The Advantage of an Active Approach in Emerging Markets

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Notes from the Global Growth Equity Desk

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"Investors can deploy passive and active strategies as complementary tools across their portfolios."

Investors can choose active and passive strategies when investing in emerging markets (EM). Those who subscribe to the efficient markets theory—the belief that all available information has been accurately priced into securities in a given market—may choose a passive approach. We believe emerging markets are inefficient, thereby creating opportunities for active managers to add value through security selection and portfolio construction.

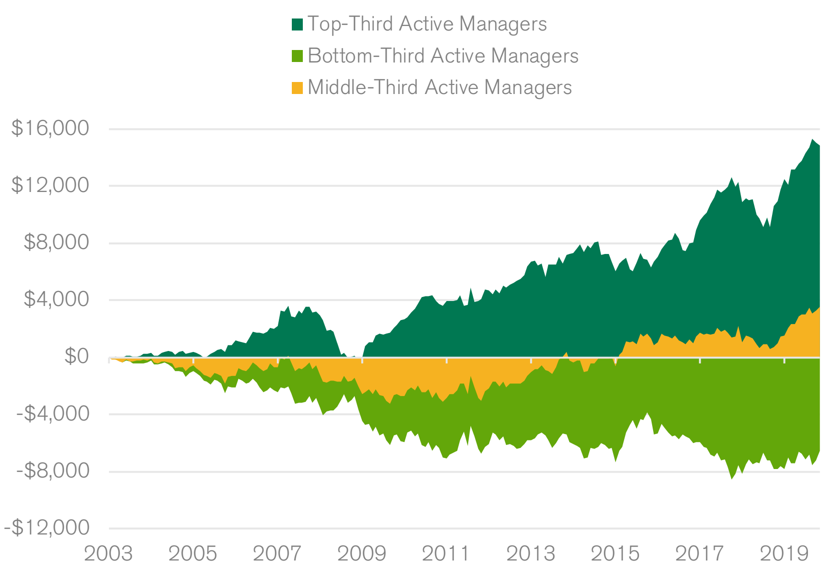
Emerging Markets Are Less Transparent

While access to information on EM companies is improving, emerging markets remain less efficient than developed markets. Information isn't priced in as quickly and dependable EM data can be harder to acquire. Compared to developed markets, fewer financial analysts cover the average EM company and many EM companies have no analyst coverage at all. This discrepancy is particularly pronounced among smaller companies.

Numerous EM companies are also less transparent. Lower levels of financial disclosure, less access to management, and language and cultural barriers often result in less transparency in corporate governance and reporting. This results in greater dispersion among analysts' earnings forecasts, a higher likelihood of earnings revisions, and more earnings surprises, both positive and negative. These factors place a premium on fundamental analysis and security selection and contribute to a greater dispersion of returns generated by EM portfolios. Figure 1 shows the differences in wealth that active managers generate compared to a passive EM ETF. The top-third of active managers generated wealth in excess of the ETF while the bottom-third lagged.

Figure 1 | Skilled Active Managers Have Historically Added Value in EM

Wealth Generation of Active EM Funds Minus Wealth Generation of the iShares MSCI EM ETF

