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Alex Duffy
portfolio manager
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The economy for emerging markets

Emerging markets are thriving on global economic growth. The Fidelity Global Emerging Markets Fund gives investors access to some of the world's fastest growing economies with sensible and sustainable investments for the longer term.

For the past 18 to 24 months emerging markets equities have rallied globally to be one of the star performers in investment portfolios. But as company valuations continue to rise and more day-to-day volatility enters global markets, investors are questioning just how long the emerging markets rally can continue.

Fidelity Global Emerging Markets Fund portfolio manager Alex Duffy[01] says historically these types of EM bull market rallies last between 50 and 60 months. They also tend to have a trajectory which is anywhere between 150 to 250% from the lows to the peak.

In 2017, Duffy adds, emerging markets equities recorded a "very healthy year" and returned about 40% in US-dollar terms. The asset class is about 60% higher than its mid-2016 lows, he says, reminding investors this recent success comes from a low base which included negative results in the period between 2012 and 2016.

The portfolio manager says emerging markets hold a long structural story which is now leading to natural growth. Young populations, growing populations and rising consumerism – all from low penetration bases – are all compounding the EM growth story.

"But we have to remember emerging markets are cyclical as well – and what we saw through that period of five years from the end of 2012 to the middle of 2016 was a softer period cyclically for economic growth within emerging markets. Commodity prices were under pressure, the Chinese economy had been slowing down slightly and that led to capex budgets being cut," he says.

"Since the middle of 2016 and with improvements in global trade and global synchronised growth starting to accelerate, now we're really starting to see pickups in global capex. Pickups in global trade are now leading to capital being redeployed into emerging markets."

Duffy says that growth trajectory is one similar to what emerging markets experienced in the few years prior to 2012.

Looking ahead for the remainder of 2018 and then into 2019, Duffy sees a pickup in investment from companies – not just emerging markets companies investing in their own businesses, but also increased foreign direct investment from multinationals "who are recognising the importance of these markets and starting to accelerate their spend and grow their businesses within emerging markets."

Now more than ever emerging markets are playing a crucial role in the global economy and there's still plenty of vigour heading into 2019, the portfolio manager says.

"Emerging markets have always been important in the global economy due to their size. If you look over the last 20 to 30 years, you've seen emerging market GDP go from 30 to 40% of global output – today it sits at about 60% of global economic activity," he says.

"If you look at incremental GDP growth, around 80% of the growth each year is coming from emerging markets. What's changing is the importance of emerging markets to global equities.

"Despite being 60% of global GDP, currently within a global equity index emerging markets are about 10% of that representation – so they are significantly underrepresented relative to the size and importance of these economies."

Investors may question how long the emerging markets rally can continue and Duffy says while it's been an 18 to 24 month recovery, this by no means suggests that "we're extended in terms of the duration of this recovery in emerging market equities."

He does hold the view that in terms of company or stock valuations there are particular pockets of the market which have become extended. Duffy says technology is one area where Fidelity is seeing some fairly aggressive valuation multiples – but not to the same extent that is seen in developed markets where operating profits are also "very high." He adds operating profits haven't recovered as much in emerging markets.

In an update to investors in 2017, Duffy said many of these large companies are good businesses with strong economic moats defending their cash flow.

"Ultimately, however, the current market behaviour is leading to an extension of valuation multiples where in some instances stocks at the head of the current rally have re-rated to an eye-watering 12 to 13 times their annual sales revenues, despite delivering relatively little or no net cash flow to shareholders," he says.

"It's nearly impossible to identify exactly which straw will break a camel's back, but with these kinds of forward estimates, such businesses will need to deliver revenue growth rates above 20% and show positive operating leverage for a number of years to avoid disappointing shareholders. There is a clear risk that such stocks may face a period of stagnation whilst their earnings grow into the lofty multiples."

The quote

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He adds that his biggest day-to-day task currently, and especially over the last three to six months, has been very much about managing that valuation risk.

"So there's still opportunities out there but you have to be even more discerning than you were previously in managing valuation risk because that can be a real source of permanent loss of capital if you pay the wrong price for a good business."

This speaks largely to Duffy's investment philosophy. He only wants own good businesses that he understands and to own them for as long as possible.

He says within emerging markets the major risk tends to come through poor corporate governance or poor balance sheet structures. His approach is about mitigating those sources of real risk, or "owning businesses that have got good corporate governance structures and appropriate alignment of interest across all stakeholders in a business" and "a balance sheet which can serve the operations of the business across the economic cycle – so an ability to continue to invest in the business so it can continue to take market share."

It's here where Duffy's portfolio management really comes to the fore. Within these good businesses he seeks to identify the resilient earnings streams and cashflow profiles where sustainability and duration of that return profile are being perpetuated into the future.

"What that results in is a portfolio which is very strongly focused towards companies with robust cashflow profiles – and lower volatility in terms of that cashflow profile across the economic cycle," he says.

"Sensible balance sheets [means] less volatility in the balance sheet and ultimately it leads to companies whose stock prices tend to be less volatile than the broader investment universe."

The portfolio manager says what's been a key property of the portfolio in recent years is an ability to deliver healthy compounding over a three to five-year investment horizon whilst mitigating the drawdown in an equity market selloff.

"It's giving clients that exposure to the growth within EM whilst managing the risk on the downside at the same time and that's resulted in a relatively healthy return but at the same time lower volatility than what we might see in the index or in other emerging market portfolios," he says. FS

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