Ashmore

The EM equity universe: 7 implications of evolution

By Edward Evans

The size of the Emerging Markets (EM) equity universe is significant. It is evolving quickly and becoming more sophisticated as EM broaden, deepen and liberalise, better reflecting their underlying economic growth drivers. This has several important implications for investors, not least given common perception can often lag reality.

1. The size of the EM universe

Global equity market exchanges total USD 85.3 trillion. EM, including frontier markets (FM), comprise USD 28.4 trn, or 33%, so are significant. EM have grown from USD 17.0 trn a decade ago.[1]

However, the magnitude of EM exchanges is still modest in comparison to the importance of their economies. EM economic GDP represents 59% of the global economy on a purchasing power parity basis.[2] EM's market cap to GDP is 90% which compares to 118% for developed markets.

IMPLICATION

EM should be a meaningful strategic allocation in a global portfolio reflecting their economic and market significance.

2. Stock market liberalisation

The EM opportunity set is broadening and deepening driven by the opening up of markets and equitisation. The drivers of market liberalisation are country specific, and sometimes politically motivated, all this can result in different speeds of evolution.

Provided below are those exchanges which have seen the largest increase in market capitalisation over the past five years.

Fig 1: **Stock market liberalisation**

Exchange	Country	Tradeable market cap (USD bn)	5 years % change in market cap	Country market cap to GDP
Bolsa de Commercio de Buenos Aires	Argentina	109	217	0.2
Shenzhen Stock Exchange	China	3,622	215	1.1
Shanghai Stock Exchange	China	5,090	100	1.1
National Stock Exchange of India Ltd	India	2,351	90	1.8
Taipei Exchange	Taiwan	112	87	2.0
BSE India Limited	India	2,332	85	1.8
Abu Dhabi Securities Exchange	UAE	125	83	0.3
Hong Kong Exchanges and Clearing	China	4,351	54	1.1
Budapest Stock Exchange	Hungary	32	52	0.2
Korea Exchange	Korea	1,772	50	1.2

Source: World Federation of Exchanges, December 2017 and WEO, April 2018.

1 World Federation of Exchanges, 31 December 2017, based on monthly statistics. Emerging Markets as defined by the IMF. Frontier markets, South Korea, Taiwan and Hong Kong exchanges are classified as EM.
2 WEO, April 2018.

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The countries highlighted come as little surprise. As discussed further below, China is opening up their domestic exchanges to foreigners on an unprecedented scale. Meanwhile, Argentina and the UAE are good examples of frontier markets undergoing rapid capital market structural change.

The table also highlights still modest equitisation of the economy in some cases. This can be expected to change should structural reform be implemented which will in turn increase market confidence. For example, over the last two years there was a net increase of 961 listed EM companies, or 3.7% of the total equity universe.[3]

