Ashmore

The Emerging View
2012: A Lesson in Value Investing

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Introduction

2012 was a strong year for Emerging Markets. In the final 'Emerging View' of 2012, we look back at the performance of Emerging Markets asset classes over the past 18 months. We explain how performance was heavily influenced by events in the HIDCs (Heavily Indebted Developed Countries) and how a value investment approach was highly effective in realizing returns through the noise. In our concluding section we provide a brief summary of the key principles of value investing.

The Opportunity

The solid returns to Emerging Markets fixed income in 2012 were the realization of value infused into the asset class during episodes of gross mispricing, especially in the second half of 2011. On 31st July 2011 global markets began to panic about the US Congress' difficulties in raising the debt ceiling. Four days later Standard & Poor's downgraded the US credit rating. The bear market soon turned its attention to Europe (always a reliable source of bad news). In October 2011 private holders of Greek debt suffered a massive haircut. But by then the sell-off was over. The Greek default was fully priced. The S&P500 Index bottomed out on 4 October 2011. On September 29th 2011, a few days prior to the trough Ashmore issued a recommendation to all clients to buy Emerging Market fixed income ("*Engage that first bullet now*", Market Commentary, 29th September 2011). The recommendation was based on the following views:

(a) *Global market sentiment was about to turn less negative.* We argued that Europe was moving towards broader support for banks and sovereigns, thus alleviating the most serious tail risks. This was subsequently confirmed with several interventions, including LTROs, ECB President Draghi's commitment to defending the Euro, and other measures.

(b) *Actual risk in Emerging Markets had not materially risen.* In 2011, Emerging Markets grew on average 6.1% in real GDP terms and already by the middle of 2011 there were clear signs that Global PMIs were commencing a swing back into expansion territory.

(c) *The panic over the US debt ceiling and Greece had created value in Emerging Market assets.* Our top recommendation was sub-investment grade corporate debt. Spreads were 937bps over US treasuries at the time of our recommendation versus 253bps pre-Lehman and 478bps post-Lehman. Sovereign external debt – on average an investment grade asset class – was also mispriced at 450bps over US treasuries compared to 165bps pre-Lehman and 220bps post-Lehman. We also pointed to attractive value opportunities in Emerging Market currencies and local rates.

We recommended that investors put money to work using a 'three-bullet strategy', whereby investors progressively lock in value during sell-offs. The first bullet locks in already established value; the second bullet is at hand if the market weakens further; and the third bullet is just in case. Each bullet lowers the average purchase price of assets, progressively locking in more and more value. Provided you know the risk in your credits. Otherwise you are merely speculating.

Harvesting Returns

After a brief recovery in October, global sentiment went into limbo in November and December over lingering hysteria about Europe. The spell was only broken after the ECB launched 36-month long-term repo operations (LTROs) on 21st December 2011.

The return to rational pricing in Emerging Markets was by no means uniform. Corporates began to deliver almost immediately. Yields on corporate high yield debt declined from 12% to 10.5% between October and December, delivering index returns of 11.5% amidst considerable volatility. External debt returned 5.8% over the same period, but local currency assets lagged. Local rates returned 2%, while currencies declined marginally (-0.5%). This price action illustrates an important point: Emerging Market value opportunities rarely play out at the same time, so tactical asset allocation can generate considerable additional alpha during HIDC sell-offs and in the subsequent recovery period (for more detail see "*Blended Debt: Enhance Returns and Reduce Risk*", The Emerging View, October 2012).

When the market re-opened at the start of 2012, Emerging Markets ripped. Currencies rallied 7.3% in January alone then flat-lined in February and March. The equity rally lasted until late February, while sovereign debt and corporates continued to rally until mid-March. By the end of March, many Emerging Market investors had tactically reduced exposure, eyeing the opportunity to buy at cheaper levels in the event of a correction in the US stock market, which seemed increasingly likely.

On 2nd April 2012 a set of disappointing US labour market triggered the expected US stock market correction and with it the next global sell-off. Once again attention quickly turned to Europe. The French elections and Greek opposition politician Alexis Tsipras (remember him?) commanded all the headlines until the febrile headline-obsessed market finally caught sight of the real risk, namely Spanish banks. Ten year Spanish bond yields rose above 7.5% and EURUSD tested 1.20. Ten year US treasury yields pushed below 1.5%. How did this second global sentiment collapse in less than 12 months affect the value opportunity in Emerging Markets?

Unlike the HIDC panic of 2011, the 2012 HIDC panic materially impacted the global economy. Europe is 20% of global GDP and the slowdown in Europe in particular triggered a world-wide inventory correction in the manufacturing sector.

Emerging Market economies were not immune. As major manufacturing producers, real GDP growth in Emerging Markets slowed from 6%+ in 2011 to about 5% in 2012. Not only was the slowdown modest, it was also short-lived due to the absence of a debt overhang in Emerging Markets. By August 2012 global PMIs were already picking up steam.

