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Emerging-Markets Growth Best Accessed Through Mid-Caps

As for style, value is a safe way to go, but we like GARP best, says Van Eck Global's Angus Shillington.

ETF Specialist | 09-28-11 | By Patricia Oey

Before appearing as a panelist at Morningstar's second-annual ETF Invest Conference last week, Angus Shillington spoke with us on why he is optimistic about the emerging markets for the long term, and how he is managing his portfolio during this volatile period.

Q. About a fourth of the money invested in emerging-markets mutual funds and exchange-traded funds is in vehicles that track a market-cap-weighted index. Is this the best way to access the faster growth in the emerging markets?
A. At Van Eck, we break up the emerging-markets universe into two distinct spaces. The first includes the global cyclicals, such as the oil, materials, technology—these account for about 40% to 50% of the investable market cap and have very little to do with what is happening in the emerging markets and more to do with global growth. The second group is domestically oriented, but about half of this group is comprised of government-owned banks and other domestic cyclicals, which we think are not necessarily well-run businesses. The final quarter, which we find super exciting, is the very entrepreneurial, privately owned businesses that focus specifically on what is going on inside the country. We are always overweight sectors that are exposed to the secular growth in domestic consumption, and these firms tend to be more mid- and small-cap.

Q. What are some examples of these types of firms?
A. We really like supermarkets; we're seeing a shift in shopping habits from wet markets to large, indoor markets. For example, in China, there were about 80 million middle-class households in 2005, and we expect this figure to more than triple to 300 million by 2015. Other ways to access the rise in domestic consumption include investing in firms related to the auto, housing, mall, entertainment, and Internet industries. We also like companies exposed to areas in need of investment, such as power, roads, and other infrastructure plays.

Q. So, you tend to see much better opportunities in the mid- and small-cap space. Do you invest by style as well?
A. Given the growth rates, you would think it would be best to invest in the growthiest companies, but we have seen that these companies tend to deliver some of the worst performance over the long term. These companies tend to be first movers, through luck or ingenuity. However, there is a lot of entrepreneurialism in the emerging markets, and once someone is successful, we quickly see a throng of competitors, who drive down pricing and ROEs. We have seen this a lot in technology.

The safest bet on emerging markets has been value, but the style that beats value is GARP (growth at a reasonable price). We usually find these companies in the second quartile of growth companies, by screening for firms that are trading around 12 times to 15 times P/E. We look for firms with high ROEs and sustainable business models with high barriers to entry.

Q. The long-term fundamental outlook on the emerging markets remains intact, but we've seen a large sell-off in emerging-markets equities. How are you managing your portfolio during this period of high volatility?
A. The emerging markets will never be disconnected global systematic issues. Even though the problems are in the developed world (such as the U.S. banking crisis, European sovereign debt crisis) emerging markets are impacted when markets grow more volatile, when liquidity risks becomes an issue, currency risks become an issue, and we see a rise in correlations across asset classes.

At this time, we are holding elevated cash levels in our portfolio, and we are using this opportunity to switch into higher-quality companies as their valuations come down. We also expect to get whipped around, as we invest in mid-cap names. As a point of reference, we tested our 2008 portfolio, and while some names went down 60%, the earnings went down no more than 10%. We are comfortable with the business models of our investments. And we don't hold a lot of companies leveraged to high-end consumption.

Q. One of the issues investors have with the emerging markets is transparency. Are you seeing improvements in this area?
A. Better transparency is a function of time. As these markets develop, and as more sophisticated investors get involved, we have seen

companies understand that they need to deliver. This was not the case 10 years ago.

Q. The high-profile IPOs still tend to be from government-owned entities. How is the IPO outlook for the smaller, domestically oriented companies?
A. We are definitely seeing IPOs that are in line with our domestic-consumption investment theme. We continue to be excited about the future of emerging markets, and we expect growth to be driven by wealth creation, innovation, and even cost arbitrage, which we don't think is going away any time soon.

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