



## Alpha abroad – the buy-side looks to emerging markets

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*Buy-side firms' interest in exotic instruments has risen in recent years as their domestic equity and bond markets returns remain in the doldrums. But for some managers 'exotic' extends beyond OTC derivatives and structured products – these firms bet on emerging markets, where they see alpha and risk diversification opportunities, from the simplest to the most esoteric instruments. By Stewart Eisenhart*

Emerging markets – Brazil, Russia, India and China (BRIC) as well as South Africa and other economies in Asia, Africa and South America – display high risk-reward characteristics attractive to those hedge fund and asset managers able to take advantage of those opportunities regardless of whether they are long-only firms looking to globalise their equity portfolios or multi-strategy hedge funds chasing cross-asset, cross-border alpha.

Caveats, though, are always quick to follow on the buy side. Managers active in emerging market must also appreciate the unique risk factors inherent in these markets, and utilise operational and technology resources sensitive to these investments' multiple moving parts. Volatile emerging markets can just as easily deliver heavy losses for the unwary as they can stellar pay-offs to the shrewd. The search for higher yields fundamentally drives managers to get involved in emerging markets, although the extent of their participation naturally depends on their investment mandates, risk management and trading capabilities, and experience.

A US traditional investment manager looking to diversify its portfolio and employ new hedging devices may make a single-digit asset allocation to emerging market equities, while a more aggressive hedge fund manager might focus alpha generation efforts wholly in emerging markets across asset classes. In either case, the benefits of pursuing these efforts in emerging market economies become more and more evident – effectively tapping into emerging markets requires successful managers to develop unique blends of vigilant risk management techniques, internally developed systems and adequate third-party tools.

According to a number of sources, alpha generation and diversification of risk exposures stand as the biggest attractions to emerging markets for managers. It is the same formula driving bigger buy-side forays into other alternative investment vehicles, with their own idiosyncrasies.

Susan Payne, chief executive at UK-based emerging markets hedge fund manager Emergent Asset Management, argues that while managers currently pursue emerging market strategies for alpha, the growth predictions for many emerging market economies will eventually necessitate more involvement in these countries' financial markets. "It is not just about search for yield, it is also that these economies are growing so strongly and so rapidly that they cannot be ignored," Payne says. "The BRIC nations and South Africa represent 15% of global trade and hold more than 30% of the world's reserves... the simplistic answer here is the search for alpha because these countries are now improving in terms of creditworthiness, with dynamic and robust economic fundamentals."

Raj Keswani, chief executive and co-chief investment officer at emerging markets investment manager Dolomite Capital Management in New York, says that buy-side expectations of unique emerging market behaviours has also driven interest in recent years.

Keswani, who founded Dolomite with fellow veterans with whom he previously managed Chase Manhattan and JP Morgan's emerging markets business, explains: "One driver would be excess return relative to developed market risks. In other words, you are not going to take legal and operational risks with a company in an emerging market unless you are going to get paid more than you would taking a similar risk in the US."

In addition, Keswani says, buy-side interest in emerging markets is driven by correlation: "The expectation is that emerging markets will not behave the same as developed markets, and as a result, a source of return that is not excessively correlated with developed market risks is of value to many funds."

Once a manager decides to become active in emerging markets, the more complicated question arises of which regions and asset classes to target more specifically. Industry observers report that managers just getting into these markets tend to stick to the asset classes they have successfully traded domestically. It basically boils down to a blend of comfort and familiarity.

Michael DeStefano and Cynthia Doe, markets leader and senior manager for technology assurance respectively at Ernst & Young's Americas asset management industry centre, report a mixed bag in terms of hedge fund and buy-side managers' emerging markets investment choices. "They are looking for diverse investment opportunities, and it also depends on what individual managers are used to trading domestically or in developed markets," says DeStefano. "What people are historically comfortable trading domestically, they will try to replicate that success in emerging markets."

Payne at Emergent Asset Management reports that investment decisions should also be made based on the nature of particular countries' capital markets. "When I talk about emerging markets, I am talking about any investments that are opportunistic in non-G 10 economies," she says. "Some countries have liquid equity markets, like Brazil and South Africa, but their bond markets are not as interesting, or visa versa, like Argentina. It depends on where you happen to be – it is a question of how developed their capital markets are."

**Other observers indicate a growing popularity of emerging market strategies among managers, but also cautious entries into these markets given their volatility. Chris Grandi, president at hedge fund IT outsourcing provider Eze Castle Integration, sees heightened interest among fund managers in emerging markets but less appetite so far for stand-alone emerging market products among funds lacking experience in these products.**

**"We have seen some funds starting up to pursue emerging market strategies, but more often we are seeing existing managers going out and hiring emerging market teams and introducing emerging market products," Grandi says, adding that risk-reward ratios in emerging markets can prove intimidating.**

**"All it takes is one macro event or, say, a move by China to devalue its currency and everything falls apart," he says. "We are not seeing the investor community wanting to fund someone completely focused on emerging markets, but it is becoming a very popular strategy."**

In light of these risk scenarios, Doe at Ernst & Young recommends managers thoroughly evaluate their existing infrastructures to make sure they can support emerging market strategies.

"Managers looking at different investment strategies in emerging markets should evaluate their current capabilities and run gap analyses to see whether their systems are providing appropriate reporting and collecting the right data in order to effectively understand where their performance is coming from," Doe suggests, adding that managers must also ensure their tools can capture the right data to make effective risk management decisions around emerging markets instruments. "It is more than just a technology play – it is also the operations around the box," she says.

