

## Press Clipping

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### COVER STORY: ASIA

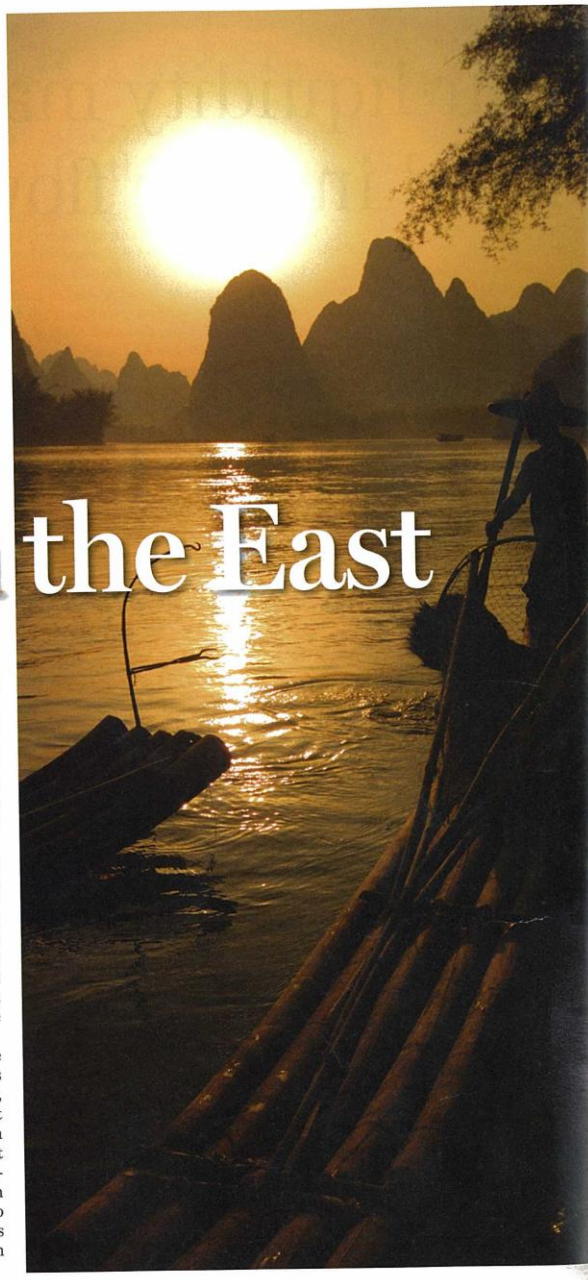
The case for investing in Asian emerging markets is clear but should investors go directly through a mutual fund or indirectly with an ETF?

## Light in the East

If investors have been hesitating over whether to invest in emerging markets, they are no longer. Spurred on by what one economist at Citi described as the 'submerging' developed markets of Europe, investors in Europe and the US are revising their preconceptions about risk in these countries and are moving their assets into global and emerging market bonds and equities.

The MSCI World Index indicates that emerging markets' capitalisation has jumped from \$500bn in 2003 to some \$3.4 trillion this year, equivalent to a leap from 4% of the market to almost 13%. It is difficult to establish how much money has gone to frontier markets, but the MSCI Barra indices suggest they have a total market value of \$123 billion. That may be up six-fold from 2003, but it remains just 0.5% of the \$23 trillion market capitalisation of the MSCI World index.

Investment flow trackers EPFR Global estimate that since 2003 emerging markets have seen inflows of more than \$80 billion committed by equity funds, while 22 frontier equity markets have seen a net \$1.83 billion. These numbers should be treated with caution, as they reflect a period of a global market that has seen booms, busts and capital flight. Neither do they include the investment flows through US or European-based companies with exposure to the frontiers, or indeed companies with operations on the ground in frontiers but with equity listings in London or New York.



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**JEROME BOOTH, ASHMORE INVESTMENT MANAGEMENT**

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Volatility in these markets ensures that long-term investors are those most likely to benefit, whether in the equity, real estate or private equity markets. But other investors, only wanting short-term exposure, or who do not have access to localised stock picking expertise, find that ETFs are a useful tool. Data from BlackRock reveals that in the first four months of 2010, European ETFs focused on emerging equity markets recorded net inflows of \$3.25bn (€2.6bn), against \$7.5bn for the whole of 2009. European ETFs targeting China have attracted just \$118m so far this year, compared with \$863m in 2009. US investors, however, have been much more cautious and have cut back their exposure to emerging market ETFs, with net inflows of just \$1.5bn so far this year, compared with \$27bn in 2009.

Lipper data shows that in Europe last year equity funds were much more popular than bond funds, attracting €112bn of net inflows compared with €85bn for bond vehicles. But this year, fixed income appears to be pulling ahead. In the dominant 'international' segment, net inflows into bond funds totalled €35.7bn in the first quarter, against €19.4bn for equities. The four top-selling equity sub-sectors in the first quarter were emerging market, global, Japanese and North American. In fixed income, both the emerging market and global sectors saw net inflows above €6bn.

