

## Emerging markets web chat transcript

On Thursday 22 April 2010, we hosted a live web chat with investment experts Sheridan Admans, investment adviser at The Share Centre, and Peter Eerdmans, fund manager of the Investec Emerging Markets Debt fund, to discuss how you could benefit from investing in emerging markets.

Thank you to everyone who joined in and asked questions. Here are the responses.

### Q: What is emerging market debt?

**Sheridan:** Debt in this instance is regarded as bonds issued by governments or corporations. In the case of the Investec Emerging Markets Debt fund, it invests primarily through investment in public sector, sovereign and corporate bonds issued by emerging market borrowers.

**Peter:** A key distinction to make is that between bonds issued in dollars, and bonds issued in the currency of the emerging country, so South Africa issuing in Rand, Mexico issuing in peso. At Investec we very much focus on this so called local currency, emerging market debt.

**Sheridan:** Bonds (debt) are essentially IOU's from an incorporated company or government to an individual or corporation who has lent them money. In return for the loan, the investor will receive an amount of interest (known as a coupon payment) from the company for the period of the loan's life. If held until the end of the loan's term, the amount should be repaid in full.

### Q: Why should I invest in emerging markets?

**Sheridan:** What makes an emerging market investment attractive is the broad access to investments in Asia, Eastern Europe and Latin America. These are three major regions of the world that have either growing populations, an abundance of raw materials, developing financial markets and strengthened internal consumer demand for discretionary items.

On the flip side, emerging markets, have a greater risk than investing in the UK due to exposure to currency fluctuations, political risk, availability of information and accounting standards to name a few.

**Peter:** The key attraction of investing in local emerging market debt is that you get returns from two different sources, bond yields and currency appreciation. As emerging markets converge towards developed markets over time, you expect both to contribute positively. The advantage of debt is that you get access to the emerging markets story but with much less volatility than equities.

### Q: When is an emerging market no longer classed as 'emerging' and how is that decision made (and by whom)?

**Peter:** There is no one definition that everyone agrees upon; different index providers do different things. But one quite widely acknowledged methodology is that of the World Bank, where all countries that have GDP per capita below a certain threshold are classified as emerging markets.

**Sheridan:** I agree with Peter. Another popular index amongst retail investors is the MSCI index. And it's interesting to note that this year Israel will be promoted to a 'developed' market based on the MSCI criteria.

### Q: What charges are levied?

**Sheridan:** The Investec Emerging Markets Debt fund has a standard initial charge of 4.5%, an Annual Management Charge (AMC) of 1.5% and a Total Expense Ratio of 1.6%. The Share Centre is currently offering favourable terms of no purchase commission and 0% initial charge until the end of May 2010 at which time a dealing commission will be applied to purchases and sales.

However, most IFAs or brokers may have different terms and it's always best to contact them before placing any purchases.

### Q: With sterling so low why would I want to invest in a local currency?

**Peter:** There are of course, different views on sterling at the moment, particularly depending on the election. But more generally, we find that in the medium to long term over currency, emerging markets will out perform developed markets and developed markets' currencies including sterling. In addition, it is a nice diversifier compared to domestic investments thanks to local correlations and high potential returns.

**Q: Is it safer or better to invest in a broad-based emerging markets fund or a more focused one such as Asia Pacific?**

**Sheridan:** As with all investment, it is down to the risk you can afford to be exposed to, but with regards to whether a broader investment or a specific region investment is better, a manager that has broader focus has more options for seeking value and returns. Whereas a manager focused on a specific region is tied into a mandate which requires investment regardless of evaluations.

**Q: Is the emerging markets bubble about to burst?**

**Peter:** First of all, we would not see it as a bubble at the moment. Yield spreads of local emerging markets debts are still above average compared to developed market debt.

A lot of emerging market currencies are still below the levels they were before the Lehman crisis. So, we think there's still a lot of value in emerging market debt, particularly given the very strong fundamentals. Emerging markets don't have over leveraged governments or banks, and have very positive characteristics in terms of demographics and growth outlook.

**Sheridan:** Historically, emerging markets have tended to show higher degrees of volatility to those of developed markets. And for those investors that are able to accept the risk, we would encourage to drip-feed money in over the long term, and over time, market bubbles and troughs should be averaged out.

