EMERGING MARKETS: DIVERSIFICATION THREE APPROACHES

- The first half of 2015 was challenging for investors in financial assets – and there is much to suggest that the rest of the year will be even more so!
- The Federal Reserve seems close to move towards tighter monetary policy, China’s model is challenged by slowing growth and rising market turbulences, while Greece’s saga raises fundamental questions about the future of the European Monetary Union.
- Diversification as a way of reducing portfolio risk is becoming more appealing in this context of likely rising volatility and increasing asset de-correlation.
- We highlight the advantages of diversification through three approaches: country diversification, cross-assets diversification and diversification using active and passive funds.
The first half of 2015 was challenging for investors in financial assets – and there is much to suggest that the rest of the year will be even more so!

Indeed, more and more areas of the world are seeing major changes, leading to rising uncertainty and thus greater financial asset volatility. There are plenty of examples of this, notably the uncertainty stemming from the US Federal Reserve apparently still dithering over when to move towards tighter monetary policy after six years of unprecedented liquidity injection. But centre stage are undoubtedly the situations in China and Greece, neither of which are making the Fed’s task any easier.

China, which like India and many other emerging economies is slowly transitioning towards a new and more sustainable growth model, has just suffered a heavy fall in its onshore equity markets – the second biggest since 2008. The massive intervention by Beijing aimed at stopping the market rout eventually succeeded, but at the same time raised doubts about the solidity of an already slowing Chinese economy and its financial system and thus about the timely implementation of China’s reform agenda. Although contagion seems to have been limited, global growth fears have nevertheless re-emerged, which have weighed on risky assets, especially those closely linked to China.

Greece, after months of fruitless negotiations with its creditors, has regrettably managed to get itself into a far worse economic state than the one that prevailed before the parliamentary snap election at the end of January. “Grexit” fears don’t seem to have impacted greatly upon economies and markets, most likely because – unlike in 2011 – there are now powerful firewalls in place that should limit any financial or real economy contagion effects. Still, the agreement that was reached at the heads of state and government summit on 12 July to work on a solution brought some relief, although whether it provides a sustainable path towards rescuing Greece and avoiding a Grexit remains to be seen. In fact, the reform demands are even more drastic than those rejected by the Greeks via a referendum. Whatever happens, it looks likely that political preoccupations over the future of the monetary union will build and generate uncertainty. Will the Greek drama push the eurozone further towards federal fiscal union as a way of restoring trust in the long-term ideal of a more united Europe? Or, conversely, will the eurozone – in the face of rising political arguments for greater national sovereignty – end up as just a trade bloc, as those supporting “Brexit” advocate?

There are many other potentially destabilising questions for financial markets to ponder. Among these is whether an eventual Fed rate hike would prompt a “risk-on” mode again and thus trigger a rotation towards those markets that have suffered the most from the speculation surrounding the possible timing of the Fed’s tightening. Particularly sensitive to greater volatility will be those emerging markets that have less transparent economic models and are less well known or invested in.

Diversification as a way of reducing portfolio risk is becoming more appealing in this context of likely rising volatility and increasing asset de-correlation. In this quarterly issue, we look at three diversification strategies used in BNP Paribas Investment Partners. First, Arthur Kwong and Felix Lam describe their team’s investment process, which mixes top-down elements with bottom-up considerations to successfully manage an equity fund spreading across APAC countries. Second, Christoph von Scheurl explains why it makes sense for the multi asset strategy team to soon launch a multi-asset emerging markets fund. Finally Clement Niel and I will briefly examine when to combine active and passive strategies to enhance risk-adjusted net of fee returns and how to choose the right funds to achieve this goal.

The Asia Pacific Equities team, led by portfolio manager Arthur Kwong, uses a top-down thematic approach which leverages on its proprietary structural market development (SMD) research coupled with bottom-up stock analysis.

Given the inherent inefficient pricing in many (emerging) markets, bottom-up stock picking is an essential part of capturing value. Even more importantly though, the team views top-down analysis as a key element in its investment process because it offers the opportunity to diversify the portfolio across the best potential sectors and markets. If diversification is well known as a means of protecting investors from unsystematic risk, one could ask: can portfolio returns be boosted beyond that, for instance through country diversification? Arthur’s team believes this is indeed the case.
Reducing risk, increasing returns

Beyond reducing overall portfolio risk, the team is convinced that the identification of SMD themes can also offer better returns. The team has a particularly strong preference for those factors that drive industry and earnings growth from a demand perspective, such as demographics, the resilience of domestic demand and market penetration rates. Factors that drive earnings growth from a supply point of view (i.e. oligopolistic structures) are also important to the team’s approach. Indeed, an oligopolistic structure can not only protect existing companies when market entry barriers fall, but it can also create consolidation and integration opportunities, thereby further strengthening the market influence of leading companies. SMD themes can be based around countries, sectors, regions and/or cross-sectors, which allow the team to construct a diversified portfolio that comprises its best and most sustainable convictions. In fact, based on these themes, the team members filter out companies that they deem weak and target the companies most likely to benefit from any strong tailwinds for sustainable and superior earnings growth. Figure 1 shows the areas where Arthur’s team deeply believes the SMD opportunities are most significant.

