Beyond BRIC: Emerging Market Hedge Funds

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Emerging markets have continued to develop as major components of the investment portfolios of investors both large and small. To be sure, this is for good reason: as the returns offered in developed economies flat line, those seeking higher returns have been forced to venture abroad. And for many, the returns have been well worth the additional risk. In recent years, much ado has been made about the rapid ascent of China from a backward economic outpost to a blossoming global powerhouse. Additional praise along similar lines, though on an admittedly smaller scale, has been attributed to India, blessed with many of the same labour and natural resource benefits. With approximately 15% of the nations on Earth considered to be emerging market countries, there are no shortage of investment opportunities. And perhaps best poised to exploit those opportunities are emerging market alternative investment funds.

Emerging Markets Defined

Put very broadly, emerging markets are considered to be countries where economic activity is rapidly growing and the process of industrialization has firmly taken hold. The idea is that these nations will move from "emerging" to "developed" over time and, by investing early in the boom stage of these countries, investors can gain the always sought-after outsized returns. While different groups (FTSE, Dow Jones, The Economist magazine, and MSCI to name a few) each maintain a list, there is unfortunately no uniform consensus as to which countries are truly "emerging" economies. For the purposes of this discussion, we will use the following list as compiled by Dow Jones, as it is the broadest.

Emerging Markets of the World				
Argentina	Czech Republic	Kuwait	Oman	Russia
Bahrain	Egypt	Latvia	Pakistan	Slovakia
Brazil	Estonia	Lithuania	Peru	South Africa
Bulgaria	Hungary	Malaysia	Philippines	Sri Lanka
Chile	India	Mauritius	Poland	Thailand
China	Indonesia	Mexico	Qatar	Turkey
Columbia	Jordan	Morocco	Romania	United Arab Emirates

Source: Dow Jones, 2010

Unfortunately, navigating the often turbulent waters of emerging market economies is not as easy as identifying a few countries and making an investment. Just as different investment classes offer unique aspects that contribute to both risk and return, so too do the opportunities that presentthemselves in emerging markets. Beyond that, the nations themselves are unique and their various merits and detractions must be given sufficient attention.

Just Like Funds, Not All Emerging Markets Are Created Equal

One of the difficulties for money managers in this space is figuring out where and how to allocate capital to take advantage of emerging markets. The days of being able to make a generic investment in an economy like China or India is over; with the easy money already made, more diligent work is required to outpace the market. Within emerging markets, there are different tiers of nations with unique attributes that makes the investment decision process a specific one. Each of the unique features presented below, plus countless others, are what create the opportunities that investment managers desire. As you can see from just a quick glance at the aforementioned list of emerging market nations, there is a great deal of disparity amongst these countries. Though the nations all share the title of emerging economies, their differences could not be more pronounced and require serious insight before any investment decision is made.

Regional Variances

Even just a cursory look at the nations on the list of emerging nations reveals some regional bias. For instance, Eastern Europe (Latvia, Lithuania, Poland, Hungary, etc.), South East Asia (Malaysia, Indonesia, Thailand, etc.) and South America (Brazil, Argentina, Columbia, Chile, etc.) all feature prominently in the list. However, each region has its own specific risks which need to be identified and appreciated. For instance, there are a few Middle Eastern countries on the list (Kuwait, Jordan, Oman, etc.). If your geographic neighbours include Iraq, Iran, and Afghanistan, you certainly have some regional instability issues to confront before making any investment.

Sources of Economic Growth

To borrow from high school economics and the first introduction to Adam Smith, different nations specialize in different things, and this often leads to a comparative advantage over other countries when it comes to trade. Such is frequently the case with the nations on the list of emerging markets. As an obvious example, countries such as Kuwait, Qatar, and the United Arab Emirates (UAE) are oil-producing nations and this is the bedrock of their economic growth. However, with this area of specialization comes risk. A decline in commodity prices could undermine the development of these nations, as it did in 2008-2009. In 2009, 85% of the UAE's economy came from the export of natural resources and they were hit hard by the rapid descent in the price of oil; any economy so dependent on a single piece of the economic pie is subject to heightened risk.

