Investing for the Long Run

The investment strategy for the Government Pension Fund Global

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Emerging Markets in Long-Term Asset Allocation

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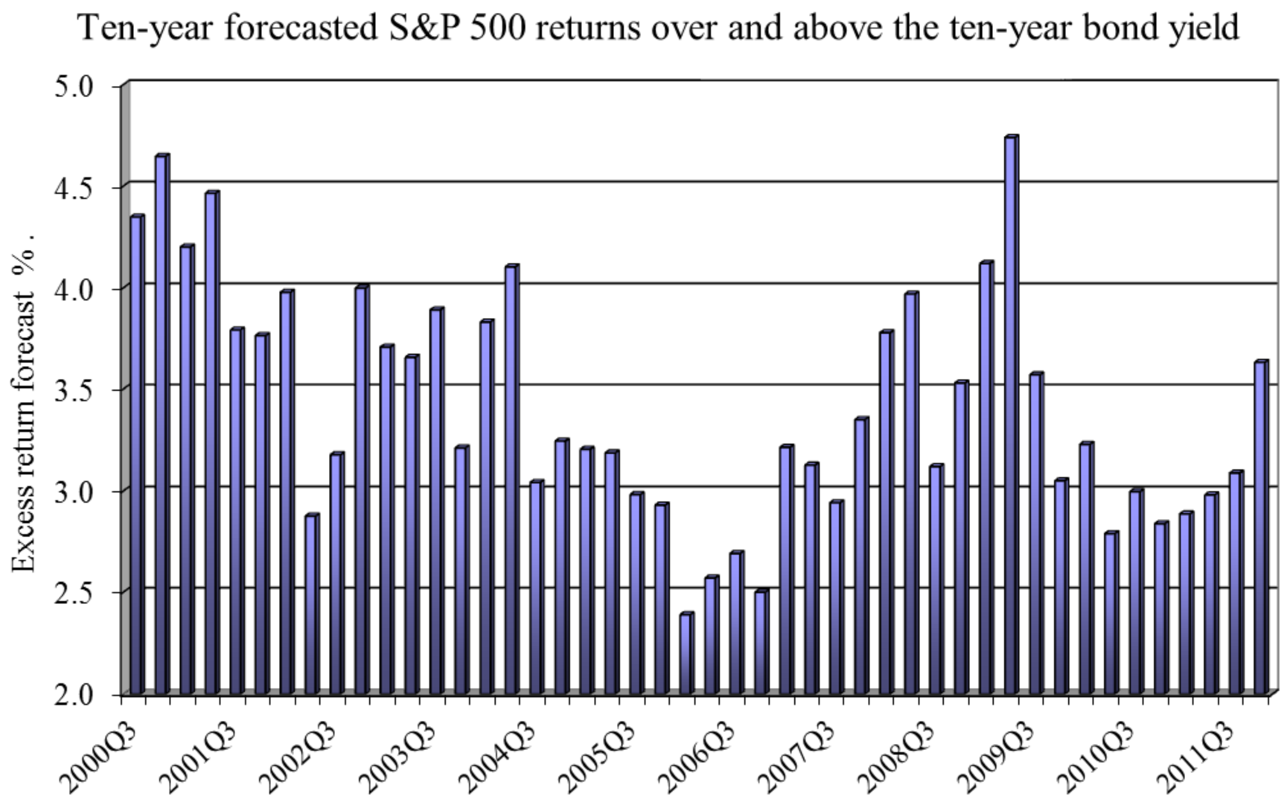
Perspective

