Ashmore

Mispriced risk? Investing in the Middle East

By Julie Dickson

There was no shortage of concerns about Emerging Markets (EM) last year. Investors fretted about the tapering of the US Fed's quantitative easing programme, China's growth outlook, tension escalated in Syria, and both Turkey and Egypt faced social and often violent unrest. Global Emerging Markets investors read the news and increasingly diverted their funds to the developed markets, leaving EM stocks to post a dismal -2.6% return for the year. But investors in Middle East equities apparently missed the memo. There, markets delivered a whopping 30.6% (MSCI GCC USD Net), outpacing developed and Emerging Markets by a wide margin. **Why? How? This note aims to explain the investment landscape in the Middle East and also address some misconceptions about risk in the region.**

Too big (and liquid) to ignore

Middle Eastern equity markets, defined here as markets covering the GCC[1] and Levant regions, account for USD 1,138bn, or roughly 1.8% of total global equity market cap. The oldest stock exchange is the Kuwait exchange, which formally opened in 1983. Its predecessor, the Souk Al-Manakh (now closed) was at one point in 1982 the third largest stock market in the world by market cap. In total, there are over 1,000 listed companies in the GCC and Levant.

Country	Market cap USD billion	% of region	% of world	Exchange name	Number of stocks	3-month average daily volume USD million
Saudi Arabia	516	45.3	0.82%	Tadawul All Share	164	2,135
United Arab Emirates	236	20.7	0.38%	Dubai Financial Market, Abu Dhabi Securities Markets, Nasdaq Dubai	126	731
Kuwait	112	9.9	0.18%	Kuwait Stock Exchange	208	115
Qatar	195	17.1	0.31%	Qatar Exchange	44	209
Other GCC/Levant	79	7.0	0.12%	Muscat SM, Amman SE, Beirut SE, Bahrain SE	640	c 50m
Total	1,138	100	1.81%		1,182	3,240

Source: Bloomberg, Ashmore as at 11 April 2014.

Now compare this to markets we are all more familiar with:

Country	Market cap USD billion	% of world
Turkey	240	0.38%
Indonesia	420	0.68%
Mexico	470	0.76%

Source: Bloomberg, Ashmore as at 11 April 2014.

None of these more familiar markets are anywhere near the total size of the Middle East. In fact the size of the Saudi market alone is larger than any of them – and has daily trading volumes greater than the Russian market.

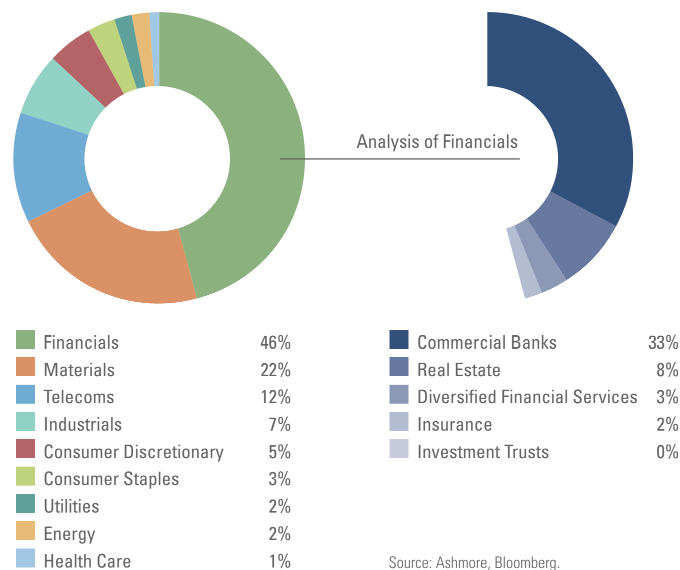
Given their individual and collective sizes, equity markets in the Middle East are simply too big to ignore. Moreover, the average daily trading volumes of the major markets and stocks (including P-notes) in the region make the Middle East a highly accessible investment destination for large investors. These advantages are now finally beginning to be recognised with the imminent re-classification of the UAE and Qatar from the MSCI Frontier to the MSCI Emerging Markets index. However, other markets – especially the Saudi Arabian market – remain largely unnoticed. Certainly, having direct access to these markets is a key factor in determining how practically investable these markets are. But even today it is possible to gain economic exposure to these companies through P-notes, in very similar fashion to the way investors have been accessing Indian equities for years.