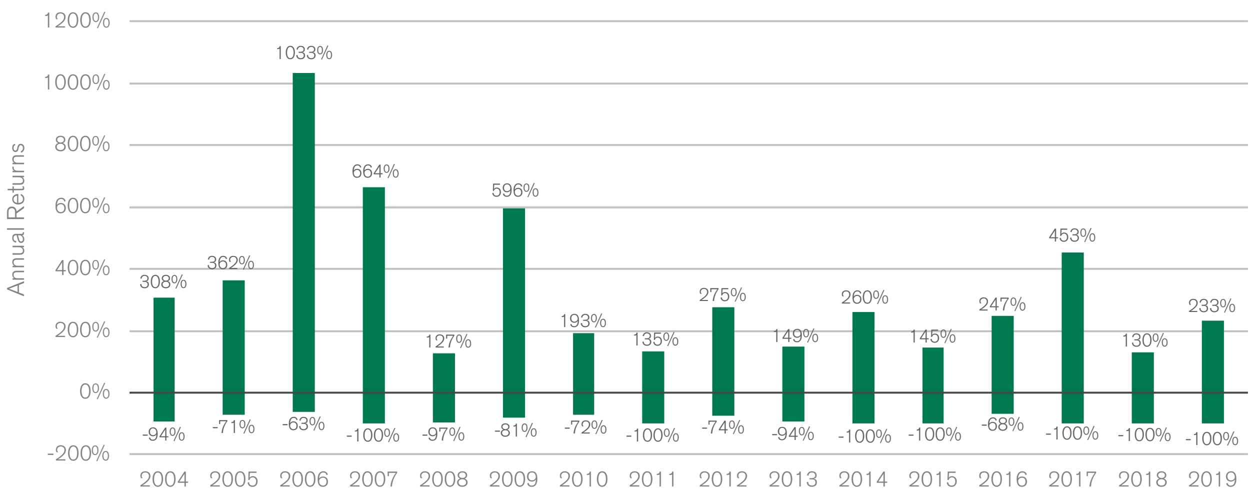


Data from 4/30/2003 – 2/29/2020. Source: FactSet.

Emerging Markets Are More Volatile

EM stocks have historically exhibited greater volatility and lower correlations than developed markets equities. Over the past decade, the standard deviation of EM stocks was significantly higher than non-U.S. developed markets stocks, 17.08 versus 14.53.[1] During the same period, there also was greater dispersion of returns among stocks in the EM index compared to the developed markets index. The wide range of performance, which we illustrate in Figure 2, suggests companies in the EM index are at different stages in their business cycles and the market is differentiating between them. We believe this again illustrates the value of active security selection. Passive strategies must own all the companies in the index –the good and the bad – while active managers have the advantage of being selective.

Figure 2 | The Dispersion of Returns Among EM Stocks Has Been High
Ranges of Annual Returns for Stocks in the MSCI Emerging Markets Index



Data as of 12/31/2019. Positive numbers represent best performing stock within MSCI Emerging Markets index for the given year. Negative numbers represent worst performing stock within the index for the given year. Source: FactSet.

Emerging Markets Don't Move in Tandem

We believe the idiosyncratic nature of EM countries and companies plays to the strengths of an active approach. Even though they are often tarred with the same brush, EM countries don't necessarily move in tandem. Many investors believe shifting economic conditions such as U.S. dollar moves, commodity price fluctuations and trade disruptions affect all EM countries and companies the same way. This is not the case—EM countries tend to be more affected by local economic conditions and less by global macroeconomic trends than developed markets countries. In fact, EM companies generate approximately 71% of revenues locally, compared to 34% for those in developed markets.[2]

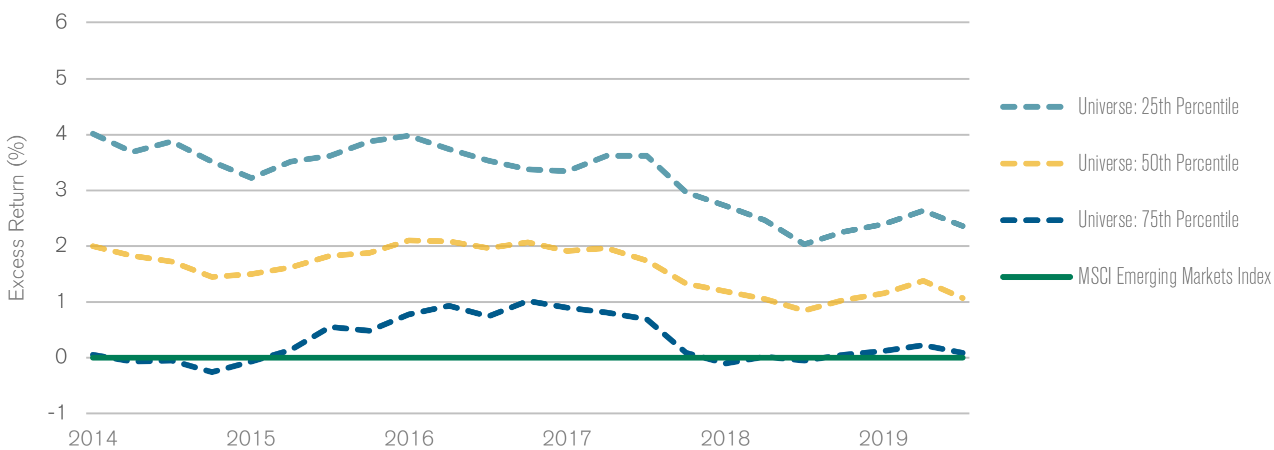
[1]Source: FactSet. Data as of 12/31/2019. Emerging markets are represented by the MSCI Emerging Markets Index and non-U.S. developed markets are represented by the MSCI EAFE Index.
[2]Source: FactSet. Data as of 12/31/2019.