Finding the best growth opportunities across Asian markets

Finding the best opportunities is not simply a case of picking the best countries; it is about targeting the best stories for each country. The members of the team believe deeply that each market has its own unique investment opportunity or specialty. The example of Unilever Indonesia illustrates this. The company is a local market leader in each of its key household goods and food products businesses. It benefits from a superior local management team within a solid global organisation and operates in a high-growth market in one of the largest economies in southeast Asia. For the team, there is a strong investment case on the grounds of favourable demographics and low product penetration across urban and rural areas. Of equal importance, the oligopolistic structure of the sector gives the company the opportunity to gain further market share, thereby potentially improving its profitability.

Figure 1: SMD opportunities in Asia

While country diversification may occur in the context of selecting one market over another, the team tries to find the most remarkable stories even in weaker markets. China is a telling example. While many observers have doubts about investing in China at a time when the economy is facing challenges and headwinds, the team believes there are sectors that are strongly resilient and, as a result, offer great opportunities as in the case with e-commerce. This benefits companies such as Tencent. While economic growth has decelerated to its slowest in decades, this leading company has shown a rapid growth. Benefiting from a broad user base, its core strength lies in its social platform leadership through its QQ Instant Messaging and Weixin/WeChat applications. It has been gaining traction in the mobile games business and has started to monetise the mobile advertising business, while extending its platform strategy to banking. Compared with Japan, the mobile games sector in China remains underpenetrated, which spells great potential for strong growth. This clearly shows that a market perceived as weak can in fact contain companies that are thriving.

Identifying the right stocks

Last but not least, the team seeks to identify stocks that are less correlated to market beta in the pursuit of achieving genuine diversification. Further benefits of diversification can stem from company-specific factors that depend less on economic cycles. As an example, the team is particularly positive on Indian private bank HDFC Bank as it benefits from the long-term growth opportunities as a result of the low penetration of the Indian mortgage and credit markets. Most importantly, the team sees a clear advantage in the bank’s characteristics, which are low-correlated with the overall market and thus serve the purposes of risk diversification. Supported by favourable demographics, the team believes that India’s private sector banks can gain significant market share from the state-owned banks by growing their loan books, mainly due to the rise in bad debts taken on by the public sector banks.

Each market presents its own unique investment opportunity

The Asia Pacific Equities team believes that each market presents its own unique investment opportunity. It is worth noting that the team members will not hesitate to target the best potential opportunities even in markets facing difficulties. Those companies less dependent on economic cycles and driven more by company-specific factors can also represent good investment opportunities, in the team’s view.

By ignoring short-term market noise arising from economic cycles and focusing instead on longer-term fundamental opportunities, the team is convinced that a diversified portfolio focused on the best investment potential within each country can generate higher returns for clients.
THE CASE FOR A MULTI-ASSET APPROACH TO EMERGING MARKETS

While there is a strong strategic case for an allocation to emerging markets (EM) assets, we recommend investors follow an active multi-asset allocation approach when they decide to invest.

In summary, the argument for a strategic EM allocation is three-fold: First, developing countries tend to grow faster than developed ones (e.g. demographics, higher productivity growth, strengthening consumption). Secondly, higher income potential, since emerging assets carry elevated risk premiums that tend to diminish over time as countries’ economies and policies improve. And thirdly, there is the diversification benefit when adding emerging markets investments to a portfolio. Yet despite all this, investors remain underweight in emerging markets-related assets.

However, we expect this to change gradually as investors reflect on emerging markets’ already significant and growing contribution to global economic output (c. 40% of global GDP) and market capitalisation. This will eventually shift the perception of emerging markets from a satellite to a strategic core holding.

When investors do decide to add strategic exposure in emerging markets, we recommend they follow a dynamic multi-asset approach that allows for changing regional and asset class exposure over time. Specifically, we expect growth across emerging nations to become more heterogeneous again; this will require a greater regional focus. Additionally, as emerging markets can be accessed through a number of asset classes that have different sensitivities to aspects of growth and business cycle stages, there is greater scope for investment opportunities, diversification and thus better risk-adjusted returns in the long-run.

