Morgan Stanley

Every Emerging Market Is Different in Its Own Way

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Pioneer's Andrew Feltus takes a bottom-up approach toward investing in emerging markets

Andrew Feltus, who runs Pioneer Investments' Global High Yield Fund, is not a big fan of the term "emerging markets," a concept, he says, that tends to treat most nations outside of the U.S., Europe and Japan as if they were one and the same. "Each emerging market is different in its own way," he says. And Singapore and South Korea, he notes, are grouped under the "emerging markets" umbrella, despite income levels that are on a par with those in the U.S. and Europe. Instead of relying on the "emerging market" label, Feltus looks at each country as if it were a company—treating gross domestic product as a balance sheet to get a sense of where the country has been and analyzing economic policies to understand where the country may be headed. He recently spoke with Morgan Stanley Wealth Management's Tara Kalwarski about his outlook and where he sees opportunities. The following is an edited version of their conversation.*

Tara Kalwarski: Can you share your current thoughts on global markets?

Andy Feltus: We've seen outflows from the emerging-market funds. Europe has been pounded day in, day out. In emerging-market debt and emerging-market equities, we have switched from overwhelmingly positive flows to steady negative flows in a few months. It is very easy to be negative on Europe: There's no growth, the euro may cease to exist, the periphery nations like Greece and Portugal are plagued with problems. But I think emerging markets are more interesting because you have a dynamic [growth] story. [I believe] the problem is that people were buying commodity stocks that happened to be listed in emerging markets. That is not the same as investing in emerging markets. So when commodity prices turned over, they got burned.

I think the reality is that emerging markets will have better growth than developed markets. They [potentially] will outgrow the U.S., Japan and Europe. So there are [emerging-market] opportunities, but you have to be targeted. You want to be exposed to the domestic economies. [In my opinion], Venezuela and Argentina probably are not good options, but Mexico and a lot of the African economies are starting to turn around. The analogy I use is that investing in emerging markets is like using salt: When you put a little salt in your food, it tastes much better, but when you use too much salt, it's awful. More important, you have to put the salt on the right places.

Kalwarski: What is the process you use in deciding where to invest?

Feltus: On the fixed-income side of the firm, we don't compartmentalize or silo our investments with an emerging-market specialist, a high-yield specialist and a Treasury specialist. Rather, we take an integrated approach and manage the fund as a global portfolio, where the emerging markets represent a part of the investment process.

We do the same thing on the currency front. We cherry-pick the Mexicos, the Nigerias—the economies that we think have strong fundamentals. Often when you buy an emerging-market bond fund, you end up in a situation where the managers may like Mexico and the Philippines but—since [these managers] are benchmarked against an emerging-markets index—they have to invest in markets they may hate. As a result, you have a situation where 70% of the portfolio is working and 30% isn't.

We ask ourselves, "What do we like?" And if we can build a portfolio that's 50%, 60% or even 80% emerging markets because the opportunities are there, fine. But if there are no opportunities, we're not forced to go out and backfill. [I think] the key is to make sure you have international exposure. You have a wider opportunity set to choose from, and you have a greater chance of potentially finding good opportunities

Kalwarski: Where are you finding opportunities?

Feltus: Mexico is one of our favorite stories. Since the late 1990s, everyone has been aware of what the problems are in Mexico: too many monopolies, a regulated utility sector, a shortage of electricity and a shortage of oil, even though Mexico is an oil producer. These were easy fixes, but the country never did anything about it. In that regard, Mexico was similar to what you saw in the U.S. [insofar as the country was] losing manufacturing to China. But that is beginning to change. China has become more expensive to operate in, and companies are moving back to the U.S.. And on the low end [of manufacturing], they are moving back to Mexico. That's the secular story.

Then last summer, the election returned the PRI—the party that basically ruled Mexico for 80 years—to power. For the past eight years, they were on the outside looking in. Now they are addressing all of the issues. It is still in the early days, so not everything has been implemented. But you have a very strong structural story. And Mexico is still very cheap.

Kalwarski: How has a strong dollar affected international investing?

