

Vontobel

# Fortune favors the bold

Active investors start to seize the opportunity in emerging markets



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## Editorial

Low or negative interest rates will stay, the search for income continues. Hence no surprise that the topic of emerging markets has continued to be a central point in the many discussions we have with clients around the globe.

One question keeps re-appearing: Why do many investors only allocate a tiny proportion of their portfolios to emerging markets, despite the possibility that these may provide higher returns over the medium term? And myriad statistics showing that emerging markets are overtaking so-called developed markets in many areas? At least from our own experience of nearly 30 years of EM investing, we have a positive attitude towards this asset class.

So will EM investing finally become mainstream? Would investors increase their allocations to emerging markets? We commissioned a survey of 300 institutional investors and discretionary wealth managers across 18 countries to find out. We were encouraged to learn that investors plan to increase their emerging market exposures, both in equity and fixed income. A driving factor was the desire for new sources of returns, as well as their assessment that it is possible to achieve excess returns in those markets. However, the data suggests that the perception of risk around EM investments is still a significant barrier to realize a strong increase in allocation. Not surprisingly, the impact of Covid-19 virus tops the list of risks, but issues such as trade tension and economic nationalism follow closely. As a result, investors indicated they prefer an active approach, citing the need to avoid a strong country bias in indices (notably to China) as well as the high volatility of returns. They also look for strategies incorporating ESG considerations, viewing this as an important risk reduction tool.

Will fortune favor the bold? We certainly think so.

A handwritten signature in black ink, appearing to read 'Schwarzer', written in a cursive style.

**Axel Schwarzer**

Head of Vontobel Asset Management



# Introduction

Emerging markets collectively provide the engine of growth for the global economy. The world's seven largest developing economies were half the size of the G7 developed economies in 1995, matched them by 2015 and are expected to be double their size by 2040.<sup>1</sup> And while the stock market capitalization of businesses in emerging markets currently accounts for only 12% of total world capitalization,<sup>2</sup> this is set to increase: the value of quoted emerging markets companies has already grown tenfold over the past 30 years to more than USD 5 trillion.<sup>3</sup>

Yet institutional investors and discretionary wealth managers have not always been bold about taking advantage of the opportunities offered by emerging markets. In many cases, their allocations to emerging market assets have stalled in single figures as a percentage of their portfolios – below the levels that would materially capture the enhanced returns available and provide diversification benefits. The reasons for this range from the natural home bias of investors to concerns about elevated risk.

This is now set to change. Our research suggests that investors plan to significantly increase their exposure to emerging markets over the next five years, in both fixed income assets and equities. Even in the coming year, amid the fallout from Covid-19, many investors plan increases.

There are good reasons for this. There has long been a consensus that emerging markets may offer more growth than developed markets in the years ahead, powered by structural drivers such as rapidly increasing productivity, the shift from mass production and commodities to higher-value economic activity, and demographic factors such as an expanding middle class. But now the Covid-19 pandemic threatens to prolong the era of low-to-negative interest rates across developed economies. Even before the crisis, Vontobel research shows investors were widening their search for higher returns.<sup>4</sup>

Nevertheless, our latest research, surveying 300 institutional investors and discretionary wealth managers globally, highlights the complexity that comes with growing emerging market allocations. Many investors worry about volatility, macroeconomic challenges and transparency, and now the pandemic has increased risk aversion across the board.

In this study, we investigate how investors can manage those fears to seek the additional returns that emerging markets could give them. Find out why fortune will favor the bold.

<sup>1</sup> Organisation for Economic Co-operation and Development

<sup>2</sup> MSCI, April 2019

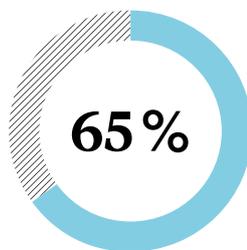
<sup>3</sup> MSCI, as at June 2020

<sup>4</sup> Vontobel Asset Management

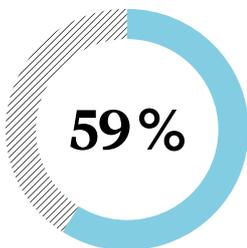
# In emerging markets, fortune favors the bold



## 2/3 of investors are planning to increase exposure in emerging markets



of 300 respondents plan to raise their emerging market equity exposures over the next five years



plan to raise their emerging market fixed income exposures over the next five years

## Why?

### Investors are seeking:

#### Better returns

**38%**

of investors planning to raise emerging markets exposure are looking for enhanced returns

#### More diversification

**35%**

of investors planning to raise emerging markets exposure are looking to diversify and spread the risk

#### And in fixed income,

the Covid-19 crisis is leaving investors with little choice



**“Investors have to increase their allocations, because central banks in all the developed markets are cutting their interest rates again – rates will now be lower for longer. Emerging markets are a very big opportunity for us to get the returns that we are looking for.”**

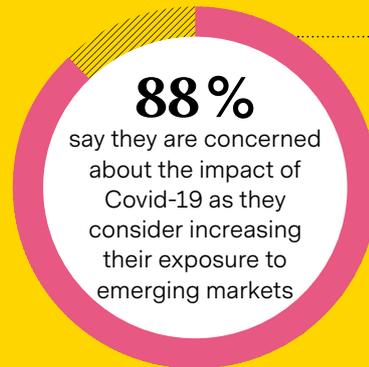
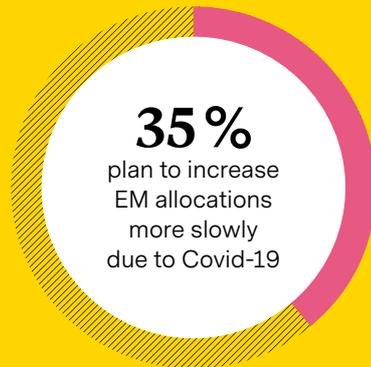
**Guillermo Uriol Sanz**

Fixed Income Portfolio Manager, Ibercaja Gestión

## Investors still evaluating Covid-19 impact

They worry about risk

And they're ill-prepared to take it on



## Succeeding in emerging markets: Managing risk with the right tools

**60%**  
say they have defined a mostly small risk budget for investment in emerging markets



They can manage the risk, using:



**Tools and strategies**



**Active management**



**Specialist support**

**“Downturns show how valuable active managers are to investors – picking good managers can save clients so much money.”**



**Carly Moorhouse**

Fund Research Analyst,  
Quilter Cheviot Investment Management



**51%**

say that specialist investment consultants and investment intermediaries can add significant value