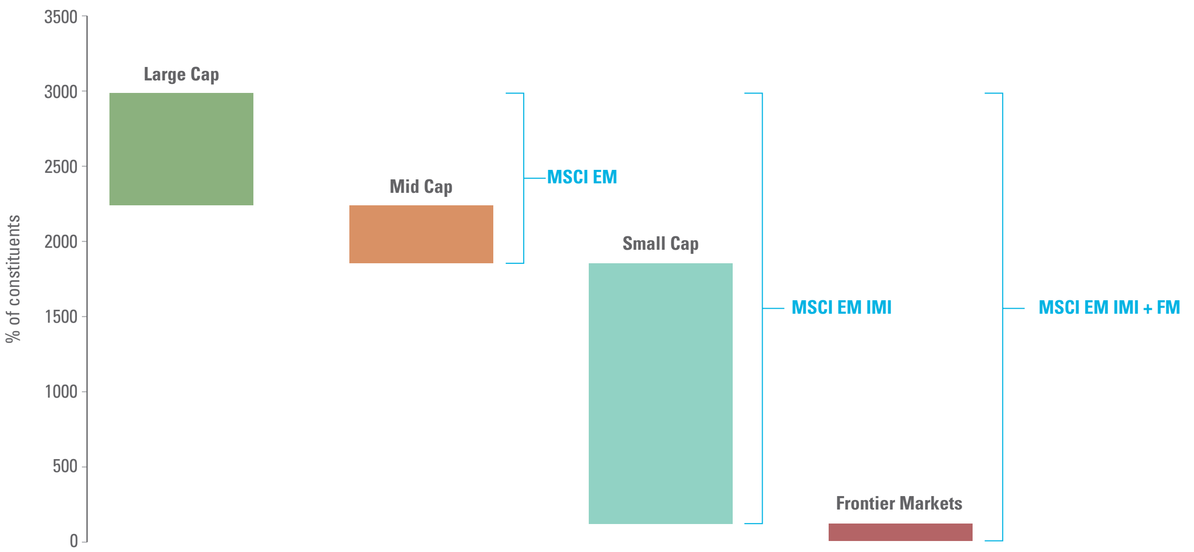
IMPLICATION

Stock market liberalisation is diversifying the opportunity set and providing investment opportunities.

3. Defining the universe

Reflecting the increased size and breadth of the EM universe, index providers have segmented the opportunity set based on market cap and discovery, among other factors.

Fig2: **MSCI indices**



Source: MSCI, as at 31 July 2018.

The dominance of indices, together with the growth in passive funds that seek to track them, are a source of market volatility. Index classification announcements trigger expectations that passive funds will be 'forced' buyers. Local investors with a shorter term investment horizon only tend to exacerbate the situation.

Should a market be 'promoted', for example from MSCI FM to MSCI EM, this is a positive for its profile and capital raising ability. It may also incentivise the attainment of higher, international standards of institutional framework, transparency and governance. However, for smaller or less liquid FM, it may risk them falling between the cracks and not being systematically considered by larger cap EM managers.

Index providers have had a busy 2018. China-A shares joined the MSCI EM and it was announced that Saudi Arabia and Argentina will join the index next year. FTSE announced Kuwait will join their EM index which has triggered expectations that MSCI may follow in due course.

IMPLICATION

Index classifications trigger market volatility and, in some cases, can be a mixed blessing for 'promoted' markets.

[3] World Federation of Exchanges, 31 December 2017, based on monthly statistics. Emerging Markets as defined by the IMF. Frontier markets, South Korea, Taiwan and Hong Kong exchanges are classified as EM.

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4. The changing face of the EM equity universe

The inexorable rise of China

The opening up of the domestic Chinese market, A-shares, through QFII in 2002, Stock Connect in 2014 and China Connect in 2016 have provided foreign investors with improved access to the second largest stock market globally.

China A-shares trade on mainland China on domestic exchanges and represent a liquid pool of close to 3,500 stocks with a market cap of over USD 8trn. They offer enhanced exposure to fast-growing sectors such as technology, healthcare and consumption in comparison to H-shares.

Improved accessibility has led China A-shares to be gradually included in indices. In May 2018, 234 A shares were added to the MSCI China index at a 2.5% inclusion factor. This represented 1.3% of the MSCI China index and it took China's weight in the MSCI EM index to 30%. The inclusion factor increases to 5% in MSCI's August 2019 Review. Should all current A-shares be included in the MSCI EM this would equate to over 40% of the index. However, inclusion will take time and will not be without its challenges.

IMPLICATION

The opening up of the Chinese market provides significant investment opportunities. The wide dispersion of A-share returns provides alpha opportunities and the low correlation to other major global equity markets can also provide diversification benefits. However, selectivity will be key given mixed levels of quality, disclosure and transparency.

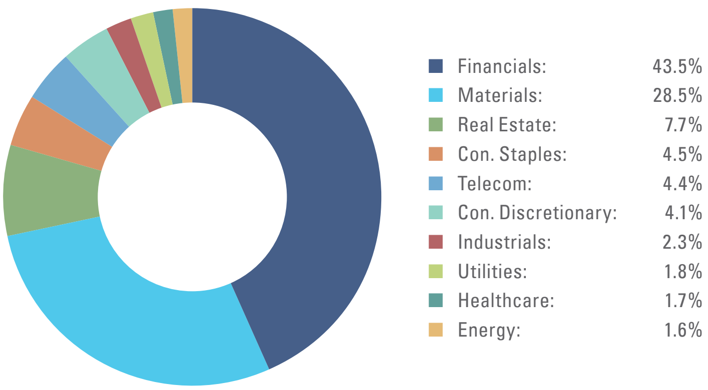
Saudi Arabia's arrival on the global stage

Crown Prince Mohammed bin Salman's 2030 Vision for the development of Saudi Arabia's economy centres around diversifying the country's income sources beyond energy. As part of these efforts authorities have been quick to implement international standards of market practice and operations. This has culminated in index inclusion – see *'Saudi Arabia's Big Year'*, Market Commentary, April 2018.

