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BLOOMBERG

Emerging champions

Morgan Stanley's developing-market guru Ruchir Sharma identifies breakout nations

| BY ASSIF SHAMEEN |

When he isn't travelling around the world, most evenings, Ruchir Sharma is sprinting in New York City. Tall, soft-spoken Sharma is a competitive sprinter who wants to clock the shortest time for the 100m dash. Though he is no Yohan Blake or Usain Bolt — the two record-breaking frontrunners in the sprint events in the London Olympics, which opens late next month — Sharma is constantly pushing himself to run ever faster.

He brings a similar focus and drive to his day job as head of emerging-market equities and a member of the global tactical asset allocation investment committee at Morgan Stanley Investment Management. "Emerging markets are an asset class that is here to stay," he says. "The key is to identify the markets that will outperform over the next five to 10 years and give outsized returns."

Indeed, Sharma is sticking his neck out and doing just that. Last month, he published a new book, *Breakout Nations: In Pursuit of the Next Economic Miracles*. A prolific writer, Indian-born Sharma was an investing columnist with *Newsweek* for years until he started contributing to rival news magazine *TIME* a year ago. His conclusion: Emerging-market investors focused on long-term returns might be better placed betting on breakout markets such as Indonesia, Turkey, Nigeria and Sri Lanka rather than chasing older emerging stories such as the BRICs (Brazil, Russia, India and China), which still have a lot of room to run, but might not outperform the likes of Turkey and Indonesia.

It helps that Sharma hails from an emerging nation himself and went to school in Singapore in the early 1980s, when it was an emerging market. A graduate of Delhi's Shri Ram College of Commerce, Sharma attended schools in Mumbai, Delhi and Singapore. His father, a former naval officer, served as the Indian High Commissioner here. After college, Sharma joined Prime Securities, a non-banking financial services firm in Delhi and regularly wrote columns for Indian financial newspapers such as the *Economic Times*. In 1994, he was hired by Morgan Stanley in Mumbai and later, went to work for the giant US investment bank in New York. At the time, Morgan Stanley's fund management unit was headed by fabled asset manager Barton Biggs, who retired a decade ago and now runs his own hedge fund, Traxis Partners.

The case for higher exposure in emerging markets has never been stronger. As developed nations remain mired in a slump, returns in emerging markets will look even more enticing over the next three to five years. "Emerging markets now make up more than 40% of the global economy, so if you are betting on global growth, you must have some exposure in emerging markets,' says Sharma.

But the Morgan Stanley guru is at pains to stress that investors need to be careful about lumping all the emerging markets together as a homogenous entity. "China is as different from India as India is from Russia or Brazil or South Africa," he says. "These are nations that are at different stages of development. The only thing they have in common is that they are not in the same league as the US, Japan or Germany." The key to investing in emerging markets is to have realistic expectations, says Sharma. Moreover, investors need to understand that it is more of a roller coaster in emerging markets than it is in developed markets "because when countries grow, they never grow in a straight line".

Rise of China

Having covered emerging markets for two decades now, Sharma says the key difference since the early 1990s has been the rise and rise of China. Investors have seen firsthand China emerge from a per capita income of about US$400 to about US$6,000 in less than 20 years, he says. They have also witnessed how the rise of China has dramatically reshaped the global economy and shifted the balance of power from the developed world to the emerging world. "Investors understand that China is here to stay," Sharma says. "It's not going to go away. If you are a global investor, you need to have some exposure in China."

The degree of exposure might vary, depending on market fundamentals, but Sharma argues that China has reached a stage where global investors need to have some exposure there. Yet, as emerging markets such as China mature and become a more permanent feature of global portfolios, "expectations of growth also need to be tempered. You can't have an economy as big as China growing at double-digit rates when the global economic climate is as cloudy as it is today", Sharma says.

Investors' bloated expectations have long been the bane of China. "Because of the command-and-control economy, there was a sense that China could do no wrong: Everything was perfectly coordinated, every decision was perfectly executed," Sharma tells *Personal Wealth* in an interview recently. "What we are learning about China is that it is a huge and complex economy and, as such, difficult to simplify in a sound bite."

The Morgan Stanley fund manager says as China has grown by leaps and bounds over the past decade and changed dramatically, it is unrealistic to expect similar growth from it or from countries operating in a maturing or a middle-income economy such as China. "What a country with a per capita income of around US$6,000 can do is different from one with a per capita income of US$2,000," he points out. And as China continues to grow, growth will become even more difficult. "It's very easy to extrapolate things with all the fancy charts, but the reality is that the larger the economy, the slower its pace of growth."

Moreover, since China has long under-delivered in terms of corporate earnings, investors shouldn't expect outsized earnings growth, particularly as Chinese companies are having to deal with more mundane issues such as higher costs, margin squeeze and lower volume growth.

What about his own home country India? How did it slip so fast from being the darling of global investors to an almost untouchable? Sharma chuckles, then coughs, as he measures

his words. "I think they somehow thought the whole boom of the last decade was about them, not realising that it was merely a tide of global liquidity that actually helped the acceleration of growth in India," he says. "A lot of budget assumptions in India were made on high growth being sustained. When global growth slowed, suddenly India slowed and policymakers found themselves in a spot."