## ESG can help investors decide where to invest

Among investors with time horizons of 10 years or more,



say that ESG factors influence the decisions they make about emerging market asset allocation and stock selection to a great extent

Part 1

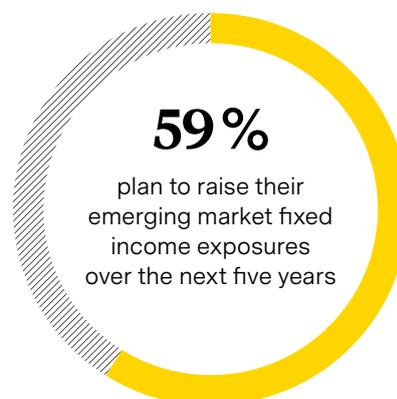
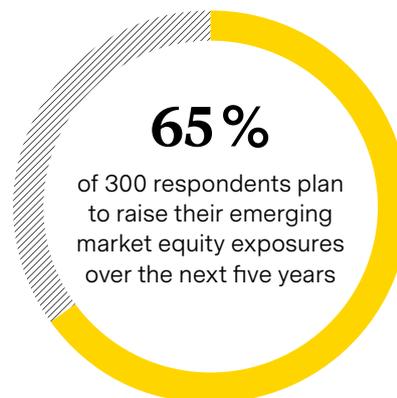
# The search for alpha



Investors expect to increase their emerging market exposures, both in equity and fixed income. A minority intend to move to higher allocations over the next 12 months, but the bigger shift will take place over the longer term: in both equities and fixed income, more than half of respondents expect to increase allocations over the next five years.

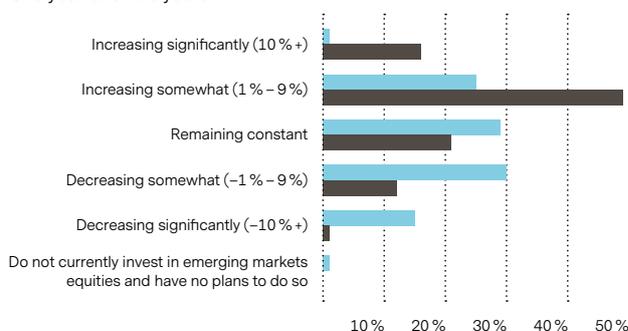
North American and European investors are more likely to plan for higher exposures than their counterparts in Asia-Pacific (APAC). For example, 29% of North American investors are planning higher emerging market equity allocations over the next 12 months, compared with 20% of those in APAC. And over five years, 67% of European investors plan higher allocations to emerging market equities, compared with 57% in Asia.

This may reflect the fact that APAC investors already have higher allocations to emerging markets as a result of their natural tendency to invest in their own region: in our research, investors based in APAC are already more likely to hold higher weightings to emerging markets.

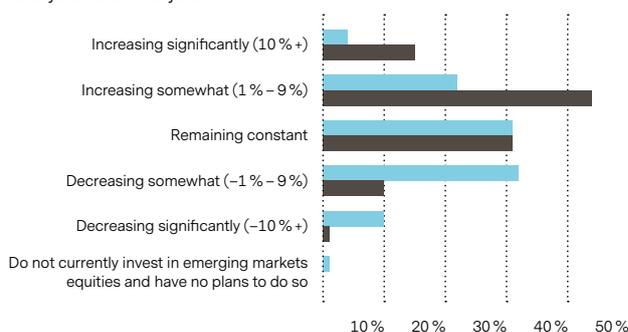


**Chart 1: How investors will increase their emerging market allocations**

“Thinking about your equity holdings, how do you envisage your current allocation to emerging markets changing over the next one year and five years?”



“Turning to your fixed income holdings, how do you envisage your current allocation to emerging markets changing over the next one year and five years?”



■ Next 12 months  
■ Next 5 years

**Enhanced returns**

That is not the only driver, of course: for many investors, the desire for new sources of return is the primary reason for their shift toward emerging markets. This may be more pressing for investors in Europe and North America, where central bank interest rates, which were already at near-historic lows, have been cut or pushed into negative territory in response to the Covid-19 pandemic.

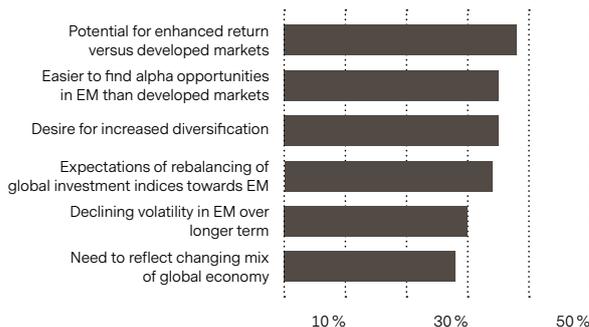
Nearly four in ten investors who plan to increase emerging market exposure (38%) say that one of their top two reasons is the potential of enhanced returns compared with developed markets. And 35% say they believe it is easier to secure alpha in emerging markets.

Roger Merz, Vontobel’s Head of mtX Portfolio Management, says that emerging markets may offer a wide range of yet-to-be discovered opportunities. “Dynamic growth rates in emerging markets have produced many profitable businesses,” he says. “However, market participants are often slow to fully acknowledge high returns on invested capital, which we consider an important share price driver. This failure on the part of the market creates opportunities for stock pickers.”

In fixed income, meanwhile, investors simply have no choice but to look further afield for return opportunities, according to Luc D’hooge, Vontobel’s Head of Emerging Markets Bonds. “For some time, we have had low yields in developed world markets such as the Swiss franc and the euro, but even in the US there’s now not much yield left,” he says. “That will push investors toward emerging markets.”

**Chart 2: Drivers of increased emerging market allocations**

“You said that you intend to increase portfolio exposure to emerging markets. Please rank the following factors potentially driving this increase in order of importance.”



**“The big tectonic changes are actually quite rare. The point with emerging markets is to look for the steady improvement. If you don’t, you’ll miss the opportunity.”**

**Matthew Benkendorf**  
Chief Investment Officer,  
Vontobel’s Quality Growth Boutique

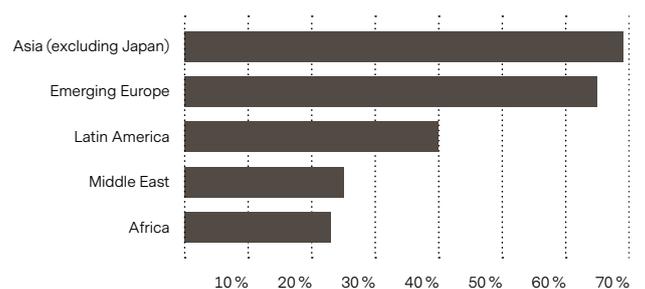
Initially, investors will favor the better-known and larger markets of Asia, which accounts for about 70% of emerging market equity indices. But many investors are also looking at opportunities elsewhere – about two-thirds, for example, expect to increase their allocations to emerging Europe.

