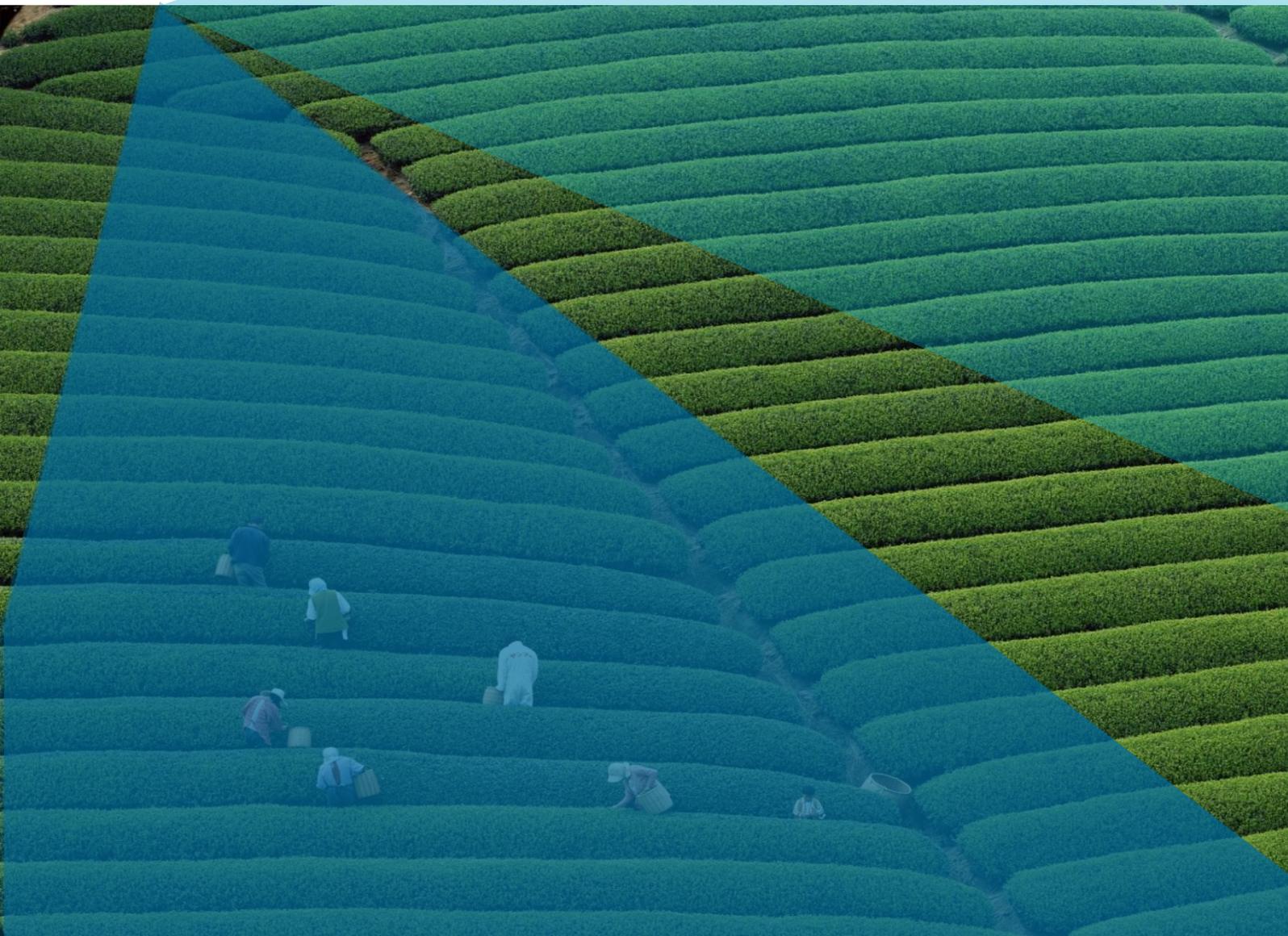


# EMERGING MARKET EQUITY PERFORMANCE

September 2013

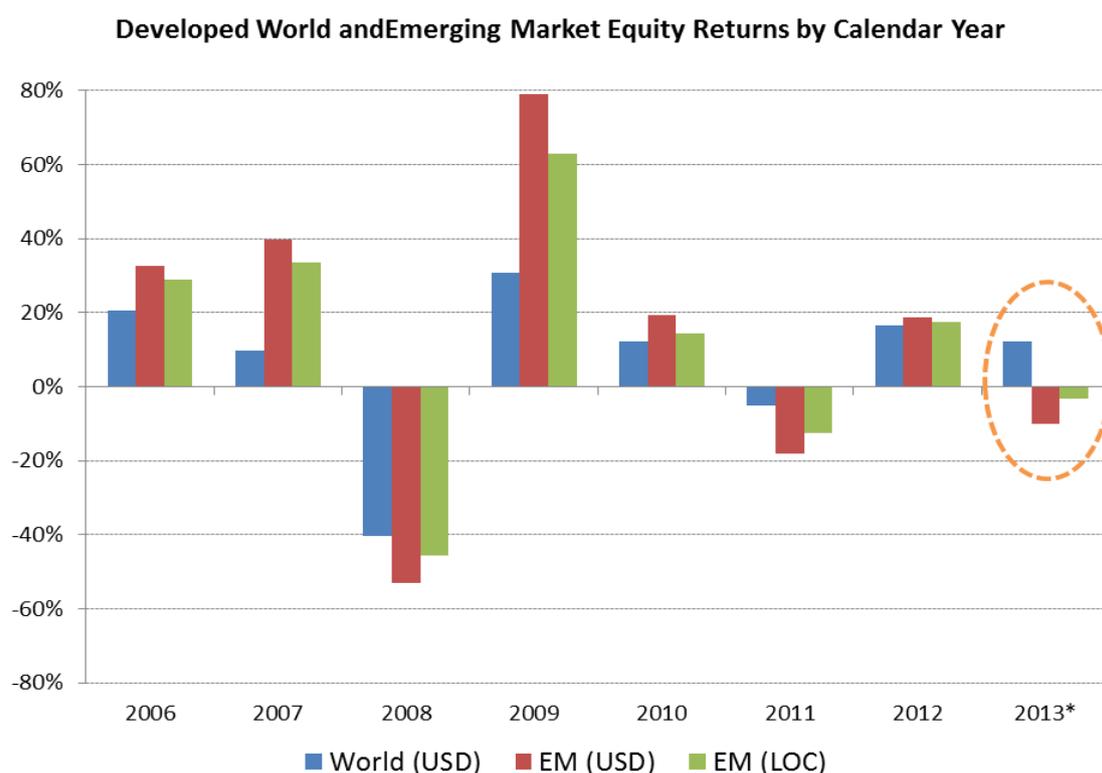


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## BACKGROUND

Emerging markets are often thought of as providing equity investors with an amplified version of developed market equity returns — put simply, many investors expect long-term structural outperformance over developed markets, with more extreme upswings in buoyant markets and more violent downswings in periods of heightened risk aversion. This line of thinking was broadly supported by the evidence in the years leading up to and immediately following the financial crisis: emerging markets strongly outperformed developed markets in 2006 and 2007, fell faster than developed markets in the turmoil of 2008, enjoyed a stronger recovery during 2009 and 2010, underperformed through a difficult 2011 (despite market concerns being centered on the eurozone), and outperformed (albeit only slightly) during 2012.



Source: Thomson Reuters Datastream. USD indicates dollar returns; LOC indicates local currency returns; \* indicates year-to-date return.

The significant underperformance of emerging markets over 2013 to date is therefore likely to have come as something of a surprise to investors who have come to think of emerging market equities as providing a high beta play on developed equity markets. At the time of writing (early September 2013), developed markets have *risen* by 12.2% this year, compared with a *fall* of 9.9% in emerging

markets.<sup>1</sup> Emerging market underperformance of around 22% against a strongly rising global stock market is indeed arresting, and investors will rightly be wondering what has driven this divergence in returns and whether any action might be justified in response. We attempt to address both of these questions in this paper.

