Institutional Investor's
alpha
Alpha volume 13 autumn 2015

Betting on growth

Rock Creeks Group's Afsaneh Beschloss says the recent carnage, emerging markets are still an attractive investment

These days many investors cringe at the thought of emerging markets. On the surface, they may be right. The late-summer meltdown across the southern hemisphere, brought on by extraordinary monetary policies enacted by the Chinese government in August, as well as collapsing commodities markets and slowing global growth, translated into plummeting regional equity and currency markets and heavy losses for hedge funds. Sixteen of the 23 emerging-markets currencies fell in the three months through early November. Roughly $1 trillion of investment capital has left emerging markets in the past 16 months.

The U.S. Federal Open Market Committee's late-October meeting did little to allay the uncertainty. The committee decided to keep the Federal Reserve's benchmark short-term interest rate close to zero percent, where it has stood for nearly seven years. The news sent emerging-markets equities spiraling to three-week lows as investors recognized the greater likelihood of a rate hike in December. The MSCI Emerging Markets Index fell 1.65 percent the following day on fresh fears of a surging U.S. dollar and capital outflows from developing economies.

Though emerging markets have lost their luster for many investors, Afsaneh Beschloss sees the space as rich in opportunity. "This is a very exciting time for investing in emerging markets," says Beschloss, the 59-year-old CEO and founder of $11 billion global investment and advisory firm Rock Creek Group. The Washington-based firm is a strategic partner to large, sophisticated institutional investors, including public funds, corporate pension plans, sovereign wealth funds, endowments and foundations.

Photo credit: Abby Greenawalt

Emerging markets had a big run-up after the 2008–'09 crisis as the U.S. pushed liquidity into the global financial system through its stimulus policies. Many developing countries experienced incredible economic growth and enjoyed heavy inflows of financial assets, while developed economies faltered. But circumstances have changed. In the past 12 to 18 months, the uncertainty surrounding U.S. interest rates has grown, oil prices have dipped nearly 60 percent, China has introduced financial policies unfavorable to global markets, and economic activity in the world's second-largest

economy — which historically has fueled growth in export-oriented emerging markets — is slowing. China is expected to grow by 6.8 percent this year, down from 7.3 percent in 2014.

"Once a country hits a certain base of GDP, its growth rate naturally comes down," Beschloss says. "You can't always grow at 12 percent. Markets were a little amiss to expect that from China."

Rock Creek's emerging-markets equity fund has performed well in this challenging environment. The fund is up a cumulative 35.56 percent since its August 2009 inception, more than double the return of the MSCI Emerging Markets Index, which is up 16.69 percent over the same period, according to data provider eVestment. This year, however, the Rock Creek fund has failed to beat the benchmark, losing 10.91 percent through October, compared with a 9.45 percent loss for the MSCI index.

The firm's analysts research thousands of emerging-markets and frontier-markets companies. Roughly 30 percent of Rock Creek's capital is allocated directly to emerging-markets equities; a further 13 percent is in funds of hedge funds and commingled funds. The remainder is in customized portfolios.

"I've always been very passionate about emerging markets, having worked in many countries, having been born in one and having done business across different emerging markets at J.P. Morgan, Shell, the World Bank and Rock Creek," says the Iran-born American citizen, who first came to the U.S. at age 16 as an exchange student. She began her finance career at J.P. Morgan in London and New York after earning a master's in economics with honors from the University of Oxford in 1978; she also worked at Shell International Group Planning in London. During her two decades at the World Bank, Beschloss worked in multiple roles, including overseeing $95 billion as CIO from 1996 to 1999 and later serving as treasurer. She directly invested in oil, gas, renewable energy and power projects in emerging markets during her time at the Bank. In 2001 she joined private equity firm Carlyle Group to start a fund-of-hedge-funds business, which two years later was spun off as Rock Creek in a management buyout.