For now, only 40% of investors are focused on Latin America – and even fewer on the Middle East and Africa – but that may change over time as those markets mature and grow in their own right.

Matthew Benkendorf, Chief Investment Officer of Vontobel’s Quality Growth Boutique, predicts a consistent shift over time. “The big tectonic changes are actually quite rare,” he says. “The point with emerging markets is to look for the steady improvement. If you don’t, you’ll miss the opportunity.”

**Chart 3: Where investors are looking in their search for returns**

“You said that you intend to increase portfolio exposure to emerging markets. In each of the following emerging market regions, please detail your intentions.”



**Structural and tactical opportunities**

Investing in emerging markets may give investors the chance to benefit from both long-term, powerful structural drivers and more tactical or sectoral opportunities.

Structural reasons to invest in emerging markets include rapid growth in many of the middle-class population and their purchasing power, fast-improving productivity, and the scope for innovation and technology to supercharge growth. By 2030, the global middle class is expected to reach 5.3 billion people – two billion more than today. Two-thirds of the middle class will be accounted for by China and India alone.<sup>5</sup>

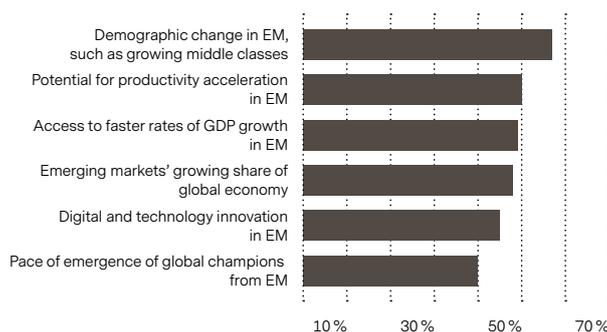
As for tactical drivers, it is striking that in this survey, investors see particular opportunities in areas such as technology, healthcare and consumer goods. The purchasing power of the middle classes is already shifting economies such as China away from dependence on manufacturing and toward higher-value services and consumption. Research from S&P<sup>6</sup> suggests that these new sectors are outperforming other areas of the market, which is one reason why an active approach makes so much sense in emerging equities (see part 3).

The bottom line, says Peter Laity, Portfolio Manager, Equities and ESG integration at IOOF-OnePath, is that across the board, emerging market equities now may offer a return profile that investors will struggle to match anywhere else. “We think that global emerging markets look very attractive – not only relative to their own history, but also relative to developed market equities, whilst noting the risks that Latin America is facing from Covid-19,” he says.

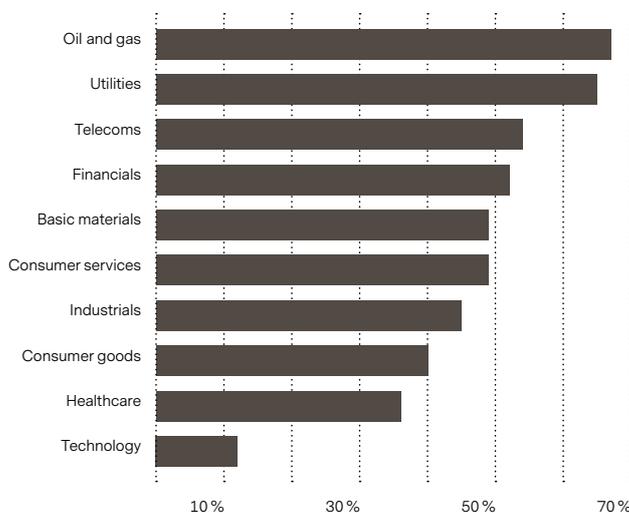
Laity points out that while emerging markets outperformed significantly over the decade leading up to the global financial crisis, increased risk aversion and lack of growth (outside a couple of sectors) over the past 10 years has dampened demand and held returns back. “Emerging markets went from a premium valuation to a discounted valuation,” he says. As the search for new sources of return intensifies, that trend may now be set to reverse.

**Chart 4: In equities, emerging markets are attractive for a range of reasons**

“Which opportunities appeal to you most as you consider increasing exposure to emerging markets?”



“Thinking about emerging markets from a sectoral perspective, which of the following groups of sectors represent the greatest potential for higher investment returns over the next three to five years?”



<sup>5</sup> European Commission, February 2020.

<sup>6</sup> S&P Global, January 2020

**Opportunities for fixed income**

It is a similar story in fixed income. Guillermo Uriol Sanz, Fixed Income Portfolio Manager at Ibercaja Gestión, says the monetary policy response of developed markets’ central banks to the Covid-19 crisis simply leaves investors with no choice.

“Investors have to increase their allocations, because central banks in all the developed markets are cutting their interest rates again – rates will now be lower for longer,” he says. “Emerging markets are a very big opportunity for us to get the returns that we are looking for.”

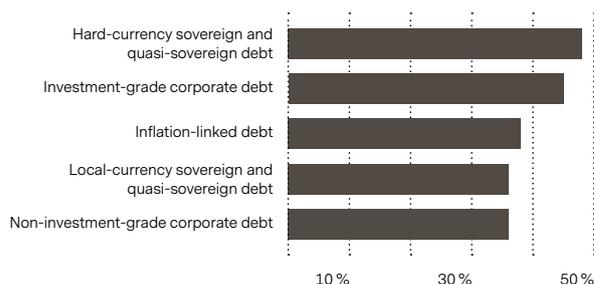
As with equities, fixed income investors making the move into emerging markets are likely to start out more conservatively – particularly given the added complexity of currency risk. Almost half of investors in this research see hard-currency sovereign and quasi-sovereign debt as an area of interest – compared with only a third who are focusing on non-investment grade corporate debt, for example. Nevertheless, there is appetite for increased exposures across a range of opportunities.

Respondents’ focus on inflation-linked debt – a small but growing sub-sector of emerging market fixed income – is also noteworthy. Emerging markets are often associated with higher inflation risk, so a focus on real yields makes sense. And for investors with inflation-linked liabilities, the opportunity to buy protection against inflation at a global level may be compelling.