Saudi Arabia is set to become the tenth largest country constituent of the MSCI EM at 2.4% implemented over two tranches in 2019.

The local market, the Tadawul All Share index, has a market cap of USD 499bn (similar to Mexico and Malaysia) and an average daily trading value of around USD 1bn. It comprises 179 stocks and it is expected this will increase over time given privatisation is a key part of the reform programme.

Fig 3: **Tadawul All Share Index sector composition**



The Saudi Arabian market is majority owned by local institutions, with foreign ownership currently modest at approximately 1.8%. This compares to 9% for Qatar and 12% for the UAE. Meanwhile, local individuals, at over 85%, dominate trading volumes.

Source: Ashmore. Data from Bloomberg, as at 16 August 2018.

IMPLICATION

Saudi Arabia offers significant investment opportunities and low hanging fruit. However, active management will be key as reform will be disruptive and complex.

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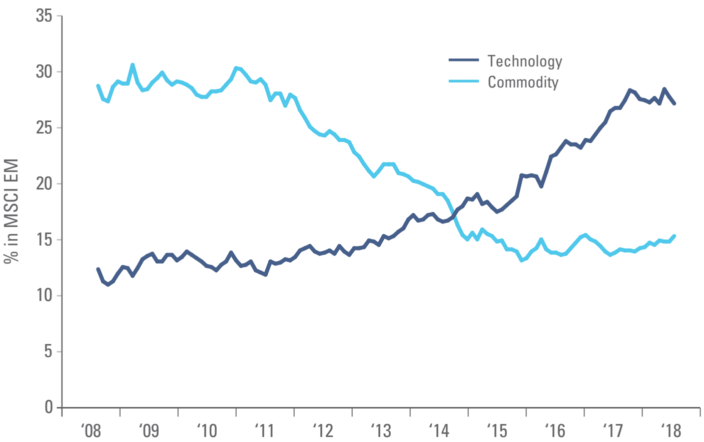
5. Larger cap EM: A widely owned yet still misunderstood universe

The larger cap universe has undergone significant development and maturity and is now widely followed and commonly invested in by global investors. However, investor perceptions still often lag reality, sometimes by decades.

The often held view that EM equities is primarily a commodity and cyclical play is outdated and incorrect. Structural growth drivers now comprise 51% of the MSCI EM index, twice that of cyclical drivers at 20%. See *'EM overtakes S&P 500 in Tech!'*, The Emerging View, September 2016.

The commodity (energy and materials) component of the MSCI EM index has halved over the past decade, from 29% to 15%. Meanwhile, technology has more than doubled in importance, from 12% to 27%, and now represents a greater weight than in the S&P 500 at 26%. Seven of the largest 10 companies in the MSCI EM are technology companies.

Fig 4: **MSCI EM composition: technology and commodities**



Source: MSCI, 2018.

IMPLICATION

The oft-cited MSCI EM valuation comparison with its history risks not comparing 'apples with apples' given the significant composition change to the index. Technology advancements in EM can also accelerate economic growth as countries leap-frog stages of development. Moreover,in a growing number of specialisations, EM companies are establishing themselves as world leaders.

EM economies and capital markets can be more dynamic and volatile compared to developed markets. This is due to the idiosyncratic nature of their institutional, political and capital market development. This means 'top down' perspective is important, not least since it can dominate 'bottom up' stock drivers. However, this is often misunderstood.

In the 1990s and early 2000s 'top down' often meant country allocation based around the compression of a country's risk premium as it normalised and underwent institutional and capital market development.

However, EM's increased breadth, depth and sophistication mean 'top down' drivers tend to have very different ramifications across the market. This is reflected in the wide dispersion of returns at both the country and industry level, including industry dispersion within the same country.