The volume of investments pumped into the emerging markets has been such that some observers have feared the onset of bubble conditions. Kunal Ghosh, senior vice president and portfolio manager at Allianz Global Investors Capital, disagrees. He says: "The market in Asia is not being overplayed. China, India and Indonesia are providing the true opportunities in the region."

In fact, says Jerome Booth, head of research at Ashmore Investment Management, "investors are massively underweight Asia. The shift is all to come, as the rebalancing of the global economy is a 20-year process. There are perhaps a few places with bubble-like conditions, such as China real estate, but otherwise the bubbles are all in Europe and the US."

Jonathan Pines, director of global emerging markets equities at Hermes Fund Managers, says: "The secular trend is clear. There is a structural change in GDP/capita in favour of emerging markets, but there is also no reason why the trend can't go the other way. We are due for a cyclical pull-back. Stock valuations are not excessive. This is not a bubble."

The new power bloc in global markets is 'Chindonesia', essentially Asia ex Japan. The bloc constitutes an alternative source of economic growth that is independent of the prospects and

the future of the developed economies. Ghosh says: "These countries have a critical population and are at an economic stage where they can sustain their economic growth primarily from their domestic consumption."

Pines adds: "Chindonesia is the power centre because it has potential for an economic rebound and valuations are so cheap. But deals are not so easy to find.

Exploiting market inefficiencies is key to outperformance in emerging markets. "For example, some stocks that are listed in Shanghai on the A-share market are also listed on the Hong Kong market at very different prices. Certain airline stocks trading on the Hong market are also trading at a 100% premium in Shanghai. There are many mispriced shares, but to take advantage of this requires a deep understanding of the markets."

Memories of Asia's financial crisis in 1997 have led many investors to overlook Indonesia. During the crisis, the aspiring Asian Tiger lost 13.5% of GDP for the year and the rupiah spiralled out of control, sending the country into economic collapse. "Indonesia learned from those mistakes," says Ghosh, "and it has an improving and stable political environment, pro-cyclical economic policies, favourable tax rates, minimal foreign debt and a disciplined fiscal environment. All of this has helped it emerge from this current crisis unscathed.

"If you believe in the future growth of the large Asian economies such as India and China, then you believe that they're going to need to invest in commodities, and this is where Indonesia comes to the fore. Indonesia adds diversification through its role as an exporter of commodities and offers relatively low correlations to India and China. If you believe people are going to consume more in India, China and Indonesia, they will need more energy. Investing in Chindonesia thus offers you higher returns than investing in Chindia with a similar level of risk."

For most investors have neither the skills for stock picking from the Asian markets, nor the time and the resources to find an outperforming active manager specialising in the region. The same problem faces Asian investors wanting to invest in other Asian markets, so passive access through indices and ETFs have become attractive to them as well.

Andrew Clark, chief index strategist at Thomson Reuters, says ETFs are gaining popularity for the ease of access to the markets and for relatively low cost. Last March, Thomson Reuters launched 7500 new indices with a leaning towards the emerging markets. Clark says: "Given the lack of investment products benchmarked against indices in emerging

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**ANDREW CLARK, THOMSON REUTERS**

markets, fund houses and exchanges in these markets have increasingly been looking West to see what's working and what isn't. As a result, a number of emerging market players have been much less attracted to another domestic index, but extremely interested in indices for their fellow emerging markets, from which they can build ETFs."

Clark says: "Our experience in talking to fund managers in India, China and Hong Kong has been quite varied. All have an appetite for investing both locally (ex-country but somewhere in Asia) and also in emerging markets outside of Asia, such as Brazil." Korea attracts a lot of interest, as does Hong Kong for its role as a financial centre and as a springboard into Taiwan and the China mainland.

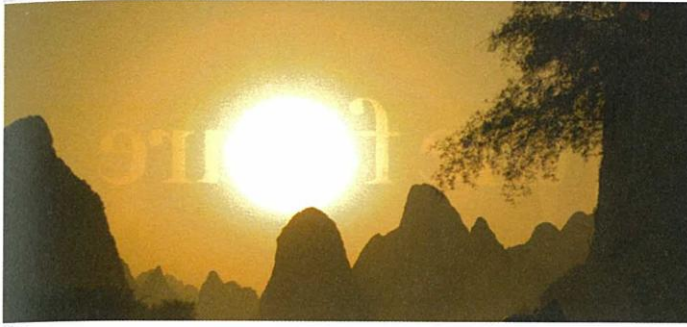
"As to whether these countries have the expertise to pick ex-country stocks, that also varies," says Clark. "In Hong Kong, the skill is most definitely there, while in China and India, the skills are present but in much smaller numbers and with less experience so the interest in indices is greater, whether

they are used as a passive investment or as the starting point for stock selection."