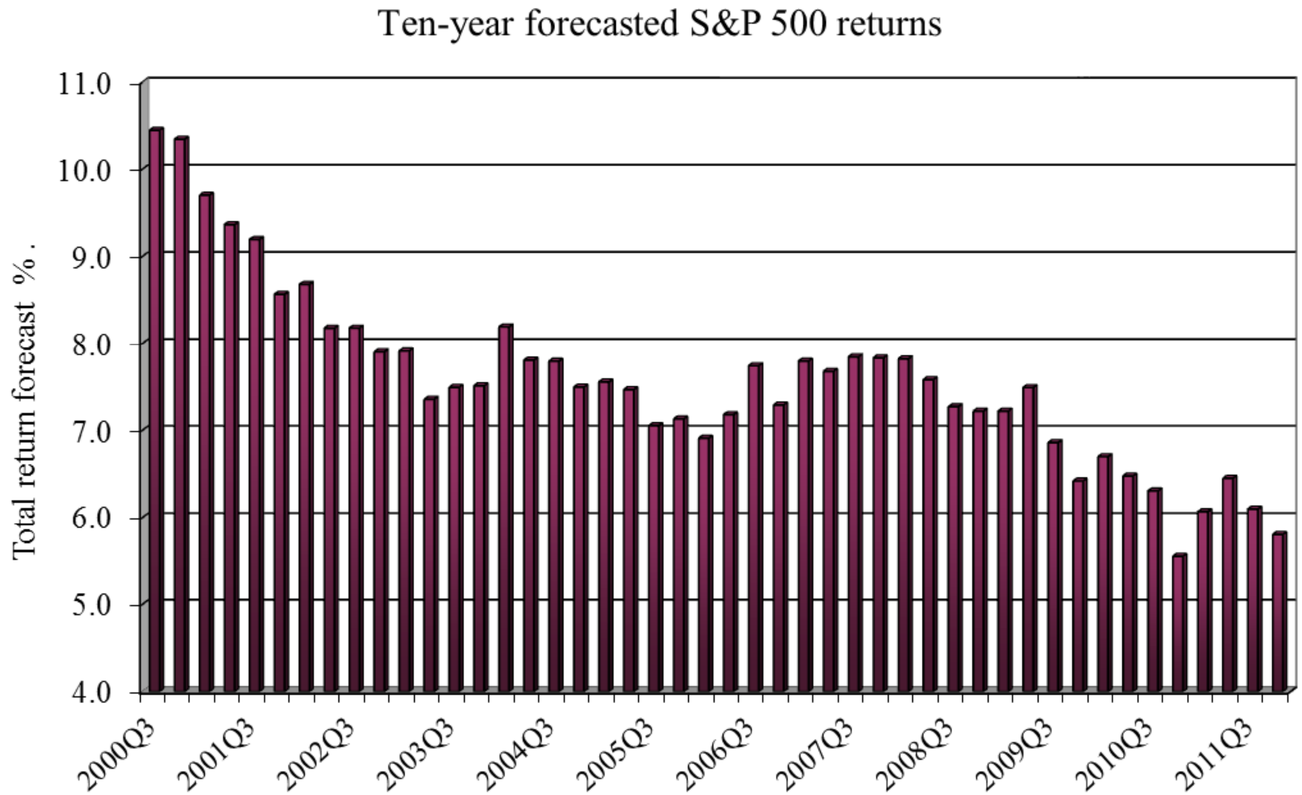
- Where are the expected returns?
  - Fixed income at record low rates (low expected returns)
  - Real assets have challenging track record
  - Alternatives ideal but limited capacity
  - Are equities fully valued?

