Eq EQUITIES

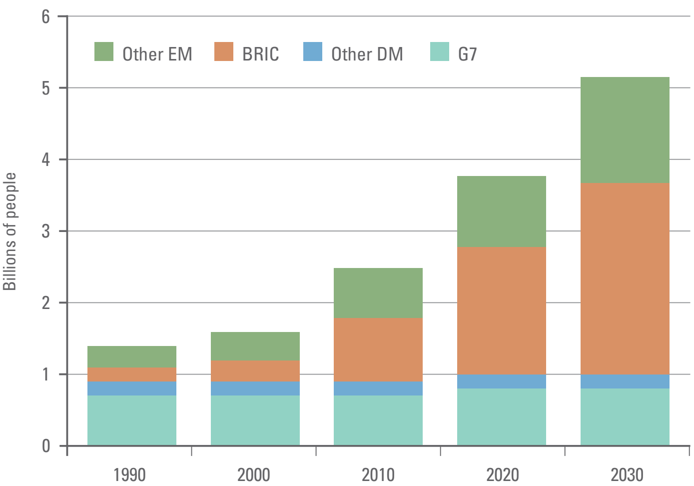
# Emerging Markets small caps – growing up fast

By Michael Mulvihill, CFA and Ted Smith

**Emerging Markets equities have matured as an asset class. Once-controversial arguments for investing in Emerging Markets (EM) are now widely accepted and most large institutional portfolios have a dedicated strategic exposure.**

As a group, emerging economies are growing faster than developed economies and will continue to do so for the foreseeable future. Starting from a lower income base helps, and favourable demographics, rapid urbanisation, and large populations of ready workers and consumers are key drivers (see figure 1). This backdrop provides fertile ground for existing companies and new market entrants to grow earnings quickly. At the same time, the reluctance of global investors to delve too deeply into the weeds when putting money to work there leaves occasional pockets of value. For asset allocators, EM equities provide diversification and, in return for modestly higher volatility, have delivered on the promise of higher returns.

Fig 1: **Population with incomes above USD 6k per annum**




Source: IMF World Economic Outlook, April 2013, World Bank.

Many investors still treat EM equities like an immature child, despite their having grown up. They constrain EM equities to a single 'broad-market' allocation, which practically means large-caps only. They resist engaging with EM in the same way they do with EM's siblings in the developed world—with specialist managers and dedicated exposure to both large caps and their smaller peers (not to mention the nine 'style boxes').

Investors appear uneasy with an allocation that calls too much attention to the rowdier side of the EM markets, for reasons that are sometimes unclear and often unfounded. But EM equity markets have matured and it's time for investors to pay more attention to how they construct their EM allocations and to give small-cap stocks the attention they deserve. The most common arguments in support of the current unequal treatment are not very compelling.

## Too small to make a difference?

The first justification for dismissing small cap EM stocks is that an EM allocation of, say 5%, doesn't warrant the attention that one affords to developed market equity. The EM equity allocation is too small to bother. But EM equities as a whole have grown to about 12% of global equities when measured by capitalisation-weighted indices. Moreover, EM's weight in a global index is not a direct measure of its relevance to investors. The reason to make a strategic allocation to equities in the first place is to share broadly in private sector wealth creation, which is only approximated by the growth in public companies' earnings, dividends, and assets. Wealth creation is at the heart of the emerging countries leveraging vast populations, natural resources, and other competitive advantages. They make up roughly 50% of the global economy, host more than 80% of the global population, and hold nearly 80% of global foreign exchange reserves. Economically speaking, EM countries punch above their weight. Market indices understate the magnitude of this wealth creation to a greater degree in emerging countries than in the developed world due to the much lower market cap/GDP ratios found there.

Another reason to increase one's allocation to EM equities above their current market cap weight should be familiar to any parent: they're growing so fast. Rather than setting an EM allocation based on weights that reflect the current state of the markets, it makes sense to plan for future growth. After all, playing catch-up has never been a successful investment strategy.