“You can certainly see scenarios where all this fiscal and monetary stimulus, all happening at the same time in unprecedented amounts, leads to strong growth and inflation in some parts of the economy,” says Andrew Cormie, Head of the Global Emerging Markets team at Eastspring Investments, the asset management arm of Prudential.

**Chart 5: Investors look into a wide range of fixed-income opportunities**

“In each of the following areas of the market, please detail your intentions.”



**“Investors have to increase their allocations, because central banks in all the developed markets are cutting their interest rates again – rates will now be lower for longer. Emerging markets are a very big opportunity for us to get the returns that we are looking for.”**

**Guillermo Uriol Sanz**  
Fixed Income Portfolio Manager  
at Ibercaja Gestión

**Covid-19 adds to risk aversion**

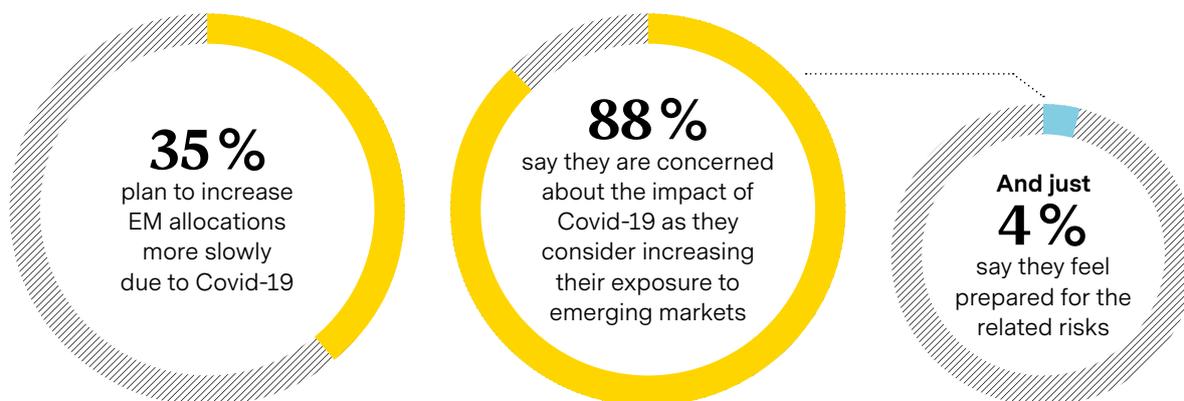
Investors are excited by the prospects for emerging markets, but they are also anxious. They have longstanding concerns that the price of higher returns will be increased volatility. And their broader concerns about the risks of these markets have been exacerbated by the impact of the Covid-19 pandemic.

For many investors, the virus has prompted a rethink of their short-term plans for emerging market allocations. Some 31% expect to reduce their emerging market allocations over the next 12 months as a result of the pandemic. And a further 35% say they will now increase their allocations more slowly than they had previously planned.

**Chart 6: Covid-19 could delay higher allocations to emerging markets**

“In each of the following areas of the market, please detail your intentions.”





It is important to separate investors' existing anxieties about risk in emerging markets from the risk aversion they may be suffering specifically in the context of the pandemic.

"Many investors think top-down factors such as GDP growth are the ultimate driver of stock returns in emerging markets," says Vontobel's Roger Merz. "This is largely not true in our view. Globalization and the digitalization of business models have led to a change. Company-specific factors such as profitability are today way more important for the success of an investment strategy."

There are perceptions that emerging markets are more volatile – particularly in aggregate. For those looking at markets as a whole – through a passive investment lens, for example – this is problematic, but investors focused

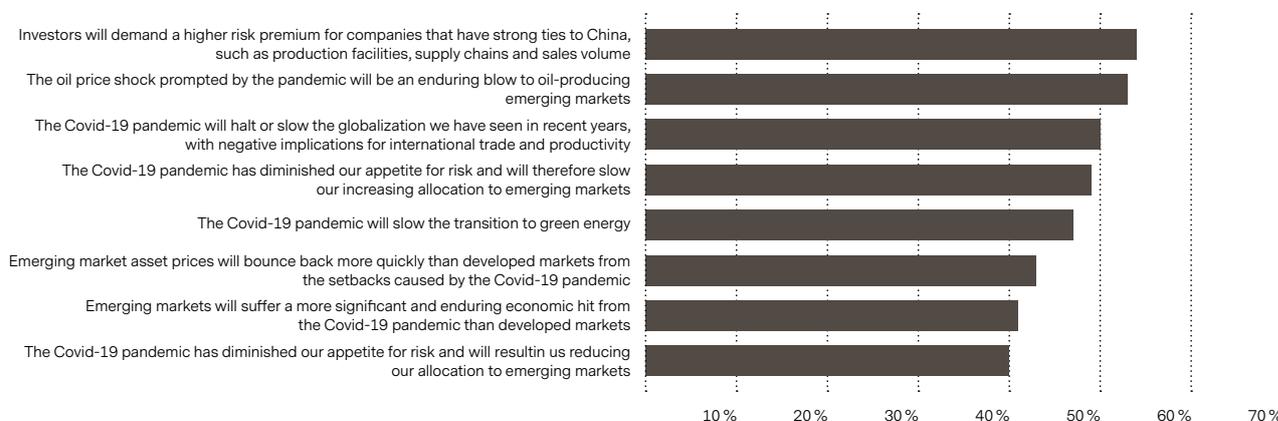
on stock selection and active management may be less concerned. These investors have a chance to steer a path towards lower volatility.

As for the specific impacts of Covid-19, there clearly has been a spike in volatility as both equity and fixed-income markets have reacted to the turbulence and uncertainty. "We've seen some extreme volatility in the markets," says Vontobel's Luc D'hooge. "And you might therefore see some investors become worried and step back from these assets."

This research suggests that investors do have very real worries about the impact of Covid-19. More than half think investors will now want to be better rewarded for investing in markets such as China; almost as many say their appetite for risk has gone down.

**Chart 7: The impact of Covid-19 in detail**

"Thinking specifically about the impact of the Covid-19 virus, to what extent do you agree or disagree with the following statements."



**“It’s always good to increase exposure to an asset class at a time when it is underweighted in general by investors. And the structural situation is very positive for emerging markets: we have dovish central banks and a benign inflation outlook, plus fiscal stimulus and the desire to spend on infrastructures. All of that makes emerging market debt and equity exposure more interesting in relative terms.”**

**Paolo Maggioni**  
Chief Investment Officer,  
Fineco Asset Management

However, some analysts believe investors may even increase their emerging market exposure because of the pandemic.

