The emerging markets still have a lot to offer in the coming months

Outstanding performances and record funding in 2017 for liquid alternative products focusing on developing markets

by Elisa Pellati

LIQUID ALTERNATIVE PRODUCTS FOCUSING ON DEVELOPING MARKETS

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Performance 2017*	10,25%
Numero di fondi	29
Asset in gestione	13,8 mld di euro
Raccolta netta 2017	3,8 mld di euro

*performance dell'indice MA-EURIZON Ucits Alternative Emerging Markets Index (EW).
Dati aggiornati a fine dicembre 2017.
Fonte: MondoAlternative

Key:

2017 Performance*	10.25%
Number of funds	29
Assets under management	€13.8 billion
Net funding 2017	€3.8 billion

* performance of the MA-EURIZON UCITS Alternative Emerging Markets Index (EW).
Date updated to end-December 2017.

Source: MondoAlternative

The positive trend in the emerging markets attracted the attention of investors seeking better returns, especially in the bonds field, than those on offer in the main developed countries.

Liquid alternative funds operating on those markets, in both debt and equity, recorded their best ever results in 2017. They closed the year with a performance of +10.25%, according to the MA-EURIZON Ucits Alternative Emerging Markets Index, thus confirming the strategy as the best of the year. MondoInvestor decided to analyse this type of product more closely and also examine the outlook and principal risks on the horizon for the emerging countries.

The analysis

Liquid alternative funds operating on the emerging markets were managing a total of €13.8 billion at the end of December 2017. They consisted of 29 products, 18 of which equity and 11 bond, with assets under management of, respectively, €1.1 billion and €12.7 billion. In the course of the year, in addition to achieving record performances, these types of product brought in net investments of €3.8 billion, the best net annual funding result ever. But what were the drivers of these outstanding results?

"The great results achieved by our Greater China Equity fund in 2017 are the fruit of a highly disciplined value approach. We focused on top quality companies: some of the world's best and with annual growth of 30%, but still trading at reasonable valuations.

We concentrated on well-known companies that are leaders in their sectors, such as Kweichow Moutai and Wuliangye. Even if they're not yet affordable for all pockets, these historic liquor producers in the Chinese market will, over time, become accessible to ever-growing numbers of consumers. We also placed great faith in Alibaba and Tencent, the social network on which Chinese people spend nearly double the time US citizens spend on Facebook", states Dawid Krige, manager of Banor SICAV's Greater China fund.

He points out that "at present, the fund has a 40% exposure on Chinese companies that are leaders in their sectors and 40% exposure on leading internet companies. We believe that the growth in domestic consumption in China is undoubtedly the main factor to monitor. The increase in domestic consumption – 10% a year – is a story of long-term growth starting from low volumes. The growth in consumption has in part been driven by urbanisation – Chinese consumers living in cities spend three times more than those living in non-urban areas. In part it's underpinned by favourable Government policies – for example, on public health. And lastly, it's been driven by the rapid growth in wages. Indeed, the entire portfolio of the Banor Greater China Fund is focused on companies that are benefiting from the growth in domestic consumption".

"Within the Eurizon range", explains Luca Sibani, Head of Discretionary Investment and Total Return at Epsilon Sgr and manager of Epsilon Fund Emerging Bond Total Return, "this is the product designed to offer cash enhancement opportunities. It does so by searching out higher returns than the money market, decorrelated from the emerging bond market, while still keeping volatility and risk low. The management strategy is characterised by two portfolio components: a buy & hold (or strategic) component which invests primarily in short-term bond instruments (maturity within 36 months) issued by the governments and companies of emerging countries (Europe, Middle East and Africa (EMEA), Latin America and Asia), with almost total currency risk cover.

This component is designed to grasp carry potential, in other words to exploit the differentials between the interest rates of emerging regions with respect to core countries and eliminate the impact of currency. And it has a yield enhancement (or tactical) component which tactically exploits the interest rates of the emerging countries, credit instruments with maturity higher than 36 months and currency markets, to seek out yield opportunities and implement risk hedging strategies. An analysis of performance since the fund was launched in 2008 highlights the contribution of the buy & hold component, about two-thirds of total appreciation".

Opportunities and risks

The emerging markets offered excellent investment opportunities last year, on both the equity and the bond markets. "Most of the emerging countries are in the early stages of the economic cycle, with interesting growth prospects", comments Sibani. He continues: "Some countries, like Russia and Brazil, are still going through a period of disinflation and can thus benefit from further interest rate cuts by their central banks. Others, like India and Indonesia, have initiated a structural reform process that will bring improvements in the medium term and for which they have received recognition from the rating agencies.

Positive macro-economic fundamentals, which make both public and private debt sustainable, translate into investment, and not just portfolio, flows. They have positive repercussions on the performance of both financial and real assets. And that's the context in which the emerging countries have found themselves for over 18 months. In the case of these countries' local currency debt the presence of positive real rates far higher than those offered by issuers in the developed countries should be underscored", notes Sibani. The positive trend that the emerging countries are experiencing, with the help of synchronised global growth, has led many investors to seek out better returns, especially from bonds.

But what is the outlook for the coming months? In Krige's opinion, "The emerging markets tend to out-perform and under-perform in five to seven-year cycles. Between 2011 and 2016 they lagged significantly behind the markets of the developed countries. In 2017, however, this trend was reversed. We believe that the out-performance by the emerging markets has only just begun, especially if we consider their valuations, which are even more interesting. So investors should expect many years of out-performance".

As regards China, Krige states: "China's stock markets are notoriously very volatile and I don't think that in future we'll see changes in that. For us, the volatility risk isn't a problem because we're long-term investors. In the medium term, we'll be keeping an eye on indebtedness. The longer-term risk that we have on our radar is linked to the uncertainty and instability arising from the slow and gradual process of opening up the country to a system founded on the full recognition of civil and social rights".

Sibani's view is that "the emerging markets have seen significant progress from both a macro-economic perspective and that of the quality of the public institutions whose remit is to control fiscal accounts and monetary variables. From our point of view, the equity and bond asset classes are, in the medium term, a valid alternative to expand the 'investable' universe of a global portfolio. However, the emerging markets remain sensitive to the international financial context, in which the main developed countries’ central banks are ready to leave behind the ultra-expansionary monetary policies that until now have supported equity and bond prices and have reduced volatility and, consequently, the risk premiums included in financial instruments.

The rises introduced by the American Federal Reserve and the Bank of England, and the end of quantitative easing in the euro area in the second half of the year, could lead to increased volatility and risk premiums and also hit the emerging countries”.