

## Asset allocation followed by fund selection are the keys to successful emerging market investing...

### The asset mix in emerging markets is responsible for most of the return

Gary Brinson and his colleagues published an article in 1986 stating that "studies show that asset mix determines 93.6% of the return of a portfolio". Brinson et al. defined investment policy to be a combination of the choice of asset classes and the choice of asset mix. At Focus Capital our research and experience indicates that this has particular relevance in emerging markets. John Cleary, Chief Investment Officer of Focus Capital, says "**investors mistakenly believe that emerging markets is a single homogenous asset class**". But we believe they could not be more wrong. Differences between equity, bond and distressed securities risk/return profiles make them very different opportunities that offer significant diversification benefits. It is for this reason that we will consider investment in any asset class within emerging markets.

### Strategic asset allocation is the starting point

Asset allocation is the starting point of our investment process. To truly have the option to invest in all asset types in emerging markets an asset manager would need a huge and global investment team. No emerging market manager in the world has such a team. It is for this reason that we chose a fund of funds approach to have the flexibility to exploit many investment teams and combine them in a portfolio that takes advantage of their full skill base across all asset types. Cleary says, "**we believe global investment needs global resources and that is what we are aiming to achieve through our fund of funds approach**". We believe all investment approaches should be considered within an emerging market fund. For this reason we analyze emerging equity funds, emerging bond funds and emerging hedge funds and will consider tactically allocating between them over the emerging investment cycle.

### Specialist fund selection is the next stage

Emerging market strategies have gained in popularity among institutional and private investors. Poor returns in developed markets are encouraging investors to consider these markets and their return opportunities. We have observed how a large number of asset management companies have increased their range of emerging market funds in response to demand from investors. This has led to an increase in the number of professionals managing emerging markets and the expertise within this specialist sector. However Elena Villalba, Director of Investments at Focus Capital, says "**we believe emerging markets are still significantly under-represented in most investment portfolios**".

### Fund volatility should be managed not avoided

One of the concerns of investors in emerging markets has been historical volatility. The volatility that developed market funds had 5 or 10 years ago is similar to the volatility emerging market funds are experiencing today, at around 20%. Whilst global developed market investors may have enjoyed a significant drop in volatility over the past years they have also experienced a significant drop in returns. The risk/return relationship looks far more attractive in emerging markets. Sharpe ratios over the last 5 years in US Equity Funds has been slightly negative at around minus 0.1 versus Sharpe Ratios of around 1 in Global Emerging Market Funds. Given this Sharpe ratio why are not investors putting more money to work in emerging markets. Villalba says, "**investors often fear volatility but they should manage it – only then can you reap the rewards available**".

**Specialist  
managers  
outperform  
generalists**

Our approach when selecting emerging fund managers is different to the approach typically employed selecting developed market funds. We have found a large correlation among developed market funds reacting to global economic data, whereas emerging market funds have a lower correlation to the same data. However the same global data might have implications for all countries but the reaction is often different from emerging markets. Emerging funds therefore have less predictable returns and a number of additional variables need to be taken into account. There is no one framework into which all funds fit. Each region may require a different approach given differences in local politics or development. Globalisation affects all countries in different ways. It would therefore make sense for emerging market managers to specialise given these differences. Cleary says, **“we have found that specialist emerging market managers tend to outperform generalist emerging managers”**.

**Our fund of fund  
approach allows  
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talented managers**

The world is constantly changing and so are the opportunities in different markets. More versatile investors are taking advantage of this opportunity and are giving more consideration to emerging markets. Asset management companies are trying to cope with this demand and we have observed an increasing number of emerging market funds each year. For instance, five years ago there were around 20 funds specialized in Indian Equities, today the number of funds has almost doubled. We think institutions are aware of the importance of adding emerging market funds to their portfolios. What before was a tactical allocation is now part of strategic allocations in both institutional and retail portfolios. We believe this is an important step for this asset class however. Cleary says, **“increasingly talented managers are leaving big investment companies and moving to smaller more specialist managers”**. We believe the number of emerging markets funds available will increase over time and so will the expertise in the market. Our fund of fund approach allows us to exploit talented managers. We believe emerging market fund management is actually in an emerging and exciting phase....

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