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Emerging equities – get pure stock performance, not "noise"

Key Takeaways:

- Translating the growth potential of emerging markets into consistent investment returns requires an approach that is focused on companies of genuine opportunity
- A bottom-up strategy is needed, taking high active share in high-quality companies, weighted to fast-growing smaller-mid caps, while keeping tracking error low and achieving similar volatility than the benchmark
- Such an approach allows risks to be concentrated where intended – on specific stocks rather than sectors, countries or themes
- The risk framework should also limit the negative potential of behavioural biases, where portfolio managers favour the stocks to which they are closest

What's the best strategy for investing in emerging markets? Most investors need little convincing of the growth potential of emerging markets, despite some potential future headwinds. But translating that growth into consistent investment returns is not straightforward and requires an approach that is focused on companies of genuine opportunity, rather than a broad-brush approach.

High active share, low tracking error

"Not very long ago, emerging markets were all about macro calls," says Stephane Mauppin-Higashino, founder and head of Ostrum EM capability. "It was about country allocations and calling the currency right. These factors no longer amount to an investment case, as they no longer define your excess return and ranking."

That's why Ostrum created a bottom-up approach to emerging markets that aims to perform from stockpicking alone, and exclude market "noise".

It aims to find 50 companies among those 7,000 that have undisputed growth and quality characteristics. That is, those companies who have the best earnings growth prospects and the best returns on capital.

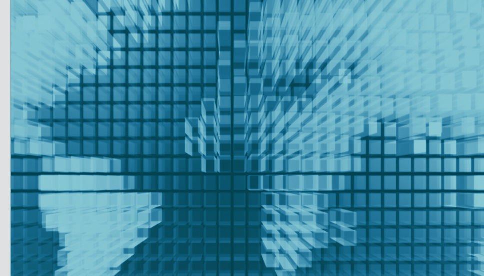
The big question is how you isolate these characteristics from market noise and produce a pure - or purer - fundamental process. "Very few managers really do stockpicking," says Mauppin-Higashino.

Stéphane Mauppin-Higashino, CFA,
CEO Asia
Global Head Emerging Equities
Ostrum Asset Management

"There are two ways to prove to clients that you really do it – via performance attribution, and tracking error level and decomposition."

In other words, can performance be explained by those individual companies improving their true fundamental positions or could that performance be explained by wider macro factors? If the performance of the portfolio is the result of its sensitivity to factors such as oil price or interest rates, then the process has likely been infiltrated by market 'noise'. This is not therefore an example of pure stockpicking. Then there is tracking error; many investors believe stockpicking must involve high tracking error. There is no reason this must be the case. High tracking error is often due to excess factor risks to certain industries or countries and can lead to sizeable volatility.

"We are pure bottom up guys," says Mauppin-Higashino. "But we also recognise that the benchmark is relevant for most investors, so we aim to respect its structure as closely as possible while maintaining high active share. It sounds counter-intuitive, but we are the living proof that it can be done."



Focusing on the right risks

How then can it be done? How is it possible to find 50 high-growth, high-quality emerging market stocks, be smaller-mid caps-minded, keep tracking error low and have a similar volatility than the benchmark?

The development of market structure has been helpful to Ostrum's approach: the potential of an all-cap emerging market strategy has increased in recent years as equity issuance has grown, and more than 7,000 emerging market companies are now listed on world stock markets. Deeper markets mean a larger, higher-quality universe with many small and mid-companies offering greater diversification possibilities.

Ostrum takes a view on the whole of this universe using a combination of quantitative and human analytical skills, with a feedback loop that means the two techniques are constantly compared to check for opportunities and inconsistencies.

To explain, a technology-based screen is first used so that the entire emerging universe can be filtered. The screen is based on Ostrum's core beliefs, using 20 separate criteria to score the stocks for growth and quality and providing a strong long-list of portfolio candidates. Sometimes the screening will unearth lesser-known stocks. If the Ostrum team likes the profile – the history of the company, products, competition and so on – they will then seek to interview its senior management. In fact, Ostrum meets about 1,000 companies a year, or about 130 companies per investment team member.