U.S. Long-Term Equity



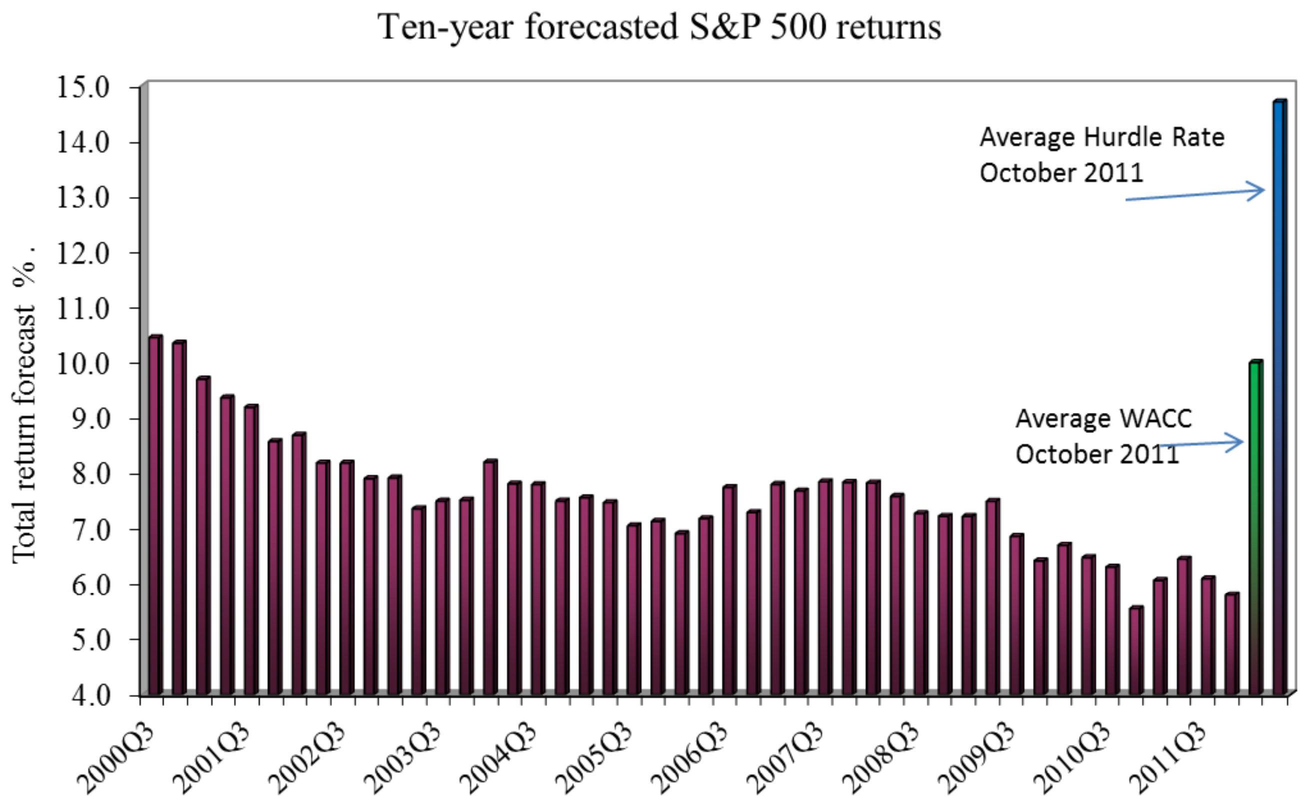
Source: Duke-CFO Survey

U.S. Long-Term Equity



Source: Duke-CFO Survey

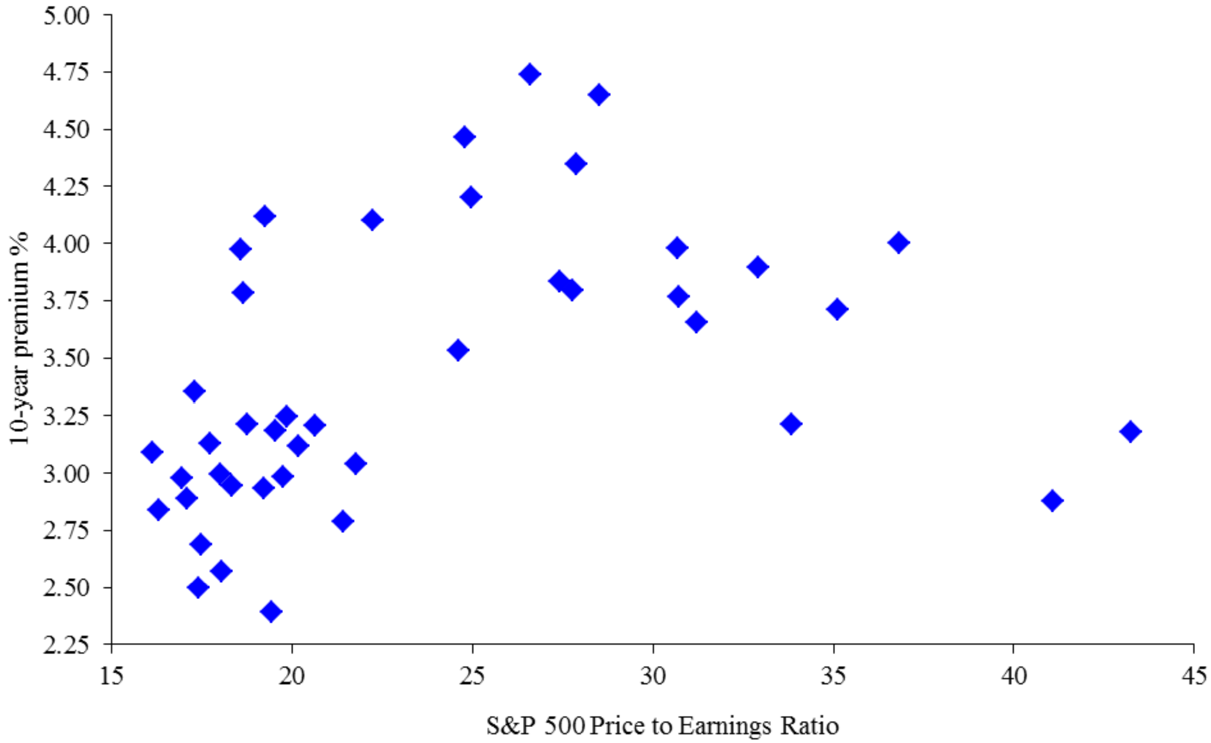
U.S. Long-Term Equity



Source: Duke-CFO Survey

Perspective

- The world is non-linear in expected returns



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Perspective

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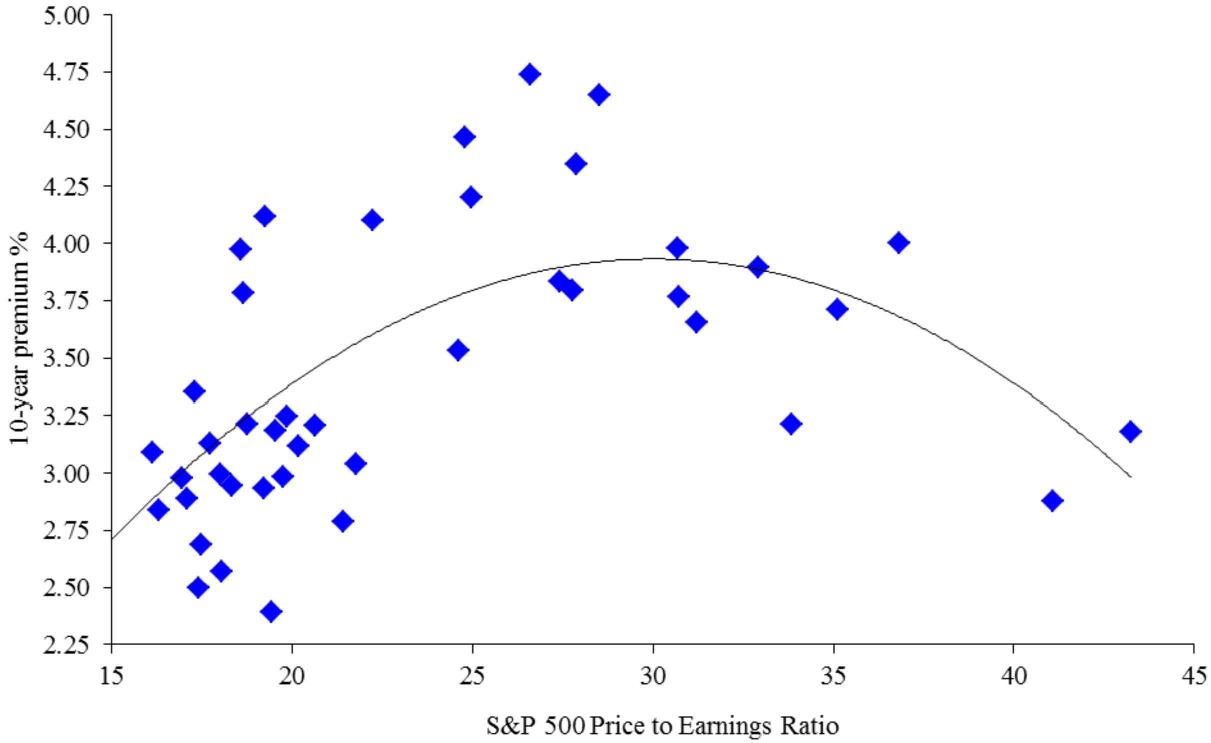


Source: Duke-CFO Survey

Emerging Markets

Early insights

1. Standard risk/segmentation (JF 1995, 2005)

- Significant early confusion because many of these emerging markets had zero beta risk
- However, this did not mean they were risk free
- Many of these markets were “segmented”

Emerging Markets

Early insights

2. Explosive volatility/regime changes (1997, 2003)

- In contrast to developed markets, structural changes in emerging markets created challenges in applying standard tools

Emerging Markets

Early insights

3. Non-normality (1995)

- Many of these markets more resembled option returns rather than standard equity returns

Emerging Markets

Early insights

4. Contagion (2005)

- Defined as comovement over and above what you would expect from the existing risk exposures to common factors

Emerging Markets

Early insights

5. Risk and Reward (1995, 2000)

- Country risk ratings quite valuable in separating high and low expected equity (and fixed income) returns

