limited from 2001 until 2007. He was managing director of Harper Trade Journals Limited for five years from 1996.

Previously he was commercial adviser to Lipper Analytical Europe, publisher of The European Fund Directory, and a director of Professional and Business Information Plc, publisher of the UK Fund Industry Directory.

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Fiona Rintoul
Editor at Large

Fiona was editor of Funds Europe from its inception until June 2005 and is now Editorial Director. A financial journalist specialising in the international investment fund markets, she has 14 years experience of financial publishing and has contributed to personal finance and professional publications in the UK and Germany.

Before establishing Funds Europe, she edited a quarterly European fund management journal; at Lipper Limited, she was in charge of European publications.

Bios

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Romil Patel

Senior Staff Writer

Romil has worked in broadcast and digital journalism since 2013. He was previously the deputy night editor at Newsweek Media and has also worked as an associate producer for Bloomberg TV.

His work has been aired on the BBC and Bloomberg and been published by Newsweek Media, The Telegraph, the International State Crime Initiative, and the Sunday Times.

Ashmore

Dr. Jan Dhen

Head of Research and Member of Investment Committee

Dr Jan Dehn, Global Head of Research and member of the Investment Committee, joined Ashmore in 2005. As a global strategist and economist, with vast experience in international macroeconomic issues, Jan is responsible for making key calls on markets and economies at a global level.

His expertise spans developed and Emerging Markets with particular emphasis on the international linkages between economics, finance and politics. At Ashmore, Jan has traded developed and Emerging Markets, including sovereign external debt, local currency bonds, FX, corporate bonds, and Frontier Markets. Earlier in his career, Jan was a strategist at Credit Suisse First Boston in New York and London.

He has also worked as a consultant at the World Bank in Washington DC undertaking research on public finance and commodity issues, and has been an economic adviser to a number of Emerging Markets governments. Jan holds a Doctorate in Economics from Oxford University, a Master's Degree in Quantitative Economics from Warwick University, and a Bachelor's Degree in Economics from Sussex University.

He has lived on three continents and travelled to more than 140 countries. He is also a fully qualified wooden shipwright.

Speaker

Bios

CAMRADATA

Sean Thompson

Managing Director

With over 25 years' experience in London's financial services, including investment consultancy, asset management and insurance, Sean brings wide industry knowledge to CAMRADATA. He was previously Managing Director at Meridian Performance Services and has also worked for companies such as AllianceBernstein and City Capital Counselling UK.

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IN A CHANGING WORLD

Emerging Markets are set to continue

their long-term outperformance

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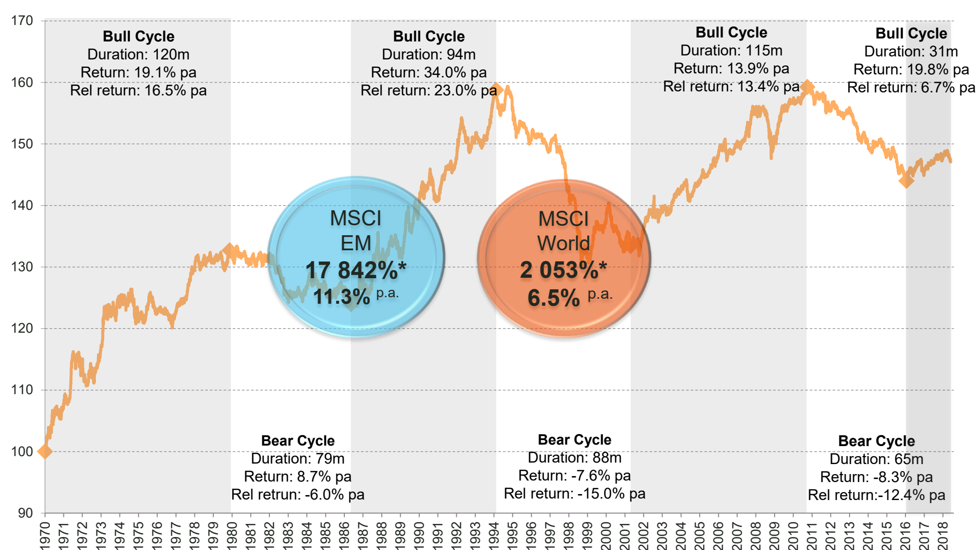
Although emerging markets (EMs) have outperformed developed markets by a substantial margin over time, we have recently seen some underperformance in EMs. This can be ascribed to investor fears brought on by geopolitical events. However, it's important to remember that similar geopolitical events have occurred in the past – and EMs have outperformed developed markets over the long term, regardless. We believe that there is a significant disconnect between the fundamentals of EM companies and the macro noise reflected in the media, and that there are still long-term growth opportunities to be found in EMs.