The feedback loop involves a return to the database to check whether the portfolio exhibits excess growth and quality characteristics and is likely to achieve a target of returns that are about 4% above the benchmark.

The resulting portfolio has an unusually high active share of 80% (80% stock-specific risk), with a strong weighting to fast-growing smaller-mid caps companies. The risks are concentrated where they are intended – on specific stocks and not on sectors, countries or themes.

Avoiding biases, stopping losses

Like the investment research, risk management is based on a combination of technology and human judgement on stock purchases and sales. Selected stocks must have the potential for at least 35% upside.

The goal is really to minimize style, country and sector biases. The investment process studiously avoids making country calls, such as avoiding Thailand because it has political risk, or overweighting Chinese and Indian manufacturers as a theme. In any country and any sector, history shows there are always a number of companies with outstanding growth and quality profiles.

So the bottom-up process limits biases while maximising active share. This has led to reduced volatility compared with reference indices over the last three years.

The bottom-up process necessarily requires deep research which can lead some portfolio managers to become overly attached to particular stocks. Underperformance of these stocks can then be hard to come to terms with. That's why Ostrum employs an automatic stop-loss mechanism to take emotion out of the equation.

"Even good portfolio managers will be wrong 40% of the time, and we help them to put clients' interests above personal pride," says Mauppin-Higashino. "That's why we have a stop-loss system." Stop-losses are rarely used in long-only strategies, which claim to ride out turbulence in the name of solid research and conviction. But in a concentrated, high active-share strategy, this is a dangerous approach, Mauppin-Higashino believes.

Best of both worlds

Some emerging market strategies are managed solely from Europe or the US, others are managed locally. Ostrum prefers to split its emerging markets team between Asia and Europe.

It believes this offers the best of both worlds. First, this structure creates an internationally-minded team, with diverse skills. Being on the ground helps with researching smaller-mid caps, with the analysts and portfolio managers able to talk directly to companies in their own language, potentially uncovering better quality information.

Second, it leads, says Mauppin-Higashino, to a more disciplined approach. "When you are in several locations, you have to make sure your investment principles are explicit, that the handbook is fully shared, that the tools are the same," he says. "So you need to go into a level of detail that is beyond what may seem necessary if the team is all in the same office, and ensure strict adherence to the identity and approach." The benefit of which is shared characteristics and signature tilts across the range.

A good moment to invest?

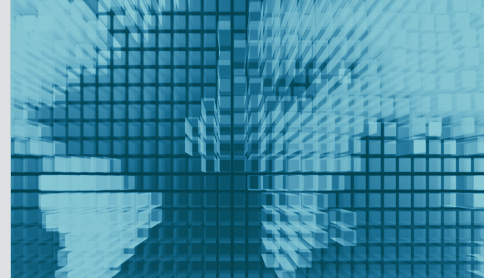
A final, and important, consideration is whether now is a good time to allocate to emerging markets.

"Three years ago, I said emerging markets carried a lot of risk," says Mauppin-Higashino. "There was a debt overhang, the cycle was not great and return on capital was going through a soft patch."

In the last 18 months, the outlook has dramatically improved, with substantial earnings improvement emanating from north Asia and the technology sector, and spreading outwards.

However, risks have shifted from internal to external. Most important ones are related to the US with the rate cycle, the valuation of equities and potential protectionism.

Topline and margins are rising in emerging markets, as evidenced by recent quarterly releases. Even in Brazil, where there has been political and economic turmoil, fundamentals are



improving and valuations will surely follow.

Conclusion

A pure stockpicking approach has the potential to pick the best performers in strong markets, and should also produce excess returns if negative external factors do impact the market.

That's the advantage of an investment process which has a unique identity, as demonstrated by a very high active share and, at the same time, unusually low volatility. It is simple and intuitive, and yet unique among long-only emerging equity funds.

Written on 13 June 2018

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