The New Emerging Markets

While the term emerging markets has been in use since 1983, emerging markets themselves have seen drastic changes. Today, the increase in access of communication methods and the globalization of the world economies have given emerging market countries new tools to grow and thrive.

But with great change also comes new risks. While some Canadian plan sponsors look at terrorism and the Avian Flu as reasons to avoid investing in emerging markets, others have accepted them as universal risks that shouldn't deter them from taking advantage of the possible growth of emerging nations.

Management companies have also started to take a different approach when it comes to this market. No longer satisfied with an arm's length involvement, they are being more proactive about engaging entrepreneurial businesses in emerging market countries. By setting new standards and best practices, management companies are aligning themselves with businesses that are more sensitive and open to a western business approach.

Now, more than ever, Canadian plan sponsors can be more secure about their investments in the developing world.

With the heightened interest in emerging markets, ***Benefits Canada*** sat down with two leading managers — David Creighton, President and CEO of Cordiant Capital and Paul Easterbrook, Managing Director & Senior Vice President, Schroder Investment Management North America Ltd., Canadian Representative Office — to get an insider's view on what's been happening, what's to come, and how Canadian plan sponsors can take advantage of this exciting growth area.

Interviewed Participants

David G. Creighton
President & Chief Executive Officer,
Cordiant Capital Inc.

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Managing Director &
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David G. Creighton
President and Chief Executive Officer
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What are the drivers of emerging markets' performance? How much is driven by local economic factors?

DC: The greatest drivers of the emerging market performance have been the liberalization of markets and the development of a middle class. Basic infrastructure such as the construction of roads and the introduction of cell phones, forms of communication that the western world takes for granted, are being introduced at a fantastic rate, creating an excellent foundation for further growth.

The ability of the general public, entrepreneurs, farmers and the like, to create efficiencies through communication, to exchange ideas and prices, has provided the impetus for this performance.

An external driver, which has been spearheaded by the World Bank, is the development of the "enabling environment." The premise here is to work with emerging governments on reducing the impediments to business growth in their respective countries. Hurdles such as the registration of property or antiquated labour laws are slowly being dismantled, creating a more business-friendly environment.

Have Canadian pension funds missed the ride?

DC: Not at all. While we have seen many countries develop fairly quickly over the last fifteen years, including the Czech Republic, Poland, Thailand and Mexico, there are a number of others that, for a variety of reasons, are lagging behind.

We continue to find attractive opportunities in Russia and Latin America and are now beginning to engage with the next wave of countries in such places as El Salvador, Bulgaria and Kazakhstan. It's all about finding the right risk/return profile.

What key messages should be communicated to pension committee members or trustees regarding emerging markets?

DC: One message is that higher returns are going to be generated by higher growth countries. Over the long term, the increase of a country's equity index will tend to be equal to the growth of GDP. Given this, does it not make sense to have exposure to those countries with higher growth?

Another way of looking at this is the comparative demographics. Very simply put, if your liabilities are in an aging population, your assets should be in a young and growing one. The demographic profile of the emerging markets is markedly different from that of the Western World.

When dealing with our clients, which include long-term investors such as pension funds and life companies, there is an increasing desire for non-correlating assets. The emerging markets are vast and the diversification and non-correlating assets are there, particularly in the private, not listed sectors.

As well, we shouldn't paint emerging markets with a broad brush. There are entrepreneurs all over the world and plan sponsors should look for good management on the ground. And it's our job to find these good managers who operate with good governance.

What is your long-term prognosis for these markets?

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What are the drivers of emerging markets' performance? How much is driven by local economic factors?

PE: We believe that unlike developed markets, the decision in which country to invest is important and should balance stock selection decisions. In a universe of 26 countries it is difficult to generalize about factors. In some countries like Poland, for example, domestic pension funds are a factor in market moves, while in other countries foreign investors play a more dominant role. In general, investors in emerging markets pay more attention to macro-political and economic developments than in developed markets because there is more risk these factors can have an effect on stock markets.

Have Canadian pension funds missed the ride?