EMs outperform developed markets over time, despite volatility over the short term.

Although EMs are riskier and more volatile than developed markets, they have outperformed developed markets dramatically since 1970. We calculated that if you had invested $1 million into the MSCI Emerging Markets Index in 1970, it would now be worth $179 million. This is $158 million more than what you would've earned from the MSCI World Index!

> "There is a significant disconnect between the fundamentals of EM companies and the macro noise reflected in the media, and that there are still long-term growth opportunities to be found in EMs"

Figure 1: Emerging markets have outperformed developed markets substantially over time (relative equity performance index in log terms)



Source: FactSet, DataStream, Bloomberg, Goldman Sachs Global Investment Research
**Cumulative returns in US dollars, as at 31 July 2018.*

Looking past fear and focusing on company fundamentals reveals that EMs remain attractive.

Many EM companies are reporting robust growth in revenue and earnings, on the back of improving consumer sentiment. But because of the poor macro outlook and geopolitical events, share prices are being driven down and quality companies have become undervalued. This dislocation presents investors with great opportunities for selective stock picking and to invest in quality companies that were previously too expensive, and in so doing, continue to reap the benefits of EM outperformance.

The reasons why EMs outperform over time represent long-term factors that carry a lot of weight.

1. They are long-term drivers of growth.

EMs are under-represented in equity markets compared to their contribution to global GDP.

As countries move up the development curve, their stock markets typically grow. This results in a rising ratio of market capitalisation to GDP. It is interesting that the IMF expects EMs' share of global GDP to increase at a growing pace going forward.

There are structural drivers of growth in EMs.

• An abundance of resources and human capital
The number of people and resources available in EMs is generally much higher than in developed markets, allowing more room for growth.

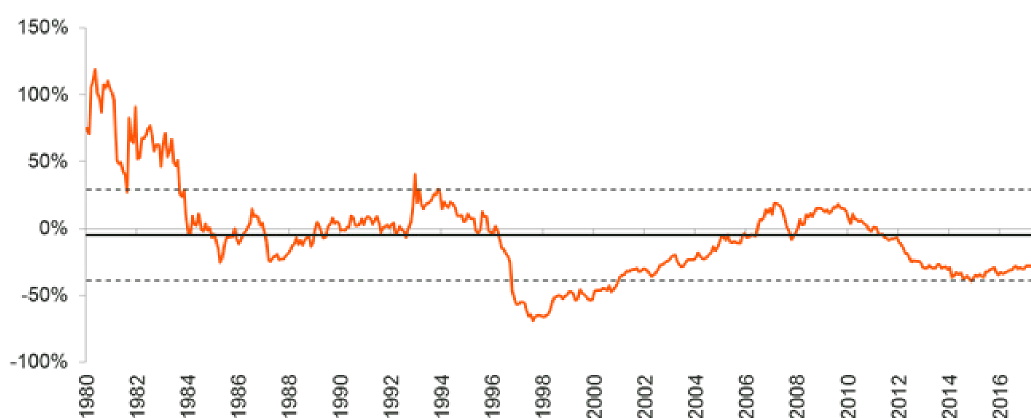
• Younger and faster-growing populations
EMs typically have populations that are much younger and growing at a faster rate, which further supports future growth, whereas the majority of developed market populations are ageing. The challenge that this represents is not only the number of older persons but also the ratio of older to younger people. An older and shrinking workforce places more demands and pressure on markets, such as an increasing demand for healthcare infrastructure and a decline in economic capacity and growth.

