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Tapping The Growth Of Emerging Markets

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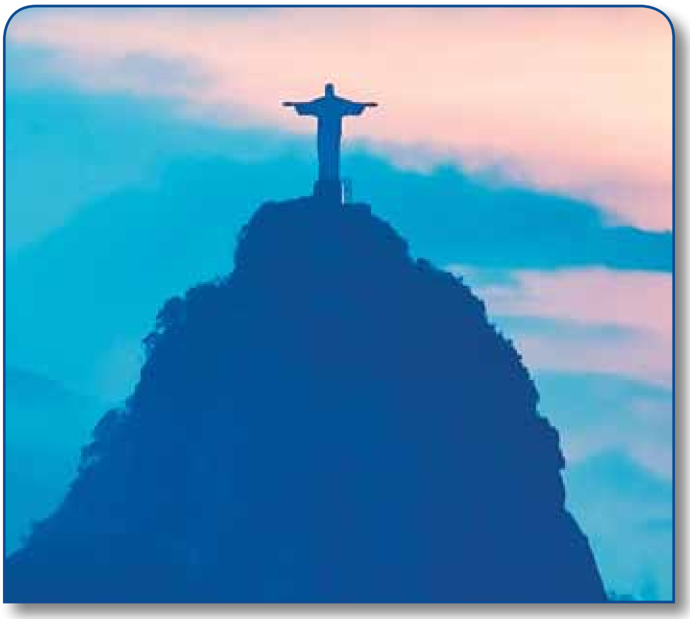

Emerging markets offer investors opportunities waiting to be captured and should not be disregarded by common fears from the past, but instead tapped for the benefits they offer in the present.

With a growing market capitalization of US$3,747 billion at June 30, 2016, representing 10 per cent of the world's equity capitalization, emerging markets should be attracting investors in droves. Yet most Canadian institutional investors have no direct exposure to this flourishing asset class.

While investment managers of international and global developed equity are permitted to invest in emerging markets, investors' overall allocation generally falls well short of the emerging markets world stock market representation. With emerging markets representing the highest growth area of the world stock market, investors could benefit from having at least market representation in their portfolios.

Defining The Opportunity

Emerging markets can be characterized as countries with growing economies and middle classes. Many of these markets continue to have high rates of poverty and are often still experiencing significant social and political change.

The MSCI Emerging Markets Index (see ***Figure 1***) consists of 838 stocks in 23 countries from the largest, China at 26 per cent, to the smallest, Egypt at less than 0.2 per cent. The countries are routinely grouped into three regions: Emerging Markets Asia, Emerging Markets Latin America, and Emerging Markets Europe, Middle East, and Africa.

The asset class is often regarded as being commodity heavy, but the weightings in energy and materials are much smaller compared to the weightings in the commodity-based S&P/TSX Composite Index and are not dissimilar from U.S. and international equity developed market indices.

While the countries may be classified as emerging, 824 of the 836 companies in the MSCI Emerging Market Index are valued at over US$1 billion, which compares to only 194 such Canadian companies in the S&P/TSX Composite Index. Increasingly, emerging market stocks are becoming common household names: Samsung, China Mobile, Hyundai Motor, and TATA (owner of Jaguar, Land Rover, and Ritz-Carlton Hotels).

Steven Huang, head of quantitative equities at Connor, Clark & Lunn Investment Management Ltd., sees advantages for the broader opportunity set of emerging market equity compared to Canadian equities for adding value. "The largest 15 Canadian stocks account for 39 per cent of the S&P/TSX index, while you would need to invest in 47 emerging market companies to reach a similar index representation, highlighting the opportunities available to active managers," he says.