**Q: How likely do you think it is that if one high risk emerging market were to fail in the same way as Greece has, then they might all be likely to fall in sympathy?**

**Peter:** Contagion risk has decreased significantly compared to the 90s, emerging markets have become more of an asset class in their own right with more dedicated investors. For instance, last year both Ecuador and the Seychelles defaulted on their debt which had very little, if any, ripple effect.

Of course in periods of global risk aversion markets do move in line, but we do believe that emerging markets are more and more judged on their own merits, rather than that of a few bad apples.

**Q: You say you made 20% per annum over the last four years or so, can you explain how you managed that?**

**Peter:** The key in managing a fund successfully is a disciplined and through process. We always cover a wide range of factors and tend to be sceptical of the market that gets caught up in very specific single themes. We tend to be a bit more value driven and contrarian.

A specific feature of our process is a focus on the probability of a crisis in each country that we cover. We developed a model that helps us with that decision back in 1998. It has been very successful and also highlighted the risk of a significant crisis in 2008. We were able to steer our funds through the volatility.

**Sheridan:** In the interests of full disclosure, I and a colleague co-manage Sharefunds OEIC which has three sub-funds which own Peter's emerging market debt fund after buying into processes he's talked about and skill he has as an asset manager in this asset class. However, investors must remember that past performance isn't a reliable indicator of future performance.

**Q: What proportion of a 35 year old's portfolio should be invested in emerging markets?**

**Peter:** Investors should talk through their specific situation with investment advisers, but this question does raise an interesting point, we believe that emerging markets are an under-owned asset class.

Emerging markets are currently 31% of Global GDP and this is expected to increase to 50% in the next decade or so. We believe most investors hold about 5-10% in emerging markets and most of that is in equities. We expect a significant increase in allocations to emerging market debts by investors in years to come, this will under-pin our asset prices.

**Sheridan:** As always, your attitude towards risk, the time period you are investing the money, and your objectives are key when asset allocating any investment. And not being aware of your personal circumstances it is hard to answer in this instance, we would recommend you seek independent financial advice.

However, if you have got the attitude for the risk and you're willing to take the long term view, then having some exposure to emerging markets should provide you with reasonable diversification.

**Q: I'm an income investor, does the Investec Emerging Markets Debt fund offer any benefits for me?**

**Sheridan:** Yes, as I'm sure you are aware, emerging market investment has been very topical for a number of years. And generally exposure to these markets has been mainly via funds offering potential for growth but with limited income returns, if any.

However, this fund gives you exposure to emerging markets in a lower risk asset class than emerging equities and giving you an income yield of approximately 7%.

As attractive as a yield is, we wouldn't recommend you invest your entire portfolio in this fund. However if you can accept the risk it should be a good diversifier as an income source.

**Q: With the Chinese Yuan expected to continue to appreciate, what are some investments that can be made to capitalize on this appreciation?**

**Peter:** Yes we do expect the Chinese Yuan to appreciate this year. We have positioned our portfolio for this but we haven't built up position in the Yuan itself as the market is already pricing in a large portion of this appreciation.

Instead, we have increased exposure in Malaysia and the Philippines for instance, which we think will benefit from Chinese appreciation but give you better yields. This position has been one of our key drivers of performance this year.

**Q: Which, in your opinion, is the one emerging market to watch over the next five years or so?**

**Peter:** We look at over 40 markets and watch them all closely, it is best to diversify your holdings across a lot of countries. That said Indonesia is a country that might surprise people positively. It has a large population that is rich in resources and has pursued a very strong reform agenda in recent years. We will not be surprised if Indonesia moves to investment grade in the near future.

**Q: Are there any specific regions/emerging markets which have a higher risk factor?**

**Peter:** I think one of the nice things about emerging markets is that you buy into a much diversified asset class. Across the regions and countries you will find frontier and very developed markets. The more commodity exporters, the more commodity importers, which means more countries tied into the China story and countries looking to converge with Europe.

Overall, this gives you a relatively low risk. At the moment the risks seem highest in Eastern Europe, a spill over effect from Greece plays a part. Asia and Latin America are in a healthy position. In Africa the risks are a bit higher, and our process takes this into account.