Fig 5: **MSCI EM country return dispersion[1]**

Source: Bloomberg, as at 31 December 2017.

1 MSCI EM index calendar year country market returns (USD).

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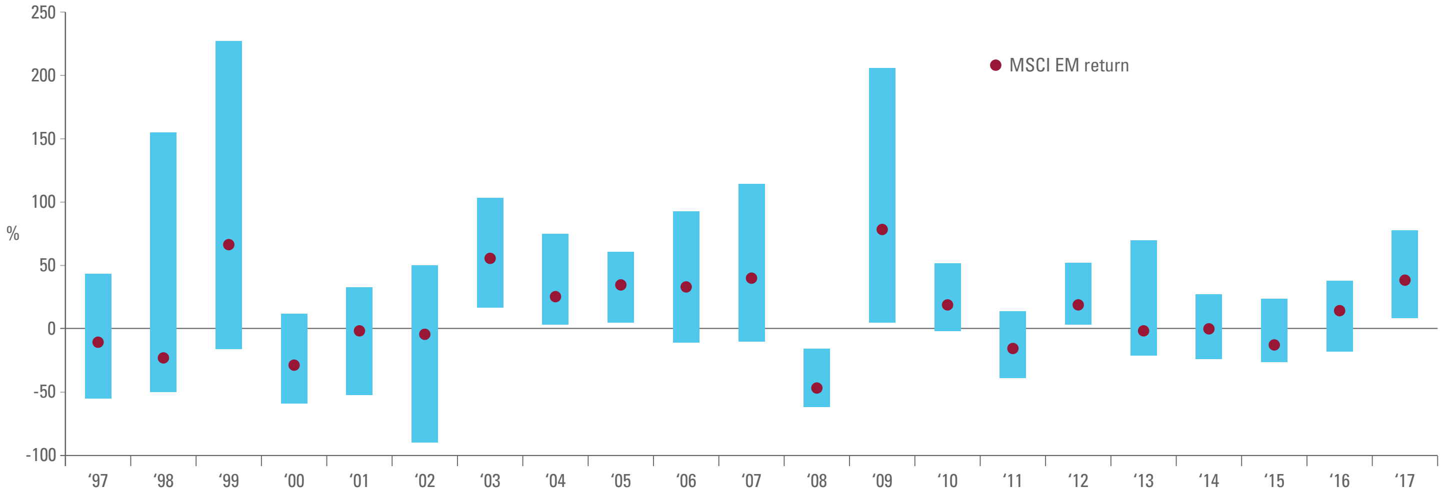
Fig 6: **MSCI EM industry return dispersion[1]**



Industry dispersion within country[2]

Year	'97	'98	'99	'00	'01	'02	'03	'04	'05	'06	'07	'08	'09	'10	'11	'12	'13	'14	'15	'16	'17
%	79	65	188	63	110	121	164	111	97	125	133	77	202	92	65	95	98	63	53	83	88

Source: Bloomberg, as at 31 December 2017.

1 MSCI EM index calendar year industry group returns (USD).

2 Median differential between the best and worst performing industry groups for the largest 10 countries in the MSCI EM index (as at 31 December 2017) on an annual basis. Please note the median differential from 1997 – 2000 reflects MSCI EM sector dispersion as industry data is unavailable.

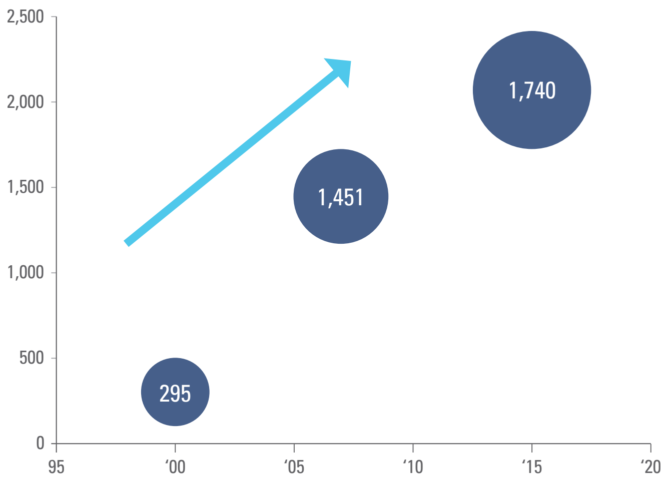
IMPLICATION

Improved breadth and representation of underlying economic growth drivers, in combination with the rise of global industries such as technology, mean top down macro effects can have different ramifications by country and industry.