Beschloss's experience in emerging markets has inspired the Rock Creek CEO to introduce environmental, social responsibility and corporate governance (ESG) investments into her firm's portfolios. "We want our investors to benefit from this area to the extent that they can," she says. The firm was an early signatory of the United Nations Principles for Responsible Investment, which prompt investors to help develop a sustainable global financial system by incorporating ESG factors into investment practices. "Hedge funds in general have not been the most proactive in the ESG space," Beschloss notes. "The investments could be very attractive because hedge funds can go long and short."

Beschloss recently spoke with Staff Writer Georgina Hurst about how to keep emerging markets–focused funds above water and why ESG considerations can help take a portfolio to the next level.

Alpha: How has Rock Creek Group's emerging-markets strategy managed to perform well amid global economic uncertainty?

Beschloss: We've succeeded in investing in emerging markets over the long run and particularly during these incredibly volatile times because we combine a macro top-down approach with micro bottom-up investments. The top-down macro views in emerging markets do matter. The combination of our experience at the World Bank — with companies, business communities, regulators and policymakers — lets us take macro views at a local micro level. Our ability to find local stock pickers with the best knowledge of local companies has been a very important element of our success in emerging markets.

What does Rock Creek do differently from competitors when it comes to investing in emerging markets?

We find the best local teams to be stock pickers in the countries in which we are investing. Having teams in Washington, New York, London and other major capitals is not sufficient for finding the top investment ideas in emerging markets. Twenty years ago, when there were huge inefficiencies in the markets, investors just went into the largest companies in developing markets and did fine. Those markets today have become more efficient. Now you have to find the midcap and small-cap companies that are not highly researched by Wall Street but are highly researched locally. You also have to avoid the problem companies and [those with] weak governance across emerging markets. We've found the best local teams to do that.

Which emerging-markets teams have been the most successful?

Our Africa team was very successful, benefiting

from the huge growth in the consumer sector across the continent. Africa has been a very hot area for investors, and it's a region where investors have to do their own research because of the risks involved. Our team has done far better than the frontier indexes and various Africa indexes since the $285 million Rock Creek Kimberlite fund was launched about two years ago. They were so successful that we had to close that fund after a year; we could not take new assets.

Do you expect the Fed to start raising interest rates by the end of 2015?

Looking forward, domestic growth rates are expected to be in the 2 to 2.5 percent range, real unemployment hovers between 9 and 10 percent, inflation is far below the 2 percent target, and the strengthening dollar is not helping our exports. We're in an economy where there are areas that are growing at a good pace and areas that are really overheated, like construction, health and technology, but average wage growth is not expected to be very high overall. The Fed must also be sensitive to international factors that can create a very unstable environment that can impact the U.S. at a time that Chinese net dollar-denominated reserves have been declining. Put all those factors together and the market believes the probability of an interest rate hike by year-end is 40 to 50 percent. My view is that the Fed is more likely to increase rates this year versus next year.

More interesting is what the Fed will do after the initial hike. The pace of rate increases will be much lower than what the market has assumed, and rates will stay low for a much longer period.

Do you anticipate greater volatility in emerging markets as a result of tighter monetary policy in the U.S. and elsewhere?

It is the marginal change in volatility that I'm concerned about. It was interesting that at the annual meeting of the World Bank and International Monetary Fund in Peru in early October, it was the emerging markets that were telling Fed chair Janet Yellen to increase rates because the uncertainty surrounding the timing of the hike is getting people nervous in these countries and G-7 markets, and creating malaise in markets both in the U.S. and internationally. We know which countries are going to get hit most by a rate rise because they have a larger stock of U.S.-denominated debt, and we know which countries will be impacted by fluctuations in oil prices and commodity prices. In emerging markets you get some periods of huge run-ups and some periods of huge downturns. Long-term investors will benefit from these inefficiencies.

How so?