Once again, growth turns more idiosyncratic

When looking across the first decade since the start of the millennium, emerging countries saw unusually swift and consistent economic expansion across all markets. The rapid real expansion started with China’s real growth accelerating in 1998 for several years at a pace of 8% a year or faster. This positive impulse, helped by a goldilocks scenario of declining inflation worldwide, spilled over to global emerging markets, doubling their economic output from around 3% (simple average GDP growth, 1980s-90s) to about 6% between 2003-07 (see chart 1).

During the 2000s, growth synchronised significantly, leading to the most homogenous growth patch since 1950 (see chart 2). In fact, during this period none of the MSCI EM countries experienced a contraction and 60% grew their GDP annually at 5% or faster (vs. 20% doing so in 2000). Growth across emerging countries has turned more idiosyncratic once again and, we believe, should continue to do so, based on our thematic view that influential factors (e.g. differences in structural reform activity, policy outlook or sensitivity to ending debt and commodity cycles) will diverge further across emerging markets.

The ‘new normal’ in emerging markets will likely be more like the ‘old normal’ as seen during the 1950s to 1970s, when annual real GDP growth averaged 5%, but the divergence in the pace of growth was higher than it is today (5% now vs. 3% during the 2000).

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1 Divergence in growth measured as the difference between 1st and 3rd quartile GDP growth of the MSCI EM countries.
Economic activity across emerging countries becoming less correlated

Means there is a need for greater regional discrimination, particularly when considering the concentrated regional exposure of the leading emerging markets indices. For example, in the MSCI EM equity index, which is skewed towards more integrated economies, EM Asia has a weight of approximately 70%. Meanwhile the widely followed JPM Emerging Markets Bonds index (EMBI) favours Latin America, Eastern Europe and Africa (80% of the index, see chart 3/4). Due to these significant regional biases, an active approach to asset allocation will help avoid some of the pitfalls of merely tracking these markets via a passive approach.

Chart 3: EM equities (MSCI EM index)

Source: Datastream BNPP IP 22/06/2015

Chart 4: EM external sovereign debt (EMBI index)

Source: Datastream BNPP IP 30/06/2015

Broad access to emerging markets themes

Aside from the regional perspective, emerging markets can be accessed through numerous different asset classes, including equities, sovereign and corporate debt, as well as currencies and commodities. Such a multi-asset investment approach allows investors greater access to investment opportunities, as each of the assets reacts differently to aspects of emerging markets growth. By using a multi-asset approach, investors can gain exposure to the actual underlying themes of emerging markets’ growth; whether it’s more based on macroeconomic strength (e.g. more debt/FX-related given inflation, fiscal and flow aspects) or on the aggregate demand outlook (i.e. more equity/corporate debt/ FX-related based on productivity, company earnings/balance sheet aspects).

For example looking at Brazil today, the weak growth backdrop combined with the government’s efforts to slash spending and the central bank's tightening rates to lower a stubbornly high inflation is a ‘red flag’ for equity investors. On the flip side, the positive underlying theme of Brazil’s improving fiscal policy and inflation outlook offer an investment opportunity in local currency debt.

Additionally, multi-asset investors benefit from further diversification potential as assets offer different sensitivities to stages of the business cycle. Considering this, and a greater potential for investment opportunities, a multi-asset approach offers better risk-adjusted returns in the long-run.

Handle with care

With a dynamic approach to allocating across asset classes or regions, investors not only have the ability to increase exposure to regions or assets that are attractive, but also to reduce their exposure ahead of deteriorating fundamentals or on signs of elevated risks.

In comparison to developed markets, the risks associated with investing in emerging markets can be more commonplace and require additional care and attention. These include the risk of short-term ‘hot money’ capital outflows and lower liquidity during episodes of market stress, and the higher risks of sovereign restructurings/defaults and of ‘doing business’ (corruption, political and legal risks).

But these factors are manageable by monitoring country-specific risks (e.g. cyclical outlook, credit risks or political developments) and currency developments. With the latter, EM currencies tend to exhibit higher levels of volatility, particularly when foreign investors dominate countries' portfolio flows, as this can be a de-stabilising factor when sentiment deteriorates. In both instances, risks can be actively controlled by reducing exposure when required.

Of course, the broad diversification provided by a multi-asset approach also helps in managing risk.

Local expertise

Having mainly focused on the ‘top-down’ asset allocation perspective, investors should not ignore the possible benefits of ‘bottom-up’ security selection. The returns from a multi-asset approach can be further enhanced by allocating investments in each asset class. BNP Paribas Investment Partners has a strong emerging markets expertise with the support of investment teams ‘on the ground’ in 17 emerging countries providing the necessary ‘local-flavour’ to our emerging markets investment processes.
Investments in passive funds have grown massively in the last few years. Exchange Traded Funds and Products (ETF and ETP) global assets under management (AUM) alone, for which statistics are more readily available, rose from about USD 400 billion in 2005 to marginally more than USD 3 trillion as of May 2015, i.e. just shy of 10% of the world public funds’ AUM1 (chart 1). AUM growth accelerated in 2009 and 2011, coincident with the start of quantitative easing (QE) in the US late in 2008 and the beginning of the equity rally in March 2009, an extension of US QE in late 2010 and a substantially softer monetary stance in the eurozone due to the unfolding of the Greek crisis during 2011.

