

Emerging markets: seizing the opportunities

June 2017

A roundtable report



WILSON WILLIS



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Our on the ground presence across these regions enables us to adapt quickly to regulatory and operational developments and work with our clients on navigating the more dynamic markets such as China and India.

That is why – as a bank that focuses on emerging markets – we are delighted to be involved in this report by Wilson Willis alongside some of Europe’s leading emerging markets managers, as well as working closely with the broader investment community to help them to achieve their investment and market access objectives.

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Introduction



Neil Wilson



John Willis

Financial markets the world over have always been something of a rollercoaster. In which case, emerging markets – arguably the most exciting areas of them – can perhaps be viewed as being like a ‘big dipper’. Their history has certainly been marked by some extraordinary and tumultuous phases of boom and bust – with an exhilarating bull market often followed by a crisis and sudden crash, then a phoenix-like recovery followed by yet another further coruscating fall... and so on and so on.

Given such wild gyrations over time, it has been possible for some investors – given great skill or fortunate timing – to make great returns. But all too many have found investing in emerging markets to be a frustrating or humbling experience. It has proved terribly difficult for investors to make consistently strong returns over a longer time frame, especially in equities.

All too often, investors have gone into EMs and made what looked like fantastic returns, and then found themselves trapped – as markets crashed and they were too late get out ahead of capital controls or total loss of liquidity.

And yet... And yet the opportunity set in emerging markets continues to look compelling. EMs have driven the lion’s share of global economic growth for decades. Their combined economies now represent around half of global

GDP – yet still under 10% of global market capitalisation.

At a time of rising populism and seismic political events in the developed world, from Brexit in Europe to President Trump in the US, and questions about a backlash against globalisation, we felt it might be opportune to host a roundtable where we re-examine the case for emerging markets; ask why they are of interest; and how to overcome the serious operational challenges of investing in them.

We brought together a range of different types of market participants – from macro and fixed income investors, to firms that run a variety of equity strategies from long-only to small and mid-cap to regionally-focused funds. Those taking part included portfolio managers, who have their eyes firmly on where to find the best opportunities, and senior operational managers, who must try and make the execution of those strategies work – while avoiding the pitfalls.

We were only able to do this with important support from our partners at Standard Chartered, who also brought their detailed knowledge and expertise in these markets to the discussion. We hope you find this resulting report illuminating.

Neil Wilson

John Willis



Panellist biographies

Edward Cole Man GLG



Edward co-manages the Unconstrained Emerging Equity strategy having joined Man GLG in June 2015. Previously, he worked for two years with Simon Pickard on Carmignac Gestion's GEM equity and balanced funds. Edward's experience on the buy-side includes five years with

Ashmore and Finisterre, prior to which he worked as an equity strategist for six years on the sell side for JP Morgan and Unicredit. Edward graduated from the University of Bristol with a BSc in Politics and from the London School of Economics with an MSc in International Development.

Michel Danechi Duet Group



Michel joined Duet in June 2015, and is the Portfolio Manager of the Duet Emerging Europe Fund. He has traded Emerging Markets for over 20 years, having navigated the trading environment in the European Emerging Markets since 1994. Michel began his career in 1986 trading Japanese warrants and convertibles.

Before joining Duet, Michel worked at Armajaro Asset Management LLP (AAM) from January 2009. Michel has established a comprehensive network of relationships throughout the region. Prior to joining Armajaro, Michel was hired by Lehman Brothers International (Europe) in London to build and head up the Emerging Markets equities team. The team managed the bank's equity derivatives and cash portfolio, mainly in Russia, Greece, South Africa, Israel, Middle East, Czech Republic, Poland,

Hungary and Turkey. Under his leadership, Lehman emerged with a strong presence in Emerging Markets. Before joining Lehman Brothers International (Europe), Michel was Head of the London Office and Head of EMEA Equity Trading at CA-IB International Markets Ltd (part of Unicredit), responsible for pricing and structuring EMEA equity derivative products.

In addition, Michel successfully managed and traded the firm's proprietary book. Michel managed the European Emerging Markets Equity Derivatives desk at Citibank before joining CA-IB. Michel has a tangible track record of outperformance. He has a Masters in Business Administration from the London Business School and a BSc (Hons) in Economics from the London School of Economics and Political Science.

Margaret Harwood-Jones Standard Chartered



Margaret is Global Head, Securities Services at Standard Chartered Bank. She is responsible for the strategic leadership of the Securities Services business globally, managing all the business unit functions including Operations, Technology, Client Management, Business Development and Product Management.

She also leads the business agenda with Financial

Institution clients on a worldwide basis, across cash management, securities services and trade finance. Margaret has over three decades of experience in financial services with 20 years in the Securities Services industry.

She is a Chartered Individual of the Securities and Investment Institute and an Associate of the Institute of Bankers.

Christian Kopf Spinnaker Capital



Christian is a partner of Spinnaker Capital, portfolio manager of the Spinnaker Emerging Markets Macro Fund, the firm's director of Economic Research and Investment Strategy, and a member of the Global Investment Committee. Christian authored papers on sovereign debt that were published by the Centre of European Policy Studies, the European Capital Markets Institute, De Gruyter and Wirtschaftsdienst. He has spoken on emerging markets finance at the BIS, Brookings Institution, EMTA, Euro50 Group, EBRD, G-20, the Institute of International

Finance, the Paris Club, and at several industry conferences. From 1999 to 2006, Christian was a senior portfolio manager at DWS in Frankfurt, Germany, in charge of global emerging markets fixed income. Prior to working in the financial industry, Christian conducted sustainability research at the Wuppertal Institute for Climate, Environment and Energy. Christian graduated from Witten/Herdecke University in Germany with a master's degree in Economics and holds the Chartered Financial Analyst designation from the CFA Institute.

Matt Low RWC Partners



Matt Low is Head of Operations at RWC Partners. Since Matt joined RWC over 10 years ago assets under management have grown from \$3bn to almost \$11bn, and RWC now manages a range of unconstrained, active strategies – all of which invest in liquid assets.