6. Smaller Cap EM: A huge and growing universe

In the case of smaller caps, it is a large, evolving and investable universe that is under researched. It comprises heterogeneous companies that are high returning with diverse drivers.

Fig 7: **MSCI EM Small Cap: Number of listed companies**



12 months ADTV	Constituents	% MSCI EM Small Cap*
<USD 1m	512	3.1%
USD 1m – USD 3m	532	11.2%
>USD 3m	696	85.8%
Total	**1,740**	**100%**

*Showing % of ADTV..

Source: MSCI, Bloomberg, as at 31 July 2018.

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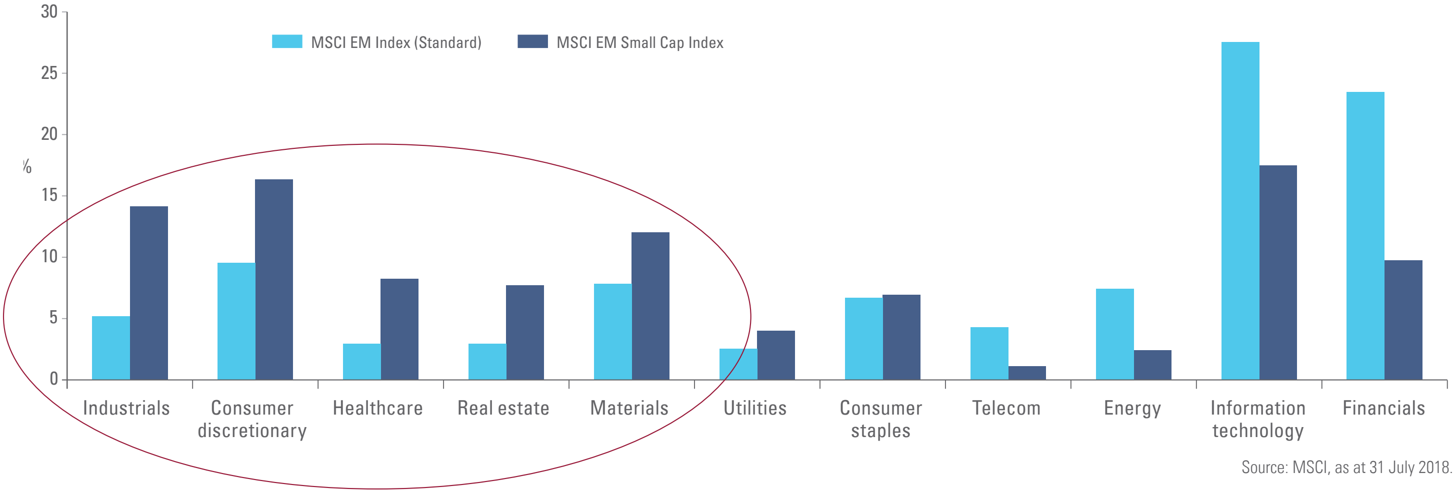
Small cap companies provide enhanced exposure to EM secular growth drivers, such as the EM consumer, compared to their larger peers. Moreover, there are fewer SOEs and the universe is more diversified both by country and sector compared to larger caps.

Fig 8: **Sector weights by EM index**



Source: MSCI, as at 31 July 2018.

IMPLICATION

Small caps provide enhanced exposure to the underlying growth drivers of an economy compared to larger cap, more global in orientation, peers.

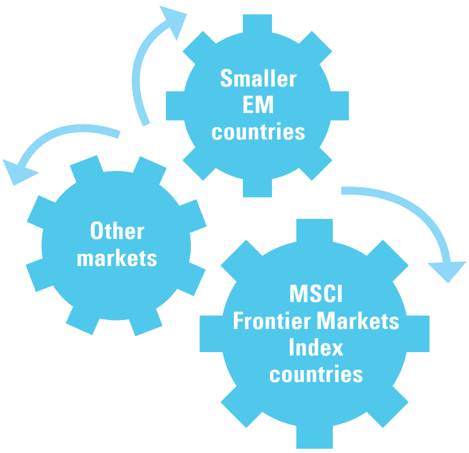
7. Frontier markets: A universe of everything you don't own

FM offer investors something quite different. The definition of the FM universe is more judgemental and investors who follow index providers are prone to restricting the opportunity set.

