Avoiding Disasters in Emerging Markets Equities

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Arjun Jayaraman, a portfolio manager for Causeway's Emerging Markets, International Opportunities, and International Small Cap equity strategies and head of Causeway Quantitative Research, joined Senior Relationship Manager Sarah Van Ness to discuss risk management in emerging markets equities. Their conversation has been edited for clarity.

Arjun, Causeway emerging markets portfolios have outperformed most peers since Russia invaded Ukraine. It is early in this crisis, but how did you and the team accomplish this?

Prior to the invasion, Causeway emerging markets portfolios had a modest overweight to Russia versus the MSCI Emerging Markets Index, mainly due to valuation. Russian stocks were extremely cheap based on nearly every metric we monitor. But even though valuation receives the most weight in our quantitative alpha models, we also consider other factor categories, such as momentum. In the weeks before the invasion, the momentum of Russian stocks had turned quite negative. These uncorrelated alpha sources in our models limit downside risk.

Our top-down model includes country credit default swap ("CDS") scores, which became very unfavorable for Russia. The alpha model penalizes sharp increases in CDS, which tripled for Russia leading up to the invasion. Our top-down model also includes the country yield spread: long bond yields minus short bond yields. Shortly before the invasion, Russia's yield curve flattened, even inverted in certain areas. Admittedly, this often happens when central banks increase short-term rates, but Russia's yield curve was significantly flatter than average, which was a red flag.

In conjunction with our fundamental colleagues, we complement our quantitative analysis with qualitative analysis and concluded that the risk of military confrontation had increased. Moreover, our fundamental colleagues highlighted a Russian bank holding as a possible target of sanctions, which did turn out to be the case. In the month before the invasion, we reduced our exposure to this bank.

We limit emerging market portfolios' country exposures to +/-5% relative to the benchmark. We recognize that geopolitical risk is high in emerging markets, and country risk can overwhelm other alpha factors. This country constraint prevents us from becoming overly concentrated in a country relative to the benchmark.

Today, the Causeway emerging markets strategy holds three Russian Global Depositary Receipts, or GDRs, listed on the London Stock Exchange. The portfolios do not have direct exposure to the Moscow Exchange or the ruble. As of their last pricing date, the aggregate weight of these three securities was about 0.10% of the total portfolio. Effective March 9, MSCI reclassified its Russia Indexes to Standalone Market Status, a classification below Frontier Market Status based on a framework that includes liquidity requirements and market accessibility criteria. Causeway may invest in stocks in Frontier Markets from time to time, but we historically have not invested in stocks in Standalone Markets. We currently do not intend to buy Russian stocks while Russia's stock market retains this MSCI classification.

You've managed Causeway emerging markets portfolios for about 15 years—I imagine this is not the first crisis you've faced. What other emerging markets disasters have you and the team avoided?

Our process has helped us navigate many major emerging market disasters since the strategy's inception in March 2007, including Russia's annexation of Crimea in 2014 and market routs in Argentina in 2018 and Turkey in 2021. In all these cases, even though the markets and currencies looked cheap on valuation, other parts of our process showed red flags. For instance, Turkey had elevated inflation levels and was running a significant current account deficit.

What would you say to investors wondering if, given these risks, they should avoid emerging markets equities altogether?

We believe emerging markets equities are a compelling asset class. Developing economies have high growth rates, strong manufacturing bases, and reasonable equity valuations. The governments of emerging market countries generally employ orthodox monetary and fiscal policies, meaning they do not have deeply negative real interest rates, nor is their spending unbridled. But to extract that return and alpha without taking on an undue amount of risk, we believe investors need a robust process. Causeway's emerging markets strategy combines multiple bottom-up factors, including valuation, growth, and momentum, with top-down country, sector, and macroeconomic factors. While valuation is the most important factor in our model, it is not the sole driver of our investment decisions. In addition, we rely on our fundamental colleagues to help navigate risks that are harder to quantify, including geopolitical risk. For these reasons, we are confident our process can navigate difficult periods such as the turbulent markets we are facing today.

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International investing may involve risk of capital loss from unfavorable fluctuations in currency values, from differences in generally accepted accounting principles, or from economic or political instability in other nations. These risks are heightened in emerging markets.

The Causeway Emerging Markets strategy uses quantitative factors that can be grouped into eight categories: valuation, growth, technical indicators, competitive strength, macroeconomic, country, sector, and currency. "Alpha" means performance exceeding the benchmark index.

Russian securities, including GDRs, were very volatile following the Ukraine invasion and market prices decreased significantly through the last pricing date of March 2, 2022 until halting trading on March 3, 2022.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index, designed to measure the performance of the large and mid-cap segments across 24 Emerging Markets countries. MSCI Indices are gross of withholding taxes, assume reinvestment of dividends and capital gains, and assume no management, custody, transaction or other expenses. It is not possible to invest directly in an Index. MSCI has not approved, reviewed, or produced this report, makes no express or implied warranties or representations and is not liable whatsoever for any data in the report. You may not redistribute the MSCI data or use it as a basis for other indices or investment products.