During this time Matt has overseen the onboarding of several new investment teams and has significantly developed RWC's operational function, which is now managed out of London, Miami and Singapore.

Before joining RWC, Matt was at Aberdeen Asset

Management, where he led a number of teams to integrate the legacy Deutsche Asset Management business.

Matt spent 12 years at Deutsche Asset Management in total, and was a member of the Operations Management Committee, heading up various operations teams including transitions, reconciliation and transfer agency functions. During this period, Matt led a number of fund launches, restructures and large scale operational changes.

Rory McGregor Emso Asset Management



Rory started his career in 1990 at Barclays Bank in New York in foreign exchange sales, and worked in Tokyo before returning to Jamaica as Foreign Exchange Treasurer for Jamaica Citizens Bank (now part of the Royal Bank of Canada).

After completing his MBA, he joined Credit Suisse's emerging markets local bond trading department in London and, in 1999, he founded and managed a

wireless technology company before joining Emso in 2003. At Emso he has established the operational infrastructure, and more recently spearheaded the successful implementation of the employee buyout of the company.

Rory earned an MBA from the Wharton School, University of Pennsylvania and a BA from Rutgers University.

Christina McGuire Elephant Asset Management



Christina is the founder and portfolio manager of Elephant Asset Management – an investment firm focused on publicly listed small-/mid-cap companies in emerging Asia and Africa.

Before that, she was a founding partner and the Chief Investment Officer of Aperios Partners Investment Management, which had a similar investment strategy. Prior to founding Aperios, Christina was a Portfolio Manager at Goldman Sachs Asset Management (GSAM) specialising on international small-/mid-cap companies and China A-shares.

In 2004, Christina was selected by the CIO of GSAM as the only non-Chinese national to help establish a Shanghai office and to set up the GSAM A-Share China Fund. She remained in Shanghai until 2008 when she

took over GSAM's International Small-/Mid-cap funds as a co-portfolio manager.

Christina began her financial career in 2001, joining GSAM initially as a research analyst before taking on portfolio management responsibilities. She has been a CFA charterholder since 2004 and received her MBA from Harvard Business School in 2001.

Christina started her career in the medical profession. She received her Doctor of Medicine from the Technical University in Munich in 1997 and thereafter practiced in various emerging countries across Asia and Africa.

Christina also obtained a Doctorate in Psychiatry from the Ludwig-Maximilians-University, Munich. She is a member of 100 Women in Hedge Funds.

Chapter 1

THE OPPORTUNITY SET IN EMERGING MARKETS

SUMMARY POINTS

- How market structures have evolved and developed
- The case for emerging markets today
- Strategies for specific markets – currencies, fixed income and equities



“I find myself more bullish on emerging market equities now than at any time over the last ten years”

Ed Cole

Not surprisingly – given a roomful of people who make their living in emerging markets – there was plenty of optimism around the table about the opportunity set ahead.

For some of the participants, this was partly to do with how emerging markets have evolved and developed over recent years – to offer a much more diverse opportunity set, and ways to manage risk. For others, it was more to do with how they are rebounding from some difficulties in recent years – and the stage in the cycle they are at now; or because of the idiosyncratic opportunities arising in specific places at the current time.

Christian Kopf, a partner at Spinnaker Capital where he is portfolio manager of the firm’s \$1.7 billion Emerging Markets Macro Fund, focused initially on how the markets had evolved. “The big change in emerging markets over the last ten to twelve years has been the development of domestic fixed income markets,” he said. “In the beginning it was just hard currency bonds and a little bit of equities, and what you were basically trading was default risk. So as a consequence

you had people who did all sorts of country analysis to figure out whether the country was going belly-up or not.”

“It was all to do with what Ricardo Hausmann from Harvard University called ‘the original sin of emerging markets’ – the inability to issue in a currency that they control,” he continued. “The issuers finally understood that, and around 10 years ago they started to migrate their issuance from hard currency to local currency.”

For Kopf, the major development in the marketplace has been this rapid expansion of domestic fixed income assets in emerging markets, the development of local yield curves, and the shifting of issuance from hard currency to local currency. “For us as macro investors, this has opened up a whole new universe of investment opportunities and of possibilities to articulate views. We have moved from a world where we were only articulating views on sudden default risk to a world where we can play the currency and we can play the rates market, and we can still play the default risk. So we now have three big macro dimensions.”

A similar fixed income-based perspective was

offered by Rory McGregor, chief operating officer at Emso Asset Management, the \$3.3 billion emerging market debt focused hedge funds group which has been running for 17 years and span out of Citigroup in 2013. "Our view on EM is that it's half of the world's GDP, and it's not going to go away any time soon. In many respects, we feel that developed markets have now become the focus of political risk. And it's something that, interestingly enough, developed market traders aren't used to dealing with very well."

"Broadly, we also obviously like local markets. Local access is key," McGregor agreed. But EM managers needed to ensure they are really offering a genuinely different type of investment strategy from what investors could be getting in DMs, he argued. "[With local market opportunities] we always ask the question: 'Are we just doing a glorified US Treasury trade or a glorified dollar/yen trade or a glorified dollar/Euro trade?' We're not being paid to trade dollar/Euro or dollar/yen."

Nevertheless, investors ought to remain very wary of the potential dangers in EMs, he cautioned. "We've also seen in our experience that a lot of our former competitors have been blown up by local markets. There's numerous examples."

McGregor continued: "From a fixed income perspective, EM is here to stay, but every country is different. You have to look at each one as a standalone. Obviously, if you get too big in any one of them, they could take you out. There are always these unknown unknowns that can take you out – so we try to be careful in how we deploy capital in all of our investments, but especially in local markets."

Ed Cole, co-manager of the Unconstrained Emerging Equity fund at Man GLG – which he and Simon Pickard joined in June 2015 – added more of an equity market focus to the discussion. "I've been doing emerging markets from a strategy perspective and on the buy side since 2000 and I find myself more bullish on emerging market equities now than I think we've been at any time over the last ten years. I have 25% of my own savings in my fund and I intend to continue to add over time, buying on weakness."