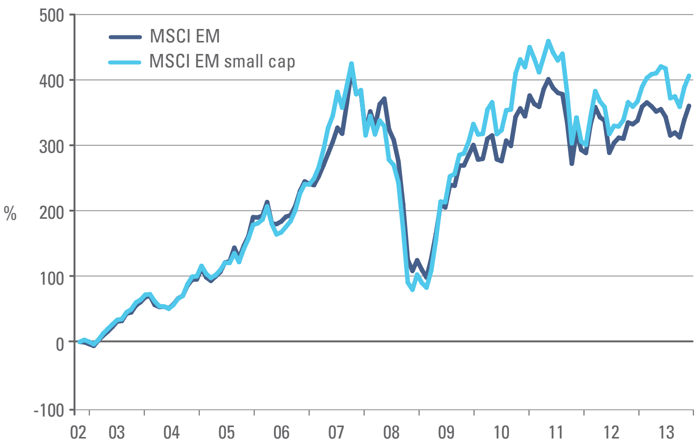
## A little more volatile, but worth it

The second excuse investors offer for avoiding EM small caps is the mistaken belief that they're much riskier than large caps. Of course, like developed market equities, small cap companies in EM do carry some additional risks relative to the broad market, such as less diversified revenue sources, less access to external capital, and ultimately, somewhat higher volatility. Fair enough, but the historical out-performance of small caps has come at a very modest cost – over the past five years, the small cap index has been only slightly more volatile, with a standard deviation of 24.8% vs. 22.9% for the broad index. That's a small price to pay.

The relatively good behaviour of EM small caps may surprise investors who believe that a risky segment within a risky asset class adds up to double trouble. On the contrary, multiple risk factors (unless they're perfectly correlated) always diversify – they partially offset each other, while the risk premiums associated with them accumulate. Enter correlations. EM small caps aren't exactly renegades, but their correlations with developed market equity indices over the past five years are a bit lower than those of the broad EM indices: the MSCI EM Small Cap index indicates a correlation of 74% relative to the S&P500, while the MSCI EM index registers 80%. While that is a welcome statistic for those seeking to diversify risk, it probably doesn't tell the entire story. A large portion of the small cap Emerging Markets universe sits outside the index, which means that there are considerable opportunities to find companies and build portfolios with even lower correlations to developed market equities for those with the skills to find them.

Of course, the more compelling reason to embrace EM small caps is to enjoy the long-term growth. As in developed markets, EM small cap companies tend to grow faster than large caps, and their prices tend to follow. The MSCI EM Small Cap index has outperformed the MSCI EM index in nine of the past thirteen years. That's 69% of the time. Over the past decade, on a cumulative basis, the small cap index returned 408.6%, beating its big EM brother by 46.1% (see figure 2). The past year was similar, with the small cap index outpacing the broad index by 3.6%. Long-term investors in EM small caps have endured some growing pains, but they can look back on their returns with some satisfaction.

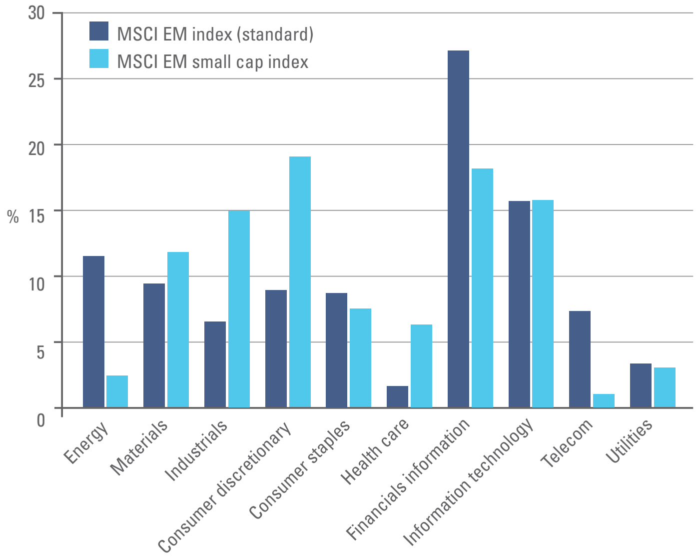
Fig 2: **EM small cap equities vs. EM all cap equities**




Source: Bloomberg, MSCI as at 30 November 2013.

