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Fund Manager Meeting Notes
– Baillie Gifford Emerging Market Bond Fund

There is no doubt emerging markets have had a torrid time of late, this has meant that the short term performance of the Emerging Market Equity and Bond Funds have been poor. We are strong advocates of Emerging Market Debt compared to UK or Global Debt. However, when the market goes against you, you have to go back to your reasoning and challenge this.

In this latest review we want to highlight some aspects of a recent meeting with the fund manager of the Baillie Gifford Emerging Market Debt Fund but I also want to tie this in with a recent update by J.P.Morgan and their Guide to Markets.

This Guide to Markets is important when looking at the reasoning behind emerging markets and in particular debt. It is a story I have discussed before but one that is just worth revisiting.

Why the panic?

The Guide to Markets was delivered by Andrew Goldberg, Global Market Strategist at J.P. Morgan. The key to any economy is the current account deficit and his explanation of this was excellent. You have a bucket full of water with holes in it, you have money coming in and going out and in theory you maintain the level of water.

The mention of tapering spooked the markets and people almost forgot about the fundamentals behind many of these economies. This meant more money has been coming out then going in, the result was a sudden fall in shares prices across these economies. The biggest sufferers were the likes of Indonesia, Brazil, India and Turkey.

The panic was almost certainly driven by an irrational fear that we were facing a crisis similar to the Asian crisis of 1997. So were the markets right to react in this way?

Overreaction

Andrew explained that tapering isn't the end of QE. It is a slowing down but still billions of dollars is going to be pumped into the markets. So the argument that the tap is suddenly going to be switched off is an irrational fear.

Perhaps this overreaction was good for the markets, so similar to us being challenged on our investment choices it has enabled the markets to analysis the data. What is happening is not a solvency crisis.

So for example, Mexico has international reserves of 50% of GDP; in 1997 this was 28.7%. Brazil a weaker economy has reserves of 15.4% compared to 5.8% in 1997. India has reserves of 16.4% compared to 6.2% in 1997.

There are fragile economies Turkey, Indonesia, Brazil, India, Turkey and South Africa but even these economies have greater reserves than they had in 1997. Other economies are much stronger.

The sell-off has effectively created opportunities within the markets were they have been oversold.

The long term story

If emerging markets have been oversold can we really be sure of the opportunities. Clearly some of economies are weaker than others but the balance sheets are stronger and QE is not stopping overnight.

Andrew discussed emerging market share of global GDP which is around 40%. The weighting in the all world index is just 11%. Clearly there is a mismatch between what it contributes to global GDP and its index weighting. So for example the US contributes 22% and holds 48% of the index. If the weighting over the next 5 years shifted just a small amount to say 15% then the returns could be significant.

The point is that the fundamentals remain strong however as we have seen it can be a volatile asset class. This is not a short term play, and many investors consider the short term aspect and assume the apple is rotten. It is not.

When we turn to debt would we be better to hold UK debt or emerging market debt?

Emerging market debt

With allocating assets bonds are seen as the safe part of anyone's money.

Interest rates will go up, however as we have indicated this may not be for a couple of years. But when they do go up then fixed interest investments will suffer. In fact according to J.P. Morgan a 1% rise in interest rates will see 10 year gilts losing 15% of their value.

In this difficult environment the areas that could potentially deliver positive returns are emerging market debt and high yield bonds because of the yield that these bonds provide.

So in a changing environment J.P. Morgan believe these asset classes could be, as part of a diversified portfolio, a good "protection" when interest rates rise.

Diversification

Before I cover the update from Baillie Gifford I want to briefly cover equities. Andrew covered this in more detail. Low interest rates are a sign of a weak economy, as interest rates go up it means the economy is growing and can sustain higher rates.

There is evidence that there is a positive relationship between yield movements and equity returns. So when rates rise, then equity prices should continue to rise as well.

Diversification within the portfolios is crucial, in fixed interest we use emerging debt because of the long term fundamentals and balance this with the Standard Life Global Absolute Return Strategy Fund which has bond like volatility but invests across different asset classes to maintain steady returns.

In the equity markets we diversify across different regions because different regions will perform differently over any cycle.