Cole said that EM has gone through an enormous transition over the last five years from a macro perspective: "We've had an historic devaluation of EM currencies. In 2013 when Bernanke sparked the 'taper tantrum' we looked at EM and thought it was a fairly unattractive proposition across most asset classes."

"We saw currencies to be overvalued as a consequence of the liquidity sucked in through global QE – and that was driving domestic demand far too hot in most EMs, and external balances into a very dangerous position. We saw a sharp deterioration between 2010 and 2013 but then a sharp improvement since,

which reflects to us the fact that economies have cooled, that currencies have become more competitive."

"The adjustment broadly has happened, in our view," Cole continued. "Against that backdrop, currencies and the risk premium that's embedded into local currency assets we now view as potentially attractive."

"Currencies appear cheap, and economies have adjusted. And EM equities are now trading on a cyclically adjusted price earnings ratio of only seven-and-a-half times – cheaper than at any point since the early 1990s. Right now, if you're buying US equities you're buying at twenty-six times cyclically adjusted earnings. So for EM equities, we think the risk reward here can be great."

Michel Danechi, portfolio manager for the Emerging Europe fund at Duet Group, which runs about \$5 billion, about one-third of which is in EM strategies, brought a more regionally-specific dimension to the discussion: "We have a regional focus," he emphasised. "The reason is basically that we believe the devil is in the detail in emerging markets – and you really need to understand the fundamentals in the companies, and you have to really understand what's going on on the ground both at the political level and at the central bank level as well as the company level. We think that's how to outperform the global guys."

"I used to run a global equity derivative position for Citibank and basically you never sleep – I mean, you're up very early doing Asia and staying up very late doing LatAm and basically at some stage you burn out," he argued. "It's very, very difficult to do it well."

Explaining his strategy now, Danechi added: "What we try to do is be a little bit contrarian. We try to be value orientated and we try to find not the big macro stuff where everybody is, but the smaller companies which are off people's radar screen. We are very active focused, with 75% - 80% of the portfolio, and we look very much at sustainable free cash flow yield, and what is available for the equity guys."

"You don't have [to have] very hard corporate governance issues but you make calculations; if you can get very good equity compounding yields of 10% to 15% per year, we think over five to ten years that's going to create very, very good outperformance."

Danechi continued: "If you're contrarian – with the flows we've seen from ETFs and so on – things undershoot and they overshoot, so you have to trade a little bit around these positions, and then you can consistently over five, ten years outperform the index. Against the S&P or the FTSE it's very difficult to do that, but in emerging markets I think you are able to do that."

"You have to do your own legwork," Danechi emphasised. "You have to do your

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"Now I think we are at another turning point. You have extraordinary P/E ratios in developed markets. In EM it's quite cheap"

Christian Kopf



"EM is here to stay, but we try to be careful in how we deploy capital, especially in local markets"

Rory McGregor



“Emerging markets move in cycles, and we may be at a very important turning point now”

Christian Kopf



own data mining. You have to find your own opportunities.”

A further specialist equity perspective was offered by Christina McGuire, founder and portfolio manager of Elephant Asset Management, a new investment firm focused on publicly listed small and mid-cap companies in emerging Asia and Africa.

McGuire, who developed her strategy in previous years at Goldman Sachs Asset Management, said she focuses particularly on eight specific countries – China, India, the ASEAN markets of Thailand, Malaysia, The Philippines and Indonesia, and then Kenya and South Africa – and across those in not more than 25 holdings.

“What we like to take advantage of is the ‘emerging middle class’ theme across those eight countries – the fact that, regardless of where you necessarily sit, you have a strong growth in the emerging middle class, coupled with a structural under-penetration of goods and services,” she said. “We think on-the-ground research is absolutely crucial. For many of the companies we look at there are no research reports, there’s no analyst coverage, and we really love the fact that when we look at these companies there is rarely anybody else out there who cares to build a model.”

“What really ties all these eight together is that they have already have a middle class

– even Kenya, which is technically a frontier market but actually has a pretty sizeable middle class already,” McGuire continued. “All of these eight markets adhere to a large extent to IFRS accounting standards, which is important to us – as we look quite a lot at corporate governance.”

McGuire emphasised that not all emerging markets may be appropriate for her investment approach: “When we launched the fund we also looked at Nigeria and Vietnam but we couldn’t get comfortable on transparency and accounting standards. By contrast, in the Chinese A share market, where you do have a large pool of companies that are rather toxic, we think you can still find a large enough subset of companies willing to provide the transparency we’re looking for. We didn’t get that feeling in Nigeria or Vietnam.”

Another broader perspective was brought to the discussion by Matt Low, head of operations at RWC Partners, an investment group running some \$11 billion across a range of unconstrained investment strategies including about \$2 billion in EM equity funds.

“We largely run long funds in EM, but a mix (including long/short funds) in DM, in lots of different wrappers – Cayman, UCITS, 40 Act and managed account structures. In terms of the approach, it’s both top down and bottom up,” Low explained, adding that the firm’s EM and Frontier funds were outperforming their

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“Client interest in India is very high. China may be complex, but liberalisation will further support inbound investment”

Margaret Harwood-Jones



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“You need to understand the fundamentals, and what’s going on – on the ground. You have to do your own leg-work”

Michel Danechi

respective benchmarks by over 13% over the last two years.

“The EM team have got their own economist (allowing top down) and 15 analysts (allowing bottom up). They follow that on-the-ground value approach out of two locations – Miami and Singapore – and they do a lot of company visits. Although they joined us only two years ago, most of the team have been working together for 20 years.”

Low concurred with previous speakers that the tide seemed to be turning again in favour of EM strategies. “In terms of fund flows we’ve probably been through five years of net redemptions in EM,” he said. “But we’re starting to see really positive flows coming in now.”

“Asset class investment cycles tend to go through passive into active,” Low argued.

“Investors, after dipping their toe in via passive EM exposure, then become comfortable with the idea of active EM – not dissimilar to DM market cycles. Certainly, in the years post the financial crisis, we have seen that EM inflows lagged behind the DM market – and that there’s a very strong opportunity now.”

