An all-encompassing approach to emerging markets

The economic growth and newfound fiscal strength of many emerging countries have created a dilemma for investors. Expectations of future growth are alluring, but their financial markets remain highly volatile. Is it possible to reduce emerging markets’ volatility without sacrificing return potential? This paper highlights that a portfolio with emerging stocks, bonds and currencies, managed in an active, unconstrained and integrated strategy, can capture a greater set of opportunities in order to seek the high returns associated with emerging-market growth, with better risk management potential.

By AllianceBernstein

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Introduction

The growing strength of emerging markets has become one of the most compelling investment stories in the world. As a group, their economies are growing rapidly, their standard of living is increasing, and their financial systems are maturing, showing remarkable resilience in recent years. Emerging markets already account for about one-third of the world’s GDP, and are likely to account for about half by the end of this decade.¹

Historically, stocks provide the best way for investors to participate in long-term economic growth. Yet many investors hesitate to increase their emerging-markets stock exposure because of the volatility of returns (see Appendix 1: Emerging markets – why the reluctance?). Despite their maturing economies, emerging market stock volatility remains much higher than in developed markets (Figure 1). Volatility can erode investments’ value over the long term because of risk drag, the corrosive effect that volatility-driven declines have on compounding.

Figure 1: Emerging market stocks are more volatile
Equity benchmark volatility to 31 August 2011

Source: Barclays, J.P Morgan, MSCI and AllianceBernstein. Volatilities shown are calculated using 12–month standard deviations. Standard deviation is a statistical measure of risk that shows how aligned or at variance the returns of an asset, industry or fund are relative to their historical performance.

¹ International Monetary Fund World Economic Outlook, April 2011
Investors don’t have to limit themselves to stocks when seeking to profit from emerging-markets growth. There are multiple potential beneficiaries of emerging markets growth, including bonds and currencies – and even developed-market stocks (because some developed-market companies sell into emerging markets). These asset classes benefit from emerging markets growth in different ways and can provide greater diversification potential to reduce volatility.

An investor could invest in these asset classes separately, but integrating them in one dynamically managed portfolio can generate much better risk/return potential than a stock-only strategy. An emerging-markets multi-asset strategy can provide multiple sources of return potential, and more ways to mitigate risk. Ideally, it can provide the potential for returns similar to a stock-only strategy, but with significantly less risk.

What is the best way to implement a multi-asset strategy? One could invest in separately managed stock, bond and perhaps currency funds – effectively “bolting together” the strategy. But unless the managers are coordinating their efforts, the investor may end up with a less than optimal result. For example, the funds might have similar risk control strategies, and the investor could end up with more risk control than desired in an inefficient part of the market. This points to the need for an unconstrained, holistic and integrated approach.

The benefits of such an approach are at least three-fold:

1. It provides utmost flexibility to seek higher risk-adjusted returns, by broadening the opportunity set to include more and different asset classes, countries, currencies and securities than a stand-alone debt or equity portfolio could access.

2. It provides greater diversification potential to reduce portfolio volatility.

3. It opens up a wider range of hedging opportunities to reduce undesired exposures and focus on what is most essentially attractive.
Dampening stock volatility with bonds

Using bonds to offset the volatility of stocks is one of the most basic risk management strategies in developed-markets portfolios, but only recently has it become a broadly viable strategy in emerging markets. The emerging market bond universe is growing and maturing and includes both sovereign and corporate bonds, denominated in either US dollars or local currency, and these sectors all have different risk/return profiles, thus adding multiple sources of diversification (refer Appendix 2: Emerging markets debt comes of age).

Further, the credit quality of dollar-denominated emerging markets sovereign debt has generally improved and now roughly 55% of the JPMorgan EMBI Global Index is rated investment grade. These bonds behave like developed market investment grade corporate bonds, making them more effective than non-investment grade bonds in offsetting the volatility of emerging-market stocks.

A key difference between a strategy combining emerging stocks and bonds and one combining developed stocks and bonds is that the correlation in emerging markets is more highly variable. At an aggregate level, emerging stocks and bonds exhibit greater correlation than developed stocks and bonds, because of global investors’ tendency to treat emerging-markets stocks and bonds as one risk asset. However, at the country level, there is still substantial variation in correlations (Figure 2).