## LOOKING BENEATH THE SURFACE

Emerging markets are a diverse group of countries, varying in size from the extremely small to the most populous country on the planet, with economies facing vastly different economic challenges. It is therefore instructive to look beneath the surface to understand how different segments of the emerging markets universe have performed over the course of this year. We would highlight the following:

- Emerging market equity returns in local currency terms (that is, ignoring the impact of currency fluctuations) have been less negative than in dollar terms (-3.3% vs. -9.9%, respectively). This illustrates that there has been some element of emerging market currency depreciation against the dollar, but this does not explain the majority of the relative underperformance this year.
- Emerging market small cap stocks have meaningfully outperformed large and mid-cap stocks (by around 4%), but have still provided a negative return over the year to date (YTD).
- At a regional level, Latin American stocks have experienced the most significant negative returns (-18% YTD), but emerging EMEA<sup>2</sup> and emerging Asia have also produced negative absolute returns (-13% and -6%, respectively).
- The four largest countries within the MSCI Emerging Markets Index are China (19%), Korea (15%), Taiwan (12%), and Brazil (11%), together comprising almost 60% of the index. Year-to-date returns in these markets have been -5%, -6%, +2%, and -21%, respectively. The next four largest country constituents in the index — South Africa, Russia, India, and Mexico — have all produced returns in the range -8% to -20%.
- There has been significant dispersion at the sector level, with IT stocks rising 1% and health care stocks falling 1% this year, while energy and materials stocks have fallen by 14% and 23%, respectively.

In summary, negative returns to emerging market stocks this year have been relatively broad-based by region and country, but conditions have been more favorable for investors focused on small caps

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<sup>1</sup> Thomson Reuters Datastream. All returns quoted are based on the MSCI World and MSCI Emerging Markets Index series and are in US dollars unless otherwise stated. Most of the analysis refers to the period from 31 December 2012 to 30 August 2013.

<sup>2</sup> Europe, the Middle East, and Africa.

or sectors such as IT and health care. Having said that, none of the large emerging markets, nor any of the underlying sectors, has come close to keeping pace with developed markets.<sup>3</sup>

So why have emerging markets faced such strong headwinds in what has been a relatively benign (or at least pro-risk) market environment? We would highlight the following factors:

- There has been an increasing volume of data pointing towards slowing growth across many of the large emerging economies.<sup>4</sup> In particular, there has been much discussion of China's attempt to rebalance its economy and rein in the excessive credit growth in the shadow banking system, and the possibility of a "hard landing" as the new leadership looks to shift the balance of the economy away from investment and towards consumption. In contrast, much of the recent news flow relating to the US has been broadly positive.
- Earnings growth has disappointed against market expectations in recent years.<sup>5</sup> While emerging market sales growth has continued to outperform the developed world, falling profit margins have negatively impacted earnings growth. Profit-margin deterioration has largely been driven by rising wages and stronger domestic currencies over the last decade, reducing the competitive advantage previously enjoyed by many emerging economies.
- The magnitude of the Japanese monetary stimulus announced in early April has been perceived as providing a boost for Japanese exporters (given the extent of the subsequent fall in the yen) and consequently as a negative for competing Asian exporters. In addition, the sudden weakening of the yen resulted in dollar strength, which typically draws liquidity out of emerging markets as dollar-based investors attempt to mitigate the impact of currency losses by repatriating non-dollar assets.
- Comments made by Ben Bernanke in May and reiterated in August raised the possibility of a "tapering" of the Federal Reserve's quantitative easing (QE) program later this year. The effect of this speech was a sharp increase in US treasury yields and falls across many equity markets. Emerging markets (both equity and debt) were hit particularly hard, reversing, to some extent, the significant flows into these markets over the period since the financial crisis. This effect was amplified by the increasing size of exchange-traded funds (ETFs) in emerging markets, some of which have seen significant outflows in recent months.<sup>6</sup>

We might therefore conclude that emerging market equity underperformance over 2013 has resulted from a confluence of three forces: first, a mixture of disappointing fundamentals at both a micro and macro level (earnings growth underperformance and slowing economic growth across much of the emerging world); second, a shift in market sentiment towards an increasingly positive

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<sup>3</sup> Returns to developed equity markets have not been uniform, but have, in general, been strongly positive in 2013. Broadly, the US is up around 16%; the UK and Europe are up 13% and 10%, respectively; Japan is up around 30%; and developed Asia is up around 5% (all in local currency terms). It is also worth noting that there has been significant sector-level dispersion in developed markets, with the materials sector returning -6.0% and the health care sector returning +21.3% (in USD terms).