Offering more background on where demand has been rising fastest was Margaret Harwood-Jones, head of securities services at Standard Chartered, active across much of the EM world, especially in Asia and Africa including many frontier markets. “Currently, client interest in India

is very, very high,” she noted. “What we hear is that, with good political stability, with the agenda of reform, there is very strong inflow into India.”

“China may be one of the most complex stories,” she added. “But it is for us the one place where everybody has a level of interest, and we think continued liberalisation will further support inbound investment there.”

“If you look at sub-Saharan Africa, it’s impossible to give a single regional answer,” Harwood-Jones continued. “South Africa for instance is such a strongly developed market. When we look at places like Kenya, you see that the government is addressing the domestic savings environment and boosting the opportunity there, trying to develop the market and to encourage inbound investment.”

“That doesn’t come without its challenges in a lot of African markets, where you have a large percentage of unbanked people. But again, if you look at Kenya you can see the development of mobile money. We’ve now got to such a level of sophistication that, as an investor in Kenya, you can use your mobile to invest in Kenyan debt.”

Rounding off the discussion on the opportunity set, Christian Kopf of Spinnaker said he concurred with much of what Ed Cole and other managers had been saying: “For me as a macro investor, it’s an extremely interesting time,” he said. “We have a huge amount of diversity with rates going up and down, some

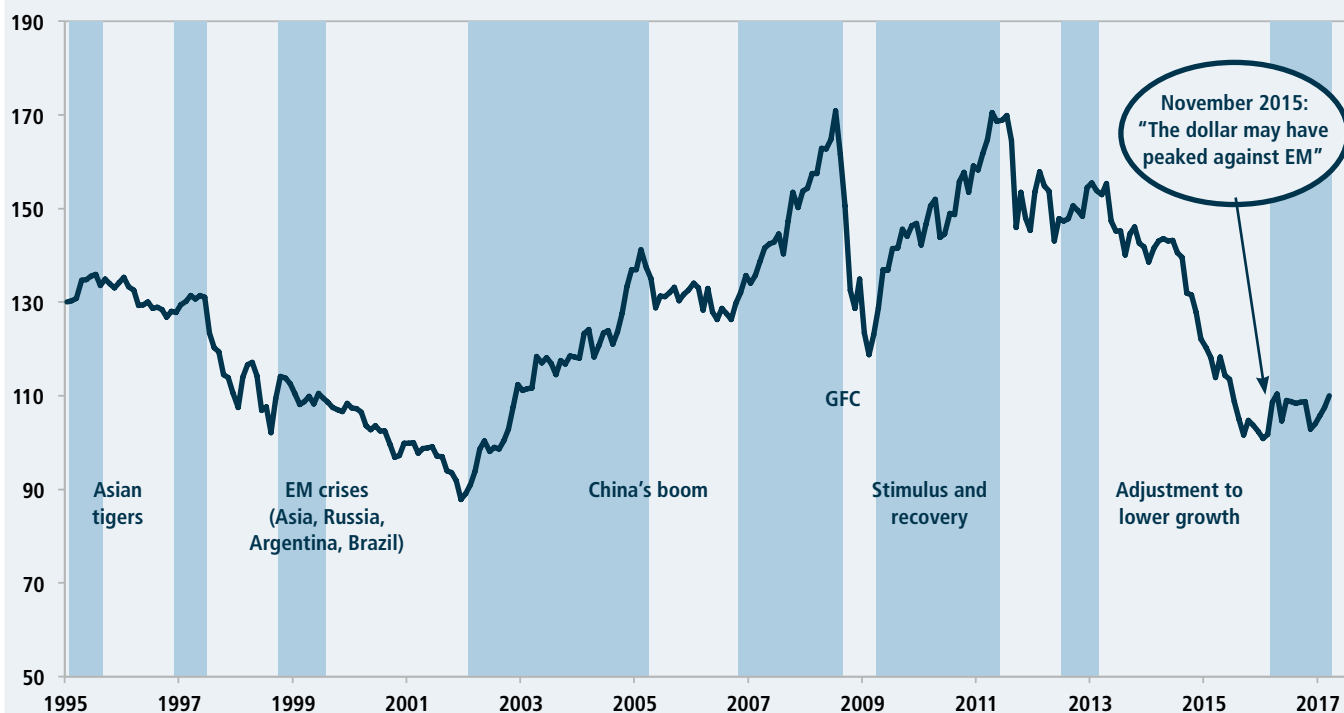
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“I would highlight the inefficiencies these markets offer, especially for active managers. They make EM much more rewarding”

Christina McGuire

Emerging Market Real Exchange Rate index against US\$

MARKET OUTLOOK



Weighted by market capitalisation (GBI-EM Global).
Sources: Macrobond, JP Morgan, Spinnaker Capital.

Spinnaker Capital Group – www.spinnakercapital.com



"We've probably been through five years of net redemptions in EM. But we're starting to see really positive flows coming in now"

Matt Low

central banks hiking, other central banks cutting rates; certain countries wanting to have a strong currency, other countries wanting to have a weak currency. You can play all of those dimensions without any long bias and deliver absolute returns from a very diversified pool of assets."

Highlighting a chart which illustrated the major gyrations of EMs, Kopf added: "What you can see is that emerging markets move in cycles, and those cycles last around six or seven years or so, and we may actually be at a very important turning point now."

These cycles change when you have a regime shift, he argued. There was a strong period in emerging markets which lasted until 1997 when the Asian crisis started. And then a period between 1997 and 2002 when almost every year there was a crisis: the Asian crisis, then the Russian crisis in 1998; the un-pegging of Brazil in 1999; the Argentine crisis in 2001; and the Turkish crisis in 2002.

Growth lift-off

"I remember 2002, when we had the Brazil crisis, many people were about to give up on emerging markets entirely," Kopf recalled. "But that was exactly the point in time when China was about to enter the WTO and China's growth took off. Then China started to consume all sorts of commodities, commodity prices around the world went up and you had

a massive positive terms of trade shock for all those emerging market countries – and a huge growth lift-off."