Figure 2: For stock/bond correlation, much depends on the country
Correlation between stocks and bonds 31 March 2011

Source: Alliance Bernstein. Correlation between stocks and bonds within emerging markets. 25 countries in both the MSCI EAFE EM Index and JPMorgan EMBI Global Index with full series of data going back to at least
Jan 2003. Countries: Argentina, Brazil, Bulgaria, Chile, China, Colombia, Dominican Republic, Ecuador, Egypt, El Salvador, Hungary, Lebanon, Malaysia, Mexico, Panama, Peru, Philippines, Poland, Russia, South Africa, Tunisia, Turkey, Ukraine, Uruguay, Venezuela. Historical analysis is not a guarantee of future results.

Correlation relates to the coincidence of direction, but not of magnitude, so even though emerging bonds in aggregate may fall with emerging stocks, they generally don’t fall nearly as far. Thus, the quality improvement in emerging bonds means that they can provide very significant downside protection and volatility reduction, but the downside protection is less powerful than in traditional developed market portfolios. On the other hand, their correlation with emerging stocks and meaningful return potential imply that combining emerging stocks and bonds doesn’t constrain upside potential as it would in developed–market portfolios (Figure 3).

**Figure 3:** Bonds dampen stock risk and provide return potential
Cumulative emerging market stock and bond returns to 31 August 2011

Source: JPMorgan, MSCI and AllianceBernstein. Stock index is the MSCI Emerging Markets Index; Bond index is the JPMorgan EMBI Global Index. Historical Analysis and current estimates do not guarantee future results.
The case for active management

The variation in correlation between different countries’ stocks and bonds points to the value of an active management strategy in the emerging markets. Whereas a passive strategy might dictate increasing bond exposure at a time when risk aversion is growing, an active strategy can choose among emerging market bonds to find those with least correlation to the emerging-market stocks. The universe of emerging market bonds includes not only countries with a wide range of credit ratings, but also different types of bonds, including dollar-denominated sovereign bonds, local currency sovereign bonds and corporate bonds.

Active management has other strong potential advantages in emerging markets, especially regarding security selection. Even if one believes strongly in passive management for developed markets, emerging markets are different in key ways. Developed markets are highly liquid, and information flows so efficiently that mis-pricings of individual stocks and among stocks may be arbitraged away quickly. Yet emerging markets are less liquid and information flows less freely, providing potential advantages for active managers.

There are fewer sell side analysts covering emerging-market companies. There are even fewer buy side firms with the resources to conduct in-depth research on companies with different languages, regulations, market structures and accounting standards. Passive strategies also cannot act on corporate governance or government intervention concerns regarding specific companies, which are still problems in many emerging markets. In a passive strategy, one is forced to take the bad apples along with the good.

An active strategy that is unconstrained across asset classes has more opportunity to find mis-pricings that arise from other investors failing to connect the dots. Whereas news about a change in an emerging markets company’s strategy or financial condition may be slow to be captured in its share price, the implications of such news for the sector, the currency or the government’s creditworthiness are even slower to make their way through the capital markets.

Because the emerging markets are still relatively young (the bond markets in particular), stock portfolio managers and bond portfolio managers and currency managers are rarely integrated in single teams. They are more likely to sit in different companies, or at least in separate teams. This segmentation creates opportunity for an approach that integrates experts in emerging stocks, bonds and currency, in order to exploit mis-pricings across asset classes more effectively.
Using currency to improve risk-adjusted returns

Active currency management is the third lever for seeking better risk-adjusted returns in a multi-asset strategy. While many international stock managers use currency to hedge the local currency exposure of their holdings in general, disaggregating currency from stock and bond investments creates new opportunities to seek return or manage risk.

For example, a manager could use currency in a stock-specific strategy – perhaps investing in a Turkish exporting company in expectation that the company’s competitiveness will improve from a weaker Turkish lira, while at the same time shorting the lira so that the currency’s depreciation will not impact the principal value of the stock. In a truly integrated approach, this can be more than a simplistic currency overlay – the awareness of the ability to hedge undesired currency exposure should change the stocks that a manager would buy, and affect their weight in a portfolio. Without the ability to hedge currency risk, certain stocks would appear less attractive and not be included in a truly integrated portfolio.

Further, a manager who can invest in currencies as investments, not just hedging instruments, can gain exposure to currency more effectively than a bond-only or stock-only manager. For example, one might believe the Chinese renminbi will appreciate against the US dollar because of China’s large external surplus and a desire by authorities to shift their economy away from exports and toward greater domestic consumption. But at a particular moment in time, one may not find sufficient stock or bond investments to reach the ideal level of exposure to the currency, so the currency exposure can simply be taken directly.
Cheaper tail risk hedging

The multi-asset approach can also find better priced tail risk protection strategies than those available if confined to a single asset class. For example, consider a very wealthy Middle Eastern country where economic development has outpaced most wealthy developed nations. Its sovereign debt is rated high investment grade in the credit markets, yet the country is labelled ‘frontier emerging’ by stock market index provider, MSCI, because it has too few listed large-cap companies to qualify as a full-fledged emerging market. These anomalies in emerging-markets indices are not unusual, especially across asset classes (see Appendix 3: Expanding the opportunity set).

