QV UPDATE

Weekly Commentary | July 28, 2017

Vanessa McNabb, BComm | Ian Cooke, CFA

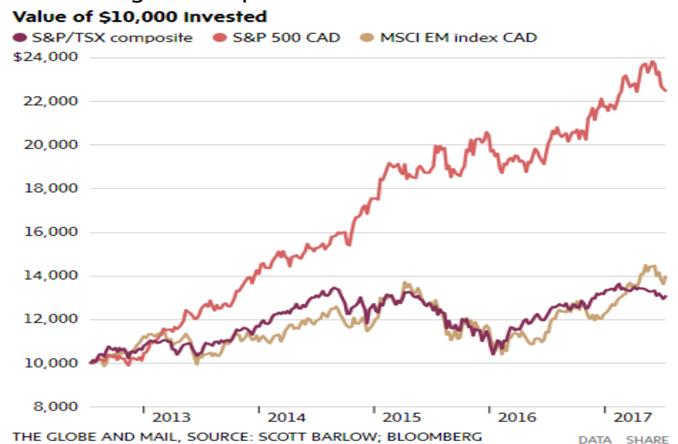
Emerging Risk

In an environment where investors' thirst for yield is insatiable, it is not surprising that capital has been flowing into emerging markets at a significant pace. Understandably, investors are looking to how they might diversify away from the excesses built into developed markets and capture a piece of the ever increasing growth expectations that are pegged for emerging markets. According to the IMF, emerging markets comprise nearly 75% of global growth in output and consumption. These expectations have already parlayed into attractive returns year-to-date with the iShares MSCI Emerging Markets Index ETF up 17.5% in Canadian dollars as of yesterday close. Emerging markets also have more attractive valuation characteristics compared to the S&P 500 Index and the S&P TSX Composite Index.

All too often investors are willing to overlook inherent investment risks when the numbers are going in the right direction. Investing in emerging markets comes with its own set of risks. The political and social climate in some of the emerging nations can pose problems for investors if there is a high degree of corruption and unrest. Knowing your rights as a shareholder is imperative in navigating legal systems that may not have a great track record of upholding property laws. Due to more relaxed securities regulations, the integrity of capital markets may not be protected to the same degree as they are in developed markets. Similarly, the level of reporting transparency required for public companies is generally lower than developed markets, making it hard for an investor to make informed decisions. Additionally, exposure to foreign exchange risk could be higher if rampant inflation were to occur.

This is not to say emerging markets should be avoided entirely. However, due to the unique risks involved, emerging markets have historically been more volatile than developed markets. Investors must therefore have a higher level of risk tolerance. Canadian investors should be especially careful given the correlation between Canadian and emerging markets.

In a recent article in the Globe & Mail, Scott Barlow points to the strong correlation between performance of the Canadian equity market and performance of emerging markets over the past five years, as illustrated in the chart below. This strong correlation has held true, however, for a much longer time period.



Commodity prices are, as Scott suggests, the primary reason for the strong correlation. Emerging market economic growth is supportive of commodity prices due to the amount of resources used in generating that growth. In turn, the heavily resource-weighted Canadian market benefits from the increase in commodity prices. In a sense, the broad Canadian market often serves as a proxy for emerging markets. So, a Canadian investor's emerging markets exposure may actually reduce the level of diversification in his/her portfolio, while adding other risks associated with emerging markets. As the chart indicates, this is not necessarily the case for a US investor, as US market performance is not as highly correlated.

For many of the reasons listed above, QV has not typically invested directly into emerging markets. Rather, we have invested in international companies trading in developed markets where we have confidence in the rule of law. For example, Swiss based QV Global Equity Fund holding Nestle generates nearly half of its sales within emerging markets. Shareholders of companies like Nestle will benefit indirectly from continued economic strength in emerging markets without adding the risks associated with directly investing into emerging market companies.

Copyright © 2017 QV Investors Inc. Readers may forward electronic versions of this Update. All views and projections are the expressed opinion of QV Investors Inc. and are subject to change without notice. This Update is provided for informational purposes only. QV Investors takes no legal responsibility from any losses resulting from investment decisions based on the content of this Update.