“The virus could actually lead to increased equity allocations, because it challenges the conventional view that what is a problem in developed markets is a crisis in the emerging world,” says Vontobel’s Matthew Benkendorf. “Covid-19 didn’t cause disproportionately more damage in some emerging markets.”

This is an important point. Some developing economies, with more rudimentary healthcare systems, clearly have struggled to cope with the virus. But others – led by China – have fared much better than some developed markets. One silver lining of Covid-19 is that it could force governments in emerging markets to improve health care and sanitation, enabling some countries to exit the crisis in a stronger position than they entered.

And in fixed income, although there is a concern that the risk of some sort of sovereign debt crisis is higher, carefully selected bonds in emerging markets should offset the yield drought elsewhere.

#### **From risk to reward**

There are several reasons to invest in emerging markets in this environment. China’s recovery, for example, is driving demand for resources – to the benefit of many developing economies rich in raw materials. The relative weakness of the dollar in the wake of the Covid-19 crisis, meanwhile, is a boost to those emerging markets that have significant dollar-denominated debt. In addition, some markets may offer valuation opportunities amid the volatility – and historical performance data suggests that emerging markets have provided better risk-adjusted returns during the recovery phase of the economic cycle.

Paolo Maggioni, Chief Investment Officer of Fineco Asset Management, argues now is the time to be decisive. “I think that the Covid-19 situation has created more opportunities for emerging markets investors,” he says. “First, it’s always good to increase exposure to an asset class at a time when it is underweighted in general by investors. And the structural situation is very positive for emerging markets: we have dovish central banks and a benign inflation outlook, plus fiscal stimulus and the desire to spend on infrastructures. All of that makes emerging market debt and equity exposure more interesting in relative terms.”

Nor is it only developed market investors who are exploring these opportunities. Jose Manuel Silva, chief investment officer of LarrainVial Asset Management in Chile, says many emerging markets-based investors are increasingly global in their outlook. “Chilean investors have been looking for alternatives to domestic equities for 20 years,” he says. “They started with Latin American equities, but they also began buying more broadly-based emerging markets funds. Then, over time, as they got to know markets better, they began buying specific markets and regions – through Latin American equity funds, Asian equity funds and EMEA equity funds, for example.”

The same search is ongoing in fixed income, he adds. “In the last two years, interest rates have come down quite dramatically in Brazil. So we are seeing a boom of local Brazilian investors investing abroad, including in emerging markets.”



Part 2

# Overcoming barriers old and new



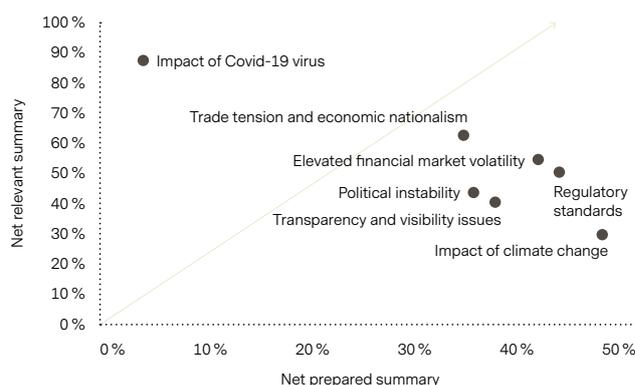
**Part 1 of this study shows that the potential for higher returns underpins investors' appetite for emerging markets allocations – but also that their perceptions of risk are holding them back. In some cases, those fears may turn out to be unfounded, while elsewhere there will be opportunities for mitigation.**

**How to confront risk**

Right now, many investors feel poorly prepared for the risks they are most worried about in emerging markets. The biggest risk of all, Covid-19, is also the one they feel least prepared for – hardly surprising given the rapid emergence of the crisis. But there is also a broad range of other, more longstanding issues that only a minority of investors feel equipped to deal with.

**Chart 8: Many investors are unprepared for significant risks**

Risks – Relevant vs Preparedness



How can investors overcome that? One way to deal with this lack of preparedness is to seek more specialist support when investing in emerging markets. And investors are aware of this: specialist advice on risk management is already the top priority for investors looking for third-party support.

Vontobel's emerging market specialists urge investors to take a realistic view of volatility, emphasizing that expert support makes it possible to both manage risk and exploit its opportunities.

“First, you need diversification across sectors and countries,” says Roger Merz. “An active manager should try to find companies with uncorrelated risks: if you invest in a business, you want it either to be as isolated as possible from potential macroeconomic risks or, if this is not possible, you try to avoid unintended concentrations of such risks across the portfolio.”

Luc D’hooge advises having room to maneuver – rather than a fixed set of rules. “Liquidity is important, and you need to be able to sell,” he says. “We see managers with very strict rules on credit ratings; in this volatile environment where downgrades are not uncommon, they may become forced sellers at an inopportune moment.”

**Chart 9: Where investors turn for help in emerging markets**

“In addition to asset management support, what other support will you increase as your emerging markets allocations increase?”



**60%**  
say they have defined a mostly small risk budget for investment in emerging markets



-  **Tools and strategies**
-  **Active management**
-  **Specialist support**

**“Liquidity is important, and you need to be able to sell. We see managers with very strict rules on credit ratings; in this volatile environment where downgrades are not uncommon, they may become forced sellers at an inopportune moment.”**

**Luc D’hooge**  
Head of Emerging Markets Bonds,  
Vontobel Asset Management

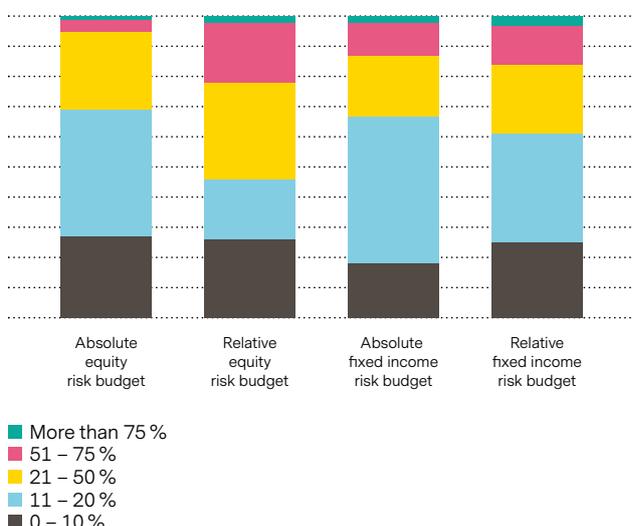
However, there is space for risk management controls that limit liabilities and manage exposures. Such tools can provide an important safety net in emerging markets.

