Ashmore

The benefits of diversification in Emerging Markets equities

By Julie Dickson, CFA

In the 1980s, the term 'Emerging Markets' was first introduced to distinguish markets which were less developed than the US, Western Europe and Japan, but which were considered to be in the process of rapid growth and urbanisation. They were also considered more risky, as a result of limited foreign direct access, currency controls, transparency and custody.

When one of the first global Emerging Markets equity indices was launched in 1988 by MSCI, just 10 markets were included: Argentina, Brazil, Chile, Greece, Jordan, Malaysia, Mexico, the Philippines, Portugal and Thailand. Korea was introduced to the index in 1992 as markets opened to foreign investors, with India joining in 1994. China wasn't added until 1996 but the major change occurred in 2000 with the introduction of Red Chips (Hong-Kong listed China mainland companies). Russia only arrived in 1997. Finally, in 2007, MSCI subsequently introduced further classifications, including Emerging Markets Small Caps and Frontier Markets. Since then, a number of markets have since been 'downgraded' to Frontier status and/or 'upgraded' to Developed status and today MSCI recognises 21 markets as Emerging and 31 markets as Frontier.[1]

Fig 1: **MSCI Emerging Markets January 1988**

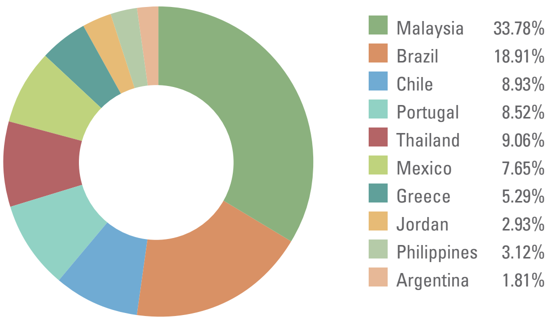
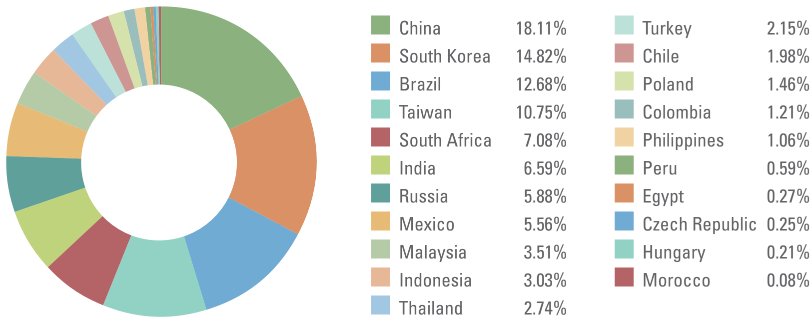


Fig 2: **MSCI Emerging Markets March 2013**



Source: Emerging Markets: a 20-year perspective, MSCI Barra 2008, MSCI 2013.

25 years on, markets have evolved rapidly – for better or for worse. Yet, the term 'Emerging Markets', which has been adopted by many investors, consultants and index providers alike is still used as the generic term for markets that fall outside the developed home countries. Index providers and government organisations have introduced terminological refinements, such as 'developing', 'industrialised', 'advanced' or 'primary/secondary emerging' to better distinguish the economic and equity investment opportunity set but the Emerging Markets equity allocation still generally remains assigned to one global pot. And it's not for the lack of choice.

The opportunity to diversify across the EM equity asset class is broad and deep. Since the global financial crisis in 2008, Emerging and Frontier equity markets have borne the brunt of changes in investor mood and perceived risk. Much of the global equity market returns have hinged on the outlook for growth in economies such as the US and China, and the ever elusive resolution of the European fiscal crisis. As a result, recent EM equity returns have disappointed, despite a stronger economic and earnings outlook. The result is a broad and deep set of high quality stocks with superior earnings growth which are trading at a discount to their peers and their long-term intrinsic value. Given recent news on China's economic growth, and the stuttering recovery of the US economy, we believe market softness will continue in the short term – despite strong fundamentals in Emerging and Frontier Markets. As investors begin to recognise the bargains available across these markets we believe the returns will pick up later in 2013, so the next few months provide an optimal entry point for EM equity allocations. The window for investing in these markets is wide open and we believe the time to allocate within the EM equity asset class is now.