• Rapid urbanisation
The established urban areas that represent developed markets tend to dominate global economic activity (even more than the high population levels would suggest), which is evident in their considerably higher disposable incomes and wealth. Average urban incomes are roughly three times those of their rural counterparts in emerging countries like China and India. These income gaps, and the fact that urbanisation in EMs is expanding, show that there is scope for urbanisation to be a driver of growth in these countries. There is a lot of capacity available for urbanising EM cities to attract skilled workers, productive businesses and economies of scale that enable workers to be more productive and reduce the costs of supplying basic services.

2. Their valuations are attractive.

EMs are still attractively valued. This enables investors to potentially achieve superior long-term returns if they can identify and exploit the right investment opportunities.

Figure 2: EMs are attractively priced compared to developed markets (price to NAV)



Source: FactSet, as at 31 July 2018

Long-term investors who can withstand short-term volatility should reap considerable long-term benefits when investing in EMs.

The attractive valuations and company fundamentals of EM companies, coupled with an abundance of natural resources, large and growing populations, and rapid urbanisation, should continue to support the strong growth we've seen in EMs. This gives patient, long-term investors the opportunity to earn attractive risk-adjusted returns, while diversifying their portfolios.

> "An older and shrinking workforce places more demands and pressure on markets, such as an increasing demand for healthcare infrastructure and a decline in economic capacity and growth"

Written by

Neal Smith
Portfolio Manager

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Does your emerging markets strategies include small caps?

Most investors understand the allure of emerging markets and the long-term secular demographic and consumption trends that offer patient investors the potential of attractive returns. In addition, some of today's smaller, less-established frontier markets may eventually be added to the emerging market country list and thereby expand the opportunity set even further.

With this as a point of departure, the real question becomes: What is the best way to capture the full diversification benefits and growth potential of emerging market equities?

Michael Reynal, chief investment officer of Sophus Capital, and Laurence Siegel, the Gary P. Brinson director of research at the CFA Institute Research Foundation, have studied emerging markets extensively.* Empirical evidence, they argue, advocates for a broad approach that includes an allocation to all market capitalizations, including smaller companies within the emerging markets universe.

> "One indicator of the amount of alpha generation opportunity an asset class affords its investors is the cross-sectional dispersion of the returns of the stocks in the asset class"

According to analysis by Reynal and Siegel, emerging market small and large caps typically behave quite differently, each offering unique characteristics to a global multi-asset-class portfolio. Allocating to smaller emerging market companies exposes investors to different sectors and competitive forces than emerging market large caps.

Correlations of monthly total returns (in U.S dollars) of major global indexes. December 1994 - February 2017

	SP500	MSCI EAFE	MSCI ACWI	MSCI EM SMALL CAP	MSCI EM LARGE CAP
MSCI EMERGING MARKETS SMALL CAP	0.54	0.72	0.71	1.00	0.89
MSCI EMERGING MARKETS LARGE CAP	0.66	0.79	0.81	0.89	1.00

