Ashmore

The Emerging View
Benchmarks: Lessons not learnt

Jan Dehn
March 2012 Issue No. 90

Head Office:

London:
T: +44 20 3077 6000

Other Locations:

Beijing:
T: +86 10 8800 9235

Bogota:
T: +57 1 347 0649

Istanbul:
T: +90 212 349 40 00

Melbourne:
T: +61 0 3 9653 9524

Moscow:
T: +74 9566 04258

Mumbai:
T: +91 22 6608 0000

New York:
T: +1 212 661 0061

Sao Paulo
T: +55 11 3556 8900

Singapore:
T: +65 6823 1319

Tokyo:
T: +81 0 3 6860 3777

Ashmore Investment Management Limited
61 Aldwych London
WC2B 4AE
T: +44 20 3077 6000

Bloomberg Page:
Ashmore <GO>

Fund Prices:
Bloomberg, FT.com, Reuters, S&P, Lipper

Website:
www.AshmoreGroup.com

The Inefficient Market Hypothesis

The Inefficient Market Hypothesis explains why investors do not recognise the redundancy of the notion that markets are efficient. The Inefficient Market Hypothesis says that markets are inefficient and that they will stay inefficient, because market participants refuse to acknowledge the inefficiency. This refusal in turn leads to a prediction that investors will repeat their mistakes again and again and again. The reasons why investors refuse to acknowledge the obvious inefficiency of markets in the face of overwhelming evidence are many. They include abundant information asymmetries, behavioural biases, the structure of the investor base, weaknesses in finance theory and agency problems.

Despite the predictive power of the Inefficient Market Hypothesis, it is its ugly twin, the Efficient Market Hypothesis, which is more widely accepted. The Efficient Market Hypothesis is both extremely popular and often wrong. It states that it is impossible to predict the future, because all knowable information is already fully embedded in the price. But this is evidently not the case: Asset bubbles of frightening proportions regularly rip through G10 markets, witness LTCM, DotCom, Telecoms, US housing, and most recently the European periphery's government debt bubbles. Indeed, the supposedly efficient G10 markets have managed to produce in just a few years not just one but several tail events, which each ought not to have occurred in millions of years if the Efficient Market Hypothesis is to be believed.

Emerging Markets are of course not immune to these market inefficiencies either. For example, most investors still trade Emerging Market bonds as if they are far more risky than G10 bonds, despite long-established and demonstrably stronger credit fundamentals. Within the last three years alone Emerging Market bonds have experienced sharp sell-offs on two separate occasions, once in 2008/2009 and again in 2011, yet, in both cases the triggers had nothing to do with Emerging Markets per se. Moreover, the sell-offs occurred despite the fact that it was possible to establish quite easily—simply by paying attention to credit fundamentals—that there was little reason to expect asset quality to fall, i.e. the ability or willingness of issuers to pay did not materially change. Asset price volatility was clearly not the same as risk. So much for market efficiency. So why do markets continue to repeat the same old mistakes?

Herd Jostling, Agency problems, and Behavioural Biases

One reason why markets keep making the same mistakes over and over again is monetary and psychological costs. From the perspective of an individual manager the efficient market view of the world is hugely attractive, because if the market correctly picks up changes in fundamentals then the manager can do away with high quality expensive proprietary fundamental researchers and save fees on active management. The manager is not required to think about credit risk and he can pay lip-service to research, say, by hiring ratings agencies, which, after all, work for issuers, are biased against Emerging Markets, and have a track record of contributing to bubble creation, for example by assigning investment grade ratings to sub-prime mortgage securities.

When a single investor behaves this way, it does not matter. When many investors behave this way, you get a market failure. What is optimal for the individual manager - to save cost on research - turns out to be highly sub-optimal in aggregate, because no research is done at all. The whole market travels blind.

Sadly, this is not just a trivial theoretical curiosity. Only this year we experienced precisely this type of market failure when Greece defaulted on its sovereign debt. Emerging Market managers, who do not even trade Greece, spotted the coming default years ago, while most G10 analysts and traders did not even entertain the possibility of a default on "risk free" Greek bonds until 2010. When fundamental analysis is ignored then investing becomes a game of herd jostling, jumping on and off momentum band wagons, and trying to capture elusive turning points. Managers are rewarded for positioning against peers rather than working out what the real risks are.

The other set of explanations why markets repeat mistakes is rooted in agency problems and behavioural biases. An entire industry has been erected around the idea that investments can be 'risk free' (a term we regard as an abuse of the English language). It takes time to change industry thinking. Unlearning prejudice is hard. Regulators are pushing in the wrong direction too. In this environment, it takes vision, strength, and courage to walk the lonely, unfamiliar, and cost ridden path to the world of credit risk. It is a path fraught with personal disincentives for asset allocators.