While we expect volatility ahead, we are looking both in terms of our top-down and our bottom-up investments in companies to explore areas going forward that could benefit. This is a time where passive investing in emerging markets may be ineffective. You want to have active management in this environment. In a number of these countries, the consumer and domestic growth will continue to prosper over the medium to long run versus export-oriented growth. If you can find the companies that benefit from those trends, you'll do well in these countries even under difficult circumstances. If you invest only in the large energy- and commodity-related companies, you'll just be subjecting yourself to what's going to happen to the price of oil and commodities versus the particular developments in that country.

Which sectors are best positioned to capture this consumer-driven growth?

One of the areas I'm most excited about is the health sector. Over the past three years, the emerging-markets equity market has fallen 10 to 15 percent, depending on what market you look at. If you look at the health sector in emerging markets, it's up more than 20 percent in the same time span. We are also overweight in the information technology sector and over the past year avoided some of the big banks and energy conglomerates. What's very powerful and what I'm very excited about is the potential to develop these countries while generating strong returns.

How does Rock Creek take into account the different ways countries respond to external factors like commodity price moves?

There is not one overarching rule for investing in every country. As we've seen, the BRICs have had their individual fates. There's been the negative political situation and commodity price decline in Brazil, the oil and gas price decline and recession in Russia, the positive infrastructure potential in India and the slowing growth in China. These trends have had different impacts on emerging markets. By and large, we have an attitude of being value-oriented and long-term, but there are times

in certain countries where we might do a little more active trading. In Korea, for instance, we are beginning to shift back from some of the midcap companies to the large-cap companies.

What did you learn about investing from your time at the World Bank, and how have you carried those lessons over to Rock Creek?

At the World Bank I learned the importance of investing for the long run, especially in energy, including clean and renewable energy before it was popular. I also learned how to manage global bond portfolios and a derivatives book of $160 billion for risk management. We were early investors in emerging markets and in private equity and hedge funds. Our job was to find investments that were aligned with our interests and to create a portfolio that fit within our total portfolio. We selected the hedge funds where the managers had a large amount of their own money in the funds and were focused on the 15 or 20 percent incentive fee. I introduced the same model at Rock Creek. We were early in creating customized, direct multiasset-class portfolios for our investors with strong emphasis on user-friendly technology.

Has the role of fund-of-funds investors changed since then?

Over the past 13 years, the industry has changed in extraordinary ways. Beginning in the early 2000s, some large managers became more like traditional managers in the sense that they're more interested in the 2 percent management fee than the incentive fee. Investors are starting to demand what we've done consistently: Look for hedge funds interested in returns, not just assets.

Do you see this evolving any differently over the next ten years?

You have to have the best people and strong technology to be successful in investing. What's changing is the narrowness of the investment world. I expect there to be more women investors and more portfolio managers with diverse backgrounds. We build our own databases and have our own indexes of women-owned funds or minority-owned funds. We found that during the financial crisis in 2008 some of these did far better than the bigger names.

The other area that you hear about is ESG. I was heavily involved in clean and renewable energy and environmental assessment at the World Bank. Today there are two schools of thought: One is the assumption that a fund's sensitivity to ESG factors will have a negative impact on returns, and the other assumes returns from ESG will be positive. I happen to be in the second group. We incorporate ESG factors into our emerging-markets investing and have been developing a comprehensive database of ESG investments.

Does investing in ESG funds sometimes conflict with investing in rapidly growing emerging markets?

Investing in ESG companies is completely compatible with making money in emerging markets. Many local partners incorporate ESG parameters in their investment processes and are often at the forefront of developing and maintaining strong corporate governance standards in the companies they invest in. Some countries in emerging markets are ahead of some developed countries in terms of promoting ESG standards across the corporate landscape, with Chile and Korea being notable examples.

When I studied economics, we were taught that capital and labor were the main determinants of economic growth. We did not value what used to be called externalities, such as air and water. Today these are not externalities. If you're talking to the Chinese leadership and they say they agreed to new climate change policies ahead of the Paris climate meeting, they didn't do it to please anyone, they did it because they need to. The air in Beijing is getting their own children sick. It's very personal. The same thing is true in Indian infrastructure and around the globe. It's an evolving area, and we hope to participate in these investments.

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