Chart 1: Global ETF and ETP Growth

Source: ETFGI

1 A more exhaustive comparison of active versus passive asset management will be published at a later stage

The rise of passive funds

Rising interest in passive funds, notably ETFs, was undoubtedly boosted by the failure of active managers as a whole to provide enough downside protection to investors during the “Great Financial Crisis” while still charging high fees in comparison to passive funds. Thereafter, the disappointing average excess returns (alpha) of “active” managers, not least due to liquidity-induced re-correlation between and within assets, likely fuelled the trend towards passive. Crucial, however, was the fact that, in general, post-crisis market returns were significantly lower than in pre-crisis times, accentuating the significance of fund costs as a proportion of the gross returns of a portfolio or investment strategy.

The latter still today very much validates the use of passive funds, indeed all the more so as, besides costs, passive funds – and specifically ETFs – also provide more flexibility and can help reduce a benchmarked portfolio’s risk, i.e. its tracking error. But to achieve these objectives satisfactorily one has to understand when or in which market configurations it is best to use passive instead of active strategies. In situations where active strategies look superior to passive it is crucial to understand how to choose the truly active managers.

Passive funds love mature markets

The theory behind ‘passive’ helps to determine the ‘when’. Supporters of passive strategies believe in the so-called ‘efficient market hypothesis’ formulated by Nobel Prize winner Eugene Fama in the early 70s2. This states that at any given time and in a liquid market, security prices fully reflect all available information. In other words, the market is still perfectly (strong form) or largely (weak form) arbitraged and it is thus impossible or very difficult to beat it with active management. Inversely interpreted, the efficient market hypothesis implies that in markets that are illiquid, badly regulated, little diversified in terms of both industries and investors, broad in terms of securities listed in them, not transparent as for pricing etc., there are plenty of arbitrage opportunities that give active managers a fair chance to beat them, even net of fees.

In fact, studies show that the more ‘immature’ or complex markets are, i.e. the more inefficient they are, the more likely that active strategies can outperform passive strategies net of fees, and indeed all the more so as such markets are much more complicated and thus costly to replicate in an index. A. Dyck, K. V. Lins and L. Pomorski for example find that from 1998 to 2013, active management largely outperformed after fees both in EAFE (Europe, Australasia and Far East) and emerging markets.3
What is an active fund?

‘Active share’, a concept created by Antti Petajisto and Martijn Cremers, is in our view the prime tool for understanding whether a portfolio manager is really active or just claims to be. Active share is “the share of portfolio holdings that differ from the portfolio’s benchmark index”\(^5\). Put simply, a long-only fund that holds none of the securities of a specific benchmark would have an active share of 100%. Conversely, one that fully replicates the benchmark (an index fund) would have a 0% active share. As round 50% of the index value will always be below average and the other roughly 50% above average, the cut-off between active and passive management is set at 60%. Between 20%-60% Petajisto speaks about closet indexing funds, i.e. funds that are passive but claim to be active. Further, combining active share with tracking error, i.e. the annualised standard deviation of excess returns of a fund against its benchmark – a measure of the consistency of excess returns – Petajisto demonstrates that one specific category of funds, which he calls “stock-pickers’ funds” (i.e. those associating high active share and high tracking error) consistently beat their benchmarks net of fees between 1990 and 2009, even during the great financial crisis (chart 2). Interestingly, the universe he covers for his study is the US stock market, considered the most mature market in the world.

In conclusion: Improving net of fees portfolio returns by mixing active and passive strategies

- Passive management has a higher probability of outperforming active management after costs in efficient, well-arbitraged and liquid markets such as US large cap equities, where it is even difficult to match the benchmark, and where the costs of passive funds are lowest. Active strategies are better suited for ‘less efficient’ markets or subsets of broader asset classes. Emerging markets, small caps, credit and corporate bonds, listed property, private equity, to name a few, fall into this category.

- Actively-managed funds with high active shares and tracking errors have a strong probability of beating passive management net of fees over a full market cycle of usually three to seven years, provided the passively-managed funds they are compared to are truly passive, i.e. have low tracking errors.

- Active and passive asset management are complementary, not exclusive. A portfolio wisely combining these two asset management approaches will allow a better risk-adjusted return net of fees than each of the single strategies taken alone.
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