Source: Sophus Capital, Bloomberg, as of Febraury 28, 2017

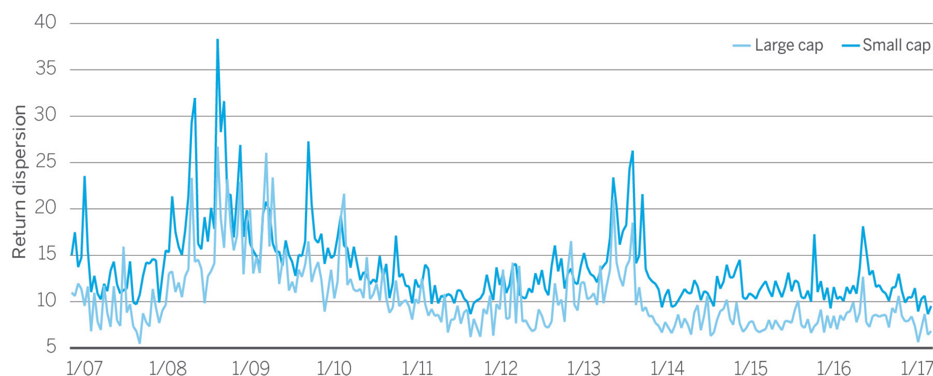
Reynal and Siegel also point out that emerging market small caps have historically had more dispersed returns, less analyst coverage, and larger payoffs attributable to skillful factor analysis than their large-cap counterparts. All these factors make smaller companies an attractive playing field for potential alpha generation, particularly for active managers willing to veer away from the largest cap stocks that tend to dominate popular emerging markets indexes.

Small company, large alpha?

One indicator of the amount of alpha generation opportunity an asset class affords its investors is the cross-sectional dispersion of the returns of the stocks in the asset class. If all the stocks were perfectly correlated with one another, the asset class would in effect consist of one security and there would be no opportunity to add value through security selection. As these correlations decrease, the opportunity to add alpha increases.

* Source: "How Emerging is Your Emerging Markets Manager?," Michael Reynal and Laurence Siegel, June 2017.

Month-by-month cross-sectional standard deviations of one-month returns on stocks in the emerging markets small cap and emerging market long cap benchmarks, 2007 - 2017 (as of January 31, 2017).



Past performance is no gaurantee of future results. Indexes are unmanaged. It is not possible to invest directly in an index.
Sources: Sophus Capital, FactSet, as of January 31, 2107.
Large- and small-cap universes include MSCI Emerging Markets Index and S&P Emerging Plus BMI constituents.
Diversion is standard deviation of monthly returns.

One way to visualize the difference in alpha generation opportunities between the emerging market small- and large-cap asset classes is to look at the dispersion (standard deviation) of monthly security returns for the two categories. Reynal and Siegel conducted such an analysis in the exhibit above, with each month from January 2007 to January 2017 shown separately. The monthly results are then connected by a light blue line (emerging market large caps) or a dark blue line (emerging market small caps).

Note that there is nothing in this analysis that says a particular manager is going to come out in the top half of the distribution of alphas. No matter how inefficient a market is, or how much opportunity is afforded by the cross-sectional dispersion of returns, active management versus a properly chosen benchmark is still a zero-sum game, with half of all managers underperforming the benchmark before costs, and more than half underperforming after costs.

> "Active management versus a properly chosen benchmark is still a zero-sum game, with half of all managers underperforming the benchmark before costs, and more than half underperforming after costs"

Taking the MSCI Emerging Markets Large Cap Index as the measure of large caps and the MSCI Emerging Markets Mid Cap Index and Emerging Markets Small Cap Index combined to represent smaller caps, large caps comprise 456 names, while smaller caps comprise 2,164 names. So an active manager in emerging market smaller caps has almost five times as many stocks to choose from, or (applying the square root rule) 2.2 times as much opportunity to apply his or her skill, just based on the number of names. In addition, the emerging market smaller stocks have lower cross-correlations and significantly higher volatility. So there are many more opportunities for emerging market small-cap managers to differentiate themselves from the benchmark and from other managers, relative to large-cap managers.

However, it may be difficult for emerging market managers with substantial assets under management to take advantage of opportunities in smaller-cap emerging market stocks. Such managers typically hold mostly, or only, emerging market large-cap companies, and may also invest in developed market companies believed to offer emerging market exposure. This could be problematic, particularly for investors believing they are getting pure and diverse emerging market exposure.

Avoid large biases

It's important to remember that largest emerging market country at any given time may dominate an emerging market index in a way that is disproportionate to that country's importance in world markets. This mirrors the more general large-cap bias prevalent in popular emerging market benchmarks and suggests that such benchmarks should be viewed skeptically as a guide to portfolio construction. Rather, Reynal believes active emerging market managers should use as broad an opportunity set as possible, even if it means making off-benchmark bets.