EM Portfolios May Benefit from Active Risk Management

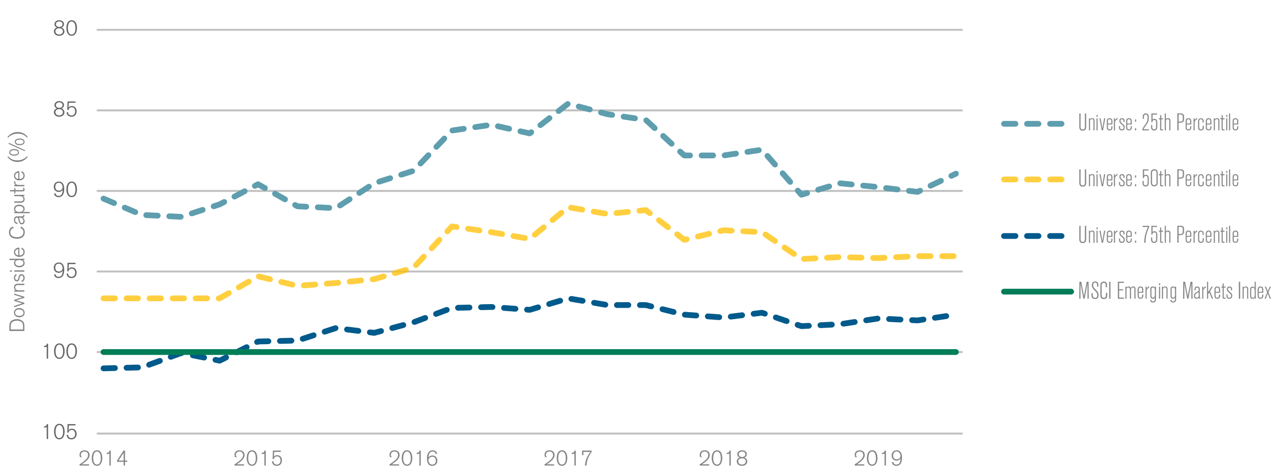
The largest and most prominent companies in the largest countries tend to dominate EM large-cap indexes. Thus, index investing can increase the risk of concentration in a small number of names. Such companies are sometimes more global in nature and may react to macroeconomic events like a developed markets company, diminishing the diversification benefits some EM investors seek. Portfolio managers can employ active risk management in an effort to selectively increase, decrease or avoid exposure to such companies. **Figure 3** demonstrates how successful active managers (top quartiles) have historically outpaced the average (index) and delivered more excess return with less downside risk.

