Emerging commodities offer insane valuations

Bryan Collings, of the Ignis International Hexam Global Emerging Markets, talks to Adam Lewis.

BRYAN COLLINGS co-founded Hexam in July 2006 after joining from Baring Asset Management where he was head of the global emerging markets team.

Q: How would you describe the environment in emerging markets?

A: It is an amazing time in emerging markets. There are so many myths and conceptions flying around, but never before have the less developed markets been more sustainable than the developed markets. In emerging markets it is only in a crisis that you can make a material difference in your portfolio and I think the risk is not having enough emerging markets in your overall portfolio. Given the valuations and the distress in the market I haven't been as bullish on the region as I am right now for the past two years.

Q: Are emerging markets cheap?

A: It is not cheap right now, it is insane. You can buy the entire free float of China and India with today's market cap of Volkswagen and still have enough spare change to buy Turkey.

The markets are discounting the fact that no-one has any savings. The savings are still there but in emerging markets the valuations are unbelievable. Our portfolio is currently on six times price/earnings (P/E), whereas the P/E on the S&P 500 is 12 times.

Q: Has the extent of the falls in emerging markets caught you by surprise?

A: We did expect some form of correction but we were surprised by the 20% pullback in recent weeks as events became completely uncoupled from fundamentals. It never ceases to amaze how fear manifests itself in the decline of share prices. One day some stocks were down 40-60% and then a few days later they rise 40-60%. What has also surprised me is just the extent emerging stocks have exhibited a wide dispersion in their performance.

What has caught me by surprise is that I did not think commodities would be hit this hard. They should be performing better than the banks and electronic stocks, but the reason they are underperforming is down to liquidity.

This is being driven by distressed sellers trying to raise capital as fast as they can and selling stock they really like. However, there lies the future alpha. We are going out and buying more. Commodities is the biggest overweight position in the fund, representing some 23% of the portfolio.

Q: For what reasons are you positive on commodities?

A: Several. The large commodity companies still have strong balance sheets relative to other emerging market companies. They also have free cash flows, capex [capital expenditure] is generally self funding and the M&A is likely to pick up over the next two years as many of the more junior companies struggle.

Also commodity companies have discounted the current global economic crisis and in this environment it is not difficult to see the winners and losers in the sector are.

I also still maintain that global emerging markets [Gems] could make up more than 100% of global growth in 2009. Indeed, the engine of economic growth for the next 10 years will be Gems. This is based on factors such as savings, population and the needed infrastructure spend in many of these countries is remarkable. Some 12,000 miles of railway are set to be laid in China in the next five years. The backbone of providing this infrastructure will be commodities.

It is important to understand that during different points in an economic cycle not all commodities will perform well. However, right now all stocks are being tarred with the same brush and are down significantly.

Right now we are less keen on coking coal and steel that relates to global discretionary consumer spending, such as that used for automobiles. However, we are positive on steel that relates to infrastructure, like railways. We also like iron ore, integrated oil stocks, cement and thermal coal.

Q: What areas are you negative on?

A: I don't like consumer discretionaries and stocks in the market that are exposed to debt issues. I also don't like markets that don't have high savings, such as central Europe, South Africa and Korea.

Q: What has happened to the earnings of companies in this environment?

A: Out of an investment universe of 1,000 stocks, some have seen their earnings fall about 85%. However, while earnings will continue to fall, within this are huge opportunities because not all companies are the same. In addition, these falls are already being discounted by the market and the emerging market index has never been so cheap.

Q: What are you doing with the fund in these conditions?

A: We had taken a cautious stance until the end of September, but given conditions in the market and the cheap valuations we have since reduced the number of stocks in the portfolio from 48 to 36 and upped country weightings in Brazil, China and Russia to 10% each of the fund. This means the extent of the fund's tracking error has risen as has the beta on the portfolio.

This is because right now is a great opportunity to buy assets that are not distressed from irrational sellers. All the funds I manage have been buying and are now all very exposed to up markets.

As such following [last week's large rise in markets on November 24] all our funds did well, with the Emerging Markets fund up 5% relative in one day. Our annual relative target is 3%.

Russia is an area I have been gradually adding to over the last six weeks, steadily increasing it to be a significant overweight position.

This is quite a contrarian stance as many people seem to have thrown it out and there have been times when I have been extremely cautious. However when markets bounce there will be a significant squeeze on Russia and it will go up.

Q: Hexam is soon to bring your offshore fund into the retail market via an onshore fund. Why did you decide to this?

A: A number of UK clients can't put money into the offshore [Dublin domiciled ICVC] fund so we decided to launch the unit trust, which basically mirrors the fund I already manage.

We also plan to launch a US version, which will also mirror the existing strategy. Despite the recent falls there is demand for emerging markets, the offshore fund has grown 25% in net asset value terms in the past few weeks via inflows of investor money.

The plan is to cap the strategy at $1 billion (£660m) and given the growing size of all the mandates I run already, I think we could close it in three years.