

# vast and varied



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What exactly are investors getting when they invest in 'Emerging Markets'? **Christopher Cade** assesses the choices for Emerging Market exposure.

**W**ithin any portfolio that contains an allocation to International Equities there will be an increasing amount apportioned to Emerging Markets. These are increasing because most allocations are made upon a market cap weighted basis, and as Emerging Markets have outperformed developed markets in recent years, their relative weights have increased. In addition, many asset allocators have tactically over-weighted Emerging Markets in recent times in light of the fact that, amongst other things, they seem less affected by the credit crisis.

This month's *informer* investment content focuses on several of the key emerging markets themes, particularly the BRIC countries – Brazil, Russia, India and China. Before our fund group partners offer their expert assessment of these areas in more detail, it's worth considering what Emerging Markets actually represents and why its profile is in the ascendancy.

Emerging Markets, we are told, give us exposure to a debt-free, young, educated and consuming population. But any forward-looking global company will also be

trying to exploit this opportunity and in many cases are likely to be listed in countries with greater economic and political stability, on more liquid exchanges and with much better accounting regulation. So, are we really getting 'bang for our buck' with Emerging Markets?

## defining emerging markets

'Emerging Markets' was a term first coined in 1981 by Antoine W. Van Agtmael of the World Bank. The criteria used to define whether an economy is emerging or developed changes depending upon who you speak to, but Gross Domestic Product per head, Growth Rate and the Stage of Development in their financial markets are the generally accepted measures.

Typically, therefore, a country with low to middle per-capita income is defined as

'emerging,' but given this constitutes 80% of the global population the easiest definition is perhaps 'every market that is not developed'. Figure 1 shows the categorisation of 'emerging' and 'developed' markets according to the MSCI.

**figure 1**  
– developed and emerging markets

**Developed markets\*:**

|           |             |             |         |
|-----------|-------------|-------------|---------|
| Australia | Austria     | Belgium     | Canada  |
| Denmark   | Finland     | France      | Germany |
| Greece    | Hong Kong   | Ireland     | Italy   |
| Japan     | Netherlands | New Zealand |         |
| Norway    | Portugal    | Singapore   | Spain   |
| Sweden    | Switzerland | UK          | US      |

\*Israel likely to join this list in 2010.

**Emerging Markets:**

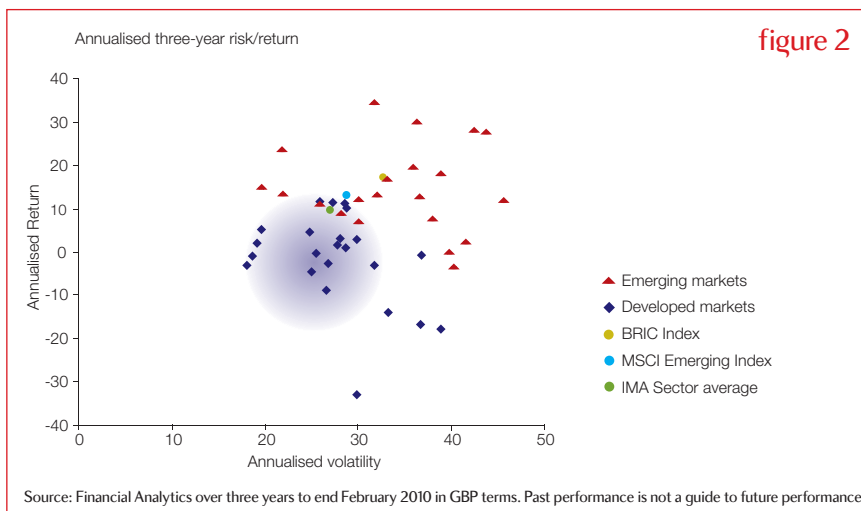
|           |          |              |          |
|-----------|----------|--------------|----------|
| Brazil    | Chile    | China        | Columbia |
| Czech Rep | Egypt    | Hungary      | India    |
| Indonesia | Korea    | Malaysia     | Mexico   |
| Morocco   | Peru     | Philippines  |          |
| Poland    | Russia   | South Africa |          |
| Taiwan    | Thailand | Turkey       |          |

At the time of writing Emerging Markets make up just under 15% of the world's stock markets in GBP terms, rising as their currencies appreciate and they outperform developed markets. That is to say that within the equity allocation of a portfolio, a neutral position is currently 15%. Getting this allocation right is therefore becoming increasingly important.