Two opportunities arise here. First, the frontier designation puts the country’s companies off limits for institutional investors restricted from owning such presumably risky investments. This artificially suppresses potential demand for shares and creates opportunity for unconstrained investors to get in at better prices for the upside potential of earnings growth. Second, the country’s stocks have downside risk, as any stocks do, and because they are based in the Middle East, they carry the risk of geopolitical events that are difficult to forecast. If one were to purchase downside protection in the stock options market, it would be very costly because these instruments are priced off the perceived risk in the shares. Yet the bond market perceives credit risk as very low, because of the country’s strong fiscal health. Therefore, insurance against extreme downside risk can be purchased in the credit markets at a much cheaper price. It is only possible to take advantage of such an approach in a strategy that is truly unconstrained and holistic. And, equally important, a simplistic bolting together of an emerging stocks portfolio with an emerging bonds portfolio would fail to capture such an anomaly.

Overall, the ability to look across asset classes for the most attractive investments should allow investors to earn the returns they expect from emerging markets stocks with a lower level of market risk. For those interested in total returns rather than consistency in tracking a benchmark, this should be a better approach and should be reflected in a higher Sharpe ratio. Both approaches can deliver alpha, but a multi-asset approach should deliver that alpha at a lower level of risk (Figure 4 below).
Figure 4: A multi-asset strategy seeks alpha with lower risk
Emerging market multi-asset strategy potential long-term risk and return

Source: AllianceBernstein. For illustrative purposes only.
Don’t forget the foreigners

When most investors speak of investing in emerging markets, they mean it literally – that is, directing assets to a country with an emerging economy. But that definition may be needlessly narrow. If the goal is to benefit from emerging-markets growth, why not invest in a developed-market company if it derives much of its earnings from sales into emerging markets? Many large multinationals, as well as smaller companies, are enjoying an increase in sales to emerging markets. A truly unconstrained mandate allows investors to participate in this growth.

In some cases, this strategy may be the best way to gain the exposure sought. As an example, consider the Chinese auto industry. This market is booming, dominated by large players, and is expected to continue its rapid growth as China’s consumer population expands. Yet the largest manufacturer’s stock is not available to foreign investors. The second-largest car maker is privately held. However, foreign companies have made headway in the Chinese auto market through joint ventures with local companies and also by selling components to manufacturers. Many of these companies are publicly traded and may be available far more cheaply than smaller Chinese manufacturers whose shares are available to foreigners. In the months following the 2010 natural disasters in Japan, one such company was Sumitomo Rubber in Japan. It operates factories in China, as well as other parts of Asia for export to China. And, after the tragic earthquakes and tsunami, the prices of virtually all Japanese shares dropped sharply – creating an excellent opportunity to buy into the Chinese auto market at an attractive price, albeit indirectly.
Making a multi-asset strategy work

Clearly, an unconstrained, actively managed active strategy in emerging markets may offer the potential for better risk-adjusted returns and a greater opportunity set for investing. However, executing such a strategy well requires skill in all the asset classes, a global infrastructure and an ability to integrate the management of the various assets.

Consider the example of the Middle Eastern frontier country. Taking advantage of the discrepancy between one of its companies’ stock price and its credit rating assumes the manager has good enough information about both sides of the company’s balance sheet as well as the geopolitical and economic climate to have confidence. Further, excellent communication across specialists is essential. If the individuals covering different asset classes and/or regions fail to share information and ideas promptly, the portfolio may fail to capture the mis-pricings that arise.

This is why an integrated approach to multi-asset class investing – i.e. one portfolio management team – should be more effective than a bolt-on approach that attempts to do the same with separate single-asset teams of managers. Single-asset class managers may take positions that only look attractive in the context of a single-asset class portfolio. For example, an emerging market bond manager will likely own at least some Venezuelan bonds, despite its tremendous political risk, because the country represents such a large proportion of the bond benchmark’s yield spread. Given a range of choices beyond the bond benchmark companies, however, many stock investments would appear to offer greater return potential at lower levels of risk (Figure 5).