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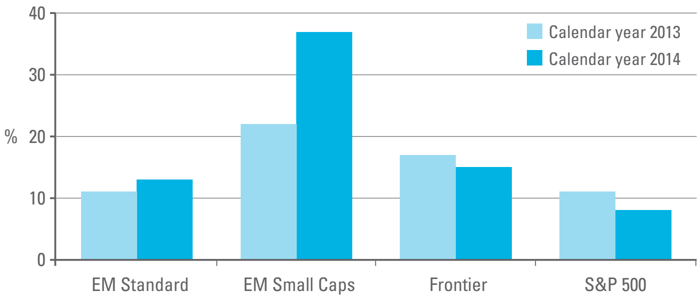
[1] Source: Emerging Markets: a 20-year perspective, MSCI Barra 2008, MSCI 2013.

Valuations, earnings prospects and returns

One of the key features in Emerging Markets investing is the growth theme. Whether economic or financial, Emerging Markets are poised to outperform developed markets in the mid and long term. Fig. 3 shows the expected earnings growth over this and the next calendar year, in both Emerging and developed markets, based on consensus forecasts. Not only are Emerging Markets set to outstrip the US, but when looking deeper into Emerging Markets (and also considering Frontier Markets) the case for earnings growth is even more compelling. Small caps far outweigh the US and Emerging Markets large caps in terms of earnings growth opportunities. Even Frontier Markets, which have long been perceived as fraught with risk – provide a higher and more sustainable source of domestically-driven fundamental growth.

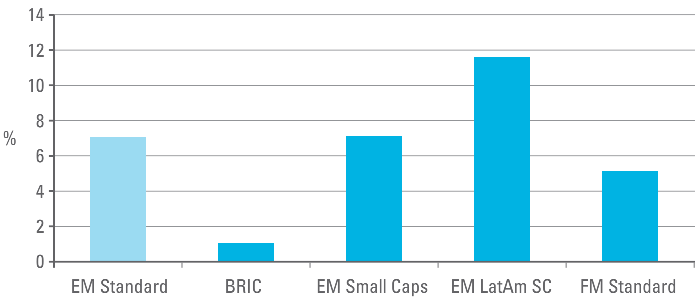
Fig 3: **Earnings growth forecast**



Source: MSCI, Bloomberg, Ashmore, based on consensus forecast on Earnings per Share as at 19 April 2013.

Given these projections, one would have expected returns to strongly favour Emerging (especially small caps) and Frontier Markets, however this has not been the case. Since the end of 2009, Emerging and Frontier Markets equities have *underperformed* the US equity market, including the first quarter of this year. In our view, this is simply not justified. The outlook for domestic revenue and earnings growth remains strong, underpinned by local consumer growth and infrastructure spending, when such trends have struggled to keep pace in the more indebted developed economies.

Fig 4: **Returns over last three years**



Source Bloomberg, MSCI, Ashmore as at December 2012

Returns however are not the only reason to allocate within the Emerging Markets equity asset class. Correlations between EM large caps, EM small caps, Frontier Markets, and the US for example have clearly indicated the benefits of spreading investments across the broader and deeper investment universe. Risk levels are equal to or less than EMs – even for the same or higher level of returns. With ample choices across regions, market caps and single countries at a time when markets have, in our view, been oversold, means that the overall risk-adjusted returns can be improved by allocating across all or some of these strategies.

Sharpe Ratio	EM Standard	BRIC	EM Small Caps	EM LatAm SC	FM Standard
Since inception	0.58	0.59	0.59	0.83	0.47
Last 7 years	0.27	0.22	0.32	0.48	-0.11
Last 5 years	0.02	-0.11	0.10	0.26	-0.42
Last 3 years	0.32	0.05	0.32	0.46	0.35
Last 12 months	0.04	-0.30	0.40	0.57	1.28

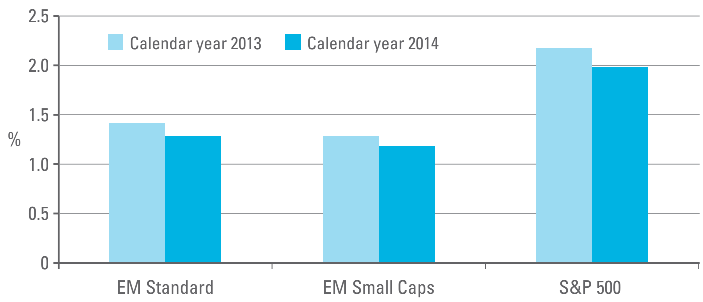
Source: MSCI, Ashmore. (Assumes 0% interest rate) as of December 2012.