There was then a major bull market which lasted more or less from 2002 until the 'taper tantrum' in 2012, Kopf continued. "At the end of that period you were left with countries that moved from current account surpluses to current account deficits, and with very expensive currencies. Our analysis shows that a basket of goods and services which would have set you back \$10,000 in 2002 would have set you back \$17,000 ten years later in constant 2002 prices. Everything had become 70% more expensive in real terms. And then we had the big sell-off which began in 2012 and lasted until the end of 2015."

"Now I think we are at another turning point," Kopf argued. "If you look around the world, you have these extraordinarily high P/E ratios in developed markets. And in emerging markets it's actually quite cheap. You get negative real interest rates in advanced economies; in emerging markets, you actually get some decently high real interest rates. So it's now a pretty good time to buy emerging markets."

"Of course, if you can time the business cycle then you should go for a long-only manager. If it's more difficult to time the business cycle, then I think it's worth looking for vehicles that allow you some sort of downside protection by running an absolute return approach."

Chapter 2

INVESTMENT IDEAS FOR TODAY

Participants around the table offered a tasty selection of their investment and trading ideas for the current markets at the time of the roundtable in late April 2017 – with popular ideas including China A shares, India, Russia, frontier markets in Africa and Asia, and also Greece.

Ed Cole of Man GLG was one of those enthused about opportunities in China A shares. “Today, China A shares is the world’s biggest frontier market, and the second most liquid stock market in the world after the US, I think. It’s 85% retail investors, which brings with it some inefficiencies. But it’s also a market where quality-focused investors can make money by buying good companies with a long-term view. Despite being a highly inefficient market, high quality companies do re-rate in China.”

Cole pointed in particular to Yutong Bus, an electric bus manufacturer in a market that is virtually a duopoly, with perhaps three real players at most: “I think this idea really encapsulates something we think about the opportunity for there to be a bull market in

stock picking in China,” Cole said. “Our view is that now, as China starts to deflate its credit bubble and the government starts to manage supply side reform, you have the capacity for industry leaders to take greater market share.

“For Yutong Bus, about a third of its business is new energy vehicles like hybrids and battery buses. Anyone who has been to urban China knows how severe the pollution is and the government is trying to do a lot to change that with a generous subsidy regime.”

Cole noted how at least one big fund management company “has told its clients for the last ten years that China is ‘uninvestable’ and that corporate governance and disclosure is appalling. But I think anyone who actually does their digging now knows that is just not true. There are some companies that disclose as well as anywhere else in the world; where access to management is good; and incentivisation and alignment are good.”

Christina McGuire of Elephant Asset Management also highlighted a China A-share company called Suofeiya among her top picks.



“The last three years have been rich in contrarian country opportunities”

Ed Cole



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“It took a lot of effort, but we reaped the rewards of that because we were, we believe, one of the first funds in”

Rory McGregor

The company makes customised furniture – which she admitted “sounds like a terrible business”. But she quickly added: “Actually, they’re not competing with the IKEAs, they are much higher in terms of the price point. What you find in the Chinese middle class is that they love customised furniture and the market is incredibly fragmented. Suofeiya’s competition consists primarily of independent small-scale carpenters.”

“Suofeiya has managed to build a customised furniture franchise that is almost like a tech company,” she enthused. “Customers design their furniture on computer terminals using standardised elements. The beautiful thing about this is that the customer pays 100% upfront, so this company has a negative cash cycle and can expand simply by using working capital. It’s market share is less than 4%, meaning it is relatively insensitive to the vagaries of the Chinese property market – it simply is too small.”

McGuire also cited an Indian company called Vakrangee, an exclusive local distributor for Amazon. “A lot of Indian people don’t have a firm home address or bank account so what they do is establish a delivery point via a little convenience store and Amazon delivers there,” she pointed out. “Vakrangee has thousands of them all over India. They’ve established those,

they do the Amazon distribution and now can add other services on top.”

McGuire’s third top idea at the current time was in Africa: “I think people should be looking at Kenya,” she said. “It had an awful start to the year – for concerns about the election coming up in August, and a poor rainy season. When you look at the market historically, after every election, regardless of whether it was a tumultuous election or a peaceful one, the market has always bounced back very, very strongly.”

Participants cited a great diversity of EM investments around the world. Matt Low of RWC for instance highlighted the infrastructure sector: “In terms of current themes, infrastructure is a big trend for us and we’re investing in many places – China, Indonesia, Korea, Pakistan, Egypt, India and all across Africa. We’re investing in companies along those sector lines in all those countries.”

Rory McGregor of Emso said: “We’re involved currently in Argentina local, Nigeria, Uganda, Sri Lanka. Those tend to be where we feel we can add more value to our investors, where we can assess political risk.”

Echoing McGuire’s comments on Kenya, McGregor also felt “there’s lots of value to be had” from frontier markets. However, he also cautioned: “You need to be careful when you

invest in them. You have to go in with eyes wide open in these markets. In many cases, there could be instantaneous capital controls – and you're locked up. Or the capital controls regime can change, liquidity can change, and so on."

One market attracting interest currently from various managers around the table is Greece – which, despite its status as an EU country and Eurozone member, is still regarded by most participants as a bona fide emerging market.

Michael Danechi of Duet highlighted a trio of investment ideas in Greece, which he called "one of the areas which we feel has been neglected because of the problems dragging on for a long time – [it's been] off a lot of people's radar screens."

Although it is in the EU, Greece remains very much an emerging market, Danechi argued, where during its long-running crisis a lot of companies have reshaped their business – one being a stock called Motor Oil. "It has a 17%-18% free cash flow yield, pays a dividend of around 7% or 8% per year, and basically by the end of this year it will be debt-free," he predicted. "We bought our first position at around 9 to 10 Euros a share and now the shares are around 15 and change. So it's had a good run – but it's still very, very reasonable with no debt."