J.P. Morgan explained that year to date (so from 1 January 2013 to 30 September) the World ex UK Index has returned 20%, All Share Index 14.6%, MSCI Emerging Markets 0.8% and Emerging Market Debt -5.2%.

In the third quarter (so 1 July 2013 to 30 September 2013) the World ex UK Index returned 6.7%, All Share 5.6%, Emerging Markets 5.8% and Emerging Market Debt 1.4%.

If we consider a ten year period the top performers are emerging market equity and debt.

The point is that diversification means that we should be able to pick up consistent long term outperformance even when one area falls out of favour.

BAILLIE GIFFORD EMERGING MARKET DEBT FUND

Introduction

This fund was added to the portfolios in 2012. As we have indicated in this review the reasons were due to the underlying fundamentals. The fund performed strongly in the first half of this year but has suffered in recent months.

Our initial meeting was with Sally Grieg who was one of the co-managers; this meeting was with one of the other co-managers John Barry.

So what went wrong?

One of the first questions John asked was "were we surprised by the extent of the sell-off?" This is a challenging question and fundamentally I believe the answer is yes.

John explained that the team was taken by surprise, for two reasons. Firstly there was no discrimination, everything was sold-off. So clearly some countries are stronger than others but in the sell-off it was seen as an homogeneous group.

Secondly and this concurs with JP Morgan they didn't think the recovery in the US was that strong and therefore the reactions to the comments were excessive.

In summary what went wrong, fundamentally nothing went wrong other than an excessive reaction to market news. This in turn has opened open up opportunities.

A long term story

Holding emerging market debt for us was never about a short term story. As we have indicated before the volatility is similar to global bonds and potentially when interest rates rise these bonds should provide an element of "protection" in the fixed interest space.

So there will be volatility as there is with any holding but the long term fundamentals are the key to success.

Active management

As we have indicated not all the markets are the same so active management is key to success.

We talked around some areas they like and dislike and this gives an interesting insight to their investment style.

For the management team it is about exploiting long term opportunities. Colombia five years ago was coming out of conflict and was perilously close to going back into conflict.

It was rich in resources but the roads were bad and not linked up. In addition using the roads was dangerous with kidnapping and murder.

Clearly there were opportunities by linking up local markets and making them more accessible.

In the last five years there has been a massive investment in infrastructure. Roads are being improved, and rivers are being dredged which means goods can be transported more easily.

In addition they are building pipelines so oil can be transported more easily, currently this is done via road.

But corruption is a problem a recent crackdown announced by the government saw a slowdown in projects however the long term story remains strong.

Hungary in contrast has high levels of foreign currency debt mainly Euro and Swiss debt, and it has a populist government and therefore for them this country is a worry. It is not doing the right things and therefore they will be underweight in investing in Hungary.

They do have some holdings in Venezuela, the reason is that they have strong cash flow, massive oil reserves and have always shown a willingness to repay debt. Their key export is oil and to stop this would cripple the economy. They have also invested in a refinery in the US. There have been changes to the government and long term they expect to see a more stable government.

One country they don't hold is Ghana and it is one they are watching. To them it is similar to Peru of the nineties where if someone said this would be one of the fastest growing economies of the decade you would be laughed at.

It has has had 50 years of peace, it has a functioning civil service and there are no religious tensions. It has large oil reserves, gold and coco. In terms of oil it could begin to start exporting soon. There is still more to do but this is a possible investment for the future.

In summary active management is about hunting out the long term opportunities, and emerging market debt and equities requires that active approach.

Conclusion

The fund focuses more on local debt where they see greater opportunities and we think this is a good balance to the Threadneedle Fund. Ignoring the fundamentals behind emerging markets clearly we feel that the managers can exploit the opportunities and deliver sustainable long term investment growth.

The source of information in this note has been provided by Baillie Gifford and J.P.Morgan and is correct as at 10 October 2013. These are notes from meeting the fund manager or representative and should not be seen as a recommendation to purchase any fund mentioned. Any reference to shares is not a recommendation to buy or sell. Should you wish to make a decision based on these notes we cannot take responsibility for this and you should carry out your own research before making a decision. You should note that past performance is not a reliable indicator of future returns and the value of your investments can fall as well as rise.