futurefund

POSITION PAPER

Understanding emerging markets

The Future Fund has an active focus on building its understanding of emerging markets.

The Future Fund defines 'emerging markets' as low to middle income economies typically undergoing substantial economic and political reform; countries that are transitioning from developing to developed nation status.

Around 150 countries are seen as fitting this definition, a diverse grouping that makes up around 80% of the world's population and around 50% of the globe's GDP. The fact that secular change is occurring across emerging markets is well known.

Elements of this change include:

- a rebalancing of economic scale and influence between developed and emerging economies, as emerging economies continue to take advantage of catch-up productivity and technology gains, large-scale urbanisation and high investment rates to fuel high trend growth rates;
- a concomitant shift in relative power (political and financial);
- generally underdeveloped capital markets and financial systems; and
- the impact of these rapid changes on the social fabric and political frameworks of these emerging countries.

The sheer scale of these changes suggests that these events will have far-reaching implications for our portfolio – now and into the future.

These changes, however, are not viewed as being 'one-way'. There are many risks to how this secular story may play out. Equally, the long-standing weak-to-negative relationship between real GDP growth and real investment returns helps steer us away from a generic approach to investing in emerging markets that seeks to harvest their positive growth profile.

Finally, we expect the next 10-20 years will be less about the BRICs' (Brazil, Russia, India, China) contribution to global growth and more about other emerging market nations lifting their contributions – an outcome that may not necessarily be priced in to investment markets.

As a result the Future Fund has embarked on building an emerging market strategy based on a series of investment beliefs that will underpin our investment activity going forward.

These include:

- There is no reason for us to expect stronger growth in emerging markets to necessarily translate into higher risk adjusted investment returns.
- Certain emerging market economies have become powerful drivers of our portfolio risk. We therefore need to understand the development of these economies as an integral component of our portfolio construction.
- A core exposure to emerging markets in our portfolio should reflect the diversification benefits that accrue.

- The long-term development of emerging market economies will give rise to extensive change. These changes will, in turn, lead to many and varied investment opportunities.
- In order to capture the best investment opportunities, we need to build a foundation of domain expertise in investing in these economies. This foundation includes:
  - attributes of culture, legal systems, governance arrangements; and
  - deep knowledge specific to that country for each of our key sectors.

These investment beliefs help define the specific objectives that guide our activities in relation to emerging markets:

- develop a deeper foundational understanding of investing in the key emerging market economies;
- develop our domain expertise on a sector by sector basis in the key emerging market economies;
- deepen our research on which aspects of investing in emerging markets will contribute the most to total portfolio diversification (by country, sector and asset class); and
- further deepen our macroeconomic research and monitoring in relation to those emerging market economies that have become important portfolio risk drivers.

In the years ahead we intend to continue to allocate significant time and effort to building our emerging markets knowledge base and expertise. We expect that doing so will be an important contributor to the Fund's future positioning and performance.

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