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MARKET COMMENTARY

Ashmore

Building a Better Emerging Markets Portfolio

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Most serious asset allocators by now recommend a strategic commitment to Emerging Markets equities. But the investment landscape has shifted dramatically since investors first discovered Emerging Markets and it would be unwise to expect that the common "one size fits all" approach to Emerging Markets investing will continue to deliver the way it has in the past. Professional investors need to rebuild their Emerging Market exposure, diversifying into smaller companies and a broader spectrum of markets.

It's helpful to remember why we fell in love with Emerging Markets in the first place. The investment rationale behind a strategic allocation to Emerging Markets generally rests on three pillars: (1) the higher growth rates achieved by countries and companies in the Emerging Markets, (2) the diversification of risks associated with developed economies, and (3) the potential for added returns as the capital markets of emerging countries deepen over time, becoming more liquid and less volatile. Indeed, Emerging Markets portfolios have delivered, with the MSCI EM Index posting returns of 8.7% since inception in 1999 (source: MSCI as at November 30, 2015).

Along the way, some of our favorite Emerging Markets funds got bigger. A lot bigger. En route to broad acceptance, some Emerging Markets portfolios have become casualties of their own success. Since 1995 the Morningstar Diversified Emerging Markets Fund category has grown from $5 to 293bn, and now represents 2.5% of all fund assets in the United States (source: Morningstar). Moreover, much of this growth has been concentrated in a relatively small number of very large funds. Unsurprisingly, these funds are now forced to invest in bigger and bigger companies to absorb capital flows. Clearly, these funds are less able to find meaningful exposure beyond the largest Emerging Markets companies and economies. Given that funds are so much bigger and more similar than ever, it is unrealistic to expect that the Emerging Markets funds most commonly chosen by consultants and advisors can continue to deliver on the investment potential that made them popular with asset allocators in the past.

Recent results have not been as impressive. Since 2012, the Emerging Markets index has failed to beat returns in the developed markets, as represented by the S&P 500. It's no wonder that an increasing contingent of professional investors have chosen to use passively-managed ETFs to at least save on management fees.

The most common approach employed by consultants and advisors in the Emerging Markets space is to use a single fund, generally a single, global Emerging Markets fund. The approach falls short because the standard indices are biased toward large caps and are geographically limited—which unfortunately describes a lot of Emerging Markets funds. This year, in a somewhat startling acknowledgement of the limitations of the narrow, large-country approach to Emerging Markets investing, Goldman Sachs Asset Management shuttered its signature BRIC fund. As early as January 2011, the famous fund's portfolio manager commented, "One of the themes in Emerging Markets more broadly is that the smaller markets […] have done perhaps better than the larger ones […] The lesson here is to allocate to small countries as well as the BRICs."

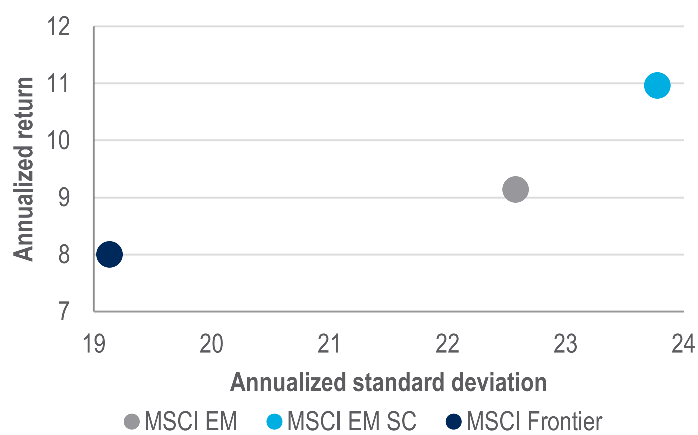
It's clear that adding exposure to [EM] small cap and Frontier Markets improves portfolios

Going forward, successful investing in Emerging Markets will require a new approach. We believe that allocators can build better Emerging Markets equity portfolios by combining the complimentary strengths of three essential portfolio components:

- Emerging Markets equities (mid- and large-cap stocks),
- Small-cap Emerging Markets equities, and
- Frontier Markets stocks.

This is in contrast to the common approach of putting all of one's Emerging Markets equity eggs into one basket. The chart below illustrates the distinctly different risk-return profiles of these three components.

