Ashmore

The Emerging View

How to Lose Money Without Really Trying

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In this month's Emerging View we discuss ten conservative ways of investing likely to prove sub-optimal. By conservative is not meant prudent, but rather following the line of least intellectual resistance: doing what others do or what has worked in the past or elsewhere.

1. Driving With One's Eyes Closed: Passive Investing

It is true that if you close your eyes this saves energy. If you do so whilst driving, this should still save you energy, but this course of action is not recommended for obvious reasons. The first job of an active manager is to reduce risk. Major sovereign problems and crises typically are well-flagged. A country does not default, or take other extreme policy action detrimental to foreign investors, out of the blue. They will typically have had highly visible macro-economic problems for months before it comes to that.

A good example is Argentina's default in 2001. This was one of the easiest events to predict in the history of emerging debt (even if not its exact timing). Anybody who did not work out that Argentina was highly likely to default frankly in our view has no business managing other people's money in emerging markets. Also, because Argentina was in such financial straits it came up with more and more innovative channels of issuing debt, in particularly making new inroads in issuing Euro-denominated bonds to retail investors in Europe. The result was that their stock of debt grew and grew. Indices, being weighted by market capitalisation, reflected this growth. Argentina was 20% of the most widely used emerging debt index and 25% of another. Having a zero weight was an easy decision for active managers. Passive investors took more risk and made big losses.

One of the reasons why investors like passive investing is because they equate deviation from a benchmark with adding risk. Yet 'benchmark risk' is a term which, like 'risk free', is so misleading it should not in our view be used. Confusion arises from the lexicographic decision-making process in asset allocation we touched on in the last 'Emerging View'. Indices are too often used to determine overall asset allocation. Then managers are selected to manage, benchmarked to the index. Deviation from the benchmark can reduce risk to the overall portfolio, but this possibility is commonly ignored.

Indices - which may have consistent rules but are still arbitrarily determined - are also incorrectly assumed to be representative of asset classes. Only 12% of EM debt is represented by available indices.

2. Excessive Reference to DM: Use DM Skills

One aspect of what I call Core-Periphery Disease is the idea that everything in global fixed income revolves around the interest cycles and monetary policy decisions in the developed world. Yet emerging markets have very different, and many, cycles at present. Not only do they not face the deleveraging reality and deflationary pressures of the HIDCs (Heavily Indebted Developed Countries), but they have very different cycles amongst themselves. There is no emerging market inflation problem: there is though a Brazilian inflation problem, an Indian one, a Turkish one, and so on. Ignoring the substantial range of domestic inflationary forces and policy choices facing emerging Central Banks is good strategy for missing opportunities.

3. Treat EM as an Afterthought: Use a 'Global' Manager

A psychological support device for Core-Periphery Disease is to treat EM management as peripheral or subsidiary. I remember a conference at which a pension fund presented on the issue of whether to allow global managers to invest in EM equities tactically or to employ specialists. Their empirical conclusion was that the global managers added value (with reference to their benchmark) by tactically investing in EM, but that their portion of EM investments under-performed the EM index, unlike the portfolios of specialists. The conclusion drawn was that one should allow both. However, what was discovered were two things: tactical asset allocation works in EM, and EM specialists are better at managing EM assets than global managers (in this sample at least). Hence: Why not allow the specialists to engage in tactical asset allocation rather than the global managers? This could be achieved by allowing specialists to use cash/some modest leverage, though possibly also by dipping into developed markets. By the way - why are they called 'global' managers and not developed world managers (or HDIC managers for that matter)?

4. Hedge Out 'Currency Risk': Increase DM FX Risk

Money illusion is the illusion that a currency is not a price like any other, but fixed. The pattern of volatility of EM currencies against the Dollar is now very similar to that of developed currencies versus the Dollar. In other words, it is the Dollar which is volatile. Investing in 30 currencies, and ones which have huge reserves, is arguably safer than investing in one - the Dollar -which is overvalued and for which devaluation offers an attractive option for reducing debts. Not having EM currency risk is having US Dollar risk.

5. Outsource thinking: Use a Rating Agency

Despite decades of trying, using simplistic and consistent measures to assess sovereign risk has been woefully disappointing. This does tell us something though - life is more complicated. Assessing sovereign risk is about understanding the intricacies of policy decisions, incentive structures, political realities, and market perceptions, all in real time. By the time the data comes out it is too late - ratings often lag reality and the market. Also, in that we are facing financial repression (see 'The Emerging View', October 2011) ratings are increasingly a tool by regulators to capture investors' savings to finance governments. Such behaviour suppresses investment grade yields further, and increases investor homogeneity and so systemic risks. Those investors not so constrained would do well to think about sovereign risk for themselves.