FM comprise a broad and diverse universe of economies each at a different stage of development. They are typically: under researched, under owned by EM investors, dominated by domestic investor flows and have underdeveloped capital market and institutional structures, among other attributes.

To our mind, the FM universe represents an incubator for future EM markets and is not dictated by index classifications. The outcome is an investable universe of over 750 stocks, compared to 115 in the MSCI FM shown earlier above.

Fig 9: **Frontier Markets universe**



Frontier markets universe	
MSCI Frontier markets index	Argentina, Bahrain, Bangladesh, Croatia, Estonia, Jordan, Kazakhstan, Kenya, Kuwait, Lebanon, Lithuania, Mauritius, Morocco, Nigeria, Oman, Romania, Serbia, Slovenia, Sri Lanka, Tunisia, Vietnam and WAEMU
Smaller EM markets with FM characteristics	For example: Colombia, Egypt, Peru, Philippines, Qatar, UAE and Pakistan
Others	For example: Georgia, Saudi Arabia, Ukraine, Bulgaria and Sub Sahara Africa

The FM universe is dynamic and growing. Market liberalisation is notably strong in Africa, such as Botswana, Namibia and Ghana. We are also currently seeing increased issuance across markets as diverse as Egypt, Pakistan and Vietnam. In future, the Latin American markets of Panama and Costa Rica could be expected to rise in prominence.

FM have domestic orientated growth drivers underpinned by low penetration of goods and services leveraged to positive demographics. This leads to high retuning companies and also lower correlations providing diversification advantages.

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Fig 10: **MSCI country and index correlations**

Country	Kuwait	Argentina	Nigeria	Pakistan	Morocco	Kenya	Vietnam	Saudi Arabia	Egypt	Sri Lanka	Kazak-hstan	MSCI FM	MSCI EM	MSCI World	S&P GSCI
Kuwait	1.00														
Argentina	0.17	1.00													
Nigeria	0.17	0.07	1.00												
Pakistan	0.22	0.11	0.16	1.00											
Morocco	0.44	0.15	0.08	0.19	1.00										
Kenya	0.22	0.14	0.42	0.13	0.16	1.00									
Vietnam	0.23	0.19	0.14	0.25	0.21	0.23	1.00								
Saudi Arabia	0.42	-0.01	0.19	0.27	0.22	0.16	0.3	1.00							
Egypt	0.16	0.03	0.2	0.27	0.32	0.29	0.3	0.16	1.00						
Sri Lanka	0.23	0.03	0.33	0.43	0.17	0.17	0.32	0.22	0.31	1.00					
Kazakhstan	0.2	0.29	0.37	0.06	0.14	0.16	0.13	0.07	0.04	0.16	1.00				
MSCI FM	0.63	0.51	0.56	0.47	0.42	0.45	0.49	0.36	0.39	0.43	0.48	1.00			
MSCI EM	0.44	0.43	0.24	0.24	0.38	0.34	0.38	0.26	0.34	0.22	0.39	0.59	1.00		
MSCI World	0.39	0.43	0.24	0.32	0.36	0.27	0.36	0.32	0.21	0.29	0.40	0.59	0.72	1.00	
S&P GSCI	0.24	0.19	0.34	0.15	0.16	0.05	0.17	0.40	0.01	0.04	0.26	0.39	0.35	0.34	1.00

Source: Ashmore, MSCI. Data reflects the correlation of monthly returns from July 2012 – July 2018.

Moreover, the universe of low correlated markets leads FM's aggregate volatility to be lower than often perceived. Over the past three years to 30 June, the annualised volatility of the MSCI FM index is 12%, this compares to 11% for the MSCI World and 16% for the MSCI EM.

IMPLICATION

FM comprise structurally higher returning and yielding companies that have lower correlations and volatility than EM providing attractive diversification benefits.

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