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EMERGING MARKET INVESTING

# Emerging market ETFs and the jaws of death

Huge inflows have gone into the largest companies — but they are not good companies says **Terry Smith**

ADVICE & COMMENT

Terry Smith

It may seem a strange position for an active fund manager to adopt, but I am in favour of passive or index investment.

The advantages of index investing are clear. Investors can invest in a widely diversified portfolio at minimal cost as management charges are low, as are the costs of dealing.

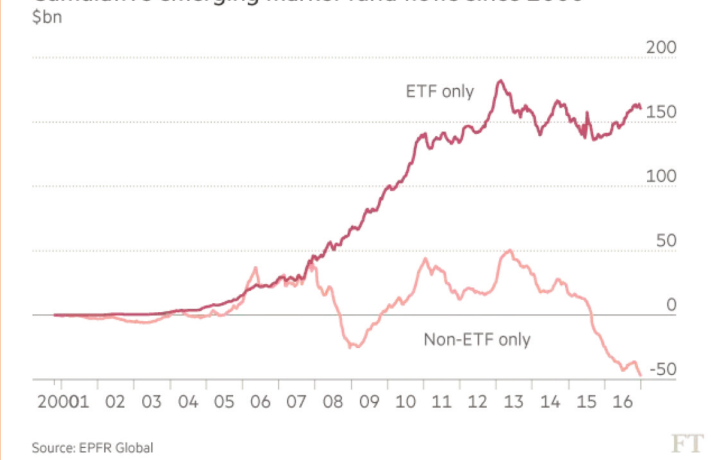
The obvious drawback to index funds and exchange traded funds (ETFs) is that they deprive investors of the opportunity to focus their investment only in good companies and/or shares which offer reasonable value or better. However, it seems that most active fund managers do not even attempt to invest only in good companies, or if they do they are not very good at identifying them. They seem to have similar problems in determining what is reasonable value.

Many hold so many shares in their portfolio that it is bound to track the index. When combined with active management fees and dealing costs this means that they are certain to underperform the index. Hence my view that most investors would be better served by an index fund.

But the growth in index funds and ETFs has significant side effects. In an index fund or ETF, the weighting of stocks is based on whatever criterion is used to compile the index, typically the market capitalisation of the companies. This means that as more money is invested via index funds or ETFs it is automatically routed via the fund into the companies in the relevant index based solely upon their market value.

This can cause some major distortions, one of which we have almost certainly seen recently in emerging markets. Fund flows into emerging markets have increased significantly in the past couple of years as investors have sought to capitalise on a recovery. However, all of this inflow and more has gone into emerging markets ETFs, while money has actually been withdrawn from emerging markets active funds as this chart shows:

Cumulative emerging market fund flows since 2000




It looks rather like the "jaws of death", a term taken from shark attack movies and military encounters, such as the Charge of the Light Brigade.

Increasing amounts of money are being allocated via this inflow into the largest companies in the emerging markets index, and they are not good companies. Last year, the return on capital employed (ROCE) of the top 10 constituent stocks of the MSCI Emerging Markets Index averaged just 12 per cent.

Of course, this is a single year and you might wonder whether it is representative. Looking back at the returns of the largest companies in the Index for the past 10 years or so shows a more or less continuous decline — particularly among the Chinese companies which seem to be investing on the basis that debt capital in particular for them is close to free. This is always a dangerous assumption, as the dotcom era and Japan in the late 1980s illustrated.

Or maybe the shares which dominate the index are lowly rated, which more than compensates for their low returns? This does not seem to be the case given the current price/earnings ratio of 28 times for the top 10 largest constituents, versus 23 times for the MSCI Index, unless their earnings are about to undergo a sharp recovery. However, this seems unlikely for a mixture of internet and ecommerce stocks, electronics manufacturers, Chinese banks and mobile telecoms companies.

Many active managers bemoan the rise of index funds and ETFs as they say it makes their job more difficult. In the short term, this is undoubtedly true. If money pours into markets via ETFs it will cause the shares of the largest companies in the index to perform well irrespective of their quality or value — or lack of it — even though active managers seeking quality and/or value will not want to own them. The weight of money flows will make it a self-fulfilling prophecy that the index will outperform the active managers who behave in this rational manner.

This can be very frustrating, but an active fund manager should regard this as an opportunity to own more of the shares which are better than the index average and will eventually produce superior returns — providing the manager and the investors have the patience necessary to wait for this to occur. The irony is that active management has value for investors as a means of exploiting market inefficiencies, such as those caused by the rise of ETFs in emerging markets, but those events make it harder for managers and investors to follow the active path.

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