MV Capital Management Thought Leadership

Portfolio Migration (1): A Strategy for the New Economic Landscape

October 25, 2010

This is the first in a series of articles on the implications of the changing shape of the world economy for investment management and portfolio asset allocation.

Tectonic dislocation of the earth's plates can be an unpleasant experience for people caught along the fault lines. Those that survive must adapt to a new landscape, and often that means moving somewhere else. So it is in investment markets. It's not the same world anymore. In fact, we have been in a transitional phase in the global economy for some time now – but it took the ice-cold bucket of water that was the 2008 market meltdown to make the reality crystal-clear. As the fallout settles from that tectonic collision, we are able to discern the contours of this new landscape and chart a course – a migratory path if you will – to bring our portfolios in line with the world as it is shaping up to be. But first we need to take a brief look backwards to see how we got here. Let's take a quick trip back to 2006.

Ah, 2006. It seems like it was an eternity ago. The US housing bubble was in full swing, Tuscan terracotta bathroom tiles were selling like hotcakes, and there was a pervasive feeling among the chattering classes that somehow in our collective brilliance we had managed to "beat the business cycle" and live in this permanent state of financial *eudaimonia* – the Goldilocks economy gently guided by the deft hand of the Fed and the impeccable wisdom of the market in carving up, quarantining and efficiently parceling out risk according to everybody's individual risk demand curve. *From each according to his abilities, to each according to his precise appetite for risk assets*. Good times.

As the second leg of the 2003-07 bull market ran its upward course towards the end of '06 we at MVCM published a research paper called "Emerged Markets, Emerging Opportunities" (the paper can be found in the Research & Commentary section of our website and it is worth a read). The theme of the paper was that the global economy was entering its third identifiable phase since the end of the Second World War, necessitating a different way of looking at the role of so-called "emerging markets" in portfolios – less as speculative punts and more as a sizable presence in keeping with their growing economic influence.

Now that our daily discourse is not crowded out by the panic of impending collapse in financial markets and institutions, we can come back and see that this scenario indeed is playing out. The fact that emerging markets today are not what they were in 2000, let alone in 1990, is no longer a peripheral observation like it was when we made our case in 2006. It is moving into the center of conventional wisdom – and the empirical evidence for that is the tidal wave of portfolio capital steadily flowing into these markets. But that does not mean that the road to prosperity is clear and straight. There are short-term and long-term considerations to take into account.

The lexicon has already changed. MSCI/Barra, which operates the popular MSCI index benchmarks for country and regional stock markets, traditionally divided the world into "developed" and "emerging" sectors. Now however that has expanded to three tiers: developed, emerging and frontier. The first two tiers still look largely like they always have – most of Western Europe, the US and Canada show up on the developed index while the BRICs and their ilk in Asia, Latin America and Eastern Europe populate the emerging index. But the less established of these emerging markets – from Argentina to Bahrain and Latvia, now occupy positions in that third "frontier" category along with such Johnny-come-latelies to the world of publicly traded capital markets as Ghana, Vietnam and Ukraine.

This recalibration makes a great deal of sense but would actually go a step further – replacing the terms "developed" and "emerging" with "mature" and "growth" markets respectively. In the world economy today a handful of the most established markets are growing at less than 2% annually, while others are growing in the high single digits or low double digits. On average this adds up to about 4.8% in worldwide growth – the question is, what side of that average are you on? Those that fall into the "mature" bucket are most (though not necessarily all) of the EU nations, the US and Japan, while into the growth bucket alongside the usual suspects of Brazil, China and India you also will have Hong Kong, Singapore and Australia (and perhaps even EU export powerhouse Germany). In other words the important division is not between developed and emerging, but between slow-growth and high-growth. And that division is dynamic – fluidly changing rather than being fixed in time.

What about that third category of frontier markets? This asset class serves a purpose similar to that which emerging markets played about twenty years ago. Frontier markets – again, this refers to places like Ghana and Vietnam – can exhibit the potential for very high growth but are also erratic, with less stability in their legal, political and market infrastructures. These countries can provide extra juice to a portfolio (not just from the prospect of high returns but also a lower level of correlation with other equities exposures) – but because of the very high level of volatility that exposure is best contained to a relatively modest percentage of the total portfolio.

So if we now have the three buckets of mature, growth and frontier markets, what is the optimal allocation for forward-looking portfolios? Here is where we invoke the word that appears in the title of this article: Migration. At MVCM we do not believe that radical overnight changes to allocation weightings is a prudent course of action. Rather, we imagine a path towards an optimal allocation that evolves over a period – say of 5 years – that *we execute at selective times when we think market conditions and asset valuations look favorable*.

That future allocation could be as much as *near-parity weightings* between mature and growth markets for portfolios strongly oriented towards capital appreciation, while frontier market weightings could range between 4 – 10% or so, depending on the usual risk and return considerations. But we will take whatever time, deliberation and appraisal of market conditions is necessary to get there in a prudent manner.

With warm regards,

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MVCM 2010 0036
DOFU: October 2010

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