STRATEGIC EXCHANGE

THE CASE FOR EMERGING MARKETS

Emerging markets can offer investors growth opportunities waiting to be captured. Investors should not disregard these markets based on common fears from the past but instead should consider the benefits they can offer in the present. This article reviews how emerging markets have evolved over time and why the focus should be on the future and not the past.

Some of the key attributes of global emerging markets include:

Greater growth	International Monetary Fund (IMF) forecasts that emerging economies will grow an average of 4.9% compared to 1.7% for advanced economies[1].
Reduced risks	Lower levels of debt and higher foreign exchange reserves than the developed world suggest risks have reduced in aggregate compared with historical experience.
Household names	Many emerging market stocks are household names such as Samsung, Hyundai and Kia Motors.
Rising returns	As emerging markets shift from manufacturing to more value-added industries, there's an expectation for returns to rise.
Alpha opportunities	Emerging markets are less researched by the analyst community compared with large cap developed equity markets, which creates added value opportunities for independent research by active managers.

(1) World Economic Outlook Update, January 2019.
(2) MSCI.

Background

The market capitalization of emerging markets was US$5,415 billion as of April 30, 2019, representing approximately 11.6% of the world equity capitalization.[2] Yet many institutional investors have no direct exposure to emerging markets.

While investors often allow their international and global equity managers to invest in emerging markets, the overall allocations generally fall well short of market representation. With emerging markets representing the highest growth area of global stock markets, investors could benefit from direct exposure.

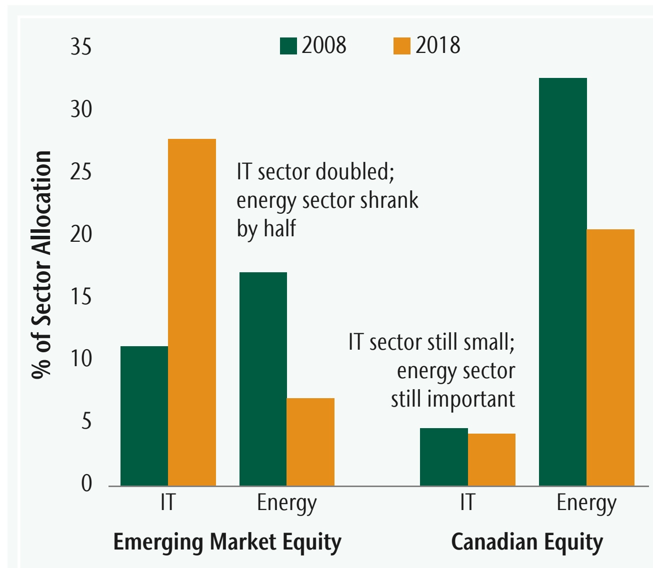
Emerging markets can be characterized as countries with growing economies and a growing middle class population. Many of these markets continue to have high rates of poverty and are often still experiencing significant social and political change. But despite these headwinds, the growth prospects of emerging markets can provide a strong base for investors to be rewarded.

The MSCI Emerging Markets Index is made up of over 1,100 stocks in 24 countries. The countries are normally grouped into three regions, Emerging Markets Asia, Emerging Markets Latin America and Emerging Markets Europe, Middle East and Africa.

Evolution

Emerging markets are often regarded as being similar to the Canadian equity market, with a heavy bias to commodities. However, today its weightings in energy and materials are significantly lower than the Canadian equity market and it has experienced a steady rise in the weight of the information technology sector, which has been a key driver of strong performance. It has grown to almost 28% of the emerging market index, from 11% ten years ago. In contrast, the last ten years have seen the exposure to energy decline from 17% to 7% of the index (Figure 1).

Figure 1: Change in Emerging Market Sector Weights



Source: Thomson Reuters Datastream, MSCI. 2018 is year-to-date to September 30.

Contrast that with the Canadian equity market, where information technology is close to its 17-year average of approximately 4%, while the energy sector represents 18% of the Canadian equity market. As a result, the overall index sector allocations are very different today (Figure 2).

The emerging market information technology sector has also witnessed a radical change in its composition with large and successful companies, such as Alibaba and Tencent. These changes have resulted in lower correlation between Canadian and emerging market equity returns than in the past.