[1] United Arab Emirates, the Kingdom of Bahrain, the Kingdom of Saudi Arabia, the Sultanate of Oman, Qatar and Kuwait.

No listed oil companies in the Middle East

Very few investors have taken time to familiarise themselves with the breadth and depth on offer. Some expect that by investing in the Middle East one gets exposure to the risk of falling oil prices. However, there are no listed oil companies in the Middle East. As a whole, energy stocks make up just 2% of the region's equity markets and these are primarily exploration and production companies with resources/concessions outside of their domicile. While banks and financial institutions account for almost half of the listed market cap in the region, there are still plenty of other investment opportunities available. Over the years, these markets have benefitted from increased listings in areas such as consumer and infrastructure growth. Whether in services or staples, industrial development, telecommunications, or even health care – investing in the Middle East provides ample diversification opportunities.

Fig 1: **Diversification opportunities across Middle East markets**



Financials	46%
Materials	22%
Telecoms	12%
Industrials	7%
Consumer Discretionary	5%
Consumer Staples	3%
Utilities	2%
Energy	2%
Health Care	1%

Commercial Banks	33%
Real Estate	8%
Diversified Financial Services	3%
Insurance	2%
Investment Trusts	0%

Source: Ashmore, Bloomberg.

Geopolitical risks

Perhaps surprisingly, geopolitical conflict has not impacted long term returns. In fact concerns about potential under-performance stemming from regional geopolitical instability have almost zero empirical support. The reality is that long term investors holding Middle Eastern equity before and through major disruptions have done quite well. If we look at the three largest flare-ups of instability over the past 20 years, which include war, conflict, and domestic uprisings, the relevant indices have materially out-performed the wider Emerging Markets index.

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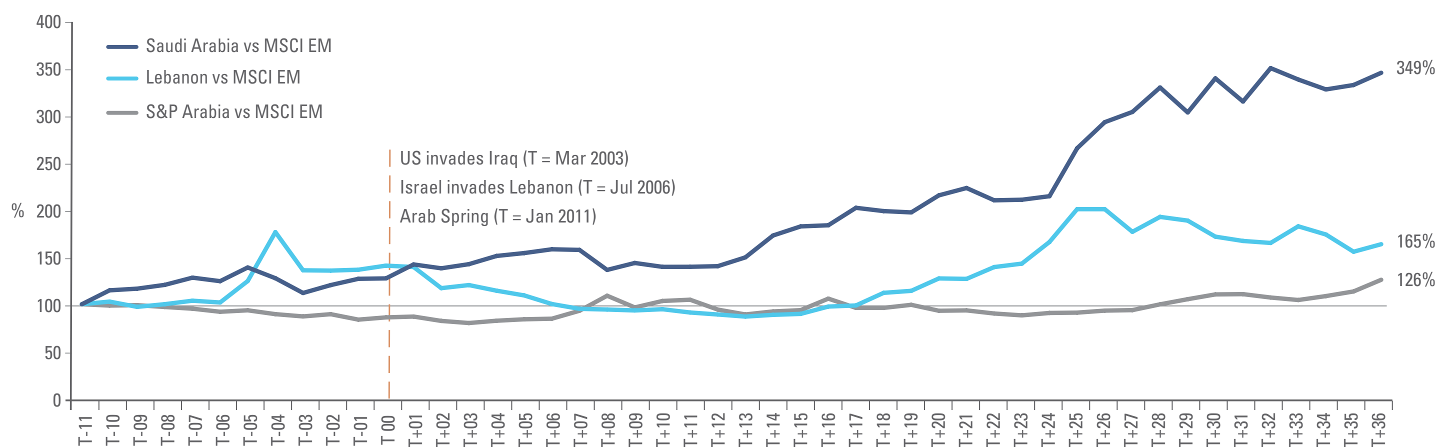
Why so little impact? Several factors are at play. By any measure, the Middle East's violent social unrest, cross-border bombings and all-out wars are at the extreme end of the 'political risk' spectrum, but stock prices reflect the underlying earnings power of a company. Typically, geopolitical flare-ups have zero impact on actual long term earnings potential, and simply offer opportunities to buy sound companies at attractive valuations, albeit during 'thin' times of below-potential growth and profitability. Both local companies and local investors have learned to survive and often thrive in difficult environments, where those with less resilient constitutions do not last as well. Second, the importance of the region to the global energy markets, and thus the global economy, means the major global players have strong incentives to support the region. There's implicit inertia stemming from the importance of oil exports from the Gulf. The world is nearly unilaterally aligned on this issue; an oil problem in the Gulf is everyone's problem. Conflicts tend to be kept relatively contained with little long-term negative impact on neighbouring markets. The outperformance on normalisation explains itself; we'll spare you the clichés about buying low and selling high.