6. Follow the Crowd: Miss the Really Big Risks

Index investing is a methodology to avoid straying from one's peer group. Career risk can only occur for those managing other people's money as it is a result of a Principal-Agent problem. This works most of the time, but not when catastrophe looms for the whole group. The wisdom of crowds needs to be balanced by the occasional stupidity of crowd behaviour. Investors needs to be constantly asking themselves whether there are possible scenarios and structural shifts ahead which could damage or outwit all their peers. If so they should consider doing things differently.

7. Ignore HIDC Macro-Risk: Buy Multinationals instead

Scenario planning is most valuable when it considers not merely the most likely scenarios, but also those with lower but still significant likelihood but which are horrendous. With the major macro-economic risks coming from the HIDCs of Western Europe and the US, one of the main motivations for investing in EM is to reduce risk, particularly in the very worst scenarios such as HIDC depression or currency crashes (even if these are low likelihood scenarios).

Emerging equities may be seen as desirable for returns and risk reduction. However, some of those not wanting to take the plunge are persuaded that they can do just as well by investing in multinational stocks based in the developed world with both significant developed world and emerging businesses and income streams. This limits choice somewhat and has emerging income streams possibly diluted by the developed world income streams. However the big difference concerns risk. When Lehman failed there were initial press reports in the US about how Lehman UK had huge cash surpluses and could survive. Then these were transferred to head office in New York. If one is investing in EM in part to reduce risk from the worst scenarios, investing in such multinationals is an inferior approach to investing directly in EM companies.

Any excuse not to invest is EM is often sought, and the idea of investing in Western multinationals with EM income streams is one refuge for those persuaded of the benefits of EM but still constrained by their prejudices.

8. Ignore the Unfamiliar: Deny the Existence of Whole Asset Classes

What is an asset class? The answer is unfortunately not very scientific, and the universe of asset classes is certainly not comprehensive. An asset class is arguably simply what one's peers consider an asset class, and this evolves gradually over time, lagging significantly the growth in the universe of possible investment opportunities. Many US public pension funds still did not invest in domestic equities in the late 1960s. At the start of the seventies they did not invest overseas, though after a few years most did. 'Alternatives' (to the established 'asset classes') have for some endowments now reached over 50% of total allocations - which arguably makes a mockery of the term 'Alternative'.

Whilst the universe of asset classes is evolving it is not keeping up with the opportunities in emerging markets and far too many investors are still not aware of the range of asset classes available. With the sovereign EM local currency debt market already larger than the US Treasury market for example (see 'The Emerging View', February 2012), how is it that some investors are concerned about whether it is significant enough to constitute an 'asset class'. If existing norms are inadequate, investors should perhaps define for themselves what is an eligible investment.

9. Believe What you Want to Believe: that EM is Risky and DM is Not

The 'China hard landing' meme is a currently topical example in a long line of psychologically-desirable excuses for not investing in EM. Without going into the details of why China experiencing anything more than a modest reduction in growth to 7% at worst is extremely unlikely, suffice it to say that if one were not concerned about this, there are many other excuses used to justify the thesis that investing in emerging markets is a bad idea. We cling to our prejudice with great tenacity. Historical precedence, macro-economic aggregates, policy myopia, the wishful thinking of electorates, and media hype may all be visible to the rational mind, and may argue for less Western and more EM exposure, but where is such rationality evident in many asset allocations? People believe what they want to believe and they want to believe that emerging markets are risky and investing in the developed world is safe. Evidence and rationality cannot be allowed to get in the way of this comforting thought.

10. Extrapolate & Ignore Factors Difficult to Quantify

If I stand blindfolded on a railway line I can estimate air velocity and estimate I am in a low volatile environment. I may employ people to measure air movements more accurately, and be reassured by the presence near me of my peers. However, if there is a train coming, I shall experience rather a lot of volatility all at once. Finding patterns in past data and extrapolating precludes picking up structural shifts. Equating volatility with risk is dangerous. Ignoring big macro-economic trends and the march of history is to tempt fate.

Be an Ostrich: Miss the Opportunity

Emerging markets represent the bulk of humanity, GDP using Purchasing Power Parity, energy consumption, industrial production, future expected growth and future global investment income. If one does not understand it one should find out rather than not try. In terms of both risk and return, the best way to lose money without really trying is not to invest in emerging markets.

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