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Parametric Uses Homegrown Strategy for Emerging Markets Returns

By Jon Asmundsson

May 31, 2007 (Bloomberg) — In 1994, Seattle-based Parametric Portfolio Associates set out to create a strategy for investing in emerging markets that would smooth out the price swings of markets such as Brazil or Malaysia.

As a way to improve returns over the long term, it's on the right track. Parametric's $1 billion Eaton Vance Tax-Managed Emerging Markets Fund returned 33 percent annually on average for the five years ended on May 29. That made it the third-best performer among the 100 U.S.-based funds investing in emerging-market stocks, according to data compiled by Bloomberg.

"What's amazing to me about this strategy is that it's performed so well over the years," Chief Investment Officer David Stein said.

Parametric Portfolio Associates manages more than $20 billion, most of it in 9,000 separate accounts. South African-born Stein, who holds a Ph.D. in applied mathematics from Harvard University, said the firm wanted "an approach which is relatively passive or structured."

Investing in a capitalization-weighted index such as the S&P/IFC Emerging Markets Investable Composite Index was too risky because the handful of largest countries in emerging market indexes can represent as much as 70 percent of their value, said Stein, 56.

"We want to increase the diversification of the portfolio by underweighting the big countries and overweighting the small countries relative to the index," Stein said.

Tier System

To do that, Parametric created a system for weighting the countries it invests in. Because of the differences in sizes, Parametric couldn't simply assign equal weights to all.

"In some countries, the total market capitalization is $1 billion, and in other countries, the capitalization is hundreds of magnitudes above that," Stein said.

At the outset, the firm used two tiers of weights. It now uses four tiers. The largest markets, countries such as Brazil, China and Russia, receive a full weight. The second tier gets a half weight; the third tier gets a quarter weight. The fourth tier, representing the smallest so-called frontier markets, gets an eighth.

Thus, Brazil, in the first tier, could have a target weight of 6 percent of the fund's total assets. Malaysia, in tier two, could have a weight of 3 percent. Tier-three Morocco could have a 1.5 percent weight, and tier-four Saudi Arabia, a 0.75 percent weight.

The target weightings aren't fixed percentages; they're calculated based on the total pool of countries that the fund invests in at a given time. As of Feb. 28, the fund owned 1,265 stocks in 40 countries.

Long-Term Growth

While these markets may experience large price swings, the smaller countries tend to have little effect on one another. A run-up in Botswana doesn't typically spill over into stocks in Romania, Stein said.

"When individual investments are volatile and you're able to reduce that volatility by combining them with other investments with lower correlations and rebalance, you can pick up a long-term growth rate," he said.

Rebalancing is the second part of Parametric's approach. If stocks in a particular country rise so that the market's weight in the fund increases to 50 percent above the target, the firm sells the stock, trimming to the target level. The proceeds go to buy stock in a market that's below target.

Consider Saudi Arabia. In 2005, the Tadawul All Share Index rose 106 percent. As the Saudi market rose that year, the fund trimmed investment there. The next year, the index dropped 53 percent. Holding over the entire two-year period would have earned about a zero percent return with a lot of volatility, Stein said.

By selling shares from countries that have risen and buying in markets that have dropped, the fund adds an incremental gain.

Weighted Approach

Parametric also uses a weighted approach to select individual stocks within a country. It invests in five areas: basic materials; consumer products; financial services; industrials; and utilities and communications.

Initially, Parametric aimed to weight the areas equally. It now takes what Stein calls a contrarian approach, buying less of sectors that predominate in a country and favoring less-prominent areas. Companies such as Rio de Janeiro-based Cia. Vale do Rio Doce, the world's largest iron ore exporter, account for less than 50 percent of the fund's Brazilian holdings.

Doing as Well

Parametric was founded in 1987 with backing from Pacific Mutual Life Insurance Co. The insurer's stake went with one-time unit Pimco Advisors Holdings LP, the Newport Beach, California-based manager of the world's largest bond fund, when it was acquired by German insurer Allianz SE in 2000.

The next year, Parametric arranged a management buyout with help from a Seattle-based private equity firm. In 2003, Boston-based mutual fund company Eaton Vance Corp. bought an 80 percent stake. It now markets and distributes the fund.

Stein says he's long been interested in how to make good decisions amid uncertainty. In a so-called nondeterministic system such as a game of bridge, for example, in which you don't know who holds what cards, how do you get the best outcome from the cards you play? That also can apply to the stock market.

"Those guys out there anticipating political issues, anticipating currency issues, anticipating which countries are going to go up and down and sort of betting on macroeconomic factors — we've done as well as they have," Stein said. "And without doing that kind of work."

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