Equities: building with BRICs

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It was in November 2001 that Goldman Sachs economist Jim O'Neill coined the term now used to describe the rapidly emerging markets of Brazil, Russia India and China, in the research paper "Building Better Global Economic Brics". He argued that these four economies could make up more than 10 per cent of world gross domestic product by the end of the decade.

In just six years, the bank has drastically revised these predictions. Last November, it forecast that China's economy would surpass the US's by 2027, India would catch up with the US by 2050 – and that the Brics as a group would overtake the G7 in 2032.

So, in spite of all the recent debate about the "decoupling" of Bric markets from the west, and their subsequent "recoupling" in the credit crunch, these are long-term capital growth opportunities that wealth managers – and their clients – cannot ignore.

Already, the Bric growth story is playing out across the globe. Last year, the International Monetary Fund calculated that the Brics and the emerging markets they are helping to fuel accounted for 30 per cent of the global economy, and 47 per cent of all global growth – with China the biggest contributor and Brazil, Russia and India not far behind.

But it is not just commodities and low-cost manufacturing that is driving the growth. According to Reuters, India and emerging Asian economies are now home to nearly 26 per cent of the global information technology services market, and this market share is growing at a faster annual rate than IT services in developed markets.

This growth is now being fuelled by both international and domestic demand. Bric economies helped to push the share of global exports from emerging markets up from 20 per cent in 1970 to 42 per cent in 2006, according to Professional Wealth Management. At the same time, capital flows into the Brics and emerging markets have reached record levels, with the Institute of International Finance reporting that foreign direct investment jumped by over 50 per cent from $167.4bn in 2006 to $255.6bn in 2007.

In fact, since Brics first featured in the wealth management lexicon, investment inflows have been fuelling their equity markets. Between November 2001 and 2007, Brazil's stock market rose by 369 per cent, India's by 499 per cent, Russia's by 630 per cent and China's by 201 per cent if you use the A-share market, or 817 per cent based on the Hang Seng China Enterprises Index.

Even after the volatility of this January, the FTSE Bric 50 index was up 10.8 per cent in the six months to March 7, while the FTSE 100 index was down 10.5 per cent.

Given these robust equity markets, it is not surprising that the Bric countries accounted for 39 per cent of global initial public offering volume last year, up from 32 per cent in 2006.

For private investors, then, the most obvious way to gain exposure to these markets is through actively managed equity funds. Data from Trustnet show that the 26 funds in its Emerging (General) sector produced an average return of 25 per cent over the year to March 7, with the best fund – the specialist Allianz RCM Bric Stars fund – up 39.8 per cent.

Michael Konstantinov, an Allianz fund manager, says the Bric countries are showing no signs of slowing in 2008. He argues they will remain key to global economic growth, with Brazil achieving strong export and

economic growth, Russia seeing higher oil prices compensate for the weaker capital inflows, India boosted by higher domestic consumption, and China maintaining GDP growth rates well above 10 per cent thanks to buoyant domestic commodity prices and freight rates.

"Brazil is expected to outperform China in 2008," he says. "We think this should support asset prices and especially the equity market in Brazil, making it less sensitive to what happens in the global economy next year."

But some wealth managers now question the timing of this move into the Brics by retail fund managers. Graeme Currie of Alan Steel Asset Management says: "The question now is how much steam is left in them? Are unprecedented rates of expansion sustainable? The financial services industry has a remarkable track record of promoting niche funds towards the upper curve of the parabola – think of technology, health funds, property and commercial property."

He still backs the more experienced retail fund managers to pick stocks wisely and capture further growth. Private banks, however, are now suggesting ways to gain a more institutional-style exposure and manage the risk to capital.

UBS uses real estate, private equity and structured products linked to commodities and currencies to give its clients exposure to the Brics. "We know where the ship is going, it just might be a bit stormy along the way," explains Gavin Rankin, head of products and services consulting at UBS Wealth Management in the UK. "So we use a longer time horizon and think about different asset classes."

Real estate investments are made through a specialist fund that diversifies its exposure across a basket of fund managers. It can make opportunist investments in developments of residential and commercial property, in areas of the Bric countries where it can take advantage of growing commercial activity and a growing middle class.

Private equity exposure can be provided across a spectrum, from venture capital to growth capital, leveraged buyouts and distressed companies. But it is in growth capital that UBS sees most opportunity – it closed a global fund last year that invests in "companies trying to get to next stage" and has a 25 per cent allocation to India. "That again is something that clients loved," says Rankin. "It has a long time horizon, and taps into a really attractive long-term theme: the emergence of giants."

Currency and commodity trends are invested in through structured products to ensure capital protection. At the moment, these offer a play on Bric currencies that are strengthening against the dollar. Agricultural commodity prices are also remaining strong, linked to the trend in Bric countries towards more western-style diets. "Clients are investing in a variety of structured products based on agricultural food indices," explains Rankin. "Initial interest came from clients who saw this as a theme – maybe they were exposed to it within their own businesses. But we had strong research underpinning to this, too."

UBS clients can even get the opportunity to invest in a fund that is going to buy farmland in Latin America, work the land, and then exit after seven years through an IPO or sale. "We do use some equity funds," admits Rankin, "but you can expose yourself to some short-term volatility. So most clients take their emerging market exposure through structured products. They like the idea, but they are not prepared to lose everything on it."

Barclays Wealth also takes a more institutional approach to providing clients with opportunities in Latin America, India, China and eastern Europe. It uses long-only funds that have exposure in line with the market, alongside longer-term investments in private equity, real estate and infrastructure.

Barbara-Ann King, head of alternative products, explains: "Often, clients cannot gain access on their own and need to have their investment professionally managed. Access to such institutional quality products is given to private clients via 'feeder funds' at lower entry levels."

At present, Barclays Wealth has a particular focus on infrastructure and real estate in India, and agriculture and infrastructure in Latin America. It also believes "tier two" cities in China look viable for real estate and infrastructure investment and is monitoring opportunities.

"Products will largely be provided through a classic private equity structure of a 10-year investment," says King.

Credit Suisse suggests a lower-cost approach. "One of the easier, less expensive but equally effective ways of doing it is through exchange traded funds," argues Paul Sarosy, managing director and head of investment solutions at its private banking business. He points out that investors can now buy a Bric ETF outright or create their own Bric portfolio of individual country index trackers.

iShares FTSE Bric 50 ETF is a good example. "It allows investors access to the four Bric economies in a wrapper that's easily accessible on the London Stock Exchange," says Nick Shellard, head of business development for iShares in the UK and Switzerland.

"There are some extremely exciting long-term opportunities, so we're trying to provide investment solutions for all investors – institutional or wealthy retail. What the iShares FTSE Bric 50 can do is add diversification to any portfolio, avoiding stock specific risk, allowing investors to allocate their risk budget elsewhere where they may be more confident that they can achieve alpha [market-beating returns]. It could be used by the largest pension fund, fast money hedge-funds, or retail investors."

iShares also offers individual Brazil and China ETFs, plus a newly launched fund tracking the JPMorgan Emerging Market Bond Index. However, to gain diversified exposure across all Bric asset classes, investors still need to go via a wealth management firm.

"The wealth manager's objective is to protect clients' assets first," says Credit Suisse's Sarosy. "We will look, for example, at private equity deals in Indian real estate – and they are few and far between, I might add. But with our open architecture, we can find opportunities that are not available to 'affluent' retail investors."

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