

The world is increasingly global... investors need to be too

Investing used to be fairly safe and easy. Bonds from developed countries produced a steady income with no defaults and low volatility. Developed market equities delivered similarly predictable returns. Investors who needed such certainty were natural buyers. But how things are changing.

Today's investors
and governments
may need even
higher returns

Corporate defaults and market sell-offs are a reality, developed market bond volatility is trending higher, whilst returns hover around historically low levels. Increasingly returns in developed markets might not always compensate for the risks. Investors will need to embrace higher risks to obtain higher returns. Life expectancy is increasing and career spans are shortening. John Cleary, Chief Investment Officer at Focus Capital, says **"retired people will need higher returns from their remaining investments"**. Governments face similar problems to retirees. Many state pension schemes are under-funded which means that they lack sufficient assets to match their future liabilities. It has been estimated that even though Europe has a larger population than the US, it has only one quarter of the pension assets. European governments face potential pension shortfalls exacerbated by investments in low returning assets. Approximately 80% of existing assets in Europe are held in fixed interest. The necessity for governments to increase both their funding of such schemes and generate sufficient returns to pay pensions will increase. Higher returning assets will be needed.

Emerging markets
will become more
important

And this is where emerging markets can help. These markets may come with higher volatility but they also come with higher returns. Average annual returns for the MSCI Emerging Market Free index have been over 34% versus only around 11% for the S&P500, for the three years ending the 29th September 2006. Already emerging markets account for over 42% of world's exports; 47% of world's oil consumption; and 85% of world's population. But emerging market issuers still represent less than 15% of global market capitalisations. But despite these valuations few portfolios have even 15% allocated to emerging markets. Cleary said **"even at these levels emerging markets are broadly undervalued"**. Rationally emerging markets should represent a growing portion of most portfolios.

These extreme
markets are fast
becoming
mainstream

But some people consider emerging markets too specialist to invest comfortably in. Such specialist sectors are generally not considered mainstream until they become part of broader market indices or portfolios. Until now the problem for investors has not only been whether to allocate to emerging markets, but also how much and whether to place the investment in bonds or equities. Volatility-adjusted allocations to emerging markets often resulted in allocations made at the wrong time or not at all. But increasingly benchmarks in both the bond and equity world include an allocation to emerging markets based on some type of capitalisation-weighting. This at least justifies an allocation. However these benchmarks may solve the dilemmas of investing in emerging markets. Cleary said **"benchmarking is not the optimal way to exploit inefficiencies in emerging markets"**. This is because specialised asset classes do require specialist managers. Which specialist manager investors choose is the next dilemma

Do not compare the risks but combine the risks....

Emerging market managers may specialise in equities. But bonds in these markets also have their place. Emerging market governments and emerging market companies are often driven by different dynamics. Emerging governments are concerned about developing economies and addressing issues using macroeconomic approaches. Emerging companies tend to operate within global industry sectors and evolve by finding solutions to microeconomic problems. Different economic cycles, drivers and solutions mean that the emerging market asset class, like the developed world, has different security types all of which benefit from a specialist approach. These sectors include amongst other asset types: emerging equities; government bonds; corporate bonds; and local currency. Cleary says **“different risks in emerging markets should not be compared but should be combined”**. The diverse characteristics of a combined portfolio can provide a complementary portfolio with a high returns. Correlations with other asset classes also remain favourably low. Focus Capital uses an investment process that can combine all types of securities in emerging markets for a multi-asset class approach.

Crises and defaults are part of the emerging investment cycle

Emerging market crises are cyclical events, somewhat like the business cycles of the developed world. Emerging market governments rarely have sizeable alternative sources of finance other than capital markets and although they may have problems paying today, they will tend to restructure their debt so they can repay at a later date. Without the past crises few countries would have had the necessary momentum to make changes and necessary adjustments that facilitate progress. Similarly such events can also make companies more competitive and resilient. Arguably, Mexico would not be one of the world’s largest exporters, a key partner in NAFTA and an increasingly large production base for US automotive production if it had not had its crisis and subsequent currency devaluation. From these events can emerge stronger countries and companies. Cleary said, **“emerging market crises are often unpredictable and painful but can be powerful catalysts for change”**.

Truly diversified emerging portfolios should have improved risk/return profiles

The way to benefit from such crises is to become a strategic and informed investor – which is what Focus Capital aims to do. Historically, people have invested too much of their portfolio at the wrong times into emerging markets equities and bonds. The mistake many made was to choose which of these two sectors they should invest in as opposed to considering both as interchangeable. Having the ability to gain exposure to both asset types can dilute the impact of future events which will always be part of the investment cycle. Focus Capital, through its innovative fund of funds approach, is aiming to offer emerging market portfolios which take full advantage of the opportunities.

The question is not ‘if’ but ‘how’

With returns decreasing elsewhere in the world, emerging markets will increasingly need to be a part of any portfolio. More emerging markets are becoming investment grade (at last count nearly twenty), which makes this asset class, estimated to be worth over US\$7.5 trillion, too big to ignore. Cleary says, **“the question for investors is not *if* to buy emerging markets but *how!*”**. Whether and when we should invest in equity funds, bond funds, or hedge funds in emerging markets is part of the everyday decisions that Focus Capital makes in running its fund of funds business. Which fund manager is best for the parts of the market Focus Capital wants exposure to is the other important decision. Cleary said **“no one manager can outperform in all market conditions which is why we use a fund of funds approach”**.

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