

## The Case for Emerging Markets





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*Richard Bottomley, Head of Institutional at HSBC Global Asset Management argues why emerging market assets should form an integral component of any diversified investment portfolio*

A decade ago, the notion that institutional investors should consider allocating a proportion of their capital to emerging markets securities would have been almost unthinkable. The equity component of a typical UK occupational pension scheme would largely consist of a substantial tranche of UK equities, together with exposure to the US, Continental Europe and Japan. Although the more adventurous would include a small allocation to South East Asia, very few opted for a specific Global Emerging Market (GEM) component and, where they did, the allocation would be tiny. By the same token, emerging market debt was almost unheard of as an asset class.

However, emerging markets have gone through a substantial evolution since the crises of the 80s and 90s. Political stability has brought with it improved economic policies, creating much more stable markets. Many emerging countries have benefited from high commodity prices, and used the proceeds to strengthen domestic finances. Whereas only 5% of emerging market countries were rated investment grade in the early 1990s, today just over 50% of the market value of the main benchmark (MSCI Emerging Markets Index) is investment grade.

As a result of these developments, it is now apparent that the area is significantly under-represented in global benchmarks, not just in terms of natural resources, population and financial wealth, but in its current and potential contribution to world economic growth, particularly given the slowdown in the developed world. During the early-to-mid 1990s, emerging economies contributed only 3-4% of world growth, but fast forward 12-15 years and the emerging contribution is over 50%\*, and forecast to rise. Despite this, emerging market equities make up only 11% of the quoted equity universe. On the bond side, emerging market debt now comprises some 20-25%† of the global market bonds

universe. As a consequence, there is an argument that emerging market assets should form an integral component of any diversified investment portfolio.

The structure of the emerging markets universe and the portfolio of related investment vehicles have also evolved rapidly. The last decade has seen a spate of fund launches associated with the BRIC (Brazil, Russia, India and China) countries, and, more recently, with the New Frontiers countries that represent the next wave of developing markets. In addition, many specialist emerging market debt vehicles have become available, including some that focus on local currency debt or special situations. Emerging markets are moving ever more firmly into the investment mainstream.

Until the summer of 2008, GEM investments were enjoying a prolonged cycle of relative outperformance, as investors recognised their superior growth prospects and improving risk profile. However, this came to an end when the global financial crisis worsened and there was a general flight out of riskier assets. GEM equities were one of the worst performing asset classes in 2008, and emerging market

bonds also suffered. Following these steep declines, valuations are improving and the longer-term investment case for emerging markets remains strong.

The advancement of emerging markets is transforming the world as we know it. Commodities markets were the first to reflect the strong rise in demand from the emerging nations, and there seems little doubt that the financial arena is set to undergo a major metamorphosis in the years ahead. As a result, allocations to emerging markets could rise greatly, due to the increasing influence of these nations on global economic momentum.

## The investment case for emerging markets remains strong

Source: \*IMF, Morgan Stanley †JP Morgan

First published in *Financial News Emerging Markets Supplement*, April 2009

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