PE: Emerging markets, according to the World Bank, make up 17% of the world's economy but only 7% of the world's stock market capitalization. Emerging markets are steadily increasing their share of the world's economy led, by countries such as China and India. Stock markets are at an early stage of development and offer considerable potential rewards for long-term investors. Proper development takes a number of years but if conducted properly can sponsor long periods of premium growth opportunities. Timing is not an issue if proper consideration of the long-term potential for emerging markets is used when investing.

What key messages should be communicated to pension committee members or trustees regarding emerging markets?

PE: We believe that emerging markets equity is a key asset class for inclusion in a well-balanced portfolio. Besides the diversification advantages, emerging markets are simply too large to ignore: they account for 84% of the world's population and 17% of the world's gross national income*. Their importance and size are likely to increase further as emerging markets are showing GDP growth on average 3% stronger than more mature, developed economies**. Furthermore, over the last five years there have been significant structural changes which challenge the traditional view of emerging markets as a risky asset class, characterized, for example, by high inflation, volatile economic growth and periodic exchange rate and debt crises. Indeed, these economies are now structurally stronger than some of the major developed economies.

*(*Source: World Bank September 2005, data as at December 2004)*

What is your long-term prognosis for these markets?

PE: By nature, emerging countries offer much faster long-term growth rates due to their early stage of development. The path of this growth has been volatile in the past for specific countries, leading to acute periods of stress in the 1990s. So far in this century we have witnessed a major improvement in the structure of emerging market economies, which has been reflected in a reduction in the standard deviation of returns in the past five years. This provides us with more comfort looking forward that high growth rates can be more sustainable in the future. A key consideration for this forecast is favourable demographics. Based on demographics and productivity growth it is possible

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Cordiant Capital Inc.

Cordiant Capital is Canada's leading investment management firm dedicated to private equity and debt investments in the emerging and high-growth markets. Founded in 1999, the Montreal-based firm has US$930 million in funds under management. Through its IFPT and CIFA funds, Cordiant currently manages investments in over 30 emerging countries in broadly diversified sectors such as oil & gas, financial services, manufacturing, mining, steel, chemicals and telecoms, among others. The professional team at Cordiant, recruited from around the globe, boasts over 150 years of combined experience in international markets.

David Creighton
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DC: With the development of communications, trade and the benefits of globalization, the outlook is positive. This being said, we will not be out of a job in the foreseeable future. As mentioned, while many countries have already moved to developed status, there are still opportunities in the next wave.

In regions like Africa, democratic elections are beginning to take place, governments are implementing western-style structures for the banking and extractive industries and, most importantly, the number of conflicts across the continent is at a forty-year low. This is paving the way for opportunities which we would not have considered in the past.

The key point is that the recent development of the emerging markets is not a short-term fad. Places like China and India are not going to return to their status of the past and other smaller countries will move in the same direction.

What are the risks to your assumptions?

DC: Traditional risks such as the contagion which rolled out from Thailand to Russia in 1997/98 have diminished for a number of reasons, including the lower reliance on foreign direct investment and the higher central bank reserves. New forms of contagion such as the shift to the left in Latin America can be more of a concern.

With the positive move to democratic elections, there are also the risks associated with these events. In Nigeria, we're encouraged by President Obasanjo's acceptance of the two-term limit in office but, at the same time, we are concerned about the transition of power.

The key to consider is that these tend to be relatively short-term events and when investing in good companies in these countries, we find the macro-risks have less influence.

Lastly, the unpredictable risks such as bird flu, AIDS and access to water in places like China have to be considered.

What regional markets do you favour?

DC: We tend to go where we believe there is untapped value. While there are opportunities in the 26 emerging countries that make up the MSCI index, we invest in a number of countries that are not included on this list. Such countries would include Romania, Tunisia and India.

From a regional perspective, the magnetic pull of European Union accession has created a tremendous

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opportunity for investment in Eastern and South Eastern Europe. As each country begins negotiation for accession, the government and populace become focused on the measures necessary to reach this goal. To be able to participate in this alignment offers an investment with a reduction in a number of traditional risks.