Social cohesion also plays a role. The social contract in the Gulf remains very strong and most countries have relatively stable systems of governance. The UAE and Qatar consistently rank numbers one and two globally on Social Cohesion (IMD World Competitiveness). The status quo has support in most of the investable Middle East. To be fair, the 'uninvestable' Middle East is a different story, at least at present. Syria and Iraq have been left off investors' buy lists of late. Moreover, the large and

Fig 2: **How did local equity markets do before and after various flare-ups?**



Source: Bloomberg, S&P, MSCI. The relative performance is measured from one year prior to three years post the event. T+1 is measured in months.

investable market in Egypt has suffered through a violent change of government. However, Egypt's recent relief rally owes much to the 'no-strings-attached' economic support from Saudi Arabia and the UAE. It's important to acknowledge this heterogeneity within the context of the 'Arab Spring'. Those countries that are able to deliver on popular demands for economic growth and inclusion, whether through their own resources or with help from like-minded patrons, can achieve a level of social equilibrium in which the advantages of oil wealth and/or favourable demographics become apparent.

OK... it's partly about oil

Although governments across the region are by no means libertarian, there is little economic incentive to expand government intervention, taxation and direct control beyond the traditional oil-related sectors. The risk of asset expropriation is extremely low. Property rights are well enshrined culturally, and cash rich governments lack the incentive to tax, either directly, through seigniorage, or expropriation. Oil prices have remained at relatively elevated levels despite the global crisis; as global recovery gradually proceeds, oil prices may yet set new highs, especially if QE policies in the US eventually translate into higher inflation.

For the foreseeable future, however, the income from oil exports creates the incentive and the wherewithal to peg the local currency to the US dollar. Currency risk is near zero given ample FX reserves and long standing USD pegs. Moreover, twin surpluses and negligible government debt levels provide ample room for fiscal stimulus. In fact, an argument can be made that no region has more potential fiscal firepower to stimulate local economies than the Middle East.

Markets are also bolstered by little risk of capital flight by foreign investors during times of turmoil - as there is little capital to flow out – foreign investors makes up less than 1% of total shareholders in Saudi Arabia, and approximately 6% in the UAE. This demonstrates just how structurally under-owned these markets are by foreign investors compared to other equity markets. Low foreign ownership is the very evidence that these markets are still generally undiscovered. As a consequence they tend to be poorly researched or simply misunderstood – which creates opportunities for out-performance by those who understand and have experience investing in these markets.

Including the Middle East in your portfolio

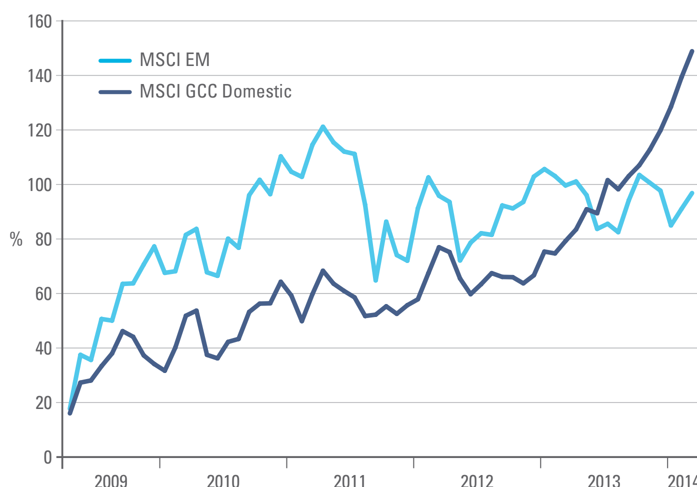
We think the inclusion of a Middle East portfolio in a global equity strategy makes sense from a fundamental point of view. Middle Eastern fundamentals are strong. Valuations as a whole are reasonable, while earnings growth is accelerating. This follows a steady return on equity that is superior to both emerging and developed market peers – offering high quality, well run businesses with room to grow regardless of the global economic backdrop. This is further supported by the higher and more stable dividend yield offered by well-run Middle East companies.