Consider that South Korea has been on the threshold between emerging and developed market status for a long time. Because index providers disagree, different emerging market indexes have materially different country weights depending on whether South Korea is included in the index or not. Similarly, Greece and Malaysia have floated in and out of the various emerging market indexes at different times. Taiwan has a highly developed economy but is categorized as emerging because of restrictions on foreign ownership of shares. Some investors have even questioned China's status as an emerging market index constituent because such a significant percentage of the country's market cap consists of state-owned enterprises (SOEs). Yet despite all this, China, Korea, and Taiwan now make up nearly half of the MSCI Emerging Markets Index.

> "Those who choose an active, fundamental approach to emerging markets must look closely to ensure that their portfolios are not unduly biased toward large caps"

Because of these considerations, the returns of emerging market benchmarks can be driven by a few large countries and a few large companies. These returns tend to be correlated to the global economy and to other factors that drive developed market equity returns. That's why emerging market benchmarks may not be an effective diversifier of developed market equity risk.

Choose wisely

Investors would be prudent to fully understand their emerging market equities allocation. Those who choose an active, fundamental approach to emerging markets must look closely to ensure that their portfolios are not unduly biased toward large caps. And even those investors who select a passive approach to emerging markets should realize what they are gaining and omitting from a portfolio construction viewpoint.

Ultimately, failure to include an adequate small-cap allocation could cause investors to miss out on what Reynal and Siegel believe is the most interesting part of the emerging markets story: the diversifiers–companies that are typically more exposed to home-country economies and less exposed to global factors and developed-country competition. Incidentally, these are often innovative, nimble and locally focused companies at the lower end of the capitalization spectrum.

Written by

Michael Reynal
Chief Investment Officer

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All investing involves risk, including potential loss of principal. International investing involves special risks, which include changes in currency rates, foreign taxation, differences in auditing standards and securities regulations, political uncertainty, and greater volatility. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume. Investments in small and mid-size companies can involve risks such as less publicly available information, higher volatility, and less liquidity than larger companies.

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Deconstructing Excess Returns

in Emerging Markets Local Currency Debt

On the face of it, any return that an active manager makes in excess of the benchmark should be attractive to investors. But excess returns can come from different sources: some involve idiosyncratic skill, while others just involve taking more risk. This is particularly relevant when evaluating managers in emerging markets (EM) local currency debt.

In equity space, excess returns can come from skill in security selection, but they can also come from simply taking "geared" exposure, for example via overweights in high-beta stocks. Geared managers who outperform in rising markets tend to give up those gains in falling markets. To differentiate security selection skill from what is essentially a lucky bet on a rising market, excess returns need to be adjusted for gearing effects.

> "Geared managers who outperform in rising markets tend to give up those gains in falling markets. To differentiate security selection skill from what is essentially a lucky bet on a rising market, excess returns need to be adjusted for gearing effects"

Can we apply this to EM local currency sovereign debt? The same broad principles apply, but here instead of amplified equity beta as a way to beat the benchmark, we consider managers' exposure to the three components of total return in the asset class: currency, coupon and rates (duration). We seek to understand to what extent managers are geared towards each driver in order to isolate "true" alpha.

To measure this gearing we use a standard multi-variate regression framework, regressing the three benchmark return drivers against the active manager's total return to identify the manager's specific sensitivity to each of them.

The table shows stylised results from the framework, isolating the true alpha from driver gearing for three different managers. Note how excess returns generated by the managers, from left to right, are below, in line with, and above the benchmark respectively. But once gearing to the different drivers is accounted for, the reverse is true in terms of idiosyncratic alpha.

In addition, by separately estimating the sensitivities to the drivers relative to both the benchmark and each other, this approach tells us something about the managers' particular investment styles. Manager A is in line with the market for currency and coupon risk, but more defensive on rate risk. Manager B is in line with the market on coupon risk but is taking more currency and rate risk. C is defensive on currency and rate risk and slightly aggressive on coupon risk.