**Figure 5: Venezuelan bonds: too much for comfort?**

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<tr>
<th>Attractive proportion of benchmark yield spread</th>
<th>but whether Venezuelan oil revenues?</th>
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Source: AllianceBernstein. Historical analysis and current estimates do not guarantee future results. As of 31 March 2011.
A bolted approach would also fail to focus as effectively on the most attractive part of company capital structures when there's a choice between stock or bond exposure. Take the case of Gazprom, a Russian energy company with strong cash flow and a solid balance sheet in early 2011. Its financial strength would have made it appear attractive to both stock and bond investors, so both its stocks and bonds would likely be found in a strategy that bolted together a stock manager with a bond manager. But if a single manager had approached Gazprom with the ability to focus on its stocks or bonds, the stocks appeared to hold far more value. All else being equal, the company's strong balance sheet and low equity valuation suggested limited downside potential for both stocks and bonds, yet a much greater upside for stock investors if the company merely met its earnings expectations and saw a modest increase of its earnings multiple as shown in Figure 6.

Figure 6: Gazprom stock vs. bonds – multi-asset can choose

![Figure 6: Gazprom stock vs. bonds – multi-asset can choose](image)

Source: AllianceBernstein. Historical analysis and current estimates do not guarantee future results. As of 31 March 2011. Potential equity return assumes earnings growth equal to consensus estimates and that one-year forward earnings multiples expand from 4.8 x currently to 6 x (average over last five years is 7.5x). Potential debt return assumes return equal to scheduled coupon payment and roll return.

Last but not least, an integrated, unconstrained strategy can use derivative securities to seek reduced risk or enhanced returns across asset classes. Tools such as futures, options or swaps can be especially useful in emerging markets where liquidity is thin or transaction costs are high, by offering an alternative method of gaining or reducing exposure to securities or asset classes. Prudent use of derivatives can allow a manager to move quickly in or out of positions where
liquidity is limited. They can also be used to facilitate investors entering or exiting a fund without forcing unwanted trading.
Integrated markets; integrated portfolio

The debate on how best to integrate emerging markets into global portfolios is ongoing, but an actively managed, integrated, multi-asset approach offers clear benefits and potential advantages over a single-asset or otherwise constrained strategy. These advantages may be summed up in three themes—more opportunities, greater flexibility and enhanced diversification potential:

- A larger universe of investments opportunities.
- An ability to invest opportunistically in situations unavailable to traditional single-asset class strategies.
- Freedom from investments dictated by benchmark indices, which may limit an investor’s opportunity set, or include risk positions that aren’t appropriate to an investor’s objective.
- Enhanced risk management, thanks to the flexibility of more hedging sources. Greater diversification potential from more sources of returns.
- An ability to arbitrage mis-pricings between stocks and bonds in one country or between separate countries.
Appendix 1: Emerging markets – why the reluctance?

Despite the increasing prominence of emerging markets in the global economy, the allocation of investors to these markets often falls far short of their weight in benchmark indices. Exposures vary widely, but many US and European investors hold only 5% of their stock portfolios in emerging market stocks. Yet emerging markets constitute almost 14% of the MSCI All Country World Index (MSCI ACWI) as shown in Figure A1.

**Figure A1-1: Institutional investors and underweight emerging markets**
Emerging markets’ percental of MSCI ACWI² to 31 March 2011

Source: Mercer Asset Allocation Survey, April 2010 and AllianceBernstein. Historical analysis does not guarantee future results.

If a global stock allocation should reflect economic activity around the world, the dichotomy is even more startling – emerging markets today account for roughly one-third of global GDP.

What is holding investors back? Presumably it is a vestige of the old approach to emerging markets. As recently as five years ago, investing in emerging markets was, conceptually at least, a fairly simple proposition – most investors allocated small portions of global portfolios to them as a source of high-octane returns with diversification benefits. The objective was to benefit from

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² GDP (gross domestic product) is the total market value of goods and services produced by a nation’s economy during a specific period of time (usually a year).
emerging markets’ occasional bursts of growth, while keeping exposure low enough not to be too badly hurt by their periodic crashes or coups.

But, under the radar of most investors, developing nations have been steadily improving their economic fundamentals. Many of them have built up their international currency reserves, their fiscal position is stronger, and their listed companies have stronger balance sheets and profitability (Figure A2). A number of emerging-market companies also are world leaders in their industries, such as Samsung in electronics or Gazprom in energy.

Figure A1–2: Institutional investors underweight emerging markets despite growing strengths

![Graph showing foreign exchange reserves and public debt as a % of GDP*](chart)

Source: International Monetary Fund. Historical analysis and current estimates do not guarantee future results. Through 30 April 2010. GDP is the total market value of goods and services produced by a nation’s economy during a specific period of time (usually a year).