But is the growth spurt over? Not likely. As their growing populations become wealthier and consume more, EM governments are working to restructure their economies to produce more of those (largely middle-class) consumer goods and services locally. Small cap Emerging Markets companies as a group are uniquely positioned to capitalise on the growth in domestic consumption when compared with the larger domestic companies, many of which are true multinationals with a global revenue base. They are armed with local market knowledge that allows them to create targeted business models or build supply and distribution chains uniquely suited to their market niche. Component parts suppliers to local OEMs retail stores, hospitals and pharmacies are just a few examples of companies geared to urbanisation and growing local consumption trends. These companies fall primarily into the industrials, consumer discretionary, and health care sectors of the market. Compared with the large and mega cap dominated broad indices, the small cap EM indices are more heavily weighted toward these sectors, while the energy and financials sectors capture a far higher percentage of the standard indices (see figure 3). To put it plainly, within the small cap segment, investors will find more of the long-term growth drivers they want from their EM equity allocation.

Fig 3: **Sector weights by EM index**



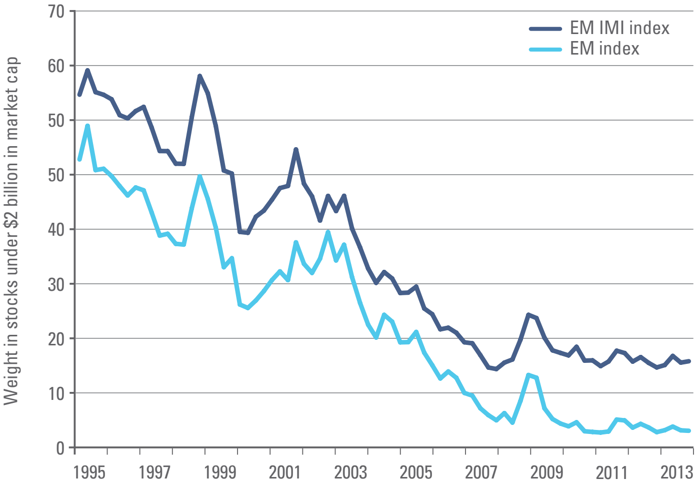

Source: MSCI as at 30 November 2013.

In many regions where small companies have thrived, they have also evolved in recent years and now offer more professional management, increased transparency, and better corporate governance. At Ashmore, we look for (and find) Emerging Markets small cap companies that have long track records of stable management and proven business models. With the broad adoption of international accounting standards, strengths and weaknesses are increasingly reflected in financial statements with sufficient detail and reliability to provide a firm basis for assessing their intrinsic values. The higher quality of information allows us, and other investors, to project valuations with greater confidence, thus contributing to lower risk premiums and higher price multiples that benefit shareholders in the long run.

## Low representation despite the growth

The third justification investors proffer when giving EM small caps short shrift is the common belief that the single EM allocation already includes enough small caps. On the contrary, EM small caps were once key players in some of the major indices, but are now largely sidelined. As shown in figure 4, in the early days small cap stocks constituted about 50% of the MSCI EM Index's capitalisation, but have now fallen off to a mere 2.5%. The introduction of the 'broad-market' IMI index series in 2008 explains some of the decline, but doesn't solve the problem: that index's small-cap exposure is equally fleeting, falling from nearly two-thirds to just under 14% currently. Asset allocation studies based on these indices should account for the fact that the historical make up of these indices comes courtesy of a heavy dose of now absent small cap stocks. Investors who want to replicate the historical characteristics or behaviour of these indices may need to add an allocation to EM small caps.