Africa cannot remain the backwater that it has been labeled in the past. We have had great success engaging with entrepreneurs in a number of countries and assisting them in the development of their business model. This is a continent that will look substantially different ten years from now.

What do you stay away from?

DC: We tend to be open to everything, but at the same time there are certain countries where the political risks are difficult to mitigate: Belarus and North Korea are good examples. But things do change, so you have to keep monitoring individual situations. Five years ago, we wouldn't touch a country like Ukraine, but now we have investments in a bank and the roll-out of a supermarket chain.

Are there systemic risks in emerging markets that a Canadian plan sponsor should be aware of? Is corporate governance an issue?

DC: Systemic risks are those that cross borders, such as the current concern over global growth and inflation. Systemic risks have been reduced for a variety of reasons as mentioned earlier. Recent examples are the Brazil election in 2002 where the country was under particular strain. This strain did not cross the borders to other countries in the region. Similarly, with the Argentine crisis, other than Uruguay, the region was not affected.

Corporate governance risks, however, are individual to each country. We strive to have a direct influence when it comes to managing these risks. We engage with the management of the companies that we are going to invest in and lay out standards of practice before we actually put our clients' money down. If they don't meet them, then we don't invest.

Emerging markets lump together all third-world countries. How do you make order of all these economies?

"A dedicated manager, preferably with people on the ground, will have the necessary access to management in order to push the risk/reward profile in favour of the investor."

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DC: We look at each country separately while considering the correlation and influence of its neighbours. While in theory the term "emerging market" would currently include both India and its neighbour Pakistan, we view these as substantially different in their stage of emergence. To categorize these countries, we look at such factors as GDP/Capita, GDP growth, trade, current account and perhaps the Human Development Index. In addition, there is always a subjective approach which may uncover opportunities that the macro-issues hide.

How does a Canadian plan sponsor gain exposure to third-world economies? Is it by employing dedicated emerging market funds, using regional or country-specific funds, or through allowing EAFE and Global managers to include emerging markets in their portfolios?

DC: There are a number of ways to gain exposure to these markets, the majority of which offer access to listed equities or sovereign bonds. In both cases, the investor is counting on the government to either have acceptable listing requirements for the equities or proper management of monetary policy for the debt. As these are both risks which are beyond the control of a manager, it is our belief that these risks can be significantly reduced by investing in either private equity or debt. In both cases, you have direct access to the managers of the business, the auditors and, if desired, the customers. In addition, if potential problems surface, they can be dealt with before they get out of control. In the public markets, investors are putting a lot of trust in elements beyond their control.

A dedicated manager, preferably with people on the ground, will have the necessary access to management in order to push the risk/reward profile in favour of the investor.

Interest rates are on the rise in some markets. How will this impact an emerging markets portfolio?

DC: As a general comment, interest rates have less of an effect in the emerging countries than in the developed world. Emerging companies tend to be less leveraged and thus have more equity in their back pocket to be able to endure such shocks. In general, emerging market countries now have their books in much better order, which is creating lower inflation and can, therefore, absorb the impact of rising interest rates.

The thing to remember is that, while we have seen a long string of hikes in the U.S., interest rates are still relatively low.

How important is local presence?

DC: With regards to corporate investments, the results of managers with local presence compared to those who "fly in" have to be in favour of the former. Empirically, it has to make sense that if you're investing in local management, the greater your ability to engage with them, offer direction and solutions to their challenges. The outcome has to be more positive than taking a more distant approach.

For sovereign investing, local presence is less important. ●

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With one of the largest networks of offices of any dedicated asset management company and over 250 portfolio managers and analysts covering the world's investment markets, we offer our clients a comprehensive range of products and services.

Paul Easterbrook
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to estimate that four of the largest countries in the emerging market universe, Brazil, Russia, India and China could make up 40% of the world's GDP by 2040*. These countries already account for 31% of world growth in 2005. We believe investors will be able to capture a significant portion of this growth through the continued development of stock markets in order to participate in a changing in the order of the world's economic power.

(Source: Goldman Sachs 'Dreaming of BRICs 2004')*

What are the risks to your assumptions?

