Opportunities in Emerging Markets
Small-Cap Investing

Adding small-cap stocks to an emerging markets (EM) allocation may improve returns, provide portfolio diversification and reduce overall portfolio volatility.

EM small-cap stocks represent a large and growing investment opportunity set. Historically, correlations with developed markets and large-cap indices have been low, and the inherent inefficiencies in EM small caps may offer opportunities for global investors. Nathan Chaudoin recently spoke with Portfolio Manager Patricia Ribeiro about her investment approach to EM small-cap investing and how EM small-cap stocks can be an important part of an investor’s equity holdings.

What are the main advantages of investing in EM small-cap stocks?

Reasons for adding EM small caps to a portfolio include the potential for a small-cap premium, increased diversification and more focused exposure to local economies in EM countries.

There’s evidence of a small-cap premium in emerging markets. While small-cap stocks have outperformed large- and mid-cap stocks in most periods, they’ve underperformed significantly in others. That’s why we believe investors should consider holding such assets over the long term instead of trying to tactically trade the asset class.

EM small-cap stocks have historically shown a modestly lower correlation with the developed markets than large- and mid-cap EM stocks and therefore can provide a higher degree of diversification. Moreover, this diversification benefit continues over most time periods. Therefore, a portfolio that includes an allocation to EM small-cap stocks could expect to achieve some benefits from this lower correlation, including lower overall portfolio volatility versus a similar portfolio that includes only large- and mid-cap EM stocks.
EM small-cap companies also tend to be less exposed to global macroeconomics and more closely tied to their local economies. This may allow them to offer higher diversification than an investment solely in larger companies more exposed to global economic conditions.

For these reasons, we think active management is well-suited for EM small-cap investing, especially within an approach focused on bottom-up stock selection.

**How can EM small caps complement mid- and large-cap EM stocks in an investor’s portfolio?**

As I mentioned, EM small caps—defined here as those companies valued between US$500 million and US$5 billion in market capitalization—tend to be more focused on local economies and less driven by global economic conditions. In fact, according to MSCI, EM small-cap companies derive approximately 25% of their revenue outside their home economies as opposed to almost 33% for large- and mid-cap stocks. They also offer some diversification benefits through lower correlations to developed markets stocks (MSCI World Index) than large-cap EM stocks. That’s why they can be a valuable complement to the EM equity portion of a portfolio.

**Can you describe your investment process for managing the portfolio?**

Collaboration is an important part of our investment process as we attempt to exploit market inefficiencies in EM small-cap investing through applying fundamental, bottom-up analysis. Three dedicated regional analysts support the management team. We also benefit from the research of eight sector analysts and nine additional portfolio managers with whom we can share insights and information. This proximity promotes cooperation, collaboration and transparency via formal and ad hoc meetings that allow a free exchange of information and ideas benefiting the entire team.

We believe the American Century Investments philosophy and process is well-suited for uncovering opportunities in the EM small-cap space because markets can be slow to recognize inflection points in growth trends, which can lead to market inefficiencies. We focus on identifying companies in the early stages of a growth cycle, hoping to uncover attractive opportunities with the potential for strong earnings growth rates. The team also tries to exploit inefficiencies in this area of the market.

First, we use our disciplined bottom-up analysis to attempt to isolate the most compelling companies. Furthermore, EM small caps are relatively under-covered by sell-side analysts. The MSCI Emerging Markets Small Cap Index includes about 500 more less-researched names than the MSCI Emerging Markets Index. Therefore, there’s a higher probability that stocks may be mispriced by the market as a whole.

**How has your process helped in adding an EM small-cap portfolio?**

An EM small-cap strategy is a logical extension of our product set. Our time-tested investment process has been in place since launch of the Global and Non-U.S. Equity discipline in New York more than 25 years ago and has been used to manage our all-cap EM strategy since 1997.

I assumed management of the EM all-cap portfolio on June 30, 2009; as of June 30, 2019, the portfolio has returned 135% on a cumulative gross of fees basis since then, compared to the MSCI EM Small Cap Index return of 76% for the same period.

Small-cap companies have made up a significant portion of the diversified EM portfolio since the current team took over. As of June 30, 2019, the average weight of small caps (US$500 to US$5 billion) represented 37% of the portfolio, delivering 43% of the portfolio’s return for the period. Thus, by adding a dedicated small-cap strategy, we believe we can leverage a successful process and our existing support team to explore opportunities in this under-utilized and growing area of the markets.

**What trends or themes are you seeing in the EM small-cap space?**

We’re seeing several broad-based trends driven by the emerging consumer class, including increased consumer activity and aspiring to a better quality of life. Demand for greater access to financial services and education is also creating opportunities across the region.
Where are you seeing opportunities to participate in these trends?

Data suggest consumer spending is increasing in several markets, including South Korea, Brazil and China. This is evidenced by strong results in consumer-based apparel companies Fila Korea and Li Ning. Sporting goods name Li Ning is benefiting from the improved consumer climate in China, shifting consumer tastes toward domestic brands and the Chinese government's concerted effort to encourage citizens to be more physically active. Multiline retailer Magazine Luiza is benefiting from the generally improving economic outlook in Brazil.

Consumers’ desire for a better quality of life and higher standard of living is driving demand for a diverse set of goods and services, including greater access to financial services and education. Beneficiaries of these themes include IndusInd Bank (India), Bank Tabungan Pensiunan Nasional (Indonesia) and Capitec Bank Holdings (South Africa), which offer financial services to largely underserved groups as well as educational services providers in China such as TAL Education Group and Wisdom Education.

While you don’t have a top-down, country-by-country outlook, have you observed any important trends in any countries or regions?

As you said, we don’t take a top-down or macroeconomic approach to finding stocks—we’re dedicated bottom-up stock pickers. That said, we’re finding companies in Brazil and China—two overweights relative to the index—affected by current macroeconomic trends in those two countries.

In Brazil, we’re seeing companies across multiple sectors positioned to benefit from improvements in the economy and consumer confidence. We’re positioned to benefit from expected increases in domestic demand. Examples run the gamut, from retailer Magazine Luiza to rental car companies Localiza Rent a Car and Companhia de Loçãoa das Américas.

China has moderated as a result of slowing economic activity that’s due, in part, to the uncertainty around U.S. trade relations. However, we expect continued fiscal stimulus, such as tax reforms and infrastructure spending, to support a recovery in economic growth. In China, we’re positioned in domestic companies, which we expect to benefit from stimulative Chinese policy. Across the region, we’re seeing opportunities to benefit from rising household consumption. Examples include South Korea-based CJ Logistics, which is benefiting from increased e-commerce shipping and Chinese e-commerce company Baozun.

China’s commitment to increased infrastructure expenditure is driving improvement for China Resources Cement Holdings and West China Cement, as well as PT Semen Indonesia and Asia Cement. These last two are based in Indonesia and Taiwan, but derive notable portions of their revenues from China.

What risk and return factors should investors keep in mind about EM small-cap stocks?

Smaller companies can be inherently riskier due to their size. For that reason, a “size premium” compensates investors for the additional risks inherent in small companies, including liquidity, information and idiosyncratic risks. Liquidity can be a concern, especially during technically driven markets, which is why we’re limiting our universe to securities with a minimum market cap of US$500 million and/or US$2 million in daily trading volume. Information risk is due to the fact that there’s often less information and transparency available to investors. EM stock returns are driven more by idiosyncratic, or unsystematic, risks than their larger-cap counterparts.

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