Differences in Government

Suffice to say, there is a great deal of variation in the governmental structures of the emerging market nations. Countries like India and South Africa, as a consequence of their colonial heritage, utilize the model of a parliamentary republic. On the flip side, nations such as Bahrain and Jordan operate under a constitutional monarchy. Even within the same forms of government there is disparity; Pakistan is also a parliamentary republic, but to say there are differences between Pakistan and South Africa would be an understatement. Quite obviously, the type and behaviour of a government can play an enormous role in the development of a nation, so this factor must be given serious thought.

Geographic Differences

Proximity to markets is an important aspect of any country looking to trade; it undoubtedly has an enormous impact on the success of a developing nation over the medium to long term. It may come as a surprise that there are a few African nations that are part of our emerging markets list, but note most are in North Africa. Nations such as Egypt and Morocco are blessed with the distinct advantage of having ports on the Mediterranean Sea for shipping their exports and being close to an enormous and wealthy market for their goods in continental Europe. Conversely, a country like South Africa is geographically removed from major markets, their goods must travel long distances to reach the majority of consumers, and their immediate neighbours are severely impoverished nations such as Namibia, Botswana, Zimbabwe, and Mozambique. This makes trade more difficult and sustained long term economic growth more challenging.

Alternative Investments for Emerging Markets

Of course, there are mutual funds and ETF's that specialize in investing in emerging markets. So many investors may naturally ask: why should one use an emerging market hedge fund over a more traditional form of investment? Really, the logic underlying using a hedge fund to invest in emerging markets is the same as that which justifies using hedge funds for other investment classes. Notably, hedge funds have the ability to go beyond the long-only investments that are restricted to mutual funds and use short selling as well as derivatives to exploit opportunities in the emerging markets. The use of derivatives can be especially useful given the market inefficiencies in developing nations. For instance, a hedge fund may have uncovered what they consider to be an excellent stock for purchase, however there may be liquidity issues with purchasing a sufficient amount of stock or restrictions on foreign ownership. The use of derivatives may allow the hedge fund to simulate the position effectively. Also, through the use of credit default swaps, the manager may be able to hedge some of the credit risk of the nation, a hedge which could not be put in place in a mutual fund.

Perhaps more importantly, a hedge fund can make investments in private enterprises, which would generally not be possible for a traditional mutual fund vehicle. This can be a huge benefit for hedge funds in emerging markets, since capital markets may not be developed to the point where there are enough quality public companies that warrant investment. By investing in private companies, the hedge fund can enter the desired position which would otherwise have been inaccessible to a mutual fund.

The key for any investor seeking a foothold in an emerging market hedge fund is due diligence. Any investment placed in an emerging market is a potential minefield which must be carefully understood by the investment manager. The difference between the top tier of emerging market managers and the bottom tier is cavernous. The investment manager must have the requisite infrastructure to support holdings in a variety of jurisdictions that are scattered throughout remote parts of the world. The legal, accounting, and tax implications of each of the nations are indeed unique and, as discussed before, each country has its own unique set of risks and challenges. A solid track record of experience and achievement in the emerging markets, as well as a strong team of professionals at the fund, is essential for success.

Conclusion

As the globalization of the world progresses, many nations are rising from poverty towards heightened economic status. Investors are looking to gain from this development and are increasingly doing so through emerging market investment managers. However, given the potential risks of investing in these markets, any investor seeking to allocate capital in these nations must do so cautiously. Through the use of a qualified, capable investment manager, the tremendous risk-adjusted returns that are associated with emerging markets can be captured effectively. Fortune favours the brave, and while being brave is a necessity for investing in emerging markets, prudence will always be an equally useful trait. *