2015 Fundamentals	Middle East	MSCI EM Index	S&P 500 Index
Price to Earnings	10.5x	9.7x	15.9x
Dividend Yield	3.9%	3.3%	2.2%
Earnings Growth	18.5%	10.8%	11.5%
Return on Equity	19.2%	11.9%	15.3%

Source: Ashmore, Bloomberg, MSCI as at 31 March 2014.

The returns in the region, compared with the rest of Emerging Markets over the last 5 years shows how much opportunity lies outside the traditional approach to investing in EM equities. Based on MSCI GCC index, the region has outperformed the Emerging Markets by 5.5% on an annualised basis for the past 5 years, with significantly lower volatility.

Fig 3: **Strong returns over past five years**



Source: Ashmore, MSCI.

As a result, the risk adjusted returns in the region over the last 5 years were more than double those of Emerging Markets.

	MSCI EM	MSCI GCC
Return	14.5%	20.0%
Volatility	21.6%	14.9%
Sharpe Ratio	0.67	1.35
Correlation to EM	–	0.61

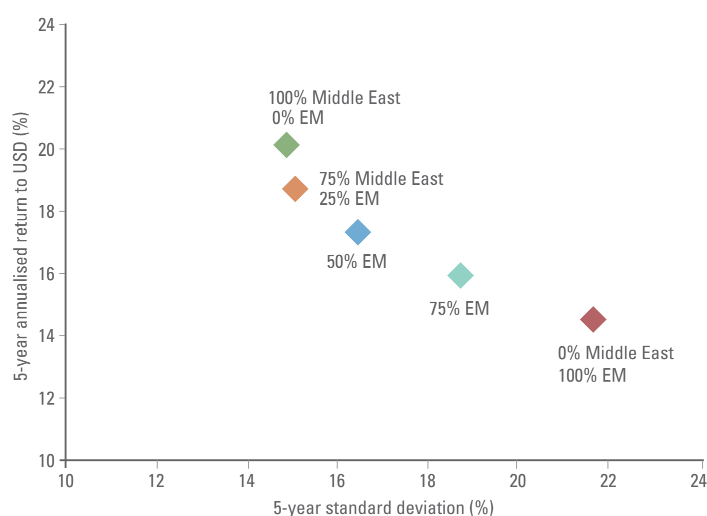
It is important to note that these returns were achieved despite concerns about:

- China's growth
- Resolution of Europe's sovereign debt crisis, including the bailout for Greece
- Tapering the US Fed's quantitative easing programme
- …and last but not least… the Arab Spring…

Including the Middle East as a discrete region within the Emerging Markets equity allocation can provide diversification benefits. The degree of inclusion should depend on the allocator's view of market fundamentals, outlook for growth, and risk/return objectives. Because the Middle East dominates the EM space with higher historical returns and lower risk, investing strictly by the numbers would lead to 100% allocation – probably more than most investors would want. Below is an illustration, based on the MSCI GCC and MSCI EM indices, of what the return/risk profile would look like over the last 5 years, based on varying levels of portfolio weightings.

What this shows is that it is possible to increase the overall risk-return profile of an EM equity portfolio by including an allocation to the Middle East – however small.

Fig 4: **Attractive potential diversification opportunities**



Source: Ashmore, Bloomberg, MSCI as at 31 March 2014.

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Conclusion

Middle East equities have been overlooked for too long, in our view. They are simply too big and liquid to ignore.

- Over the last five years they have delivered higher returns with lower volatility.
- Fundamentals are strong.
- Markets are increasingly liquid and diverse.
- Finally, with the upgrade of UAE and Qatar to EM status, they are getting more attention and continue to benefit from the structural growth trends that have underpinned their success.

We believe the time to invest is now.

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

Beijing
T: +86 10 5764 2601

Bogota
T: +57 1 347 0649

Jakarta
T: +6221 2953 9000

Istanbul
T: +90 212 349 40 00

Mumbai
T: +91 22 6608 0000

New York
T: +1 212 661 0061

Sao Paulo
T: +55 11 3556 8900

Singapore
T: +65 6580 8288

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