MARKET INSIGHT

Diamonds in the rough...

Emerging markets (EMs) is the well-worn phrase coined to describe the group of countries considered to be underdeveloped, but which are rapidly growing and urbanising. Despite their reputation for carrying significant economic and political risk, EMs present opportunities to invest in companies looking to take advantage of the growing population of consumers. The result? Potentially higher investment returns compared to investments in developed countries.

Though this one-size-fits-all definition has served well for many years, it is becoming increasingly clear that countries falling under this broad categorisation are becoming less homogeneous, differing both politically and economically, contributing to varied performance. Each EM country has its own story, its own unique opportunities and its own risks. BRICS - referring to the economies of Brazil, Russia, India, China and South Africa - was termed to represent the exclusive club of leading developing countries, but has become increasingly challenged in recent years, as several members suffer economic woes compounded by political scandals. You only have to look at Russia – a prime example of a country heavily reliant on oil exports, teeming with corruption and accused of some of the most severe human rights abuses in recent years. On this basis alone, it's not hard to see why selectivity within EM is key.

With this in mind, TAM think it's plausible that the extra effort exerted digging for the hidden gems in EMs, will reward investors in the medium to long-term. The fact that they are often less researched means positive change is often not reflected in the share prices - and who doesn't love a bargain?!

We are seeing diamonds in the rough buried in Asia, where several countries are slowly but surely, piecing together the right economic and political mix for rapid and sustained growth. These include:

Indonesia…
…Which has recently benefited from the stabilisation of the Indonesian Rupee and lower interest rates that are encouraging higher levels of investment. According to a recent study by Oxford Economics, Indonesia's output gap - the difference between the actual output of an economy and its potential output - is lower compared to other emerging markets, and balance sheets are looking strong.

Vietnam…
…Which has seen record levels of foreign direct investment over the last two years and has a young demographic, driving economic growth to average around 7% a year, second only to China. Tourism has also been given a boost by the recent introduction of the visa exemption policy, offering waivers to travellers from 22 European and Asian countries. Furthermore, Vietnam could be set to become one of the exporting power houses in Asia, as China begins to move away from the lower end of the manufacturing chain.

And let's not forget India…
…Though less of a hidden gem and more like the EM poster child, now three years on from the election of President Narendra Modi, its focus is on ushering in structural reforms attracting more foreign direct investment and increasing the ease of doing business. We are beginning to see the effects of these reforms play out, despite some negative short-term ramifications, with inflation coming down and a reduction in the country's fiscal deficit. The real excitement about India stems from the level of entrepreneurship that its society has demonstrated, particularly in the pharmaceutical and technology sectors. Many companies are beginning to sit up and notice the growing middle-class who have plenty of money to spend.

What about the risks?

Of course, investing in EMs carries risk, with a number of countries racking up debt by spending well beyond their means, often in US Dollars, therefore leaving them at the mercy of the US Federal Reserve and their decision on interest rates, which determines the cost of their debt servicing. Political risk is also prevalent in EMs, with countries such as Brazil, South Africa and Russia remaining heavily influenced by politics. The old GEMs are tarnished.

Having said that, the political environment on this side of the world is certainly not much better. Globalisation, though great for creating wealth, has caused much disruption in the developed world. The political environment in Europe has been turned on its head, starting with the Brexit vote and leading to the pending 50% of Europe now up for election.

Across the Atlantic, the US has potentially even more problems in the form of newly elected President, Donald Trump, who caused pandemonium during his election campaign and continues to unnerve markets with a lack of clarity on the direction of his policies. Similarly, the developed world is far from squeaky-clean in terms of its large stocks of debt and sovereign risk, highlighted most recently by the Greek sovereign debt crisis. Developed markets can be extremely unpredictable and the dysfunctionality of recent markets is a perfect example. Recently, bonds and equities have been sending contradictory messages; low bond yields implying economic weakness, while equities signalling strong earnings growth and an improving economy. Therefore the only difference between developed and emerging market risk, is that one has been priced in, whilst the other is ignored.

What is TAM doing?

Valuations in EMs are currently at around a 30% discount to developed markets, whilst the MSCI Emerging Market Index is up approximately 28% over one year. The two vital drivers of the view on emerging market performance in the long-term, fundamentals and sentiment, have begun to align, thus favouring the asset class. China has undergone a resurgence of growth over the last 12 months, commodity prices have recovered and EM currencies have stabilised for the first time in a while. A new era in GEMs may be unfolding.

A Trump presidency is certainly not make or break for emerging markets, it is just another risk factor to bear in mind when investing. In fact, the US election result highlights the importance of selectivity when investing in EMs, as the divergence between individual countries will present opportunities for active stock-picking managers with strong, bottom-up research processes behind them. With improving macroeconomic fundamentals in many EM countries, a gradual rise in dollar strength poses a lesser risk to EM currencies than it did in the past. They should also be able to withstand gradual and measured interest rate rises by the US central bank, which serve as confirmation of, and confidence in, improving US and global growth, which in turn should support EM assets.

TAM took the opportunity last year to enter the market through a fund which we believe will make the most of the unique opportunities this asset class has to offer. We chose to add a global emerging markets fund to Growth, Adventurous and Speculative portfolios, which follows a blended investment style, with the aim of identifying quality companies trading at attractive valuations, largely through bottom-up analysis but rooted in a top-down framework that identifies countries with conditions supportive of long-term growth. It is vital that we own a manager who is able to pick out the opportunities that lie in corners of EMs, as the success of an EM fund manager has become less about picking the right stocks, and more about picking stocks from the right countries.

More recently, we have increased our exposure to EMs in Adventurous and Speculative portfolios through a fund invested purely in India, where we believe there is a strong standalone reason to invest. We have added a fund which aims to achieve long-term capital growth by investing in companies which operate or reside in India and which focus on revenues generated domestically. We particularly like India as we believe it is one of the more robust economies within EMs that should remain relatively less exposed to global shocks and unfavourable Trump policies. In fact, India is one of the only major emerging economies that is driven largely by domestic consumption, so likely to be more insulated from the global macroeconomic environment.

It is often thought that investing in EMs adds risk to a portfolio, but TAM believe that EM investing is in fact a way to reduce your overall risk through diversification and avoiding this asset class entirely, could actually be a more risky strategy. We believe the theme is ongoing and will be looking to add to our positions, taking advantage of dips in the market.

TAM ASSET MANAGEMENT

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