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Emerging markets: what's your excuse?

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- With problems in Argentina and Turkey, emerging markets can look high risk in an already uncertain world
- Investors are waiting for a catalyst, but by the time one arrives, prices may already have moved
- Real value has emerged as investors have shunned the asset class

Investors continue to find a wealth of reasons to stay away from emerging markets. From instability in the Middle East, to trouble in Turkey, to Argentina's debt problem, the narrative runs that emerging markets are high risk in an uncertain world. Instead, investors cling to stable growth stocks in developed markets. This strategy overlooks the real opportunities in emerging markets.

The apparent problems in the asset class are not as significant as they first appear. In reality, the situation in Argentina is unrepresentative of the outlook for other emerging markets, few of which have its debt problems or its uncomfortable political legacy. Argentina is a tiny fraction (less than 1%) of the benchmark. It has long been isolated from its near-neighbours and the global economy. We would make a similar case on Turkey, which also grabs headlines but has limited potential for contagion.

The majority of emerging market economies are doing well. There is faster growth than in developed markets and all the long-term structural drivers are still in place, from the rising middle class to urbanisation. Yet as investors have kept away, the asset class has become cheaper and cheaper, offering greater value to stock-pickers.

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At Aberdeen Emerging Markets Investment Company, we find this value in unusual places. Korea, for example, has been hit recently as the government has reignited an historic spat with Japan over war reparations. This has helped push prices to their lowest level in 20 years. To our mind, this is everything to do with sentiment and little to do with Korean companies themselves.

A similar phenomenon is apparent in frontier markets. We currently hold around 8% of the portfolio in frontier markets. These countries – Nigeria, Kenya, Egypt – have been totally dismissed by global investors. Vietnam is the only one with any enduring popularity. Valuations are now so low, and dividends so high, that it is possible to uncover real opportunities.

Nevertheless, investors are still nervous about committing capital without a catalyst for a change in sentiment. Could the cheapness of emerging markets in itself be the catalyst? Possibly. Valuations can be like an elastic band that stretches, but eventually snaps back. As we see it, investors are taking a lot of comfort from areas of that market that have done well. This may prove to be misplaced as valuations move higher and they may start to reappraise their view on risk.

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Certainly, a specific catalyst hasn't always been necessary to move emerging stock markets higher. A few years ago, Russia was a pariah for investors; an oil-dependent economy, with political problems and sanctions. Yet, Russia's stock market has done extremely well in recent years. There was no catalyst except low prices, though more recently it has benefited from the US turning its gaze elsewhere. Sentiment can turn very quickly.

China is an issue and we would not downplay its problems. It is now around one-third of the index and its recent tussle with the US on trade has undoubtedly dented sentiment. However, there is also a lot of noise around China and the long-term growth trajectory still appears to be in place. To our mind, there remains a gulf between the economic and political importance of China on the world stage and its weighting in investor portfolios.

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We would also argue that China's position is not as precarious as it seems. Its key advantage is politics. While Donald Trump must win another election, the Chinese government does not have these constraints. With this in mind, there may be some concessions – albeit well-disguised - as election day approaches.

As part of the strategy for Aberdeen Emerging Markets Investment Company, we are currently raising our allocation to the 'A' Share part of the market. The market is large, inefficient and liquid, making it an ideal hunting ground for active managers. In taking exposure, we have allocated to a specialist Aberdeen Standard Investments fund that looks for 40 high quality companies with strong governance.

For all these reasons, we see real value in emerging markets. The question for investors is whether they wait for a catalyst to appear or invest while valuations are still depressed in the hope of a change in sentiment.

In our experience, it only takes a small improvement to have a disproportionate effect in share price terms. With flows depressed, relatively small amounts of capital redirected towards emerging markets can have a significant impact in share price terms. We believe that as soon any catalyst is apparent, it may be too late and markets will have moved.

In our view, investors should allocate to emerging markets through the cycle. Only that way can they ensure they are invested as the market recovers. It may feel counterintuitive to invest when sentiment is poor, but it is often where the strongest opportunities arise.

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- The Company may accumulate investment positions which represent more than normal trading volumes which may make it difficult to realise investments and may lead to volatility in the market price of the Company's shares.
- There is no guarantee that the market price of the Company's shares will fully reflect their underlying Net Asset Value.
- As with all stock exchange investments the value of the Company's shares purchased will immediately fall by the difference between the buying and selling prices, the bid-offer spread. If trading volumes fall, the bid-offer spread can widen.
- Yields are estimated figures and may fluctuate, there are no guarantees that future dividends will match or exceed historic dividends and certain investors may be subject to further tax on dividends.
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- Investing globally can bring additional returns and diversify risk. However, currency exchange rate fluctuations may have a positive or negative impact on the value of your investment.
- Certain funds can invest into other funds which themselves invest in assets such as bonds, company shares, cash and currencies. Where an Investment Trust is a fund of funds vehicle, it will have two layers of fees and expenses - at the level of the Trust and also at the level of the underlying funds held by the Trust. This means that any returns generated for an investor will be after both layers of fees and expenses.
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- Specialist funds which invest in small markets or sectors of industry are likely to be more volatile than more diversified trusts.

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