STRATEGIC EXCHANGE

TAPPING THE GROWTH OPPORTUNITY OF EMERGING MARKETS

Emerging markets can offer investors opportunities waiting to be captured. Plans should not disregard these markets based on common fears from the past but instead should consider the benefits they can offer in the present. Moreover, active management of emerging markets may offer more consistent means of achieving additional returns above the index compared with many other equity markets. These attributes make a strong case for including or adding to an emerging markets equity allocation.

Some of the key attributes contributing to the merits of emerging markets include the following:

Greater Growth	International Monetary Fund (IMF) forecasts imply that emerging economies will be responsible for more than 75% of global growth over the five years to 2021.
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.

Background

The market capitalization of emerging markets was US$5,013 billion as of September 30, 2017, representing approximately 11.5% of the world equity capitalization. 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 greater exposure to this underutilized asset class.

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 more than 800 stocks in 23 countries. The largest is China, at 26%, and the smallest is Egypt, at less than 0.2%. The countries are normally grouped into three regions, Emerging Markets Asia, Emerging Markets Latin America and Emerging Markets Europe, Middle East and Africa.

Evolution

The emerging markets asset class is 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 not too different from US and international equity developed market indices and are significantly lower than the Canadian equity market.

Figure 1: Index Sector Allocations

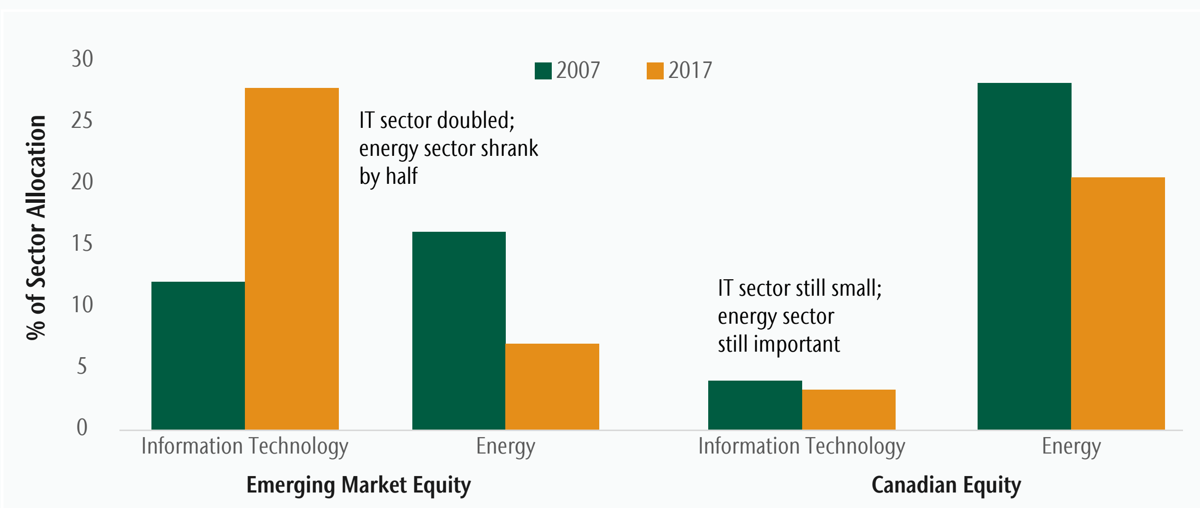
Global Industry Classification (GIC) Sector	MSCI Emerging Markets (%)	S&P/TSX Composite (%) (Canadian Stocks)	S&P 500 (%) (US Stocks)	MSCI EAFE (%) (International Stocks)
Energy	6.8	20.4	6.1	5.1
Materials	7.2	11.5	3.0	7.9
Industrials	5.4	9.5	10.2	14.4
Consumer Discretionary	10.3	5.4	11.8	12.2
Consumer Staples	6.5	3.6	8.2	11.2
Health Care	2.3	0.6	14.5	10.6
Financials	23.4	34.4	14.6	21.5
Information Technology	27.6	3.3	23.2	6.3
Telecommunication Services	5.1	4.8	2.2	4.1
Utilities	2.6	3.8	3.1	3.3
Real Estate	2.9	2.8	3.0	3.5

Source: Thomson Reuters Datastream. Data as of September 30, 2017. Due to rounding, column percentages may not total 100%.