Most managers therefore stick to conventional practices of risk management, including the widespread use of benchmarks for measuring performance and risk. The use of benchmarks to measure risk is a direct consequence of the Efficient Market Hypothesis. Once an assumption of market efficiency is applied, institutions can allocate based on the past return and volatility features of the key benchmark indices for each theme. Then a manager is selected based on a tolerance for tracking error around the benchmark. Market efficiency means that passive investing (benchmark tracking) is the optimal strategy. Departures from benchmarks are risky by definition and thus require an explicit risk budget. 'Benchmark risk' becomes actual risk. Passive managers (or active managers with "market weight" allocations) take no risk, because their tracking error is zero. The benchmark index allocation is, by implication, "risk neutral" or "risk free".

R.I.S.K-Requires Investment Skill and Knowledge

Fortunately, there are other—better– ways to manage risk. The starting point has to be a question: What is risk? We believe that risk is the probability that an issue does not pay. Risk management should therefore first and foremost be rooted in detailed knowledge of the issuer. Risk is something that Requires Investment Skill and Knowledge. Defining and measuring risk using tracking errors vis-à-vis a benchmark index does not take explicit account of actual repayment risks whatsoever. And markets are often extremely poorly informed about credit risk. Serious research can therefore yield important insights, which in turn can lead to superior performance. With careful attention to credit analysis, returns can be enhanced *and* risks reduced by active management and taking off-benchmark exposure.

Jan Dehn

March 2012 Issue No. 90

The first step towards a more risk aware approach to investing is to break the addiction to benchmarks. No bonds are entirely risk free, so neither can indices of bonds be. All portfolios of credit or currencies are risky, regardless of whether investors are market weight, over-weight or under-weight. Hugging indices for safety and risk neutrality is pointless at best, reckless at worst. This is perhaps most graphically illustrated with reference to the Argentinean default in 2001. At the time Argentina defaulted on $120bn of sovereign debt it was the single largest issuer in Emerging Markets with an index weight of approximately 20%. The recovery value was 30 cents in the dollar, so index neutral managers lost 14% of their clients' money. A market weight allocation was clearly not risk neutral. Markets did not correctly price Argentina. Sound credit analysis and active management significantly reduced risk.

Of course, the fact that benchmark indices used (and still use) market cap as weights only added to the risks. Managers ended up adding more and more to their already pregnant positions the more Argentina issued. And Argentina was able to issue despite weak repayment prospects precisely because index huggers kept buying bonds in order to maintain exposure roughly in line with the benchmark index. Those who spotted the default risk early by paying attention to fundamentals incurred massive tracking errors leading up to the default. Managing risk by limiting the tracking error would have forced managers into adding ever more exposure to a very bad credit.

The second step towards a better investment strategy is to recognise that volatility is evidently not the same as risk. While this has always been the case in Emerging Markets, QE in G10 has now pushed up all asset prices further amidst quite weak G10 fundamentals. The constellation of weak fundamentals and elevated asset prices exacerbates already significant levels of market volatility. But, crucially, the added volatility does not materially increase risks in Emerging Markets. When volatility and risk get out of line then benchmark hugging becomes particularly disadvantageous. A market sell-off can become a huge buying opportunity rather than a reason to sell as you can now get the same risk at a lower price. This same holds in reverse in rallies. Rallies can overprice assets relative to their level of the actual risk. The two biggest buying opportunities for Emerging Market assets in the past decade arose precisely at the height of the global panics in 08/09 and the second half of last year. Value investing is emphatically *not* contrarian investing; value investing means watching *both* prices and risks.

The case for active management is strengthened further by the liquidity conditions in Emerging Markets. Liquidity is still pro-cyclical, mainly due to the behaviour of large cross-over investors and banks. Cross-over investors tend to buy Emerging Markets in G10 rallies, selling in bear markets. Banks likewise expand balance sheets during G10 rallies, reducing them again in bear markets. Recent regulatory measures under Basel 3 and Solvency II only exacerbate this behaviour. The effect is to blow out and narrow bid-offer spreads in response to G10 sentiment, again typically with no relation whatsoever to actual underlying risks in Emerging Markets themselves.

