Why understanding the drivers of returns matters: An Argentine example

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- The value of Argentine equities tends to be much more driven by the direction of bond yields/equity discount rates than fundamentals, especially since they have started from such an extreme level.
- The direction of bonds/discount rates in Argentina is driven by political outcomes which we have, in my view, an inability to forecast with any degree of precision.
- The Fidelity Global Emerging Markets Fund hasn't had direct exposure to Argentina as a result, and I see no reason yet to change that stance today.

The returns an investor can expect to derive from an equity are essentially broken down into:

Endogenous factors, which are largely within the control of the management team of the company in question: the decision to invest in a new factory, open a new store, launch a new product, lower costs of production, invest in research and development, and ultimately maintain competitive positioning. We can research these areas, model ranges of outcomes and ascribe probabilities on each given outcome to determine the risk-adjusted cash flow profile of a company.

Exogenous factors, which are outside of the management team's control: exchange rates, commodity prices, interest rates and politics. Each of these are driven by a whole range of different factors which are very hard to predict, ascertain ranges of possible outcome for and have a degree of conviction in the most likely outcome. As a result, I tend not to invest in businesses where the primary driver of equity returns is exogenous.

Equity discount rates in Argentina have always been relatively high (this is due to the historic economic and political volatility, high inflation, etc.). As a result, the single biggest driver of equity returns is the direction of the bond yield (and equity risk premia) and the valuation of the currency. It is largely irrelevant what any of the individual companies do at a single stock level. When the starting point for equity risk premia and absolute yields is so high, the only thing that matters in terms of driving the stock price is whether the bond yield rises or falls; that is, you stand to make, or lose, all of your money on the equity discount rate increasing or decreasing.

Before Sunday, the market assumption was that the politicians in Argentina would pursue fiscal and monetary stability and yields were priced to continue declining. As a result, Argentine bank stocks (which are the most sensitive to changes in bond yields) appreciated by 83% from 1 January 2019 to 11 August 2019. This increase was purely driven by perceived changes in discount rates applied to bank returns. On Sunday, they fell by 55% as the market repriced Argentine risk assets for the likelihood of a populist government.

In my view, we have very little insight into which outcome is most likely to prevail – other than taking a guess. As a result, today I am reluctant to make any changes to the portfolio when it comes to Argentine exposure.

Performance, net of fees (%)

	1 year	3 years	5 years	Since inception
Fund	18.10	15.93	12.00	11.37
Benchmark	5.51	12.01	8.13	8.24
Excess return	12.59	3.92	3.87	3.13

Source: Fidelity International, Fund = Fidelity Global Emerging Markets Fund. Benchmark = MSCI Emerging Markets Index NR. Performance is shown net of fees, in AUD dollar terms at 31/07/2019. Fund inception date = 16/12/2013. Please note that past performance is not a guide to future performance. Returns of the Fund can be volatile and in some periods may be negative. The return of capital is not guaranteed.

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