Fig 1: **Since inception returns and standard deviation**
(since June 2002, inception of MSCI Frontier Markets Index)



Source: MSCI as at 30 November, 2015

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Frontier Markets offer access to different countries, risks and opportunities. But they fall off most investors' radars due to their very underdeveloped financial markets, small economies, and numerous other barriers to investment ranging from language to geography to politics. With more ground to make up, these markets have more potential to make rapid gains through relatively modest reforms or by leveraging growing demand within their own borders. While many emerging countries are facing the need to make structural reforms and remove bottlenecks to production in order to tweak their economic productivity, frontier countries are still focused on increasing the size of the economic pie.

The frontier universe has historically been less volatile than the MSCI EM Index and has demonstrated significantly lower correlations

Frontier Markets exposure can have a meaningful impact on a portfolio because the frontier universe has historically been less volatile than the MSCI EM Index and has demonstrated significantly lower correlations with developed market equity indices. The opportunity for adding alpha can also be higher because Frontier Markets are less efficient. The small size and lower liquidity in these markets tend to keep many larger investors at bay, creating larger gaps between prices and fundamental valuations. This is the stuff of active stock pickers' dreams.

The correlation matrix below reveals just how different Frontier Markets returns have been from developed markets.

Fig 2: **Since inception correlations**
(since June 2002, inception of MSCI Frontier Markets Index)

	MSCI Frontier	MSCI EM	MSCI EM SC	S&P 500	MSCI EAFE
MSCI Frontier	1.00				
MSCI EM	0.60	1.00			
MSCI EM SC	0.61	0.96	1.00		
S&P 500	0.54	0.79	0.75	1.00	
MSCI EAFE	0.62	0.89	0.86	0.89	1.00

Source: Morningstar as at 30 November, 2015

Small cap Emerging Markets companies capitalize on growth at home, in domestic markets. Rapid growth in a dynamic economy creates opportunities. Companies large and small will exploit these opportunities, but small-cap stocks provide the most focused exposure to the many drivers of domestic growth. The ranks of large-cap stocks comprise many companies plying larger, mature markets either at home or abroad, or operating in a mix of mature and newer markets, diluting higher growth rates for their equity holders. On the home front, the growth of a middle class, urbanization, the influx of capital for investment and other changes alter consumption patterns and create new demands. Small companies are often first to try out new products and services to meet these demands, and their first-mover advantage sometimes lasts for years. In short, small caps offer more of what investors want from their Emerging Markets portfolios: domestic growth drivers.

Picking the winners from a vast pool requires an active manager with skill and local knowledge, but the added value can make a real contribution to a portfolio's long-term growth. Given the fund landscape discussed earlier, getting small cap exposure in Emerging Markets requires a dedicated strategy. Contrary to popular belief, the MSCI EM Index--the most common benchmark--is not a "broad-market" index; it is explicitly an MSCI-defined "standard" index, meaning it covers mid- and large-cap stocks only. Small-cap stocks are generally defined as those with market caps under $2 billion, and those stocks constitute less than 3% of the index. Moreover, successful Emerging Markets managers benchmarked to that index face pressure to skew evermore earnestly toward large-cap stocks, leaving many investors with a gap in their EM equity exposure.