### ***The risk dilemma***

**The potential for emerging markets to provide greater returns than their developed counterparts goes hand in hand with a complex set of risk factors that can wreak havoc if not properly understood and monitored, as Grandi and Doe indicate.**

Keswani at Dolomite explains that emerging market shocks tend to coincide with shocks experienced in the developed market; just as they can out-perform developed markets on good days, they can also collapse more spectacularly than developed markets during extreme events.

"When there is a seismic risk event globally, emerging markets tend to go down more than developed markets, so the correlation issue only works over a very long-term horizon," Keswani explains. He refers to this phenomenon as tail risk, citing as an example a global re-pricing of risk in May 2006 that drove down emerging markets equities 12%, which in turn drove down emerging market hedge funds' holdings between six and 12% – hardly an ideal scenario for investors expecting these managers to perform better than developed markets.

"Investors taking emerging markets risk expect higher returns," Keswani says. "They know the concept of the cost of volatility, but to be invested in a hedge fund that is down between six and 12%, many would consider that an excessive price to pay for the kind of returns they are garnering. It is okay to be down one month, but you should not be down as much as the headline long-only indices."

Keswani prescribes a three-dimensional emerging markets risk management approach involving both in-house and third-party tools.

First, the manager identifies five distinct risks hedge funds and buy-side firms expose themselves to in emerging markets, and how each of those risks must be measured:

- Emerging market equities, for which a fund's gross and net exposures as well as its portfolio mix of small-, mid- and large-cap stocks should be assessed - Sovereign external debt, which is measured by the dollar-value change in every one-basis-point change in a fund's credit and treasury spreads
- Emerging markets foreign exchange and local interest rates, measured by how long or short a fund is in dollars
- Performing corporate credit, measured similarly to sovereign external debt
- Special situations, measured in different ways depending on what instrument – a restructured bond or short-dated CDS for example – is being held

"You need to respect each of these five sectors of emerging markets because the risks are so heterogeneous," Keswani urges. "You have got to get this right – if you cannot, you should not be managing emerging markets risk." Second, managers active in emerging markets must have a risk system in place to determine how sensitive their portfolios are to global risk factors, according to Keswani. Dolomite uses risk management technology vendor Riskdata for this phase of its risk management process.

"Getting a sense of where your portfolio's sensitivities are to global risks like commodity prices or US interest rates is critical," says Keswani, adding that Riskdata gives Dolomite a better sense of where its second-order global risks lie. "Once you deploy risk relative to your investment mandate, there are many second-order issues you need to watch. There are not many systems that will get you there, but Riskdata is one of them."

Finally, Keswani argues that it is essential to determine which risks you are taking from an emerging markets perspective, not just on a broad level but specifically across the five risk categories listed above. Emerging market instruments display behaviours and volatilities very differently from one another, and investors and managers need to be able to effectively compare their returns with each of these five sectors.

### ***No turn-key options***

The risk management process Keswani illustrates obviously requires more than implementing an off-the-shelf software package or expanding the scope of an in-house risk management platform originally designed for domestic equities or fixed income. He and other managers advocate a combination of third-party and internal systems for effective performance in emerging markets.

"We aggregate risk for each of these sectors based on those unique metrics by which you measure the risks, we look at our portfolio against a set of global risk factors with Riskdata, and then we look at our portfolio against those five specific emerging market risk factors," says Keswani. "In only one of these three dimensions do we use an external vendor. "We feel the appropriate emerging market risk management system is a combination of third-party vendors where available and internally built systems, because there is no turnkey solution," he continues.

Emergent Asset Management's Payne argues similarly, noting that many vendors such as Bloomberg and Reuters as well as prime brokers and other counterparties are well-equipped to support some aspects of emerging markets operations, but coupling that support with in-house capabilities makes better business sense.

"Our approach is a combined one, which we believe is the healthiest because it diversifies our risk," says Payne. "We certainly like Bloomberg and Reuters, and there are other capable providers. We have never had any problems, but we definitely spread our risk and now have our own in-house trading system."

### ***Risk software made to order?***

Given the broad range of instruments falling under the emerging markets umbrella and the highly varied asset mixes of buy-side firms active in this space, both managers and third-party vendors face considerable challenges developing tools able to broadly support trading in these markets. Invariably, managers require customisation.

Iain Colquhoun, operations manager at London-based emerging markets manager Finisterre Capital, sees customisation requirements causing development headaches for many third-party vendors, especially regarding risk management tools.

"There are quite a few companies out there offering risk solutions, but the problem is being able to customise it for your own needs," explains Colquhoun. "Many managers have different approaches – some require a lot of scrubbed data, while others are more interested in scalability and performance and may source their own data."

Colquhoun adds that getting correct data sets has proven especially challenging for vendors due to the particular nature of emerging markets, but that some software providers have begun taking a different approach with clients.

"What we are seeing more often now are vendors providing complete risk solutions and acting more as consultants," Colquhoun reports. He says that these vendors observe how their clients operate over a period of time, and then design individual software packages to meet those managers' particular requirements.

"I think this is probably where the sector is headed," he anticipates.

### ***Salient points***

- Emerging markets are attracting more interest from managers keen to boost returns via volatile investments
- Emerging markets' risk-reward ratios necessitate advanced, highly sensitive risk management processes
- Effective risk management in emerging markets requires a combination of third-party tools and internally built platforms and methodologies

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