PE: The main broad risk to this assumption is a retreat in the trend towards globalization due to a sharp increase in protectionism. For individual countries we do assume that the political environment is favourable towards the development of a market economy.

What regional markets do you favour?

PE: The Korean market looks good value and domestic flows have increased but there is some uncertainty on the earnings outlook. We continue to like Malaysia and the market does offer defensive attributes. We remain overweight in Thailand and China where in both cases valuations look attractive. In Latin America we are overweight in Argentina where growth is still strong and the currency appears undervalued. We continue to overweight Russia on the back of reasonable valuations supported by potential earnings upgrades as the economy continues to expand.

What do you stay away from?

PE: We think there is further downside in India due to a more negative earnings outlook and valuations are still expensive even after the recent correction. For similar reasons we remain underweight in South Africa. We are not invested in Hungary due to concerns over the currency given economic imbalances.

Are there systemic risks in emerging markets that a Canadian plan sponsor should be aware of? Is corporate governance an issue?

PE: There is no universal risk that is unique to emerging markets. Liquidity is generally lower than in developed markets. In some countries market regulation is of a lower standard, political risk is higher and corporate governance lower, but this is not uni-

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versal. Corporate governance can be an issue in some countries and is taken carefully into consideration when making investments. We do not expect perfection but do monitor closely progression in countries and companies we invest in.

Emerging markets lump together all third-world countries. How do you make order of all these economies?

PE: We prefer to follow the MSCI Global Emerging Markets Index which provides a well-diversified universe of 26 different countries across the world. There is nothing homogenous about these countries so it is very important as part of an investment process to have the ability to differentiate them. At Schroders, decision, making at the level of country allocation is driven by a quantitative model which processes relevant information on the countries in our universe. The quantitative model uses six factors, which are scored to produce a ranking of all the countries in the global emerging market universe on a monthly basis. The data inputs to the model are independent of Schroders' views as they are sourced from third parties.

The country weightings recommended by the model are reviewed at the monthly strategy meeting, attended by all members of the emerging markets team, to determine if there are any reasons not to follow its recommendations.

How does a Canadian plan sponsor gain exposure to third-world economies? Is it by employing dedicated emerging market funds? Or by using regional or country-specific funds? Or through allowing EAFE and Global managers to include emerging markets in their portfolios?

PE: We strongly advise that plans should gain exposure to emerging markets through a specialist emerging market fund manager. Allowing an EAFE or global fund manager to include emerging markets in their portfolio involves a higher level of risk, given typically they hold fewer stocks and countries than dedicated emerging market fund managers. Emerging market analysis both from a country and stock level requires specialist knowledge and active risk control which a non- specialist might not implement.

Interest rates are on the rise in some markets. How will this impact emerging market portfolios?

PE: Following a general policy post the Asian crisis in 1997 for emerging markets to adopt floating exchange rate policies, interest rate decisions are not so dependent on US Fed Funds. The influence on emerging markets of higher interest rates will depend on the impact on global growth. A soft landing for the global economy due to benign inflation numbers and commensurate near-term peaks in interest rates should not impact the current growth premium enjoyed by emerging markets over developed markets. A severe tightening leading to a recessionary outlook will create a poor environment. Furthermore, emerging markets have stronger fiscal positions, higher reserves and lower inflation than developed markets. They are stronger positioned to confront a rising interest rate environment.

How important is local presence?

PE: It is extremely important when analyzing stocks to have a local presence. Analysts on the ground with local language and knowledge have a key advantage researching and ranking companies.

What is your firm's view on the risks presented by avian flu and the Iranian nuclear question? What impact will oil prices have on emerging market investments?

PE: Event risk is high for any market including emerging markets. It depends on how extreme events are and how long they persist. Avian flu is such a risk. We do not anticipate this in our portfolios but are prepared to act quickly to protect investments should its impact become serious. The most likely output of an escalation in Iran is much higher oil prices. We have conducted research to demonstrate that higher oil prices have a neutral effect on emerging markets. For example, some countries like Russia, Mexico, Brazil benefit from higher oil prices while other countries, mainly in Asia, which import oil suffer. ●

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