

KEYNOTE INTERVIEW

Turning the tables on emerging market risk



Outdated assumptions about risk have held investors back from seizing impact opportunities, says Finance in Motion's CEO Sylvia Wisniewski

Q When mainstream investors think about risk in emerging markets, what mistakes do they commonly make?

There's quite a misalignment between perceived risks and the actual risks in emerging markets. We often see investors that have traditionally invested in developed markets relying on country-level ratings and macro indicators when they look at EMs. They don't pay enough attention to asset-level or project-level risk dynamics. And that is what actually matters when looking at the true investment performance of assets or companies.

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For instance, the Global Emerging Market Risk database, which is maintained by a consortium of 26 multilateral development banks and development finance institutions (DFI), and which comprises data points from the last 40 to 50 years, reveals that annual default rates on private entities based in emerging markets are, on average, between 3 percent and 3.5 percent – and that is broadly equivalent to what you would likely find in developed markets.

Q People tend to assume that emerging markets are small economies that are vulnerable to commodity fluctuations. Is this fair?

It's an over-simplification. Yes, being small by nature means you probably have a certain concentration risk, and you may be more vulnerable to external shocks. But many EMs have succeeded in building specialisations. Ecuador, for example, is one of the world's largest shrimp producers. The sector is highly export-orientated, and Ecuador is a global player.

There's also a perception that EMs are commodity-driven markets, but

the reality has shifted significantly over the last 20 years. The MSCI Emerging Markets index used to be largely comprised of commodities, but energy, tech and internet-connected services or sectors represent 37 percent of the index right now. With the growth of tech industries, a country's size doesn't matter. You can find very small countries that have cutting-edge technology solutions at hand and make a big impact on the global economy despite being small.

Q What can LPs do to improve their understanding of the risks and impact opportunities in EMs?

It's definitely a good idea to look for local partners that have teams on the ground and a long-standing footprint in a country. You have to take a country-by-country view, rather than lumping emerging markets together, so it's important to find specialist operators who have a really good understanding of the granularity that exists there.

You also need active portfolio management in EMs. You need partners that have a very strong grip, not only of the selection of the investments, but also of the active management of the investments during the hold period.

Finally, investors also need to understand the currency dynamics. It's important to get the timing right when you enter a country. People often think the best time to go into a country is right after a depreciation. But some investors go in too quickly and find the currency depreciation hasn't bottomed out yet. We find it's better to miss out on a little bit of the upside but go in when we really are sure that the depreciating trend is over.

Q How can you judge when conditions are in place for growth in an emerging market country?

It depends on the investment thesis for a specific strategy. If you want to focus on consumer markets, a country with

a growing middle class, like India, is a natural place to look. It's a high-growth economy that has already developed rather sophisticated ecosystems.

Other countries have specialisations in certain export-led sectors, as many EM governments have been very active in seizing particular niches. For example, in Asia you often see tech sectors being driven by government initiatives. If you look at the large players nowadays in the semiconductor business, like Taiwan or South Korea, the sector development has had a lot to do with how the governments promoted these sectors.

Another advantage of EMs in general is that you normally have a younger population that's quite tech-savvy and well educated. There are often leapfrogging opportunities in these countries as well. You don't have to go down the fossil fuel-based, traditional heavy industry-led model. That gives these countries much more agility and flexibility in how they develop.

Q Can you share some examples of leapfrogging opportunities that you find exciting?

Beyond the macroeconomic outlook, what's really exciting is how EMs are skipping traditional development stages altogether. For one thing, many EMs have very ambitious renewable energy targets. Latin America is one of the key players here. Obviously, China also started on its green agenda quite early.

Emerging markets also have a big role to play in the growth of the tech industry, including in software development. Bangladesh is a key player in software, for example. And part of Ukraine's resilience also stems from the fact that close to 10 percent of its GDP before the war was already generated in the software development industry. And it's worth remembering that software programmers are not tied to a specific location – they can move around and be very adaptive in how they operate.

“Leapfrogging opportunities give these countries much more flexibility in how they develop”

Q To what extent do you expect to see more impact capital flowing into private equity in EMs in the years ahead?

There are certain mega-trends in EMs that will help them attract capital. The growth projections suggest we will see 4 to 4.5 percent growth in EMs, compared with around 1.5 percent in developed markets.

There is also strong population growth and urbanisation, so you also have a tailwind from domestic market development. There are opportunities to meet basic needs in housing, mobility, transport, energy, education, water supply and healthcare, particularly around mega-cities. So, the fundamental investment thesis in these local markets is very strong.

Investors are now more able to get comfortable in making bets on EMs, partly because there's better data available, with longer time series. And on the other side, I feel that perhaps many of the attributes that made developed markets attractive are no longer there. It's very hard to say you still have predictability in certain developed markets. I would even argue that you may have more predictability and more consistency in some emerging markets compared to what you have nowadays in some of the so-called developed economies.

So, the real risk isn't in emerging markets – it's in clinging to outdated assumptions about them. ■