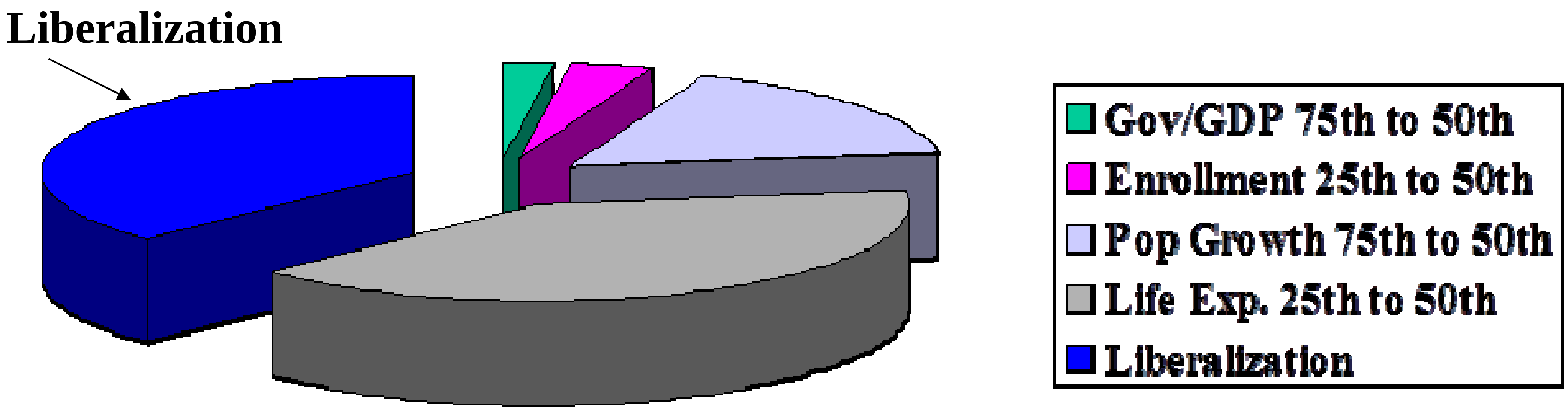
Emerging Markets

New insights

A. Strong link between finance and growth (2005, 2010)

- Decreasing investment barriers leads to lower discount rates, more investment, more productivity, more employment, higher returns

Emerging Markets



Total Growth = 3.02%

Emerging Markets

New insights

B. Industry mix important determinant of growth prospects (2007, 2011)

- Think of applying U.S. P/E ratios to local industries. The aggregate country P/E significantly forecast economic growth
- Global Growth Opportunities (GGO)

$$\boldsymbol{GGO_{i,t} = \ln[PE_{w,t}'IW_{i,t-1}]}$$

Emerging Markets

GGO Predicts future GDP

	Annual real GDP growth (5-year horizon)			
	All Countries	Developed	EU Countries	Emerging
GGO	0.0070*	0.0033	0.0027	0.0131*
	(0.0019)	(0.0026)	(0.0032)	(0.0026)
	[0.0055, 0.0072]			

Emerging Markets

New insights

C. New ways of measuring segmentation (2011)

Look at the deviation of EM industry P/E (or E/P) from average developed country P/E; aggregate across industries:

Let $\boldsymbol{EY_{i,j,t}}$ = earnings yields for country *i,* industry *j*

Valuation Differential: $|\boldsymbol{EY_{i,j,t}} - \boldsymbol{EY_{w,j,t}}|$

$$SEG_{i,t} = \sum_{j=1}^{N} IW_{i,j,t} \, | EY_{i,j,t} - EY_{w,j,t} |$$

Emerging Markets

New insights

D. Illiquidity is priced and important (2007)

- Sharp evidence from emerging markets that expected returns related to illiquidity

Implications for Long-Term Investor

1. Emerging markets still offer a high expected return opportunity.

Why?

- They are risky in terms of: volatility, illiquidity, negative skew, structural breaks, contagion, and uncertainty.
- The long-term investor has the ability to "time diversify" some of these risks

Implications for Long-Term Investor

2. Temper diversification benefits

Why?

- While seemingly having low correlation across both developed markets and within emerging markets, that can change very quickly in a crisis situation.

Implications for Long-Term Investor

3. Emerging market crises are a "known unknown"

Why?