**Q: I read in the press that emerging market debt has been seeing strong investment flows. Could you explain to me what this means?**

**Peter:** I think the reason for the strong flows has been concerns over the strength of developed economies and the amount of liquidity being pumped into the markets. What I think this has highlighted is a shift in investors' attitude and highlighted that returns above U.S. government yields can be achieved from economies that still have investment grade ratings.

**Q: Could you please comment on the risk of EM debt reaching triple digits as a % of GDP now that developed nations are nearing the same mark in 1 or 2 years.**

**Peter:** It is of course a fascinating situation where at the moment government debt to GDP in the emerging markets is only 40% versus over 100% in developed markets.

Emerging markets have been very prudent running primary services in the good years which allow them to now stimulate our economies without blowing up the budget. We think it's hugely unlikely that this situation would change in the next few years. What helps, is their high growth rates, so even if debts increase, GDP increases even faster.

**Sheridan:** What we now see in developed markets, particularly in Greece, is a good reason in itself to diversify your investments away from developed markets into emerging markets, where the situation is a lot healthier.

**Q: What advantage do funds have (if any) over ETFs in gaining exposure to emerging markets?**

**Sheridan:** Firstly, I am presently not aware of any ETFs in the UK market that are exposed to emerging market debt. However, there are a number available that track emerging market equity indices. The main advantage of a fund versus an ETF is that active management style employed tends to deliver superior returns over the benchmark.

**Peter:** I think that's important. While in the long run you expect positive returns, there will be crisis periods. An active manager with a thorough process can mitigate or avoid the negative returns in such periods.

**Q: Emerging markets may have great growth potential, at significant risk to capital! Are they available within the ISA wrapper?**

**Sheridan:** One of the attractions of the Investec Emerging Markets Debt fund is it gives exposure to emerging markets but at historically lower risk than an equity fund.

In fact, according to JP Morgan Asset Management from December 31 1993 to March 2010, local emerging market debt returned 11.1% per annum to investors, with volatility (risk) of only 9.4%. By comparison, global emerging market equities returned 6.4% with volatility of 24.7%. This fund can be held within an ISA.

**Peter:** What people don't always realise is that emerging markets with highly local bond markets are quite highly rated. The average rating of the universe is A-/BBB+. This is an investment grade rating which stands out versus the BB+ rating for dollar emerging market debt.

The reason behind this is that if you want to maintain proper local bond markets, you need to be quite advanced with a strong banking, pension and insurance industry. So, typically the more developed of the emerging markets are the big players in this universe, but you can still get a very good yield at around 7%.

**Q: I am looking to invest some of the new extended ISA allowance in emerging markets. I am putting £5,100 in cash, how much of my remaining allowance do you think I should invest in emerging markets?**

**Sheridan:** This very much depends on the level of risk you are comfortable exposing yourself to and your investment objectives. We regard emerging market equity investments as high risk and emerging market debt investment at the higher end of risk in a low risk category, so it depends on whether you are investing in debt or equity funds.

We would recommend when considering what proportion of your investment is exposed to emerging markets, or any other regions of the world for that matter, that you seek independent financial advice. This is so a portfolio of investments can be specifically built to meet your objectives.

**Q: What is the minimum investment and what sort of returns can be expected please?**

**Sheridan:** Minimum standard terms for entry into the fund are £1,000. However, often brokers and IFAs are able to offer to aggregate terms at potentially lower levels. You should contact your broker or adviser for clarification.

**Peter:** The Investec fund had generated over 20% per annum since its inception in 2006. Based on our current outlook, a more prudent assumption, going forward would be for low double digit returns. We start with a 7% yield, and would expect some appreciation from currencies and indeed bonds to get closer to 10%, plus then you would expect a good manager to generate outperformance over the index return.

**~ web chat ends ~**

**Sheridan:** Thank you very much for taking the time to challenge us with your questions today, I do hope it's been informative and educational.

**Peter:** Yes, a big thanks from me as well. I have enjoyed your questions and I wish you good luck with your investment decisions.

**Don't forget, investments, their value and the income they provide can go down as well as up and you might not get back what you originally invested.**