Emerging markets have experienced a steady rise in the weight of the information technology sector, which has been a key driver of strong performance, including calendar 2017.

Figure 2 highlights that information technology has grown to almost 28% of the emerging market index, from almost zero weighting 20 years ago and up from 12% ten years ago. In contrast, the last ten years have seen the exposure to energy decline from 16% to 7% of the index. Contrast that with the Canadian equity market, where information technology is close to its 17-year average of approximately 3%, while the energy sector represents 20% of the Canadian equity market.

Figure 2: Change in Emerging Market Sector Weights



Source: Thomson Reuters Datastream, MSCI. 2017 is year-to-date to September 30.

These changes have resulted in much lower correlation between Canadian and emerging market equity returns than in the past, offering an element of equity diversification for Canadian investors.

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.

Investors have generally not appreciated the positive changes that have occurred in the emerging market sectors over the last ten years or the differences within sectors compared with the developed market. This under-appreciation of market characteristics has contributed to underutilization by many investors.

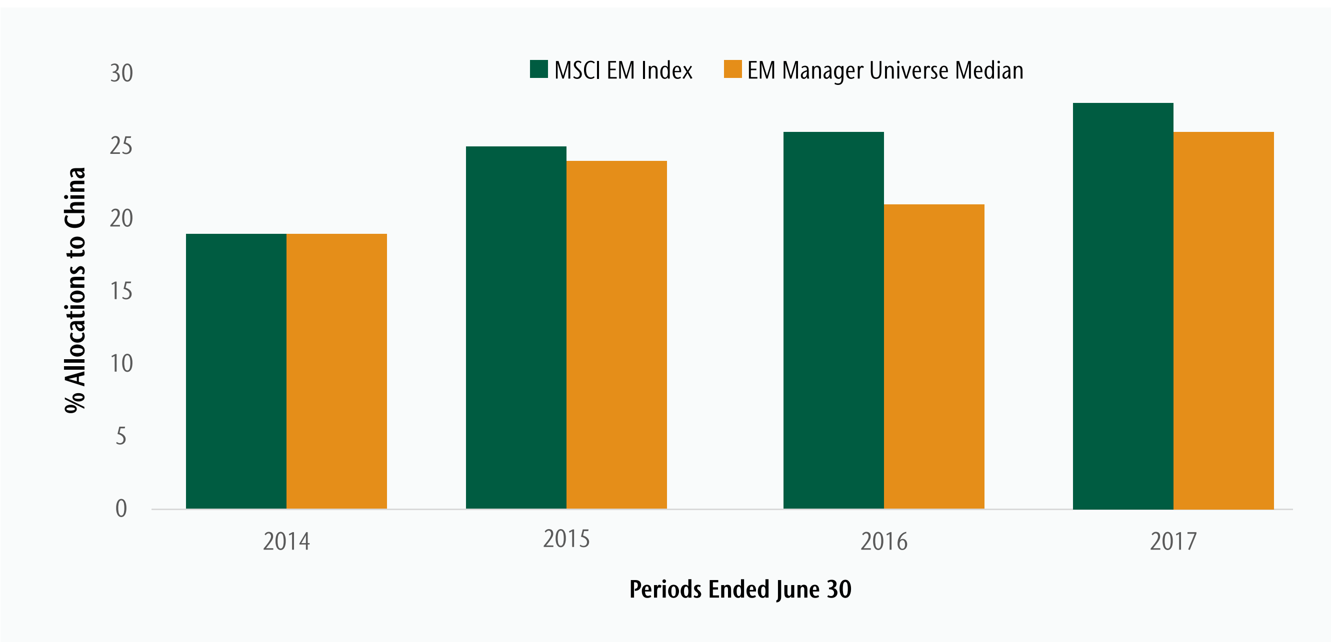
More to come

Yet 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. One of the major index providers, MSCI, has decided to include 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.

MSCI plans to add more than 200 large cap China A shares, which combined will represent 0.7% of the MSCI Emerging Markets Index and 5% of the Chinese A share market. The low initial weighting reflects caution and a governance perspective by MSCI, recognizing that a large proportion of the Chinese A share market is still state-controlled.

However, if the allocation was to become 100% of the A shares they would represent more than 16% of the index, implying a combined China index exposure of more than 40%, compared with today's allocation of less than 30%. This will be an important development to monitor and will increase the risk management benefits associated with active managers. For example, 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



Source: Intersec.