Emerging Markets Benefits

Investing in emerging markets represents a broader opportunity set, but do they offer good potential for investors? Benefits to consider include:

- Growth Opportunity

Emerging and developing countries account for 39 per cent of world gross domestic product (GDP) measured at market exchange rates and 58 per cent based on purchasing power parity (PPP). The IMF (International Monetary Fund) forecasts emerging markets to grow at an average annual rate of 3.7 per cent in the five years to 2021 versus expansion of 1.9 per cent in developed economies. Emerging markets will, therefore, be responsible for over 75 per cent of global growth over this period (on PPP basis).

A significant and rising proportion of developed market earnings are directly and indirectly linked to emerging market growth, further underlining its importance.

- Re-rating Opportunity

Ordinarily, high growth assets are priced at a premium.

Emerging market stocks have traditionally traded at a discount to developed world valuations, but the economic fundamentals for emerging markets as a whole have improved as political environments stabilize and macro management improves.

Fiscal situations, current accounts, and foreign exchange reserves are generally better than in developed world economies and there are no looming liabilities of pension fund provisions to be concerned about.

▶ Improving Returns

Emerging market firms aspire to develop their own identities and are no longer simply content to do the grunt work of western companies. Non-brand margins can often range of three per cent to eight per cent, while branded firms, with loyal followers, can achieve 15 per cent margins.

▶ Consumer 'Take-Off'

Income per capita has reached a tipping point in many emerging markets where consumption is likely to grow rapidly for the burgeoning middle classes as many luxury items become a reality rather than an aspiration for consumers.

Many emerging market companies are shifting away from manufacturing to higher value added areas using brands and technology. Return on invested capital (ROIC) should rise for emerging market companies as they develop world class brands.

The recent decision by the UK to leave the European Union, commonly referred to as Brexit, has particular implications for emerging markets. One concern often cited is the potential adverse impact on growth for China, the largest emerging market country, and how slower growth in the UK and Europe may result in sluggish growth in Chinese exports. However, Ian Beattie, co-chief investment officer of NS Partners Ltd., notes that "the Chinese economy is becoming less trade-dependent as policy-makers promote consumer spending and services activity, consequently China-related investments may be able to act as a hedge against future global shocks like Brexit."

Figure 1

MSCI Emerging Markets Index

Sector Weights	MSCI Emerging Market	S&P/TSX	SP500	MSCI EAFE
Energy	7.5%	20.1%	7.4%	5.2%
Materials	6.3%	13.8%	2.8%	6.9%
Industries	6.2%	8.4%	10.2%	13.3%
Consumer Discretionary	10.5%	6.0%	12.3%	12.1%
Consumer Staples	8.5%	4.1%	10.6%	13.3%
Healthcare	2.7%	0.8%	14.7%	12.4%
Financials	26.1%	35.8%	15.7%	22.3%
Information Technology	22.5%	2.7%	19.8%	5.3%
Telecommunications Services	6.6%	5.5%	2.9%	5.1%
Utilities	3.2%	2.8%	3.6%	3.9%

Source: Thomson Reuters Datastream

Not Without Risks

Emerging market equities are not without their risks. While active managers can mitigate some of these risks through research and careful individual stock selection, investors need to be wary of the following:

▶ Political and Social Risk – Uncertainty can be created by the political and social changes taking place in emerging market countries. The Arab Spring may bring about desirable change, but the uncertainty creates volatility and the danger of contagion to other emerging markets.

▶ Information and Liquidity Risk – Although the quality of data has improved, obtaining timely information can still be challenging in emerging markets. Currency controls remaining in a small number of markets may also create liquidity concerns.

While risk management is at the front of most investors' minds, generating sufficient return from the growth component of a portfolio is nonetheless an important task. Many investors are still underweight in emerging markets relative to its representation in world markets, yet the majority of global growth over the next five years is expected to come from this largely untapped area. As emerging market companies shift from manufacturing to higher value added interests using brands and technology, the number of emerging market household names will rise, as will investors' expected returns. Many investors would benefit from tapping into the emerging markets growth opportunity by increasing its exposure in their portfolios. BPM

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