How did India go wrong when it has been run by a bunch of smart economists and technocrats? Sharma says many outside India make the mistake of assuming that technocrats are really calling the shots. "The economists are in office in India, but not in power," he says. Among the key issues in the country, he says, was the fact that "government spending just went out of control. The budget deficits are far too high and that has crowded out a lot of private investments". A bigger issue: "There is no will to reform in India. Unfortunately, the entire focus in India has been on how to redistribute the pie rather than how to grow it and how to sustain growth."

While large Indian business groups such as Tata and others have gone overseas and bought out global brands and are doing fine irrespective of government policies, Sharma says at this stage of India's development, it's too early for the private sector to be the engine of growth. Moreover, the country's state sector is still huge even after years of giving the private sector more leeway. "I don't think India is going back to the very high levels of growth we saw a few years ago anytime soon," he shrugs. "There needs to be a prolonged and somewhat painful adjustment process before it can get back on that fast track of growth."

As costs blow out in China, Sharma is bullish on Southeast Asia, particularly Indonesia and Vietnam, but also the Philippines and Thailand, whose economies are turning around. "I think as more factories relocate from China, countries such as Indonesia, Vietnam and the Philippines will be the key beneficiaries. We will see a reverse of what we saw in the late 1990s, when manufacturing moved lock, stock and barrel from Southeast Asia to China."

He is particularly bullish on the Philippines, which was written off by investors after the Asian financial crisis "because it repeatedly promised so much too often, then broke hearts so often". Now, he believes the country is staging a strong comeback "because it has the right political leadership in place and has addressed key economic issues such as its deficits".

Thailand and Indonesia

Sharma is also bullish on a resurgence in Thailand. "Politics in Thailand is showing signs of improving," he says. It's not as divisive a country as before and everyone is indicating that they can co-exist, he notes. "For long-term institutional investors, it's really all about the rate of change. Are things improving rapidly or is change just in the margins? Investors know that by the time it looks pretty, it will be just too late. In both Thailand and the Philippines, our view is that things are improving for the better."

Sharma is bullish on Indonesia because it is the one commodities-based economy where investment as a share of GDP is rising steadily — something he says is not true of Brazil or Russia. "The other positive in Indonesia is that the growth model is now much more decentralised," he points out. "In the 1990s, it was all about Jakarta and Java. Now, you have much more decentralised growth all across Indonesia — Sumatra, Kalimantan. You can see that in consumption growth, loan disbursal numbers or the new second-tier cities that are coming up across Indonesia."

Still, Sharma is quick to warn that if there is a hard landing in China, all bets are off, because China is a big market for Southeast Asian goods and services. "Our expectation is that we won't get a hard landing in China anytime soon," he says. "I think China will just move to lower but more sustainable growth." That will keep Southeast Asia growth on track.

Outside Asia, Sharma is gung-ho about Turkey. Aside from Indonesia, the only other large emerging market with a GDP of more than US$1 trillion that will join the BRICs at the forefront of the boom is likely to be Turkey. "Both Indonesia and Turkey are Muslim democracies and that's a great role model for emerging democracies in the Middle East," he says. Moreover, like Indonesia, growth in Turkey is no longer concentrated near Istanbul and a few other centres, but spreading across the country. He concedes that the turmoil in neighbouring Greece, particularly a big devaluation in the aftermath of its exit from the eurozone, will have an impact on Turkey, but stresses that it will be temporary. "Greece and Turkey don't really compete in terms of exports, so I don't see why there should be a huge competitive devaluation in Turkey," he says.

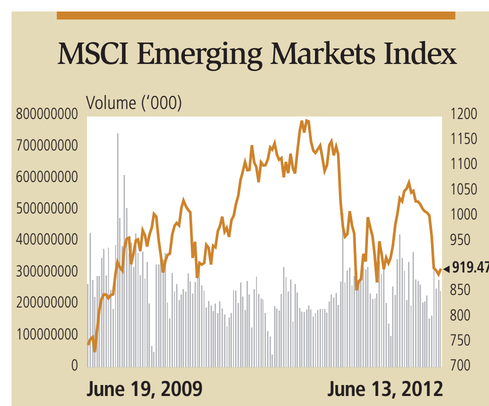
Asia", though strictly, as a developed country, South Korea isn't in the same league as India and Indonesia. "I have always been impressed by South Korea's amazing ability to keep on reinventing itself," he says. He used to be very sceptical about South Korea until a few years ago, "but what struck me about the country was how manufacturing, as a share of its economy, has kept on increasing even as the country moved up the ladder". Typically, once an economy reaches a per capita income of around US$10,000, manufacturing, as a share of its economy, starts to decline and the services segment begins to grow. "In South Korea's case, even at US$20,000 per capita income, it has kept growing its manufacturing base. I can't think of any country that's been able to do that over the last five decades."

