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unwind”

Bold moves to restore Gem’s lustre

“When the market’s imploding, it’s time to invest,” says the lead manager of Resolution Hexam Global Emerging Markets after a decision not to be defensive set the fund on a rollercoaster.

Unless you are old enough to remember 1929 – in which case you are unlikely still to be on the Fund Strategy mailing list – we are in unprecedented conditions. So when a fund manager stresses his remuneration structure is not “in the bonus environment” with all the distortions that implies, you may not be totally surprised – after all, the lesson of the past weeks is that nothing can shock.

Hexam Capital is a four-person emerging markets boutique. It’s a partnership – hence no bonuses – which has a close relationship with Resolution Asset Management (about to be rebranded Ignis). It manages Resolution Hexam Global Emerging Markets fund (Gem).

Gem was worth €95m (£74m) at the end of September. By now it could be half that or half as much again. Volatility in emerging markets is so off the scale that the Russian stock exchange has been forced to keep putting up the “closed” sign.

But what those close to the Moscow financial scene see are prices so low and so far from whatever “reality” they have learnt in Russia’s decade or so of capitalism that they reach absurdity. This month, for instance, Lukoil, a Russian oil major, was valued on just twice projected 2009 earnings (a figure calculated, thanks to the Russian tax system, using an oil price at about \$70 a barrel).

Advisers do not opt for emerging markets funds for defensive reasons. But those with clients of a predominantly nervous disposition should stop reading now.

At the end of September, Gem was in the 100th percentile position on one month performance in euros – turning the numbers into sterling improves that figure to 99th with a 24.7% fall compared with 15.6% down in its MSCI Emerging Markets total return benchmark. But the discrete August performance put it into the 30th percentile in euros – ahead of the benchmark.

More reassuring is the 21st percentile performance since it was launched in November 2006.

Bryan Collings, the lead Gem fund manager, explains that the volatility, following eight months during which six had been positive against the benchmark, is the result of a decision not to put up the defensive shutters.

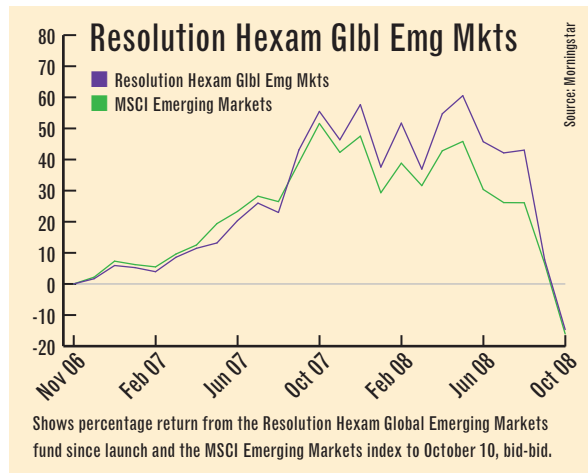
“We had been relatively defensive earlier this year,” he says. “We pulled back to waiting for buying opportunities. We started to add to holdings in early September so our September figures are poor, reflecting the rebalancing of our portfolio ahead of what we expect to be a big upside. We consciously gave up on lots of relative performance.”

“Our cash inflows from investors remain positive – around 15% over the past six weeks. So we have plenty of ammunition now to add to stock holdings.”

Collings maintains that emerging markets are far from sunk, and should rise high above the waterline. “What we’ve had is a technical unwind,” he says. “Emerging markets and the commodities that are closely aligned with many have been overcrowded with huge speculative holdings built up on the basis that prices would just continue to rise. This has unfolded very quickly. So when it comes to defensive positions, managers ditch these ‘offshore’ assets first.”

“It is understandable and even justifiable from their point of view but it doesn’t matter. What we now have is a massive buying opportunity because the technical factors have distorted long-term value – everything is so undervalued at the focal point of the unwind in emerging markets,” he says.

Gem is a concentrated fund with, at present, 37 stocks. At the moment the stock turnover is higher than the more



normal 75% to take advantage of “capitulating markets”. Gem has an “ideas pool” with a blend of “country active” and “stock active” concepts.

Collings prefers to concentrate on weightings relative to the benchmark rather than absolute positions. And if he is right, it is good news for those who bought into the Bric (Brazil, Russia, India and China) story.

The fund is 8.2% overweight in Russia. It has its problems but the two-thirds fall in equity markets over the past three months is not one of them. True, the Russian government has been supporting banks. But Kremlin sources say this is to ensure the orderly amalgamation and – perhaps disappearance – of many of Russia’s 1,000 plus institutions, which often serve more to launder money than to aid the economy.

Despite political scares over Georgia and corporate governance issues such as the BP row this summer, Russia continues to import foreign capital – a good sign.

Gem is also 5.3% overweight in China. “China will not grow so fast but it’s 15% going down to 8% or 10% – not zero. Obviously, there will be a switch from manufacturing to infrastructure and domestic consumption, but when this happens it will be positive again for commodity holdings. And we see the Chinese inflation issue evaporating.”

Brazil is moderately overweight while India is fractionally under its benchmark. The most underweight position is in South Korea – about 7% below the benchmark. “[Korea’s] relative value is poor. It has the worst current account deficit in the countries we look at; its banking sector is vulnerable as it has developed market levels of leverage. It has the weakness of developed markets with few of the advantages of emerging markets. And who wants a market dominated by consumer goods exporter Samsung?”

The nightmare scenario? Social unrest in China, and the technical market turning into something more fundamental leading into hopelessness.

The positive scenario? A 30% bounce upwards over the next year, which will still be far below previous peaks as some stocks now appear to be discounting depression in perpetuity.

“When the market’s imploding, it’s the best time to invest,” says Collings. “After all, you pay an exorbitant price when the market is happy. I see emerging markets as a long-term call option. If all goes well you will leverage your money substantially. And if it doesn’t, losses will not be that great.”