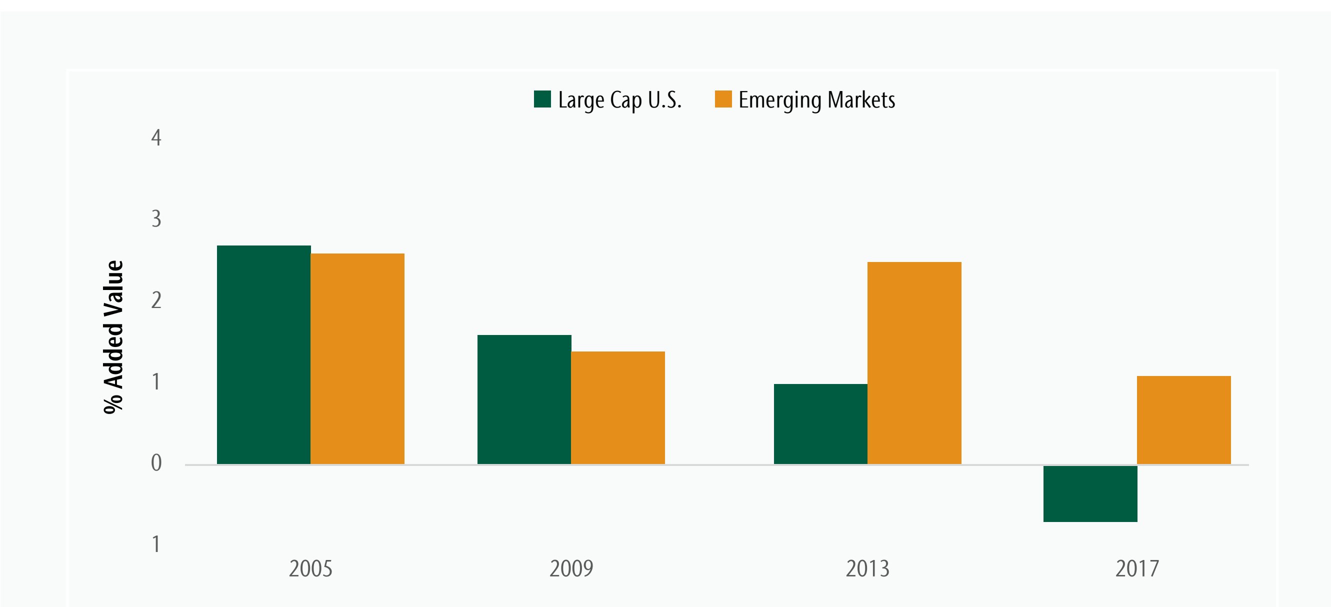
Investor Benefits

While the countries may be classified as emerging, 826 of the 832 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).

Investing in emerging markets represents a broader stock selection opportunity set, but does it offer good potential for investors? Benefits to consider include the following:

Growth opportunity	Emerging and developing countries account for 39% of world gross domestic product (GDP) measured at market exchange rates and 58% based on purchasing power parity (PPP). PPP is determined by an equalization of the purchasing power of different currencies by adjusting for differences in inflation rates and cost of living. The IMF forecasts emerging markets to grow at an average annual rate of 3.7% in the five years to 2021, compared with expansion of 1.9% in developed economies. Emerging markets will therefore be responsible for more than 75% of global growth over this period (on a PPP basis). A significant and rising proportion of developed market earnings is 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.
Consumer "takeoff"	Income per capita has reached a tipping point in many emerging markets where consumption is likely to grow rapidly for burgeoning middle classes as many luxury items become a reality rather than an aspiration.
Alpha success	Active management opportunities can be stronger and more consistent compared with some of the developed market indices. For example, emerging markets are less researched by the analyst community compared with the large cap US equity market, which can create added value opportunities for independent research by active managers, as highlighted in Figure 4.

Figure 4: Equity Alpha Opportunities (Four Year Annualized Median Alpha)



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.

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

While risk management is at the forefront of most investors' minds, generating sufficient return from the growth component of a portfolio is still an important task. Many investors are underweight in emerging markets relative to its representation in world markets, yet global growth is expected to be led by emerging 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. Investors may be able to benefit from tapping into the growth opportunity of emerging markets by increasing its exposure in their portfolios.

For more information on Tapping the Growth Opportunity of Emerging Markets, contact:

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