South Korea also has one of the highest expenditures on R&D in the world. Beyond that, he notes, there is the impending collapse of North Korea and an eventual integration of

Sharma doesn't think India is going back to the very high levels of growth seen a few years ago anytime soon

But he readily admits that a disorderly exit by Greece will hurt the whole world, including Turkey, so while the country's exit is a concern for Turkey, it won't derail the strong structural story there. Years ago, Turkey was obsessed with getting into the eurozone, he says. After what's happened to Greece, neither the Europeans nor the Turks see Turkey adopting the euro anytime in the foreseeable future. "Turkey's whole focus has changed from trying to be a European country to becoming more of a Middle Eastern country," Sharma says. "It wants to export to and engage with neighbours in the Middle East and Asia," he says. "It's actually a good thing that Turkey's obsession with Europe is now a thing of the past."

The one emerging market that Sharma gives his "gold medal" as a breakout nation to is South Korea. He calls it the "Germany of



North and South, which will result in a large domestic market of new consumers, cheaper labour and a big change to the demographics of the country. "South Korea is one of only two countries in the world that have grown at over 5% a year for five consecutive decades," he says, pointing to the rise of global companies such as **Samsung Electronics** and **Hyundai Motor Co**. South Korea's ability to build global brands is something its closest peer, Taiwan, has not been able to do, he adds. "Samsung and Hyundai have the brands and technology and have been increasing their global market share against the world's top companies in their categories for the last several years. The branding, as well as R&D, gives South Korea the cutting edge."

What's next for the two other key parts of the BRICs — Brazil and Russia? The two economies peaked just before the 2008 global financial crisis, but have struggled to maintain their growth trajectories ever since. "The problem with Brazil and Russia, unlike China and India, was their huge dependence on commodities," says Sharma. In Brazil, it was all about commodities and other parts of the economy have been suffering for years. As commodity prices turned down, the entire economy took a dive and the market has underperformed other emerging markets.

The government's role in Brazil is just too big. "Government spending as a share of the country's GDP has been too high," says Sharma. In the past, such issues were cloaked by the big boom in commodities, but they have not gone away, he notes. The state sector makes up 40% of the economy, he says. "Brazil clearly needs a larger private sector that can help drive growth." For economies at Brazil's current level of development, the right number for the government sector should be more like 25% of the economy. The Latin American giant is also more protectionist, and has not allowed foreign companies to go into the country for more effective competition, which in turn will spur local companies to improve.

Things are fairly similar in Russia, says Sharma. There is a huge dependence on commodities and the government has an outsized role. And the private sector comprises many large companies run by oligarchs. "If you look at the stock market, you won't find a single large manufacturing company listed there," he says. "The whole market is just made up of oil and gas, energy, commodities, banks and some consumer companies," he says. "If you look at the number of new SMEs [small and medium-sized enterprises] in Russia, or new SMEs starting up, you will find it's the lowest of any large economy in the world." While Russia has embraced a market economy, there are few new, small companies starting up. "There is only room at the top in Russia," says Sharma.

Nigeria and Sri Lanka

Among the smaller emerging markets, or frontier markets, Sharma says Nigeria could be a breakout nation. Why Nigeria? Isn't it one of world's most corrupt countries? The Morgan Stanley fund manager acknowledges that Nigeria has serious issues, including corruption, but says things are getting better. "They have strong political leadership now, and they are moving on reforms. They are also an oil-rich country, and if things keep improving, Nigeria will do well over time." Another frontier market that Sharma likes is Sri Lanka. "It is a very small economy, but is benefiting from a peace dividend now," he says.

Are there sectors that emerging-market investors should focus on? Is the best way to play emerging markets still betting on the picks and shovels, such as the infrastructure sector, or on consumer plays? Or should investors bet on raw materials such as iron ore, copper and aluminium that these economies will need to build their infrastructure? "I think the best way to play the emerging-market theme in general is to pick the breakout nations that will do well in five years, such as Indonesia and Turkey," says Sharma. If he were to pick sectors, he would go for consumer and healthcare. "The raw material and commodities story is over," he says. "Commodities over the last 100 years have had one decade up, two decades down. Aside from oil, most other commodities might not have a great decade." He also likes telcos in emerging markets because they are still benefiting from rising consumption trends and the adoption of smartphones and tablets.

As he talks about breakout nations such as Turkey, Sharma is at pains to emphasise that no nation's success is permanent. While countries are able to pick low-hanging fruits and climb the first few rungs of the ladder, they can and often do falter. Some see roadblocks fairly early in their ascent, others fall into the middle-income trap after they have risen halfway through to the much-coveted developed-nation status.

Argentina is a prime example of what was once a well-off country that fell off the cliff and has been struggling to claw its way back up again. "Complacency sets in, there is bureaucratic inertia, countries start believing in their own hype," he chuckles. "Nations have got to keep moving up the ladder and keep reinventing themselves," he says, because they never reach a stage where they have made it and can rest on their laurels. Sharma himself isn't resting on his laurels. He is still training rigorously every evening for the next sprint. E