In this research, 60% of investors say they have defined a risk budget for investment in emerging economies. These allow for fluctuations of returns – whether absolute or relative to an index – which limits the volatility of portfolios to parameters within which the investor feels comfortable.

In both equity and fixed income, it is important to set these budgets in the context of markets where volatility may sometimes be high. The research suggests that investors are setting generous absolute and relative risk budgets, recognizing that small budgets may force them to sell out of holdings too early.

**Chart 10: Investors set generous budgets for emerging market risk**

“What is your available risk budget for emerging market investment, expressed as a fluctuation of returns in absolute terms and relative to an index?”



Many investors also seek to mitigate risk through other restrictions and requirements on portfolios. “It’s also good to have limits around position sizing,” says Carly Moorhouse, Fund Research Analyst at Quilter Cheviot Investment Management. “Especially if it’s a fund that is used as more of a core holding for investment managers.”

Moorhouse adds that liquidity is a key consideration. “That means portfolio managers must be very conscious of considerations such as market capitalization and daily trading volumes,” she says. “We get monthly holdings from all our funds in order to assess their liquidity, and how quickly they can trade down to cash.”

Context is important: the risk parameters that investors operate to in developed markets will often not be appropriate for their emerging market counterparts. Tactical asset allocation is a good example of this. About half the investors in this research say that they allow managers to make broader diversions from their strategic allocation models in emerging markets.

This is not just a question of giving managers freedom to exploit short-term opportunities, which potentially increases volatility. It will also allow managers to respond to short-term risks, adjusting portfolios to steer around the danger.

In the end, there is a balance to strike between risk and potential reward – and investors’ approaches will vary, depending on time horizons, investment objectives and appetite for risk. But using a model to make asset allocation decisions gives investors a disciplined and strategic rationale for managing risk, and provides important reassurance in times of uncertainty.

Wim Aourousseau, Chief Investment Officer at AXA Belgium, says that extending this kind of model into emerging markets is a natural approach. “We will look at the yield or the expected return we can get from an asset, and we will divide it by the capital needed to keep it,” he says. “This will give us a certain ratio which we will compare all over the line of asset classes and regions. This will give an indication of where to go.”

At FineCo Asset Management, Paolo Maggioni adds: “We accept that volatility is part of investing in emerging markets. And we can decompose volatility into negative and positive volatility - what we are trying to do when we build our portfolios is to reduce the downside volatility and to capture as much positive volatility as possible.”

# The China question

Something that preoccupies many investors is how they should deal with the rise of China, which now accounts for a significant proportion of emerging market index weightings – almost 40% in the case of the MSCI Emerging Markets Index, for instance.<sup>7</sup>

China may offer some attractive opportunities. Already the second-largest economy in the world – and the first on some measures – its global influence continues to increase. The Belt and Road Initiative, China’s global development strategy involving infrastructure and investments in nearly 70 countries and international organizations, will accelerate that increase. And as China’s role in the global economy becomes more significant, its currency may yet challenge the US dollar’s supremacy.

But there are some difficulties. Many of China’s largest companies are state-owned or state-controlled. Debt markets may be more open to foreign investors than in the past, but they are controlled more tightly by the authorities.

Many investors feel that China exposes them to significant concentration risk – at a country level and in terms of its dominant technology sector. “It’s become accepted that the US accounts for 55% of the global market, but I don’t think people feel quite so comfortable with China dominating an index to the same account,” says IOOF’s Peter Laity. “Given the scope for political intervention and the large number of state-owned enterprises.”

**“We encourage people to take a ‘whole of China’ approach rather than just getting an A-share manager. If you’re going to give someone a China mandate, give them the ability to invest across the whole of China.”**

**Andrew Cormie**  
Eastspring Investments

Andrew Cormie of Eastspring Investments, on the other hand, says that the breadth of the Chinese equities market is often overlooked – and that it includes a very wide range of privately owned enterprises, which could offer opportunities for diversification. “We encourage people to take a ‘whole of China’ approach rather than just getting an A-share manager,” he says. “If you’re going to give someone a China mandate, give them the ability to invest across the whole of China.”

It is increasingly likely that investors will start to split China out of their emerging market allocations, giving the country its own allocation within the portfolio. “It will just make sense to allocate capital specifically to China, in the way that people allocate to Japan,” says Quilter Cheviot’s Carly Moorhouse. “It’s the world’s second largest economy and is extremely influential not just in Asia, but globally.”

## Chart 11: Managing exposure to China

“To what extent do you agree or disagree with the following statements?”



<sup>7</sup> MSCI, as at June 2020

Part 3

# From theory to practice: Achieving emerging market ambitions



**Investors will need to think carefully about how they seek to achieve their emerging market ambitions – particularly when it comes to the debate between active and passive management. While the rise of passive investment styles has been a phenomenon in recent years, there are compelling arguments for a predominantly active approach in emerging markets.**

**The home of active management?**

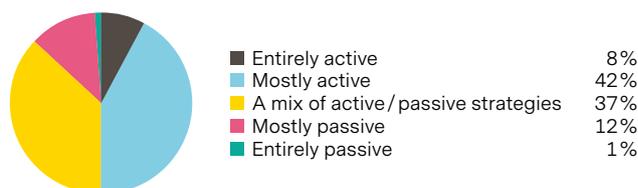
“In emerging markets, where you have a generally less-developed set of economies and companies, you have an index construct that is lopsided in many ways,” says Vontobel’s Matthew Benkendorf. “The index is a less optimal way to buy the really great companies that can compound long-term wealth with the lowest relative risk.”

Ingo Ulmer, Senior Investment Specialist at Viridium Service Management, says that the conventional case for passive styles – that efficient markets make it difficult for more costly active funds to outperform – does not work in emerging markets. “These markets are so under-researched,” he says. “In the next one-and-a-half years, I’m pretty sure that we will switch all our passive investments to active managers.”

Investors in this study largely accept those arguments in relation to equities and, to a lesser extent, fixed-income assets. While some investors mix passive and active managers – and a minority are purely passive – significant numbers are either mostly or fully active.

**Chart 12: Investors prefer the active approach**

“As you increase exposure to emerging markets equities, will you employ passive or active investment strategies?”