A second company Danechi cited was Furlis – one of few companies with a franchise for IKEA, in its case in the Balkans, including Greece, though it is also involved in Romania and Bulgaria. "It was paying 9% or 10% on loans, but issued a bond four or five months ago at 5% - so basically the balance sheet went from net debt to EBITDA of around 6-7 times at the top to now around three. So now it's becoming investable."

"The balance sheet is now fixed, so now whether the company's business is fixed or not, you look at the way they've improved, the margins are very strong," Danechi continued. "What excites us most is that in Greece the expenditure on furniture is down 70% and there is still a lot of tourism – so a lot of pent-up demand, a lot of furniture which needs replacing. And the management is very good. So we're very excited about the prospects."

A third area that Danechi highlighted was the Greek banks – which he said were currently trading at only about 0.25 times book value: "They've been cleaned up three times," he argued. "So you know if GDP stops falling and NPLs stop growing, which there are good signs of, they could triple easily."

Greece was also a market of interest to both Spinnaker and Emso – including, for the latter, the banking sector as well as the sovereign debt.

"We also have positions in Greece," said Rory McGregor of Emso. "We've been involved in Greece since 2012, mostly in its sovereign



Christina McGuire

and quasi sovereign space. Currently we like the banks in Greece, but there weren't enough bonds available – so we actually bought the equity instead. We came from a different perspective for a similar opportunity."

"Greece has been the most profitable trade in the history of our firm since 1999," added Christian Kopf of Spinnaker. "We've been buying Greece since a price of 15 cents [on the euro] for the bonds in February 2012 and we've already gone all the way from 15 to 73, and that's fixed income – so you also get a coupon on top of it."

Markets that Spinnaker is currently more bearish on include Turkey, he said. "On the short side, we're short the Turkish lira, a country which has a sizeable current account deficit, and zero real interest rates: 11% inflation, 11% interest rates," argued Kopf.

A market Spinnaker had also become more neutral on at the time of the roundtable was South Africa. "On South Africa, we're actually flat right now," said Kopf. "I was going to meet with Pravin Gordhan in London and the meeting got cancelled. At 4:30 am, a good investment bank political analyst circulated a memo speculating that Gordhan might be dismissed in a cabinet reshuffle. Between 5am and 6.30am London time we exited our entire position – trading via Tokyo and Singapore, and even before Jo'burg came in we were out."

That said, Kopf felt the episode emphasised how much some EM markets had evolved: "That tells you that a lot has happened in terms of liquidity in emerging markets – you can trade decent chunks. Even before the local traders come in."

Another market popular with more than one participant was Russia – where opportunities had attracted attention both from Spinnaker from a macro perspective and from Man GLG from an individual stock perspective.

"In the macro space what you want to own this year is actually quite simple: you want to



"After every election, regardless of whether it was tumultuous or peaceful, the market has always bounced back very strongly"

Christina McGuire

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“The banks have been cleaned up three times – so you know if GDP stops falling and NPLs stop growing, they could triple easily”

Michel Danechi



Michel Danechi

own the currencies of commodity exporting countries that are running a sustainable balance of payment position,” said Christian Kopf of Spinnaker.

“Our favourite this year is Russia. Russia had an exchange rate of 30 to the dollar back in 2014, and now we’re at 60. Back in 2014 there was an oil price of \$100 and Russia had a current account surplus of 2% of GDP. Today we have an oil price of \$50, so you would have expected the current account surplus to decline – but instead it has actually doubled from 2% to 4% of GDP. That gives you an idea of the magnitude of the adjustment of external accounts in Russia.”

Kopf continued: “There has been a lot of import substitution, and now they’re in a very, very good position where the corporates paid down a lot of the dollar debt, they’ve got a balance of payment surplus, even at current oil prices, and they’re running very tight fiscal policy and very tight monetary policy. They have a 9.75% policy rate when inflation has fallen to 4%. That gives you a huge real interest rate compared to anywhere else in the world. So we’re now long the currency.”

“When the Ruble went from 30 to 60, that was actually one of the most successful trades in the history of our macro investments,” Kopf added. “But now I think things have changed. The currency has adjusted big time, so now I think it’s time to play from the other side and I would play long the Russian Ruble here.”

“The last three years have been rich for contrarian country opportunities,” agreed Ed Cole of Man GLG. “You had Russia’s invasion of Ukraine – when I began to hear my peer group talking about countries being ‘uninvestable’ for the first time in about 15 years. So Russia became ‘uninvestable’, which was a gift because you got the opportunity to

buy some great companies exceedingly cheap. One of our biggest wins in that respect was the Moscow Exchange, MOEX, which was trading on sub ten times earnings with probably a 15% free cash flow. We’ve reduced that position now, though we believe it is a high quality company in an underpenetrated sector that we hope to own for many years.”

“Then you got the gift of Brazil – where you just knew that when your peer group starts to tell you it’s uninvestable, things get interesting, and Brazil certainly moved into that sort of state in Q4 2015 and early 2016,” Cole continued. “Again, we had the opportunity to buy high quality companies trading at very distressed levels, like BM&F Bovespa, the stock exchange operator, which had about 45% of its market cap in cash and securities”.

“We then got the opportunity in Q4 2016 to buy Mexico, again when it became ‘uninvestable’.” That one is still playing out.

Also in LatAm, McGregor highlighted Argentina as a major area of interest recently for Emso: “When we realised that the old dollar/sovereign trade was over in Argentina – that would have been the end of 2015 – we put a lot of effort into setting up local accounts in Argentina to get local clearing, because we realised that they were wary of hot money and would try to control the flow of external money entering the local market.”

It had taken a major effort to be able to make investments there, McGregor emphasised: “It took us five months and that meant calls, time (probably a month of our lawyer’s time) and we actually had to send guys, our operations people, our lawyer and our PMs down to Argentina to make it happen. It was a lot of effort, but we reaped the rewards of that because we were, we believe, one of the first funds in the investment.”