Fig 4: **MSCI EM indices historical weight in small caps**




Source: MSCI.

Active managers perform a small-cap disappearing act of their own. Managers with successful EM products face constant pressure to move up to the bigger playground of large caps as assets grow. The largest EM funds with decade-long records in Morningstar's database seem to illustrate this pressure (see figure 5). In 2004 the average of the group's market cap was less than USD 5bn, but it marched upward in the ensuing years as average AUM climbed. The average market cap finally topped out at about USD 20bn, aping the large-cap bias of the major indices. Over the past decade, the average market cap of the largest EM equity funds has increased a whopping 400%. To be fair, such a portfolio may be a reasonable representation of the asset class, given that the indices are dominated by large and mid cap stocks, but it may miss out on many of the advantages small caps offer.

The best remedy is to partition one's EM allocation into separate broad market and small cap strategies. Although managers of all strategies face the same general problem of capping their funds' assets before they grow too large to be managed effectively, the best way to ensure small cap exposure is to allocate to a fund dedicated to that market segment.

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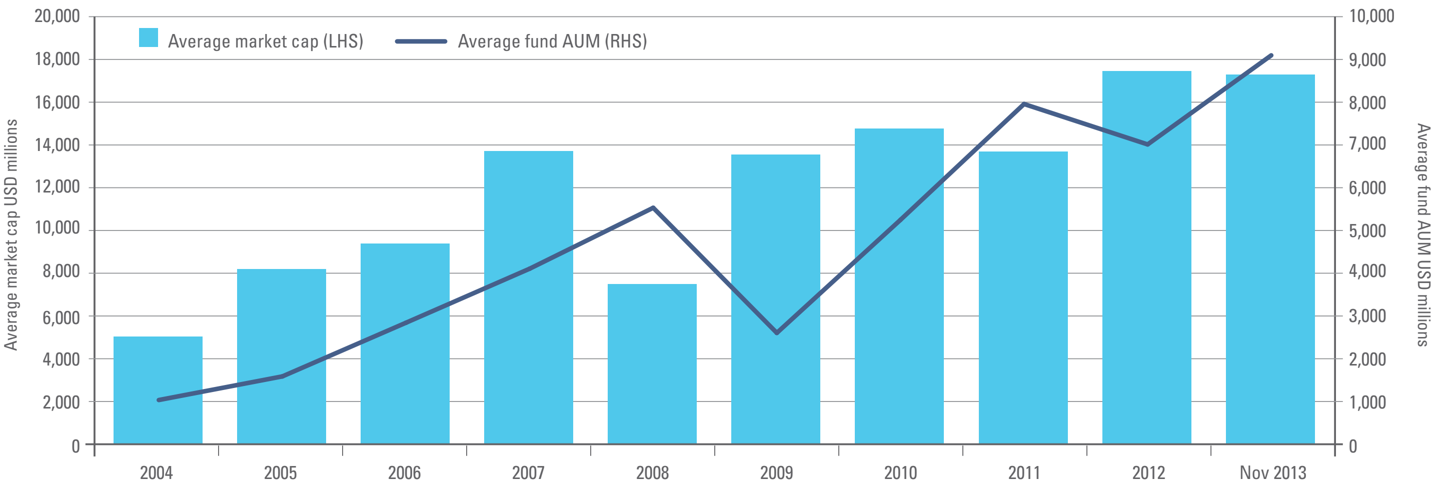
### Missed opportunities

Small cap stocks as a group represent a less efficient corner of the equity world than larger companies. By definition, small-cap stocks have a smaller investor base, which is closely correlated with lower trading volumes (i.e. lower liquidity). Because the ubiquitous sell-side earnings forecasts and company reports are not provided as a free public service, stocks with less than USD 2bn in market cap generally have insufficient trading volume to make it into the investment bankers' clique. There is no place for them within the sell-side business model. With less information readily available about a company, its market price is less likely to efficiently reflect all relevant information. In addition, some Emerging Markets are dominated by local retail investors, who may be less enamored with sell-side research and make their investment decisions on other factors, further complicating the market's natural process of price discovery. This is where talented stock pickers go to flex their muscles.