“As you increase exposure to emerging markets fixed income, will you employ passive or active investment strategies?”



**Risks hidden in indices**

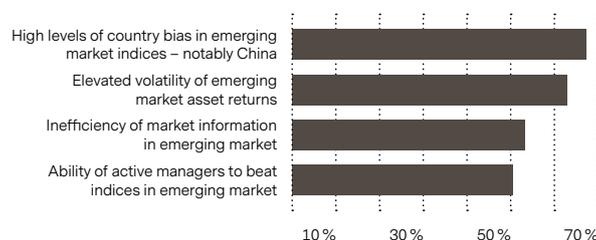
Asked why that is, many investors point to the concentration risk in emerging market indices. Those opting for a passive approach could be much more exposed to particular countries than they might want to be, and risk missing out on opportunities in particular sectors. For example, those investors attracted to technology, consumer and healthcare opportunities in emerging markets (see chart 4 on page 11) should note that while the first two of these sectors are well-represented in the MSCI Emerging Markets Index, the latter accounts for less than 4%.<sup>8</sup>

Concentration risk is not the only concern. More than half of investors point to elevated emerging market volatility as a reason to choose active funds. Simply buying the index will make it much more difficult to use the risk mitigation strategies discussed in this study. And an active approach is required for investors to pursue ESG strategies (see below).

“I hope that as people allocate more to emerging markets, they’ll do so with active exposure,” says Quilter Cheviot’s Carly Moorhouse. “Downturns show how valuable active managers are to investors – picking good managers may save clients so much money.”

**Chart 13: Why investors prefer a more active approach**

“In the debate between passive and active management in emerging markets, to what extent do you believe the following issues are relevant?”



<sup>8</sup> MSCI, as at June 2020



**51 %**  
say that specialist investment consultants and investment intermediaries can add significant value

There is a broader point here about specialist advice. In emerging markets, many investors feel that in-house teams will either struggle to manage assets effectively, or they will need substantial support. For example, 51 % of investors say that specialist investment consultants and investment intermediaries can add significant value (see chart 14).

**Why ESG plays a key role**

There is another limitation of passive investment that is important in the debate about how to invest in emerging markets: it makes it more difficult to invest using the right ESG criteria. And the growth of ESG investment at a global level does not stop when it comes to emerging markets; many investors see ESG as a crucial part of their investment process.

“ESG is something that’s going to change the way we invest,” says Ibercaja Gestión’s Guillermo Uriol Sanz. “But you can only do that with an active approach: you need active managers able to avoid the difficult and controversial areas.”

In this research, 59% of investors say that ESG factors already influence the decisions they make about emerg-

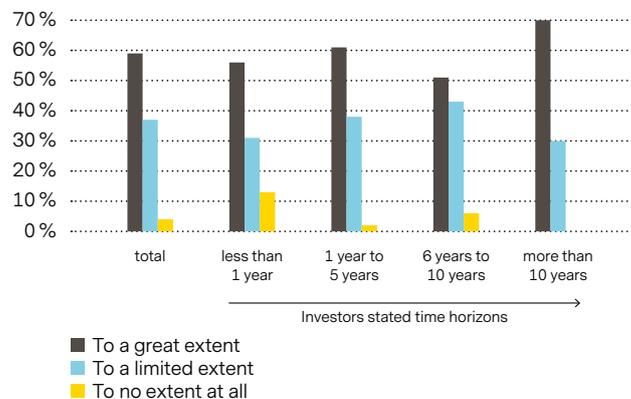
**“ESG is something that’s going to change the way we invest. But you can only do that with an active approach: you need active managers able to avoid the difficult and controversial areas.”**

**Guillermo Uriol Sanz**  
Ibercaja Gestión

ing market asset allocation and stock selection, and a further 37% say they take ESG into account to at least some extent. Among investors with time horizons of ten years or more, the proportion who take ESG factors into account to a great extent rises to 70%.

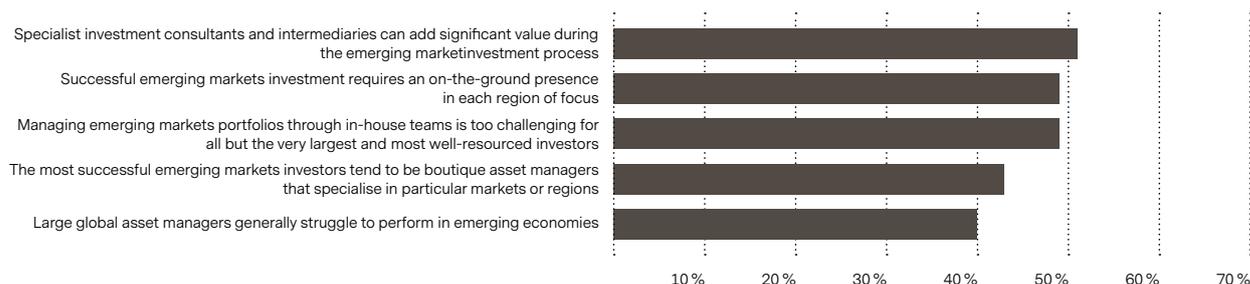
**Chart 15: ESG rises up the agenda in emerging markets**

“To what extent will environmental, social and governance factors influence the decisions you make about emerging market asset allocation and stock selection.”



**Chart 14: Many investors are in need of support**

“Thinking specifically about the impact of the Covid-19 virus, to what extent do you agree or disagree with the following statements.”



This is not a question of running emerging markets portfolios with ESG screens – either negative or positive. Investors are focusing on ESG factors as indicative of both potential risk and opportunity. “ESG is important, but is one of many factors we take into account in our decision-making,” says IOOF-One Path’s Peter Laity.

This is important in both equities and fixed income, says Viridium’s Ingo Ulmer. “We don’t necessarily see a premium from ESG in emerging markets, but it’s part of our risk management process,” he says. “You are looking at these criteria because the political risk is higher, the corruption risk is higher, the regulatory risk is higher, and so on.” The aim is not to be exposed to businesses, whether through debt or equity, from which bad news is likely to emerge.

Many investors do believe that ESG factors may be indicative of potential to outperform: some 45% of investors in this study see ESG scores becoming one proxy for quality in the decision-making process. Companies with strong ESG performance, says AXA’s Wim Arousseau, “tend to have a management which is very flexible, very intelligent, and is able to apply this mindset down through the rest of the company. Since these companies tend to make the highest margins and largest profits, it makes a lot of sense to invest in this way.”