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“The currency has adjusted big time, so now I think it’s time to play from the other side and I would be long from here”

Christian Kopf

Chapter 3

OPERATIONAL ISSUES – OVERCOMING THE CHALLENGES

SUMMARY POINTS

- Coping with market structure issues, regulations and capital controls
- Counterparties of various types – local and global
- Leverage, liquidity, risk management and governance

Emerging markets may be rich in opportunities, but they are not without challenges – and dangers – for investors. Over time, as highlighted already early in the discussion, they have been repeatedly prone to rapid changes in market conditions, notably a sudden crisis and collapse in market liquidity, and/or the imposition of or sudden change in capital controls.

Margaret Harwood-Jones of Standard Chartered emphasised: “There is a lot of excitement in emerging markets, but the devil is in the detail – you can’t just make a sort of ‘one-size-fits-all’ judgement when you’re looking at EM.”

“Just reflect for a moment on what happened in the FX market in Malaysia at the end of last year,” she noted. “There was nervousness around speculation. So suddenly at a moment’s notice the imposition of far higher reporting requirements – and the whole market just freezing and stopping.”

There are many and varied operational challenges to overcome in emerging markets

for investors seeking to invest successfully – to do with regulations, market structure, counterparties and governance, to name a few.

“There may be great opportunity in China and India,” pointed out Harwood-Jones. “But the work needed behind the scenes to make sure that the investment process can happen efficiently and in a safe and controlled way is something not visible to the PMs front of house. It’s much more visible to the guys running operations back of house.”

Harwood-Jones said Standard Chartered has been trying to work more closely with asset managers when engaging with exchanges and regulators in EMs. “The most successful environment and configuration to work with is where you’ve got client, regulator and service provider all in the room together,” she said. “You need to be able to bring into the room the understanding of what large institutional investors are looking for, which is not always understood country by country.”

Happily, that does seem to be happening more frequently as time has gone on, she



“We don’t use a lot of leverage. Emerging markets is exciting enough”

Rory McGregor



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“We tend to have a global guy, but also a local guy who knows the local settlement process”

Michel Danechi

added. “We’ve seen an ever increasing trend of the client wanting to be very active. Historically, we operated in an environment where very often the asset manager would say: ‘I’ll leave that to my custodian bank and my custodian bank can make whatever arrangements are necessary in the individual countries to support the investment process.’ That has changed.”

As an operations manager at a firm running multiple funds operating in multiple jurisdictions, Matt Low of RWC testified to the complexity of the challenge. “One of the biggest challenges I see for EM managers is tax, even more than regulatory requirements. Local tax authorities in many countries can suddenly spin out a new requirement for capital gains, for instance. You need a constant tax screen to identify that.”

“In some markets, such as Nigeria and Egypt, we have experienced restrictions repatriating currency, which is obviously a problem for managers to stay fully invested,” Low continued. “And the repatriation process can be variable by counterparty. You’ll find one counterparty is higher up the queue and gets an early repatriation, while another one is down the queue, and it’s very opaque. This can be frustrating, with some counterparties having greater influence to get the money out.”

Rory McGregor of Emso highlighted how the potential for episodes like that underscored the need for a highly disciplined approach to risk management in EMs. “We try and manage the risk – as there’s always some probability of a country placing capital controls. It is EM after all, it’s always going to surprise us with something.”

“So we ask: ‘Okay, how much could we lose if we were surprised by an event like this?’ And we calibrate the size of the position so that the potential loss is within our risk parameters. We understand it means we leave money on the table when investments do well. But this approach has allowed us to survive and prosper for 17 years.”

Echoing some of the equity managers participating, including Christina McGuire and Ed Cole – who both said they use no leverage at all – McGregor also said Emso took a very cautious approach in that respect as well. “We don’t use a lot of leverage,” he said. “Emerging markets is exciting enough.”

“Then there is liquidity – for which you need to have a choice of counterparties,” McGregor added. “We want to make sure that we always have the option to buy or sell with many counterparties. We need to have the liquidity to be able to get out of positions.”

Having the appropriate number and configuration of counterparties – in order, for instance, to try and achieve best execution – was the subject of considerable debate around the table.

From the perspective of a key service provider in emerging markets – even a very major specialist one like Standard Chartered – Margaret Harwood-Jones indicated that she could well understand why asset manager clients often needed multiple relationships in place: “We see sometimes how quickly circumstances change in a country – and whatever the change is, it’s really helpful if you’re dealing with somebody locally that can get on the phone and talk to you, explain

what's happening. It is an awful lot easier than if, say, an Africa fund manager based here in London is interfacing through a global custodian in Boston or New York or wherever their service centre is."

"It's immensely difficult to have that level of understanding, country by country, everywhere," Harwood-Jones emphasised. "So if there's an issue in Ghana you need to speak to my team in Ghana. If there's something going on in Malaysia you've got to speak to the front office in Malaysia – just as proved necessary in the recent FX crisis we talked about."

"With some global custodians, their credit and risk departments will not sign off a country like Nigeria, for example," she added. "So what do you do if you are a manager using a global custodian and that's a particular market that you want to access? Trying to find a 'bolt-on' type solution is sometimes becoming a little bit more necessary."

Hence, although many managers may like the idea of simplifying their operations by consolidating as much as possible through one provider, that may not always be the right solution. "It's an interesting dilemma for many asset managers who want a single global operating model for all funds and investments. How much do you have to let go of that ideal and adapt your operating model for those local market nuances?"

Standard Chartered was trying to respond, Harwood-Jones stressed: "We are trying to make it easier and give the client the best of all worlds. We'll try and do things in a fairly standardised way and minimise the effort it takes country by country."

From the perspective of a macro manager active in many markets, Christian Kopf of Spinnaker argued: "I think it's important that you have a diversity of counterparties. We have around 50 relationships and 15 ISDAs [master agreements with swap dealers], but we use most of them mainly as a fallback. We work a lot with the prime brokers."

Emso has an even greater number – some 35 ISDAs plus a further 60 counterparties – but tends to have an active relationship with more of them, notably for access into all sorts of local markets where it needs local broker/dealers.