<sup>4</sup> See, for example: "The Great Deceleration," *The Economist*, 27 July 2013.

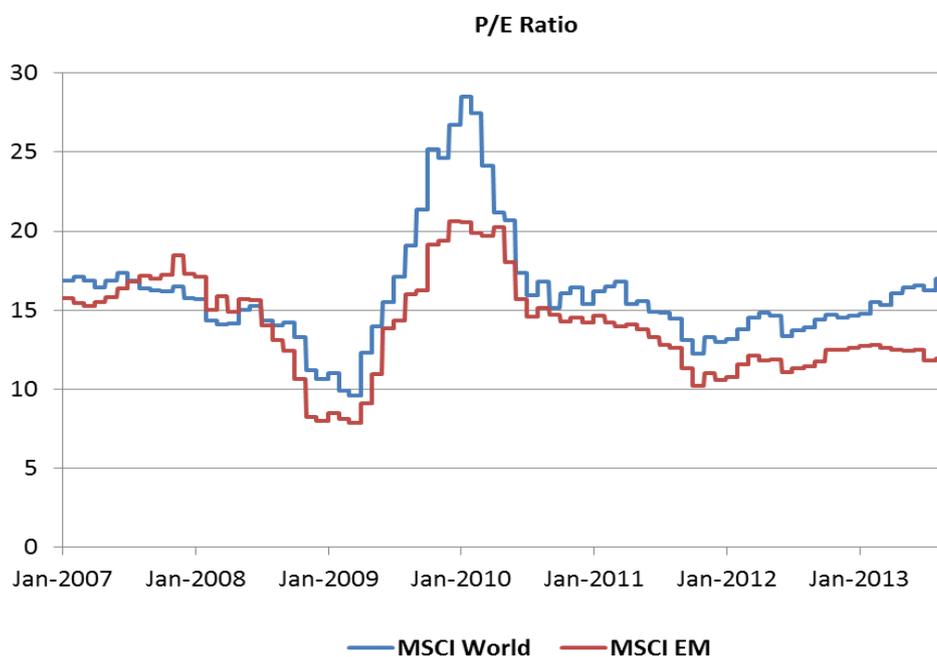
<sup>5</sup> Charlemagne Capital. "Unloved and oversold: time to reassess," July 2013

<sup>6</sup> "Investors pull \$8.2bn from ETFs in June," available at <http://www.ft.com/intl/cms/s/0/e3595b6e-e327-11e2-bd87-00144feabdc0.html>, accessed 4 September 2013.

outlook on the strength of the US and eurozone recovery; and third, a divergence in central bank action, with the Federal Reserve raising the possibility of “QE tapering”, the Bank of Japan launching a massive monetary stimulus, and the Chinese authorities tightening policy around the shadow banking system.

## LOOKING FORWARD

In the short term, it is possible that the US economy will generate further positive news flow while the large emerging markets continue to struggle with the diverse set of challenges facing their economies. This raises the prospect of further liquidity withdrawals from emerging markets as investors revisit concerns around the possible timing of QE tapering and contemplate the implications of a strengthening dollar, rising treasury yields, tighter credit conditions in China, and the urgent need for economic reforms in India. Sentiment towards emerging markets is as negative as it has been for over a decade<sup>7</sup> and some have argued that the recent liquidity reversal could be self-reinforcing, with market moves both responding to and exacerbating any economic weakness.



However, we believe that the long-term case for emerging market investment remains strong: growth in emerging economies is expected to outpace developed world growth over the next 5–10 years (although the margin of excess growth from emerging markets will be less if developed markets actually recover); emerging market government balance sheets are much less encumbered by debt than most developed economies; and demographic trends (with some exceptions) are more than for developed economies. While these positive economic conditions will not necessarily feed directly through to emerging equity market performance, it seems reasonable to expect faster, more

<sup>7</sup> BofA Merrill Lynch Global Fund Manager Survey, 16 July 2013.

vibrant economies, with a growing labor force and greater flexibility in their fiscal and monetary policies, to create a positive environment for emerging market equity investors.

