Vontobel

Fortune favors the bold

Active investors start to seize the opportunity in emerging markets

Focus region: EMEA

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.[1] And while the stock market capitalization of businesses in emerging markets currently accounts for only 12% of total world capitalization,[2] 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.[3]

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.[4]

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.

Download the global study here:
vontobel.com/em

1 Organisation for Economic Co-operation and Development
2 MSCI, April 2019
3 MSCI, as at June 2020
4 Vontobel Asset Management

Guillermo Uriol Sanz
Fixed Income Portfolio Manager,
Ibercaja Gestión

"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."

"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."

Wim Aurousseau
Chief Investment Officer,
AXA Belgium

"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. 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."

"Companies with strong ESG performance 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."

Ingo Ulmer
Senior Investment Specialist,
Viridium Service Management

"Emerging markets are so under-researched. In the next one-and-a-half years, I'm pretty sure that we will switch all our passive investments to active managers."

"This is important in both equities and fixed income. We don't necessarily see a premium from ESG in emerging markets, but it's part of our risk management process. The aim is not to be exposed to businesses, whether through debt or equity, from which bad news is likely to emerge. "

Carly Moorhouse
Fund Research Analyst,
Quilter Cheviot
Investment Management

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

"It will just make sense to allocate capital specifically to China, in the way that people allocate to Japan. It's the world's second largest economy and is extremely influential not just in Asia, but globally."

"I hope that as people allocate more to emerging markets, they'll do so with active exposure. Downturns show how valuable active managers are to investors – picking good managers may save clients so much money."

Paolo Maggioni
Chief Investment Officer,
Fineco Asset Management

"I think that the Covid-19 situation has created more opportunities for emerging markets investors. 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 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."

In emerging markets, fortune favors the bold

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

67 %

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

65 % Global

51 %

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

59 % Global

Why?

Investors are seeking:

Better returns

40 % — 38 % Global

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

More diversification

34 % — 35 % Global

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

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

Investors still evaluating Covid-19 impact

They worry about risk

35% Global

33%
plan to increase EM allocations more slowly due to Covid-19

And they're ill-prepared to take it on

88% Global

82%
say they are concerned about the impact of Covid-19 as they consider increasing their exposure to emerging markets

4% Global

And just
4%
say they feel prepared for the related risks

Succeeding in emerging markets: Managing risk with the right tools

63%
say they have defined a mostly small risk budget for investment in emerging markets

60% Global

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

48%
say that specialist investment consultants and investment intermediaries can add significant value

51% Global

ESG can help investors decide where to invest

Among investors,

60%

59% Global

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

Matthew Benkendorf
Chief Investment Officer,
Vontobel Quality Growth Boutique

"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."

"The virus could actually lead to increased allocations, because it challenges the conventional view that what is a problem in developed markets is a crisis in the emerging world. Covid-19 didn't cause disproportionately more damage in some emerging markets."

Roger Merz
Head of mtx Portfolio Management,
Vontobel Asset Management

"Dynamic growth rates in emerging markets have produced many profitable businesses. 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."

"First, you need diversification across sectors and countries. 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 potentially macro-risks or, if this is not possible, you try to avoid unintended concentrations of such risks across the portfolio."

Luc D'Hooge
Head of Emerging Markets Bonds,
Vontobel Asset Management

"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. That will push investors toward emerging markets."

"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."

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.

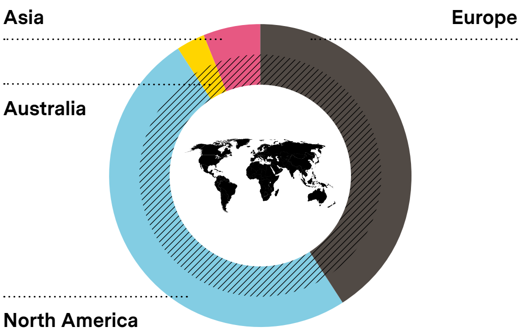
For investors able to balance risk with opportunity, the future is exciting. Strategic asset allocation across a range of emerging markets should give them access to new opportunities and enhanced returns. Fortune will favor the bold.

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:

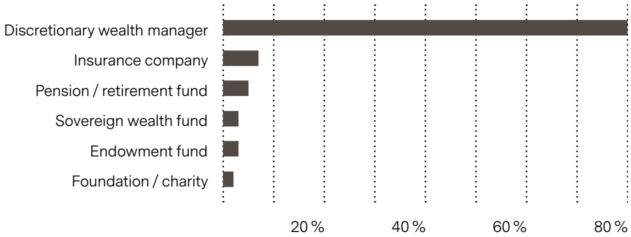
- **Andrew Cormie**
  Head of the Global Emerging Markets team, Eastspring Investments
- **Carly Moorhouse**
  Fund Research Analyst, Quilter Cheviot Investment Management
- **Guillermo Uriol Sanz**
  Fixed Income Portfolio Manager, Ibercaja Gestión
- **Ingo Ulmer**
  Senior Investment Specialist, Viridium 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 Aurousseau**
  Chief Investment Officer, AXA Belgium

Countries

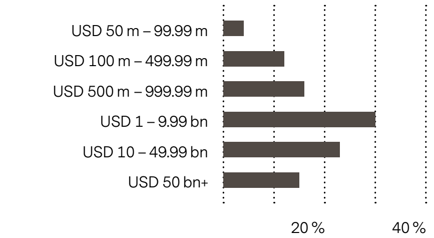


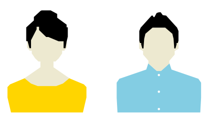
Europe	
Belgium	1%
Denmark	1%
Finland	1%
France	7%
Germany	7%
Italy	3%
Luxembourg	1%
Netherlands	1%
Norway	1%
Spain	3%
Sweden	1%
Switzerland	5%
UK	8%
North America	
Canada	8%
US	42%
Australia	3%
Asia	
Hong Kong	3%
Singapore	3%

Organisation type



Assets under Management





Role

23%	12%	29%	23%	13%
Chief investment officer	Head of asset allocation	Portfolio Manager	Portfolio analyst	Head of fund research

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

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