The good news is that the traditional stereotypes surrounding emerging market businesses – that they lack transparency and are prone to bad practice – are looking increasingly outdated.

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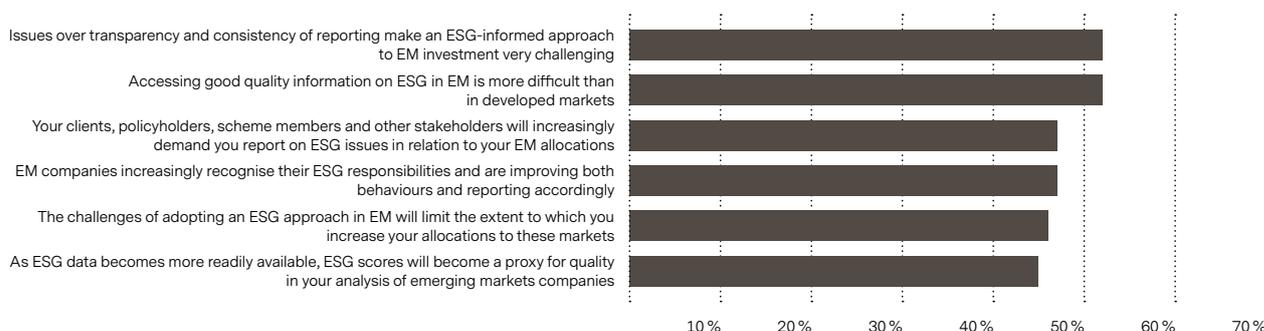
**Wim Arousseau**  
Chief Investment Officer,  
AXA Belgium

While investors say that information can still sometimes be difficult to obtain, many companies recognize the desire of a global investor base to focus on ESG issues and have moved towards more sophisticated reporting processes. Asian companies, in particular, are regarded as stronger in this regard than those in other emerging markets.

“Our experience is that the majority of companies that we invest in want to engage and will be open to listening and getting shareholders’ thoughts,” says Andrew Cormie of Eastspring Investments. “At Eastspring Investments, we are a PRI signatory and believe in the importance of being long-term responsible investors and within our GEM team, we integrate ESG into our investment process and philosophy. When you engage with companies, you get a win-win situation.”

**Chart 16: ESG is an increasingly important part of emerging markets investment**

“To what extent do you agree or disagree with the following statements?”



Sources: Vontobel original research, July 2020, based on survey of 300 respondents in Asia, US, Canada and EMEA

# Conclusion

## **Be bold to benefit**

Investors recognize the opportunities for diversification and the potential for enhanced returns offered by emerging markets. Many are determined to embrace those opportunities and move toward higher allocations to emerging markets – both in their equity portfolios and in fixed income assets.

The sticking point is risk. Investors know that volatility tends to be higher in some emerging markets, and in parts of some markets, and they are anxious about how to manage it. That anxiety is now more acute as a result of the Covid-19 pandemic, and their increased risk aversion is a natural response to the crisis.

Specialist support will help these investors to overcome their concerns. Risk management strategies that use tools and techniques such as diversification, risk budgets and allocation constraints can limit their exposure to volatility in emerging markets. And ESG factors give them further opportunities to manage risk.

For investors able to balance risk with opportunity, the future is exciting. Strategic asset allocation across a range of emerging markets should give them access to new opportunities and enhanced returns. Fortune will favor the bold.



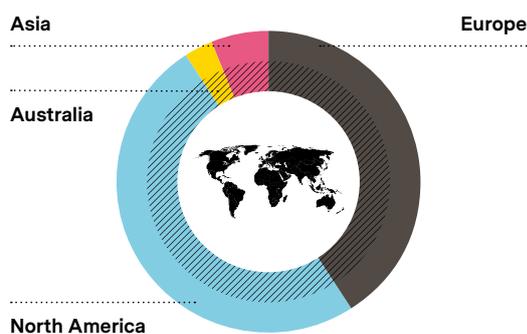


# About the research

In April and May 2020, Vontobel and Longitude, a Financial Times company, surveyed 300 institutional investors and discretionary wealth managers across 18 countries. In addition, this study draws on the insights gained from around a dozen qualitative interviews with experts in emerging market investing. In particular, we thank the following for sharing their time so generously:

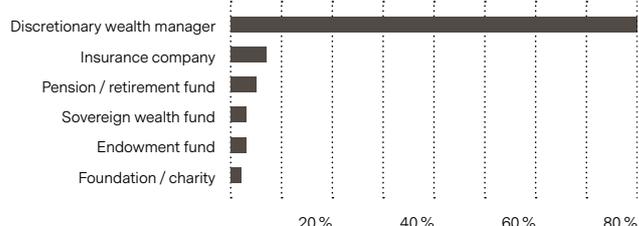
- **Andrew Cormie**  
Head of the Global Emerging Markets team, Eastspring Investments
- **Carly Moorhouse**  
Fund Research Analyst, Quilter Cheviot Investment Management
- **Guillermo Uriol Sanz**  
Fixed Income Portfolio Manager, Ibercaja Gestión
- **Ingo Ulmer**  
Senior Investment Specialist, Viridium Service Management
- **José Manuel Silva**  
Chief Investment Officer, LarrainVial Asset Management
- **Paolo Maggioni**  
Chief Investment Officer, Fineco Asset Management
- **Peter Laity**  
Portfolio Manager, Equities and ESG integration, IOOF-OnePath
- **Wim Arousseau**  
Chief Investment Officer, AXA Belgium

## Countries

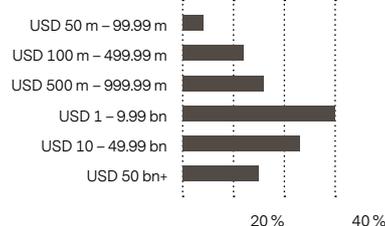


<b>■ Europe</b>		<b>■ North America</b>	
Belgium	1%	Canada	8%
Denmark	1%	US	42%
Finland	1%		
France	7%	<b>■ Australia</b>	3%
Germany	7%		
Italy	3%	<b>■ Asia</b>	
Luxembourg	1%	Hong Kong	3%
Netherlands	1%	Singapore	3%
Norway	1%		
Spain	3%		
Sweden	1%		
Switzerland	5%		
UK	8%		

## Organisation type



## Assets under Management



## Role



Sources: Vontobel original research, July 2020, based on survey of 300 respondents in Asia, US, Canada and EMEA

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