The resilience of developing nations after the 2008 Global Financial Crisis opened investors’ eyes to the newfound strength of emerging markets. Few investors would be so aggressive as to raise their allocations to emerging markets exponentially. But the feeling that a sea change has taken place is growing. If emerging markets’ share of global GDP remains this large, global investors’ allocation is likely to rise.
Appendix 2: Emerging-markets debt comes of age

As recently as the early 1990s, emerging markets debt was a somewhat rarefied asset class composed of dollar-denominated sovereign debt, mostly non-investment grade. The market is expanding and evolving rapidly, with more than half of dollar sovereign debt now investment grade. Governments have also started raising debt in local currencies, creating a new class of investments with attractive diversification potential. Local corporations are issuing bonds too, in both dollars and local currency. Issuers of all types are moving out on the yield curve and spreads in general are tightening relative to developed markets.

Local-currency emerging-market sovereign debt is now widely accepted as a separate sector within the global fixed-income universe. The risk/return profile of this sector continues to evolve and in many countries it now provides a clear offset to local stock market risk. Simply put, in many emerging markets the relationship between stocks and bonds is similar to what is seen in developed economies.
This evolution has resulted from three key and interrelated trends. First, central banks in many emerging economies can now run independent and counter-cyclical monetary policy. This means that they can loosen and tighten policy based on domestic economic growth and inflation trends, and not lock their monetary policy decisions to those of the US or euro zone. This independence has been earned by these countries running credible anti-inflationary monetary policy and conservative fiscal policy. Second, many emerging economies have now developed full government-bond yield curves, making it possible for investors to fully separate the decisions on interest rate and currency risk. Finally, emerging economies have developed more advanced financial sectors, and local investors are more important participants. These investors have begun to develop their own home currency bias and no longer flee their countries in times of economic stress. Instead, they are more likely to switch out of stocks and into local bonds.

As for emerging-market corporate debt, its growth expands the opportunity set but, in fact, it is highly correlated with other sectors of the global fixed-income markets. The universe of issuers is still relatively small, and liquidity is a major concern, with the average trade less than half that of the average sovereign emerging-market bond.

Thus, while emerging-market corporate debt can provide investors with country and issuer diversification, it remains a relatively small sector and does not offer the depth and breadth necessary to build a well-diversified stand-alone portfolio. In this regard, it can be a valuable addition to a multi-asset portfolio.
Appendix 3: Expanding the opportunity set

One advantage to an unconstrained multi-asset strategy is that it allows a manager to tap into a broader range of countries that are more representative of emerging markets. A number of large emerging markets are not represented in major stock indices or bond indices, and there are also discrepancies between the indices.

For example, Taiwan and Korea are among the larger country components of the emerging-markets stock benchmarks, but are not included in some emerging-markets bond benchmarks. And China accounts for 17% of the stock benchmark, but a mere 1% of the bond benchmark. And some emerging markets are represented only in the bond market benchmark (such as Venezuela, Lebanon, Panama and Ukraine).

Having access to a broader range of countries gives a manager more ways to win, both in terms of new investment opportunities to tap and a greater ability to avoid securities that represent larger portions of a benchmark comprised of bonds or stocks securities alone.

A manager with expertise in both emerging-market bonds and stocks may also be better equipped to find attractive stock investments in countries classified as frontier emerging markets, which in many cases are included in emerging-market bond benchmarks but not in the standard emerging-market stock benchmarks, such as Argentina, Lebanon, Kazakhstan, Pakistan, Sri Lanka and Vietnam.

Some countries are so small that they don’t (and probably will never) have local stock exchanges of meaningful size, but local currency bonds can present opportunities both for return potential and for diversification purposes. For example, the Dominican Republic is not listed on emerging or frontier country indices, but it does issue sovereign bonds denominated in local currency. These currently provide relatively high yields and exposure to the country’s relatively idiosyncratic credit risk. The power of a multi-asset class strategy becomes apparent when one considers these bonds in a portfolio alongside the stock of Gazprom, the Russian oil company. Gazprom’s share price is positively correlated with the price of oil. But when the price of oil falls, the Dominican Republic benefits, because its primary industry is US tourism, and falling oil prices usually lead to cheaper airfares between the island and the US. When not limited to looking within a single asset class for ways to offset the risk of one security with another, opportunities for diversification such as this widen considerably.
Figure 10: Discrepancies in emerging markets benchmarks create opportunities

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Source: AllianceBernstein. Through 31 August, 2011. Debt benchmark is the JPMorgan EMBI Global Index; Equity benchmark is the MSCI Emerging Markets Index
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