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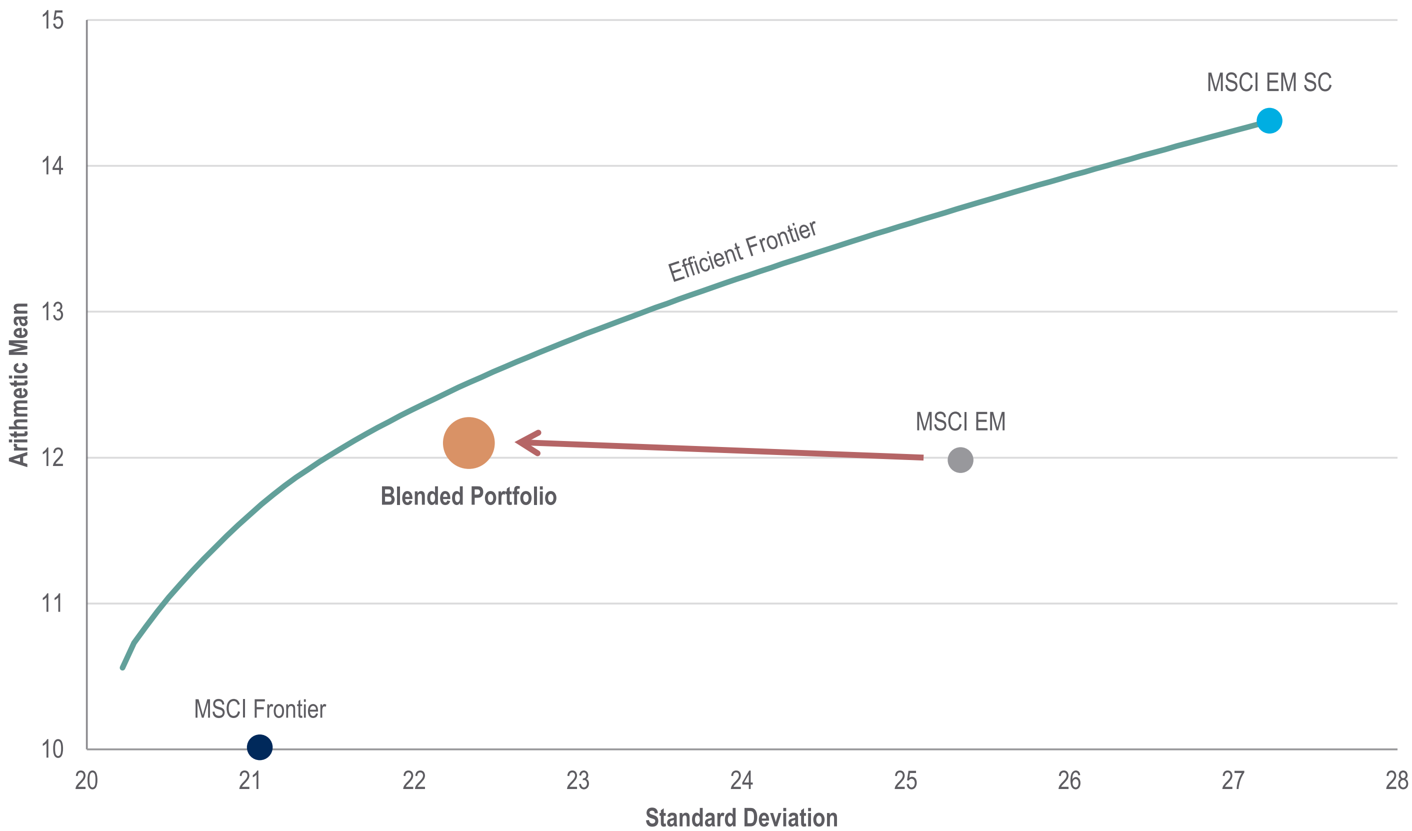
In parallel fashion, the most common indices omit Frontier Markets (by definition) and most 'broad' EM managers stick to a few of the most liquid stocks if they have any exposure there at all. The greatest opportunities in Frontier Markets exist off the beaten path where managers only dare to tread if they have experience there and investors committed to all the incumbent risks.

Finding the right balance – a simple approach works well. While it's clear that adding exposure to small cap and Frontier Markets improves portfolios, determining the optimal allocation to Emerging Markets large caps, small caps, and frontier stocks is not a straightforward task. Historical returns, standard deviations, and correlations statistics certainly don't capture every relevant dimension of risk and opportunity, so some qualitative judgments are required for making a rational allocation.

We've created a risk/return chart combining Emerging Markets large caps and small caps, and Frontier Markets, using the MSCI indices to represent each universe.

The results in Figure 3 show the diversification benefits of adding small cap and Frontier Markets stocks to an existing Emerging Markets portfolio. Essentially, investing in a diversified portfolio with roughly equal weightings in Emerging Markets large cap, small cap and Frontier Markets delivers better risk-adjusted returns than the MSCI Index on a stand-alone basis. Fortunately, this simple approach works well.

Fig 3: **Efficient frontier**
(since June 2002, inception of MSCI Frontier Markets Index through November 2015)



The Blended Portfolio represents an equally weighted blend of the MSCI Emerging Markets, MSCI Emerging Markets Small Cap and MSCI Frontier Indices.

Source: Morningstar as at 30 November, 2015

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