**accessing emerging markets**

As any adviser will know, there are a number of ways to gain exposure to Emerging Markets. Should you buy individual country funds? Should you access BRIC or traditional Global Emerging Markets funds, through which you will delegate country, currency and stock selection to the fund manager? A look at the disparity in the market shows why the choice of how to gain exposure to emerging markets is crucial.

Figure 2 shows the risk/return positions of Emerging Markets, represented by their MSCI indices together with the IMA sector average, the MSCI EM and MSCI BRIC indices for the three years to the end of February 2010. As you might expect, the dispersion of returns for Emerging Markets is wide and returns have often been superb (if you were lucky enough to select the right market and don't mind a bumpy ride). But with some countries providing negative returns over the same period, you might be right to question the rationality of opting for single country selection. For example the MSCI EM composite index produced an annualised return of 12.9% over the last three years (in GBP terms) which exceeded the



Source: Financial Analytics over three years to end February 2010 in GBP terms. Past performance is not a guide to future performance.

annualised IMA sector average by over 3.1% – highlighting the need for good manager selection within this diverse sector.

Meanwhile, the MSCI BRIC Index returned a handsome 16.8% over the same period, but Brazil, Russia, India and China represent less than half of the Emerging Markets in terms of market capitalisation. So an allocation specifically to those areas might exclude you from some of the other global growth stories.

**market efficiency**

Crucially, the dispersion of returns shown in figure 2 demonstrates the inefficiencies within Emerging Markets, while the same cannot be said for Developed Markets. Within Emerging Markets, inefficiencies exist at country level and at stock level, and managers will be trying to exploit these in different ways and to differing degrees.

The inefficiencies within Emerging Markets persist while they undertake political and economic reform without certainty that the resulting structural changes will be positive for investors, succeed or even complete; there really is no such thing as a free lunch. The success of the investment will depend on the skill of the fund manager in exploiting these opportunities.

**harnessing opportunity**

There are of course alternative ways of accessing the Emerging Markets growth story. Portfolios will likely already have exposure to these areas as Western companies seek to profit from the increasingly affluent Emerging Market consumer. For example, Volkswagen – a stock you will often find in your European portfolio – is well exposed to the Chinese export story due to the manufacture of vast numbers of units in China. Standard Chartered Bank, listed in London but whose majority of assets, revenue or profit come

from Emerging Markets, may well also appear in any UK fund.

Some asset allocators play Emerging Markets through exposure to their currencies. While this is principally done through the fixed income markets, it is part of the same story but with a slightly less volatile asset at the heart.

Finally, many Emerging Market funds do not give you exposure to frontier markets such as Vietnam and those on the African continent. How emerging do you want to go, and is your client prepared to accept the potential of investing in illiquid markets where getting your money back can sometimes be a challenge?

There is no doubt that the opportunities in faster-growing parts of the world provide long-term optimism as the economic environment in the Western world remains uncertain. But Emerging Markets are vast and varied. If you're choosing not to outsource your stock and country selection, then exposure to Emerging Markets needs to be well thought out. ●

**bric by bric**

On the following pages expert fund managers from Allianz Global Investors, Neptune Investment Management, Kotak and Gartmore assess the prospects for each of the BRIC markets.

And starting on page 16, Barings looks at the opportunities in agriculture linked to rapid population growth and expanding affluence in emerging markets.



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