Figure 3 | Active EM Managers Outpaced the Index in Up and Down Markets

Rolling 5-Year Excess Return vs. MSCI Emerging Markets Index



Rolling 5-Year Downside Capture vs. MSCI Emerging Markets Index



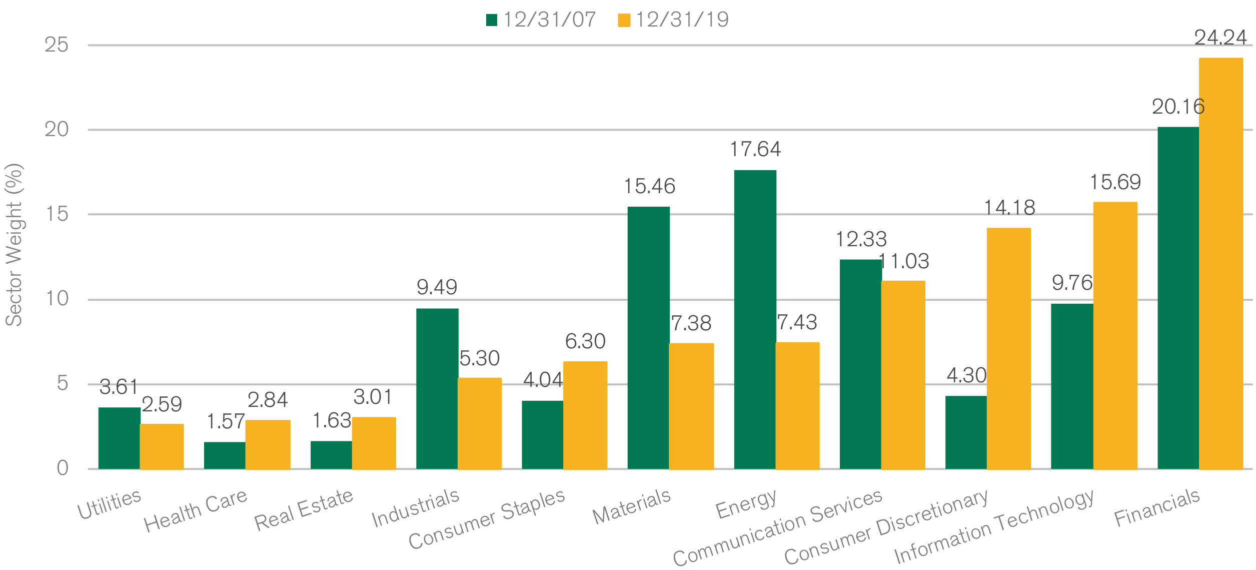
Universe: eA Emerging Markets All Cap Equity. Number of managers in universe: 226. Data from 7/1/2009 – 12/31/2019. In USD, gross of fees. Source: FactSet.

EM Index Composition Has Evolved

Developing economies tied to commodities, materials and energy and heavily exposed to currency fluctuation used to dominate emerging markets. In 2007, the MSCI Emerging Markets Index favored "old EM" sectors. Energy, materials, telecom and industrials companies represented more than half of the index while consumer-related companies were less prominent. Today, in the "new emerging markets," things have changed—consumer discretionary has more than doubled in weighting over the past 12 years, and information technology has increased significantly.

Figure 4 | Consumer-Facing Sectors Dominate Today's Emerging Markets

Sector Weights in the MSCI EM Index: Then and Now



Source: FactSet.

We Believe Active Management Is Likely Optimal in Emerging Markets

Investors can deploy passive and active strategies as complementary tools across their portfolios. In emerging markets, inherent market inefficiencies have created the potential for active managers to add value through the unique insights they generate through fundamental, bottom-up analysis and consistent application of their investment philosophy and process.

Disclosures

	Expense Ratio (%)	YTD Return (%)	1-Year Return (%)	3-Year Return (%)	3-Year Std Dev (%)	5-Year Return (%)	10-Year Return (%)	Inception Date	Daily Closing Price 3/31/2020	Daily Closing Price 3/31/2019	Daily Closing Price 3/31/2015	Daily Closing Price 3/31/2010
iShares MSCI Emerging Markets ETF	0.68	-23.69	-18.14	-2.19	17.11	-0.93	0.01	4/7/2003	$34.13	$42.92	$40.13	$42.12
MSCI Emerging Markets Index	--	-23.60	-17.69	-1.62	17.12	-0.37	0.68	1/1/2001	$848.58	$1058.13	$974.57	$1010.33

Source: Morningstar Direct. Data as of 3/31/2020.

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