As an overall trend, South-east Asian countries have been especially interested in gaining exposure to their neighbouring markets, watching each other very closely. This is particularly true of India and, to a lesser extent, Hong Kong, says Clark. "Given the small number of QDI funds on mainland China, the question is moot. Hong Kong has been home to international investing for some time, but it is relatively new in India and there is a growing appetite for foreign focused funds. The mainland is also very interested in overseas investing but given the current central government procedures that must be fulfilled in order to invest overseas, it is more of an unfulfilled appetite for some firms than anything else."

Lyxor Asset Management, the ETF specialist owned by French banking group Société Générale, has been particularly active launching ETFs in Singapore. For US and European investors, ETFs allow access to Asian markets in their own time zones and currencies, says Claus Hein, head of Lyxor UK, Nordics and LatAm. Lyxor's Hang Seng China Index, the China Enterprise Index and the Hong Kong Index offer access to China, and have been particularly active. As is also the case in China, international investors are barred from accessing some of India's stock markets, but they can use Lyxor's Indian equities ETF as a proxy tool to track the MSCI India Index.

The rationale for investing in ETFs is that they



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**CLAUS HEIN, LYXOR ASSET MANAGEMENT**

are liquid and low cost, says Hein. “Some traditional mutual fund managers can generate alpha, but this is costly. And finding the manager that outperforms is not easy. We think ETFs are very cost effective. Liquidity is daily, even intra-daily, and available through multiple brokers. ETFs are ideal for markets that are difficult to track. They are popular with all sorts of investor, from pension funds to high net worth individuals who use them for tactical asset allocation or cash management.”

Hein accepts that ETF benchmarks are focused on the large caps, and so does not include the growth end of the stock market, the small and medium-sized enterprises. Hein explains: “Most emerging market ETFs have been based on the large cap benchmarks because they need liquidity, and only the large cap firms can provide this. A lack of liquidity translates into higher costs and a number of operational considerations, which defeat the purpose of an ETF.”

But the ETF and the traditional mutual fund are complementary tools, says Hein. “It has been estimated that about 70% of the assets in ETFs in Europe is from institutional investors using these ETFs across their investment strategies in their portfolios.”

Andrzej Blachut, head of emerging market equities at Swiss & Global Asset Management, which manages the Julius Baer fund range, says ETFs are good for liquid markets. They also offer exposure to emerging markets without the risk of an underperforming asset manager. But, he says, “with emerging and frontier markets, it makes sense to go active. Buying the MSCI index is only buying the big, boring companies, and therefore not participating in the growth driver of the small to medium companies.” Effectively this means ETFs tend only to replicate the developed and BRIC markets, where the large cap stocks will be found.

Emerging markets are often thought of as a commodity play, but this is not necessarily so, says Blachut. “Countries with commodity wealth can

afford to finance infrastructure programmes. But in markets where there is no financial crisis, where salaries are rising and where there is increasing sophistication among consumers, it makes sense to have a retail focus.”

While China is the obvious choice for investments today, Blachut recommends India for those investors with a longer investment horizon of 20 years or so – as he says, “India is the next China.” India’s population is set to expand significantly, which is widely considered the essential prerequisite for GDP growth. The Chinese government, by contrast, has pursued for some time a policy of restricting population growth.

Among active managers, Asia is a happy hunting ground. Julian Mayo, investment director of Charlemagne Capital, a specialist in the emerging equities markets, says active fund managers have seen strong inflows over the past year, as investors have looked for outperforming stocks to boost their portfolio’s performances.

Different classes of investor will have different approaches to the emerging markets. “Sovereign wealth funds with an active approach to investment management will prefer to take strategic stakes in large companies. This will give them seats on boards and some measure of control over their asset,” says Mayo. Institutional investors with a shorter investment horizon may want simply to make an asset allocation call and so could invest in ETFs, while others will prefer to access the markets directly.

Charlemagne adheres to the research-based, bottom-up, stock picking approach. Mayo says, “we believe emerging markets to be a particularly inefficient asset class. This offers a stock picking strategy such as ours substantial opportunities for finding value. We allocate between stocks, looking for information inefficiency.”

Mayo does not recommend a geographical approach to their asset allocation in emerging markets. For example, an investor may allocate 20% to emerging markets, of which 10% goes to China, 5% each to India and Brazil. But, as Mayo says, these numbers are arbitrary. “It takes a very brave investor, and a very nimble one, to call a country’s performance on the global stock markets. Last year, for example, we saw deep cyclical turns within the asset class: in the middle of last year, on the back of their stimulus programme, China led the stock markets. Last autumn, it was Brazil and over the winter it has been Russia.”

Pension funds, which have to work with a time-consuming decision process when deciding on their allocations, should not take such risks, Mayo says. Stock picking is a more sure footed strategy. As he explains, the emerging markets index holds 15,000 listed companies. He says: “If you can put together a portfolio of 60-70 companies, the information advantage can reasonably provide you with some outperformance. This is the reason for active fund management, rather than exposure to an index via an ETF.” ■

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