The key factor determining whether these positive economic factors translate into future equity market returns is the extent to which these factors are already priced into the market.<sup>8</sup> While it is not clear that emerging markets are unambiguously cheap, recent underperformance has certainly increased their attractiveness on a forward-looking basis, and it is difficult to argue that markets are excessively optimistic on the future prospects for emerging market equity returns. Indeed, one might argue that developed markets are becoming excessively sanguine on the risks associated with ensuring that a sustainable recovery takes hold while managing both a long-term deleveraging of these economies and the withdrawal of QE. On simple price-to-book, price-to-cash-flow, and price-to-earnings measures, emerging markets are relatively inexpensive when compared to developed markets.

## CONCLUSIONS

The question investors are now faced with is, “Does the magnitude of emerging market underperformance this year reflect an opportunity to increase allocations at attractive levels; or should emerging markets now be treated with a greater degree of caution?” We suggest that the answer depends on the size of an investor’s current allocation to emerging markets, their risk tolerance, and their time horizon.

Ignoring any tactical or strategic views on the relative merits of emerging markets versus developed markets, we believe that an investor’s equity portfolio should provide a broad and diversified exposure to different segments of the equity universe, covering both developed and emerging markets. A natural reference point for sizing the emerging markets allocation is its market capitalization, which currently stands at around 11% of the global equity universe.<sup>9</sup> We recommend that equity investors with a risk tolerance that can withstand the volatility associated with emerging markets, that are significantly underweight the market cap exposure, consider increasing their allocation towards the market cap weight. While our medium-term (3- to 5-year) view remains positive,<sup>10</sup> given the short-term risks to emerging markets discussed above, we would suggest phasing such an increase in allocation over the next 6–12 months in order to mitigate timing risk.

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<sup>8</sup> We argue that the primary factor explaining the empirically observed lack of correlation between equity market returns and economic growth is the fact that markets “price in” expected (GDP and earnings per share) growth before it occurs. Any fundamental change in the distribution of GDP growth between the government, labour (employees), and capital (investors) will also have an impact on returns to equity investors.

<sup>9</sup> Based on the MSCI AC World as at 31 July 2013.

<sup>10</sup> We currently rate both developed and emerging market equities as “attractive” in our Dynamic Asset Allocation report.

Where the allocation to emerging markets is at or around the market cap weight and the sizing of the allocation is not delegated to investment managers, we would suggest that the appropriateness of any action will depend on investor specifics:

- For investors with a low to moderate risk tolerance with the intention of reducing equity risk over the next 5–10 years, it may be appropriate to retain the current position. Rebalancing the emerging markets allocation should be considered if it has fallen materially below the target level.
- Investors with a higher risk tolerance and a relatively long time horizon might instead consider increasing their emerging markets allocation to reflect (i) the favorable economic conditions likely to support emerging market growth (both GDP growth and earnings per share growth) over the longer term; and (ii) the fact that recent performance has left emerging markets at relatively attractive levels (both in absolute and relative terms). A phased approach could be adopted, using any short-term underperformance as an opportunity to increase exposure. We have previously suggested that an allocation to emerging markets of around 20% of the equity portfolio might be an appropriate target for investors with a balanced equity portfolio also including allocations to low-volatility equities and smaller companies around a core invested in developed markets.

Finally, it is worth noting that an active approach to emerging markets is likely to offer significant benefits in current market conditions. First, many global emerging markets managers now extend their opportunity set to include developed market companies with significant exposure to emerging markets. Such stocks offer managers the ability to reduce their exposure to emerging market currencies and liquidity flows while retaining an exposure to emerging market fundamentals. Secondly, dispersion between the most-expensive and least-expensive stocks in the emerging market universe is the widest in a decade.<sup>11</sup> This should create opportunities for skilled active managers to add value — both by good risk management (avoiding the most vulnerable stocks or countries) and by selecting stocks with the greatest future return potential. Indeed, active managers appear to have performed strongly over the first half of 2013 and in the year to 30 June 2013 — the median manager outperformed the market cap index by 1.9% and 2.8%, respectively, while the upper-quartile manager has outperformed by 4.6% and 5.7% over the same periods.<sup>12</sup>

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<sup>11</sup> Source: BlackRock. “What’s Developing,” April 2013.

<sup>12</sup> Source: Mercer Insight. We also note that the corresponding three-year numbers are also strong: the median manager (in the emerging markets universe) has outperformed by 1.4% p.a. and the upper-quartile manager by 3.6% p.a. (to 30 June 2013).

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