Figure 2: Index Sector Allocations

Global Industry Classification (GIC) Sector	MSCI Emerging Markets (%)	S&P/TSX Composite (%) (Canadian Stocks)
Energy	8.0	17.8
Materials	7.7	11.3
Industrials	5.5	10.8
Consumer Discretionary	10.4	4.3
Consumer Staples	6.7	4.0
Health Care	2.8	1.6
Financials	24.8	32.9
Information Technology	14.2	4.0
Communication Services	14.1	6.0
Utilities	2.7	4.1
Real Estate	3.0	3.2

Source: Thomson Reuters Datastream. Data as of December 31, 2018. Due to rounding, column percentages may not total 100%.

Investors have often not appreciated the positive changes that have occurred in the emerging market sectors over the last ten years, which has contributed to underutilization by many investors.

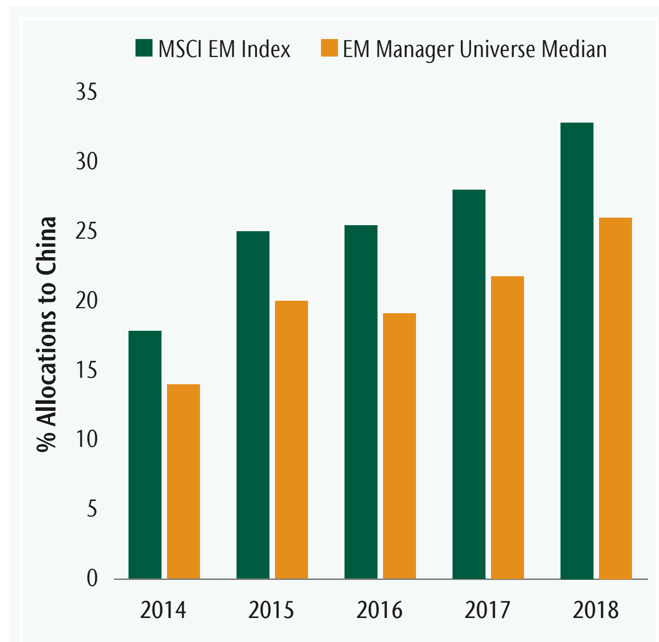
For example, while the financial sector represents a quarter of the emerging market index, loan-to-deposit ratios in emerging market companies are generally lower to allow room for asset growth. In contrast, developed world banks remain constrained by their need to shrink or reprice their assets.

More changes are coming, this time with respect to country allocation. Investors rely on index providers to construct benchmarks that they can either invest in passively or use to measure the success of their active managers. MSCI has included some Chinese shares (A shares) in the benchmark indices that were previously excluded due to the restrictions to only Chinese-based investors. In contrast, foreign investors were restricted to purchasing Chinese B shares.

The 200 large cap China A shares represented less than 1% of the MSCI Emerging Markets Index with plans to add more later. The low initial weighting reflects caution, recognizing that a large proportion of the Chinese A share market is still state-controlled.

However, if 100% of the A shares were added they would represent approximately 16% of the index, implying a combined China index exposure of more than 45%, compared with today's allocation of approximately 30%. This development would increase the risk management benefits associated with active managers. As the allocation to China in the index has increased, active managers, on average, have underweighted China (Figure 3).

Figure 3: Active Manager China Allocation (as at June 30, 2018)



Source: eVestment.

Not Without Risks

Emerging market equities are not without their risks. While active managers can mitigate some of these risks through research and careful selection of individual stocks, investors need to be wary of the following.

- **Political and social risk:** Uncertainty can be created by political and social changes taking place in emerging market countries. The Arab Spring may bring about desirable change, but the uncertainty creates volatility and the danger of contagion to other emerging markets.
- **Information and liquidity risk:** Although the quality of data has vastly improved, obtaining good information can still be challenging in emerging markets. Currency controls remaining in a small number of markets also may create liquidity concerns.