- EM crises are frequent making it important to have a diversified portfolio of emerging markets

Implications for Long-Term Investor

4. Not all emerging markets can take advantage of their growth opportunities

<u>Why</u>?

- Important to understand the institutional environment. Good institutions are associated with the ability to seize growth opportunities

Implications for Long-Term Investor

5. Beware of ratings agencies

<u>Why</u>?

- Sometimes huge differences. In September 2008, ICRG Financial rated Cuba and Congo as <u>less</u> risky than the U.S.
- Debt/GDP is a non-linear characteristic: low is bad and very high is bad

Implications for Long-Term Investor

6. Some older emerging markets are now developed and frontier markets are the new emerging markets

Why?

- Trade, technology, and conditional convergence.

Implications for Long-Term Investor

7. It is naïve to think that China will continue to grow at 10% real GDP per year

Why?

- Massive demographic bet
- Potentially fragile political environment
- There will be a crisis

Implications for Long-Term Investor

8. Tail protect should be routine part of asset management

Why?

- Some crises cannot be diversified away. It is important to manage the skew as well as the expected return and volatility – irrespective of the fund size.

Implications for Long-Term Investor

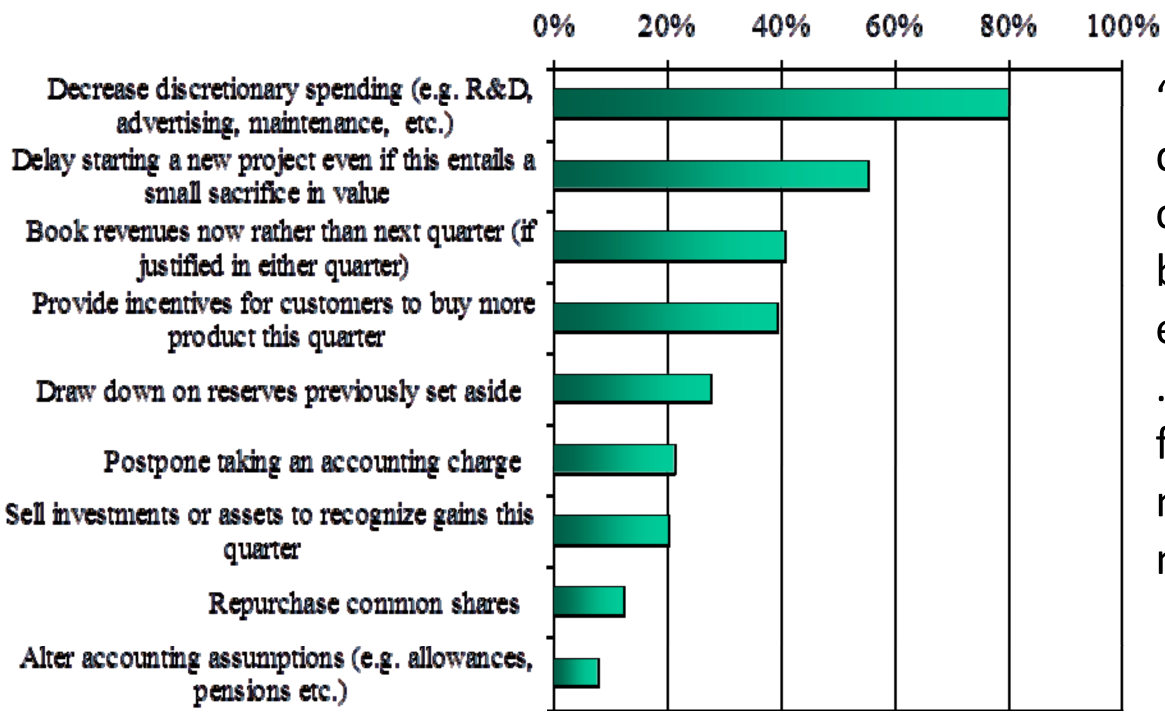
9. Consider alternatives to market cap weights

<u>Why</u>?

- GDP weights would have dramatically higher exposure to emerging markets.

The Role of the Long-Term Investor

Intense pressure to meet short-term earnings objectives leads to poor management decisions that decrease long-term shareholder value.



"Near the end of the quarter, it looks like your company might come in below the desired earnings target. …which of the following choices might your company make?"

Graham, Harvey, Rajgopal (2005)

The Role of the Long-Term Investor

- Current research project investigates whether firms operate differently when there are explicit long-term objectives

Questions

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