Thirdly, investors should favour scenario analysis over model based risk management. Quant modelling typically gives false sell signals while failing to capture buying opportunities in Emerging Markets due to their rapid ongoing structural transformations. As all econometricians know, even a single structural break in a time series renders invalid most statistical instruments for analysing time series analysis. This means that the past becomes irrelevant as a guide to the future. Moreover, structural breaks in Emerging Markets tend to be on average positive events as Emerging Economies generally tend to convergence towards wealthier economies. Any prudent manager whose model fails due to a structural break ought to recognise that he is travelling blind and pull out of the market. But when structural breaks are positive events on average then the right decision is to add, not to reduce risk. In other words, model based approaches to risk management can give precisely the wrong investment decision. A careful credit focus with detailed scenario analysis based on a solid understanding of local political and economic dynamics is more promising. Not only does this approach get you away from the illusion that tracking error tells you anything meaningful about risk, it also recognises that risks are typically not distributed in nice normal distributions, but rather hidden away in very fat tails.

The final and most obvious case for moving away from benchmark hugging and passive management is that many of the opportunities in Emerging Markets are off-benchmark opportunities. The commonly used Emerging Market fixed income index providers have failed to keep up with the growth of the asset class. Many instruments, such as Sukuk bonds, bonds denominated in EUR, GBP, JPY, and other G10 currencies, bonds with maturities less than 1 year, and bonds smaller than $500m are simply not part of standard dollar bond indices. Loans, private placements, and other OTC instruments are also excluded. Inflation linkers do not feature in the standard local currency bond indices. The most commonly used local government bond market index - JP Morgan's GBI EM BD index—covers only 16% of outstanding securities, the JP Morgan EMBI GD dollar sovereign bond index covers 43% of outstanding paper, and the dollar corporate bond JP Morgan CEMBI BD index covers 19% of the universe of paper. The most glaring omission is that the $4.2trn local currency corporate debt universe does not even have an index yet. Altogether, we estimate that only 12% of the $11.7trn total Emerging Market fixed income universe is currently covered by the indices most commonly used to benchmark Emerging Market portfolios, and the most commonly used dollar sovereign index only covers 2% of the fixed income universe (see table below). In other words, a benchmark hugger will miss out on between 88% and 98% of the potential investment opportunities in Emerging Markets. Should managers consider the full universe of Emerging Markets opportunities, even if this means that they will incur tracking errors versus the benchmarks? Absolutely. Why investors accept lower returns and more risk just because the benchmark index is a poor one?

EM FI Universe	Index Market Cap (USDbn)	Outstanding (USDbn)	% Of Outstanding By Theme	% of Total Outstanding EM FI	Commonly used index
Local currency sovereign bonds	908	5,693	16%	8%	JP Morgan GBI EM BD
Local currency corporate bonds	0	4,225	0%	0%	No index
Dollar denominated sovereing debt	287	669	43%	2%	JP Morgan EMBI GD
Dollar denominated corporate debt	219	1,143	19%	2%	JP Morgan CEMBI BD
Total	**1,414**	**11,730**		**12%**	

Source: Bank of America Merrill Lynch, JP Morgan

Ashmore Investment Management Limited
61 Aldwych London
WC2B 4AE
T: +44 20 3077 6000

Bloomberg Page:
Ashmore <GO>

Fund Prices:
Bloomberg, FT.com, Reuters, S&P, Lipper

Website:
www.AshmoreGroup.com

IMPORTANT INFORMATION

No part of this article may be reproduced in any form, or referred to in any other publication, without the written permission of Ashmore Investment Management Limited © 2012

This document is issued by Ashmore Investment Management Limited (Ashmore), which is authorised & regulated by the Financial Services Authority. The information and any opinions contained in this document have been compiled in good faith, but no representation or warranty, express or implied, is made as to accuracy, completeness or correctness. Save to the extent (if any) that exclusion of liability is prohibited by any applicable law or regulation, Ashmore, its officers, employees, representatives and agents expressly advise that they shall not be liable in any respect whatsoever for any loss or damage, whether direct, indirect, consequential or otherwise however arising (whether in negligence or otherwise) out of or in connection with the contents of or any omissions from this document. This document does not constitute an offer to sell, purchase, subscribe for or otherwise invest in Units of any Fund referred to above and is not intended to provide advice on the merits of investing in any particular fund. The value of the Units may fall as well as rise and investors may not get back the amount originally invested. With the exception of the SICAV fund, Ashmore's public funds are only available to persons defined as Professional Clients and Eligible Counterparties under the rules of the Financial Services Authority of the United Kingdom. Prospective investors should obtain and review the Scheme Particulars or other offering documents relating to the units or shares of any Fund, including the description of risk factors/investment considerations contained in the Scheme Particulars or other offering documents, prior to making any decision to invest in such Units or Shares. The funds are offshore and not regulated in the United Kingdom. Past performance is not a reliable indicator of future results.