Investor Benefits

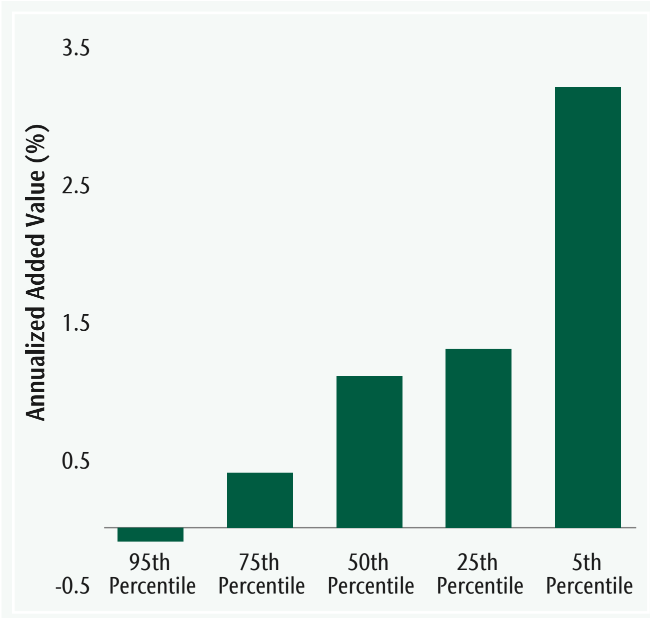
While the countries may be classified as emerging, over 860 of the 1,100 companies in the MSCI Emerging Markets Index are valued at more than US$1 billion. Increasingly, emerging market stocks are becoming common household names: Samsung, China Mobile, Hyundai Motor and Tata (owner of Jaguar, Land Rover and Ritz-Carlton Hotels).

The key benefits offered by emerging markets include:

- **Growth opportunity:** Emerging and developing countries account for a significant component of world gross domestic product (GDP). The IMF forecasts emerging markets to grow at an average annual rate of 4.9% in the three years to 2021, compared with expansion of 1.7% in developed economies. A significant and rising proportion of developed market earnings is also directly and indirectly linked to emerging market growth, further underlining its importance.
- **Rerating opportunity:** Ordinarily, high-growth assets are priced at a premium. Emerging market stocks have traditionally traded at a discount to developed world valuations, but the economic fundamentals for emerging markets as a whole have improved as political environments have stabilized. Fiscal situations, current accounts and foreign exchange reserves are generally better than those of developed world economies, and there are no looming liabilities of pension fund provisions of which to be concerned.
- **Improving returns:** Emerging firms aspire to develop their own identity and are no longer content to simply do the grunt work of Western companies. Nonbrand margins can often be 3% to 8%, while branded firms with loyal followers can achieve 15% margins. Many emerging market companies are shifting away from manufacturing to higher value-added areas using brands and technology. Return on invested capital (ROIC) should rise for emerging market companies as they develop world-class brands.

- **Alpha opportunity:** Active management opportunities can be stronger and more consistent compared with some of the developed market indices, which can create added value opportunities for independent research by active managers (Figure 4).

Figure 4: Alpha Opportunities – Four Year Annualized Emerging Market Median Alpha (as at June 30, 2018)



Source: Morningstar

Environmental, Social and Governance Considerations (ESG)

ESG factors are increasingly becoming a mainstream consideration for active investment managers when analyzing stock opportunities. Despite the political and social challenges associated with emerging market countries, investment managers are increasingly incorporating important ESG aspects into their investment process.

MSCI has developed an ESG-focused emerging markets index that will increase the spotlight on such considerations. This is a positive development for investors, since it will reinforce the importance of risk management.

Tapping Into the Growth Opportunity

Generating sufficient return from the growth component of a portfolio is increasingly important in a lower expected return environment. Many investors are underweight in emerging markets relative to its representation in world markets, yet global growth is expected to be led by emerging and other developing markets.

Canadian investors have historically shied away from emerging markets, partly due to the similarities of a high energy sector exposure. While today the Canadian market is still heavily invested in energy companies, emerging markets have a much-reduced energy sector exposure and a high allocation to the information technology sector, providing a complement to the Canadian equity market.

As emerging market companies shift from manufacturing to higher value-added interests using brands and technology, the number of emerging market household names will rise, as will investors' expected returns.

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