Despite the modest economic impact, Emerging Market asset prices once again over-reacted. Sovereign debt spreads briefly widened from 295bps to 450bps, though yields only rose 44bps against a backdrop of panic buying of US treasuries, which rallied nearly 1% between March and June. Corporate high yield spreads blew out from 635bps to 790bps over US treasuries, while currencies gave back the year's gains as did local bonds. In short, the 2012 HIDC panic created yet another opportunity to get a second bite of the Emerging Market cherry.

On 2nd June, the market turned when the market correctly anticipated bank aid for Spain ahead of the formal announcement followed on 9th June. By July, Mario Draghi declared that he would do "whatever it takes" to defend the Euro. While Greek concerns re-emerged in Q4 2012 there was little impact as Europe dealt with the issue efficiently.

Against the backdrop of improving HIDC sentiment Emerging Market asset prices resumed their return to rationality. Sovereign external debt in Emerging Markets returned more than 13% during H2 2012, while sub-investment grade corporates rose 13.5%. The extraordinary value latent in local currency assets also began to materialize. Local currency government bonds rallied more than 14.5% from June to December and currencies began to rack up decent returns too, rising 7.5% from June to mid-December. Emerging Market equities, having lagged, finally caught up. They rallied 7.6% in the four week period from mid-November to mid-December.

In conclusion, the past 18 months constitute a near-classic Emerging Market 'risk-roll-down' trade, that is, the commonly observed pattern where segments of the investors base wrongly reduce exposure to Emerging Markets in the face of some HIDC event, and then only return to the asset class once recovery is well-underway, rotating first from sovereigns to corporates, from hard currency to local currency, and from fixed income to equities as rationality gradually replaces fear.

Those who put money to work on 29th September 2011 on the view that Emerging Market fundamentals were healthy throughout the past 18 months have seen very strong returns. Based on index returns, external debt returned 22% over this period. Corporate high yield debt returned 26%. Local bonds returned about 16%. Emerging Market currencies returned 5%. Emerging Market stocks returned 17%. Those with the ability to tactically allocate across countries and asset classes during the various HIDC panics will have had additional return opportunities.

Looking ahead

The key reasons to be in Emerging Markets fixed income are: It is safer. Lower debt. Stronger growth. Higher reserves. And none of the QE policies which will eventually undermine the purchasing power of HIDC bonds.

Emerging Market assets are attractively priced. Emerging Market sovereign bond spreads are some 100bps wide of their pre-Lehman lows. Corporate high yield spreads trade several hundred basis points wide of the pre-Lehman lows. Emerging Market currencies are 5% lower than the highs of 2011. And Emerging Market equities are 14% below 2011 levels and still more than 3% below the highs of this year.

By contrast, long-dated government bond yields trade below inflation rates in the US and Germany. HIDC bond prices are artificially inflated by central bank intervention, making prices an exceptionally poor proxy for riskiness. The HIDCs will be vulnerable for many more years, continuing to cause volatility. The volatility will infect Emerging Market asset prices, because sections of the investor base still prefer to sell at the lows and buy at the highs.

Today's focus is yet another HIDC risk, namely the US fiscal cliff. This too is unlikely to derail Emerging Market growth. And this too may yet impact Emerging Market asset prices. Turning HIDC risks into potential upside requires recognition that volatility is not risk. Volatility is the upwards and downwards movement in prices. Risk is large permanent loss. Understanding this difference can both reduce risk and enhance returns. This is what value investing is all about.

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Value investing

Is it possible to tell solely by looking at the price whether to buy or sell? Those who believe in the efficient market hypothesis (EMH) will answer yes, because the EMH holds that prices at all times reflect everything knowable about the asset. This is very convenient: No need for active management. No need for research.

In the real world risk is often mispriced, both in Emerging Markets and in the HIDCs. Emerging Market risk is usually mispriced to the topside, HIDC risks usually to the downside. The examples are endless: Why did Emerging Market spreads blow out to 900bps in 2008/2009? Why did Greek bonds trade 50bps over Bunds? Why are US government bonds trading at yields lower than inflation? Why do we have bubbles?

Value investing starts from the assumption that there is risk everywhere. 'Risk free' does not exist. Hence, a strong focus on credit fundamentals. Value investing uses deep and specialized credit knowledge to spot mispriced risk rather than speculating on short-term market momentum with heavily levered bets. Value investing locks in value via multiple purchases rather than guessing specific turning point in the market. Returns from value investing often play out over months or even years.

Price changes *can* reflect changes in risk, but they can also move for entirely spurious reasons, for example in response to investor prejudice or industry incentives. In the real world, the only way to tell whether a falling price is a sell-signal or a buying opportunity is to carefully examine the riskiness in each individual credit. In short, value investing is prudent investing. And as 2012 shows, it can also be profitable investing.

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