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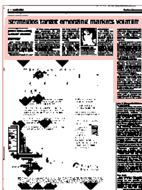

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Strategies target emerging markets volatility

Offerings aim for growth while easing investors' concerns

By Drew Carter

Some money managers are rolling out strategies designed to reduce volatility and provide downside protection in emerging markets as a way to appease skittish investors still wanting to capture superior growth.

Whether there's much of a market for these strategies remains to be seen.

In recent months, Pacific Investment Management Co. LLC, TOBAM and Acadian Asset Management LLC have introduced equity-only strategies. RCM Capital Management LLC, AllianceBernstein LP, Baring Asset Management and Franklin Templeton Investments have created emerging markets multiasset strategies designed to lower volatility or provide protection against major losses.

"For those people who are cautious about volatility, in both an absolute sense and versus funding ratios, a multiasset approach makes a lot of sense," said Philip Dawes, director and head of sales and consultant relations at RCM, London. The firm's multiasset strategy launched in February.

Although consultants see sense in the theory of lowering volatility and providing downside protection, they say implementation is key. Consultants are wary of costs and skeptical that managers are trying to time markets in multiasset strategies.

PROTECTING: Maria Gordon said the need for downside protection is particularly important.

The theory behind these strategies is not new — managers have run similar equity and multiasset approaches in other geographical areas for years. But the desire by investors and consultants for greater exposure to fast-growing emerging markets — tempered by investor wariness of risk — has fueled the recent boom in strategies, managers say.

"Institutional investors know they're underexposed to emerging markets, but they're apprehensive about risk," said Morgan Harting, senior portfolio manager and emerging markets multiasset team leader at AllianceBernstein in New York.

Downside protection is particularly important in emerging markets equity "because when you look at emerging markets returns, every five to six years you have an event that erases over 50% of your value," said Maria "Masha" Gordon, executive vice president and lead portfolio manager in emerging markets equity at PIMCO in London.

PIMCO limits losses in its strategy at 30% — or 1.5 standard deviations from the long-run average volatility in emerging markets equity of 20% — but doesn't give up any returns to do so, Ms. Gordon said. "You're not giving up upside; you're capping downside," she said.

That's because PIMCO looks for the cheaper ways to hedge against major losses. One example is the Australian dollar: AUD options won't hedge against minor performance bumps in the road, "but it is an asset that correlates with a rise in risk aversion in a global meltdown," Ms. Gordon said.

Also, PIMCO pays for this downside "insurance" with other investments, such as currency carry trades. That adds 75 basis points of additional return to the portfolio, defraying insurance costs.

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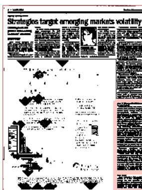

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Assets in the strategy totaled about $1 billion as of June 30; it was launched in April.

Earlier this month, TOBAM announced it had created an emerging markets equity strategy using its anti-benchmark approach. Although designed to provide maximum diversification among a universe of stocks, the approach typically reduces volatility by 30% a year, said Christophe Roehri, managing director and head of business development at TOBAM in Paris.

By maximizing diversification, investors get the fullest exposure to the equity risk premium, he said. Because market-cap-weighted indexes will be concentrated in certain sectors, removing those concentrations lowers the volatility. The emerging markets strategy was seeded by a European public pension fund with $135 million, its total assets to date, Mr. Roehri said. He wouldn't identify the pension fund.

Investment consultants say there's value in limiting risk in emerging markets equity strategies.

"We've found that very few emerging markets equity managers can outperform on the upside consistently," said Ulla Agesen, U.K. head of equity manager research in London for Aon Hewitt. "If you look at it over a full market cycle, the philosophy is that you get better performance by consistently protecting on the downside than you do by outperforming on the upside."

New study

A new study shows that asset allocation as a risk management strategy can limit downside in emerging markets equity strategies by shifting into cash, and downside protection is even greater when shifting into bonds. The study,

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"Downside Risk Management in Emerging Markets," found asset allocation reduced maximum drawdowns, cut volatility in half (vs. an equity index), and doubled Sharpe ratios, a measure of risk-adjusted returns. The paper co-written by two investment professionals at London-based hedge fund and long-only emerging markets equity manager The Cambridge Strategy was published in the most recent issue of the Journal of Investment Consulting.

Although the study used U.S. bonds to model the benefits of asset allocation, emerging markets debt would be an increasingly viable substitute, as credit ratings of emerging markets debt improve, Issam Strub, co-author of the study, wrote in an e-mailed response to questions. Mr. Strub is also a research scientist at The Cambridge Strategy.

"Our findings definitely support a multiasset approach to emerging markets exposure, particularly given the expected evolution of EM bonds" to higher credit ratings, he wrote in the e-mail.

AllianceBernstein's Mr. Harting said that asset allocation's contribution to performance in his firm's emerging markets multiasset strategy has been cut in half from what it would have been through the crisis; it's now expected to account for about 25% of returns, down from 50%. That's because the differential between expected returns from emerging markets equity and bonds has shrunk.

"What's more likely is that security selection will be where you get your performance going forward," he said.

He stressed the importance of running a multiasset strategy holistically — that is, the same team looking across the capital structure for investment opportunities. That gives AllianceBernstein the ability to exploit inefficiencies caused by investors segmenting themselves, Mr. Harting said. For example, he invests in stocks in Qatar, while buying credit default swaps on Qatari national debt, which "is seen as nearly riskless, whereas (Qatari) equities are seen as frontier," he said. The result is approximately 10% annual dividend yields on equity with downside protection costs of about 1%.

But consultants aren't sold on these strategies.

"You can significantly limit the volatility by taking some debt at various times, and not necessarily (hurt) returns," said Stuart Gray, senior investment consultant and head of emerging markets equity research at Towers Watson & Co. in London. However, "can it be done is a different question. There are not many managers that have the skill sets to manage both equity and debt at the same time. Equally, there's not much evidence that investors can time markets effectively."

Strategies that limit upside can be a hard sell to institutional investors, Aon Hewitt's Ms. Agesen said. "A client that wants to go into emerging markets often does so knowing they're going into a riskier and higher-growth asset class. Some will be a bit disappointed if the full upside isn't there."

And institutional investors don't need to outsource this function to managers, according to Cambridge Associates. Consultants at the Boston-based firm recommend investors diversify their emerging markets exposures away from the typical reliance on the largest countries and large-cap stocks and toward emerging markets debt, private equity and hedge funds, said Eric Winig, managing director. "You should have lower volatility and better downside protection if you take this diversified approach," he said.

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