Stylised Regression Results

	Benchmark	Manager A	Manager B	Manager C
Total Return	5.00%	4.50%	5.00%	5.50%
Excess Return	0.00%	-0.50%	0.00%	0.50%
FX Beta	-1.00%	1.00	1.50	0.5
Coupon Beta	2.00%	1.00	1.00	1.10
Rates Beta	4.00%	0.70%	1.30	0.70
True Alpha	0.00%	0.50%	0.00%	-0.50%

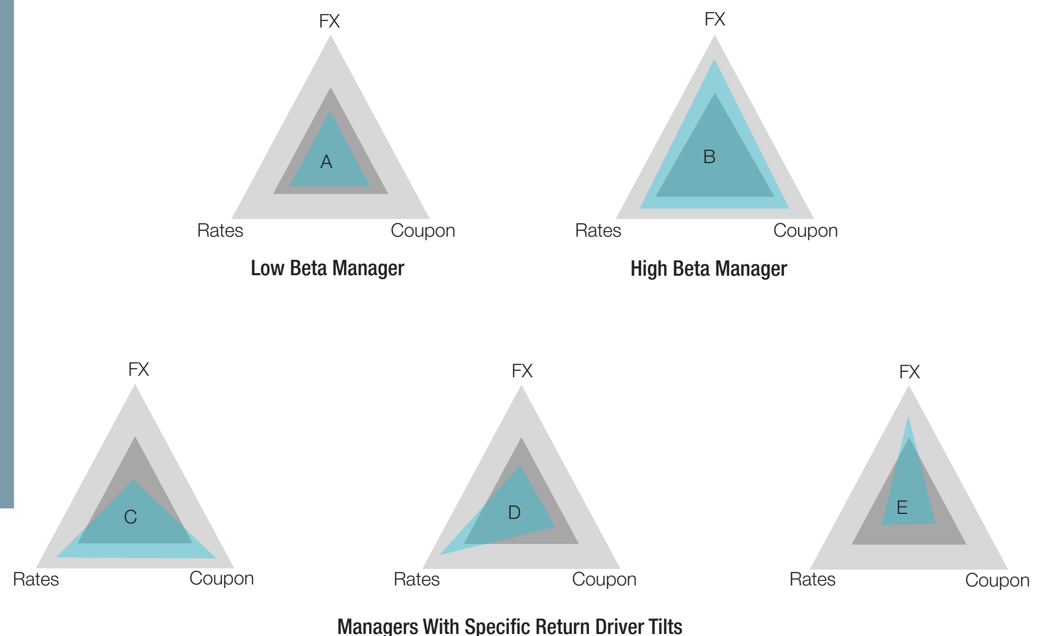
It's easy enough to illustrate this decomposition of returns in table form, but graphing the relationship is more of a challenge. In EM local currency, the existence of three market drivers means that instead of using a (single axis) bar chart we need a (three axis) triangle. The graphic illustrates this decomposition of returns, with each triangle point representing a market driver. The inner grey triangle indicates a neutral (versus the benchmark) sensitivity to the respective driver.

The below examples indicate various stylized manager sensitivities as shown by the light blue triangles.

A shows low beta (low sensitivities to all three drivers); B shows high beta (high sensitivity to all three drivers); and C,D and E are mixed-beta managers (a combination of low and high sensitivities to specific drivers).

This type of exercise not only allows for a cleaner analysis of why a manager has done well or badly in the past, but also in what environment they are likely to do well or badly in the future. A manager that has a high sensitivity to EM currency rates, for instance, will battle to beat the benchmark in an environment of US dollar strength. And, as is the case with active equity managers, understanding different manager styles allows for better blending of managers, avoiding a situation where all managers outperform or underperform at the same time.

> "With active equity managers, understanding different manager styles allows for better blending of managers, avoiding a situation where all managers outperform or underperform at the same time"



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