Correlation	EM Standard	BRIC	EM Small Caps	EM LatAm SC	Frontier
EM Standard	100%	96%	96%	90%	60%
BRIC		100%	90%	91%	58%
EM Small Caps			100%	89%	61%
EM LatAM SC				100%	59%
Frontier					100%

Source: MSCI, Ashmore. January 2006 - December 2012.

The case for adding or increasing an allocation to small caps should be obvious. With the spectre of government intervention into large, quasi-state owned companies and large exporters, small caps tend to benefit from government intervention. This is because these companies are usually domestic or export businesses that have low potential to be punished/taxed by governments. The opportunities here are found in consumer industries such as local retailers or holiday tour operators, and in emerging technologies such as those linked to the smartphone market. The universe of small cap companies continues to grow as more IPOs come to market, and already offer a large variety of stock selection opportunities: the MSCI EM small cap index alone has nearly 1,800 stocks, compared to just over 800 for the MSCI EM standard index. As they are far less researched or covered by the sell side, they provide a number of sources of alpha stemming from domestic revenue growth supported by local structural stories, niche plays, emergence from financial restructuring or acquisition activity from larger emerging or developed market players. In our view, earnings growth in small caps will continue to accelerate and exceed both the rest of emerging and developed markets as local demand for consumer goods and investment into infrastructure underpinned by local economic growth remain resilient.

Fig 5: **Projected price to book**



Source Bloomberg, 19 April 2013.

Within Frontier Markets the three most compelling features of allocation are valuations, dividends and consumer-led growth. GDP growth in Africa is expected to expand by 6% over the next 10 years and the Middle East has one of the fastest-growing middle classes, supported by a young working age population and several government policies to support local employment. Yet despite steady earnings growth across the regions in Frontier Markets, valuations are still well below those of global emerging and developed markets. They also offer a higher and sustainable dividend yield, and measurably higher earnings growth. In our view, these valuations provide a cheap source of added earnings growth and superior returns – and there are plenty of consumer stocks to choose from to access this growth: food and beverage companies, fashion retailers, mobile technologies, hotel or holiday operators and conservatively managed consumer banks are just a few examples of where these opportunities lie.

	Price/Earnings	Earnings growth	Dividend yield
EM Standard	10.6	11%	3.1%
Frontier	10.3	17%	4.3%
S&P 500	14.1	11%	2.2%

Source: Bloomberg.

The case for active management in these markets is equally important. Due to the lack of coverage by sell-side research and indexers alike, stock selection driven by rigorous fundamental analysis is critical to maximising the opportunities in small caps and Frontier Markets. A lack of sell-side coverage does not mean a lack of information. All it means is that there are many undiscovered opportunities – if one is willing to do the hard work. With a universe of nearly 2,000 investable stocks in EM small caps alone, employing a passive strategy may not deliver the desired results. Only approximately a third of EM small caps are covered by sell-side analysts, and only 67% of the total market cap of Emerging and Frontier Markets is included in MSCI's Emerging Markets and Frontier Markets indices[2]. This means that through rigorous research it is possible to tap into these undiscovered opportunities by deploying deep and local investment knowledge. It also means that investors can quickly put in place an allocation strategy whilst avoiding the operational and costly headaches associated with directly investing in the more obscure markets.

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The case for diversifying the allocation within Emerging Markets equities is clear. As we look ahead into 2013 and beyond, we believe the outperformers will lie in those markets and companies that have strong fundamentals, high quality growth and are able to tap into local demand, driven by the consumer growth story. As household incomes continue to rise against a backdrop of austerity across the Heavily Indebted Developed Countries, emerging economies will drive global growth for years to come, and we believe both small caps and frontier strategies will lead the way. Valuations are low, earnings growth is strong and, relative to history and to the rest of the world, the economic backdrop is stable if not getting stronger – the time for allocating is now.

[2] Source: Reuters, MSCI, Ashmore, as at 12 December 2012.

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