Feltus: A year ago, people thought the U.S. could be in default. Now we are in more of a bull market [for the dollar]. We have rising interest rates, strong growth and improvement in the fiscal situation. Yes, some problems remain, but there have been improvements that are dollar-positive. Unfortunately, the strong dollar presents headwinds for international investing, at least currency investing.

But just as in a bear equity market, where not every stock goes down, the same is true with currencies in a bull market for the dollar. You have to be selective and demand structural changes and improvements in the underlying economy rather than rely on cyclical or technical flows of capital.

We are long-term value investors, and for us it's about our upside vs. our downside for every trade. We try to capture the large trends, the trade that plays out over two-to-three years. We don't trade in and out of currencies—or bonds, really—because transaction costs eat into performance.

But when the market has technical blips, it can result in opportunities. The problem with our strategy is we tend to buy in early, so we temper our aggressiveness. We limit our maximum position initially, and part of that is identifying the bottom-up securities. You can't increase from 25% to 50% overnight—you have to buy 200 different bonds. We are methodical about this and do invest over a number of months. The same is true [when it comes to] trading out of positions: We seek to move out early before the market recognizes [what has changed]. Investing in this manner forces you to be more disciplined in executing trades. It forces us to dollar-cost- average, as opposed to going all in.

Kalwarski: Where do you see rates and inflation headed?

Feltus: These are two areas where everyone's been wrong. Don't fight the Fed, pure and simple. The Fed's been very easy, but now the Fed is becoming slightly less easy. It may not be raising the fed funds rate, but interest rates are up 100 basis points in anticipation. You probably have another 100 to 200 basis points before you are at historical fair value. When I think about the 10-year Treasury, I expect a 2% real rate, so with 1.5% to 2% inflation, it results in about a 4% yield at fair value. And if the Fed is tightening, there's no reason why that number can't go higher.

As for inflation, everyone has been concerned, and yet it is not happening. Now, inflation may return, and yes, you can buy gold as [a hedge]. But gold is like holding cash, it doesn't earn anything. There are other ways to hedge against inflation and [potentially] get a real return.

Currencies, for instance, are one way to hedge, but do you want to be overaggressive right now, given the strength of the dollar? Equities are another inflation hedge. If I can get a near-double-digit annual [return] on a stock, over time that will provide a hedge against inflation and is potentially a much better way than buying commodities. However, you should maintain a core bond allocation as well. Given that, I think the better way to hedge against inflation is through [exposure to] corporate bonds. Historically, they have a very low default rate, ample liquidity and are profitable [given the coupons]. But suppose I am wrong, and inflation accelerates? These companies still have the potential to increase prices. And their profits [could] increase, and the default rate [should] improve.

Kalwarski: Any final thoughts?

Feltus: I think what's going to happen is that emerging markets will fall out of favor as a concept, because “emerging markets” means nothing. The countries are arbitrarily grouped under the rubric. Singapore and Korea are so-called emerging markets, but they [are have investment-grade credit ratings]. Singapore's income is higher than [that of] the U.S., and Korea’s is comparable to Europe’s. They are not “emerging”—they have already emerged. Yet they're thrown into the broad basket.

I think it’s important to approach each country on its own merits. Let's take Latin America: there's Mexico, Peru, Colombia, Chile, and Brazil. Every single one of them is different. Brazil, for example, is deteriorating—a secular story as far as governance, as far as policy [is concerned]—and it is highly commodity dependent. Meanwhile, Chile is very copper dependent and has very good governance, but they have an election coming up. The same is true in Asia: Indonesia is different from Thailand. You have to understand both the top-down and the bottom-up to potentially get it right.

As a result, we have always looked at each country [as if it were] a company. What does an income statement tell you? Well, it is a bit like looking at a country’s GDP. But GDP is backward looking. To be forward-looking, you have to adjust for current policy. What is the strategy of the country? How is it going to grow? What is the monetary policy, the fiscal policy, the tax policy, the regulatory policy? And, finally, who's in charge? You have to understand the politics and how it's going to play out. So it is a little more complex than investing domestically, but there are opportunities as a result.

**Unless otherwise noted, the source for all information is Pioneer as of October 2013.*

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