As McGregor explained, trying to rely solely or primarily on prime brokers can be tricky for a more fixed income-based fund: "As fixed income investors, we don't actually add a lot of value to prime brokerage businesses, and so when I have a meeting with my PB, I'm sure to get asked: 'What have you done for me lately?' If we were a \$3.3 billion equity fund, I wouldn't be having those conversations with my PB."

On the equity side, by contrast, Matt Low said RWC's Cayman funds had up to eight

counterparties – because they want a good selection of PBs, custodians and specialist custodians, including Standard Chartered to access countries like Bangladesh. "It causes a lot of operational complexity, which I guess some institutional investors might not be quite so keen on. However, it fits well into a firm used to dealing with multiple PBs and custodians like ourselves."

Low added: "You need to have local trading relationships in many EMs. Reasons include to access IPOs, which can pose significant operational risk – where you're funding cash and then you're getting the stock in four weeks' time. The complexity of every step of the IPO can also be challenging. The process can be really drawn out."

Christina McGuire explained Elephant's approach as follows: "For us it is hugely important, especially in Africa outside of South Africa, to trade with local brokers, because otherwise you just can't put your positions on – or [take them] off, more importantly."

Local knowledge

Michel Danechi of Duet added: "In some countries – like, for example, where our sub-Saharan Africa fund invests – it becomes very important to choose the right partner or custodian who has access in every place [you invest]. What we tend to do is have a global guy but also in every market a local guy who really knows the local settlement process – which a global custodian doesn't necessarily know."

One market which was a particular focus for discussion was India – where foreign investors have historically accessed the market through Participatory Notes, usually referred to as P-Notes, but where the local regulator SEBI has been encouraging investors to go direct into physical cash equities onshore.

"Recently, counterparties [in India] have been creating very different types of wrappers and different propositions rather than a level of consistency appearing," claimed Low. "We have five PB providers in that market and have completed a quite detailed compare and contrast because each different wrapper is being very differently financed and funded."

For many managers, the best route to take is often about costs even more than minimising complexity. "We're a small fund so for us it's really all about costs," said Christina McGuire of Elephant, for instance. "So we do trade Indonesia and Thailand on swaps just because it is easier for us and it's cheaper. [In] the other countries, including in India, everything else is really in cash."

Another reason to go into cash equities onshore, mentioned by Ed Cole of Man GLG, can be because some investors prefer or expect



"There is a lot of excitement in emerging markets, but the devil is in the detail"

Margaret Harwood-Jones



"There are still some companies you need to avoid, until there is evidence of meaningful alignment"

Ed Cole

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“There may be a lot of operational complexity, but you need to have local trading relationships in many EMs”

Matt Low



Matt Low

the manager to be an active investor, and exercise the voting rights on shareholdings. “If you’re a long term equity investor you will have clients and prospective clients that want to see from a sort of ESG perspective that you can show some commitment to being a long term steward of the capital – which requires voting rights, or at least being able to demonstrate proxy voting.”

Christian Kopf of Spinnaker, however, took a different line on this aspect of the discussion –arguing it was more efficient where possible for him to trade in derivatives rather than cash instruments. “We would like to have our entire market exposure in derivative format, so FX via forwards and options; interest rate risk via IRS and futures; and credit risk via CDS. Only when we find incomplete markets will we resort to cash instruments. For example, Indonesia we do with cash instruments. But Mexico we play entirely via swaps and forwards; Brazil we do in futures; South Africa we do IRS and so forth. To the extent possible we articulate our trades in derivative form.”

Whatever the types of instrument traded, or number or types of counterparties, there is also pressure on all managers to demonstrate to investors that they are seeking to achieve best price execution for their trades.

“[Achieving] best execution is a big factor,” said McGregor. “That’s one reason why our view has always been to try and go local as quickly as possible. For ‘best ex’ that means we have to be able to work with some of the ‘local local’ guys, not just the big guys like Standard Chartered operating locally. You get good market reports from them but also good liquidity, and for us that’s valuable because liquidity is everything.”

“What we tell our investors and our regulators is that we try to get [best execution] wherever possible,” McGregor added. “I know it’s a major topic of conversation between compliance officers when they meet,

particularly when it concerns fixed income markets. What is difficult in fixed income markets is proving that you have achieved best execution. It’s something that you have to keep in mind and what your investors expect.”

While issues with market structure and regulations continue to pose operational challenges, arguably the most fundamental operational challenge in emerging markets – deterring many investors over the years – has been to do with perceived shortcomings in accounting, disclosure and corporate governance standards.

For Standard Chartered, Harwood-Jones noted how various markets had been working to improve matters in these respects, such as India – with its current big focus on direct investment in the market, increasing KYC (know your customer) requirements, and changes around tax considerations; Kenya, which has been working to shorten the settlement cycle; and China, where the stock exchanges have worked to accommodate the requirements of UCITS funds domiciled in Dublin and Luxembourg.

Nevertheless, there are still many places in EMs where there is a perception if not reality that corporate governance standards are weak – or where companies are not run at all with the interests of minority shareholders in mind, especially if they are foreigners.

Companies to avoid

As Ed Cole put it: “There are still some types of companies in EMs that you need to avoid, companies that will not consider minority shareholders, but are effectively arms of the state. Will we invest in them? No, not until we can see evidence of meaningful change in alignment with minorities, such that if the assets are undervalued they can re-rate sustainably.”

On the other hand, participants in the roundtable seemed increasingly confident that things were at least heading in the right direction. As Christina McGuire concluded: “Back in 2004, when I was involved with the Goldman China A shares fund, minority shareholders counted for absolutely nothing. I think that’s changing a bit now, at least in a sub-segment of companies, and I’m sure that trend will continue.”

To conclude, Ed Cole added: “2003 through 2008 was a sort of ‘golden moment’ and I guess when we think about our bullishness today it’s a very different level of bullishness to what we saw back then. Yes, we are bullish on EM today, but not because there is some enormous tailwind that’s going to lift all boats. I think it’s a bull market now, but with lots of volatility and probably a bull market in stock-picking above everything else.”

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Christina McGuire

Emerging markets: Seizing the opportunities