Apparently those active stock pickers have been taking their vitamins. Dedicated EM small cap funds are a rare breed, but three of the four separate accounts with five-year track records in the Morningstar database outperformed both the MSCI Emerging Markets index and the MSCI EM Small Cap index (see figure 6, overleaf). Further, all produced this performance with less volatility than the MSCI EM Small Cap index. Two also demonstrated less volatility than the MSCI EM index. That data

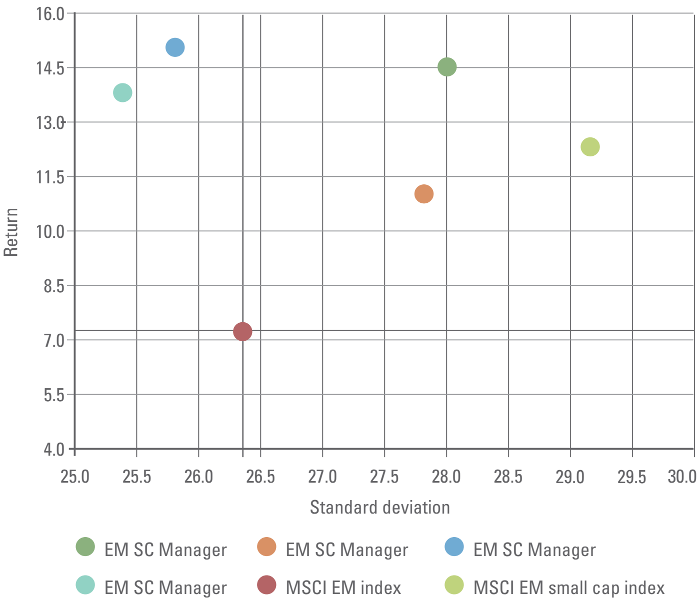
Fig 5: **Cap creeping up as funds grow**




Source: Morningstar Direct as at 30 September 2013. Funds selected were top active managers by AUM.

is too sparse to support a firm conclusion, but the pattern suggests that active managers are regularly identifying and exploiting mis-pricings – they are taming the wild child of the EM universe. Given investors generally like to overweight investment strategies that produce better risk adjusted returns, this would argue that an overweight in active EM small cap is a good portfolio construction bet.

Fig 6: **5-year returns and standard deviation of actively managed EM small cap portfolios**




Source: Morningstar Direct as at 30 September 2013.

## What's the right number?

Even the most sophisticated institutional investors frequently ask us, 'So what SHOULD we allocate to EM small caps?' In response, we often start by reminding investors that a neutral weighting to EM equities generally, based on the relative GDP of developed and Emerging Markets (PPP adjusted), would require investors with no home-country bias or pressing income requirements to allocate about half (50%) of their equity portfolios to Emerging Markets securities. Since global GDP is slowly, but inexorably, shifting towards EM, investors who want to be ahead of the curve may consider over-weighting EM sooner rather than later. It's never too soon to start a good habit.

While this seems like a logical solution, most investors from developed markets have chosen to build this allocation over time. Industry data suggests that both retail and institutional investors have steadily increased their allocations to Emerging Markets. But there is still a long way to go. For example, funds in Morningstar's Diversified Emerging Markets category accounted for USD 250bn, or only about 3% of equity fund assets. And according to a recent BAML survey, institutional investors are currently about 15% underweight Emerging Markets equities – a greater underweight than at any time in the past decade, save for the extreme period in 2009. Investors looking to redress this imbalance may want to consider breaking with the single manager, broad market solution and its (likely) high concentration in larger companies by adding a small cap portfolio to their EM equity allocations.

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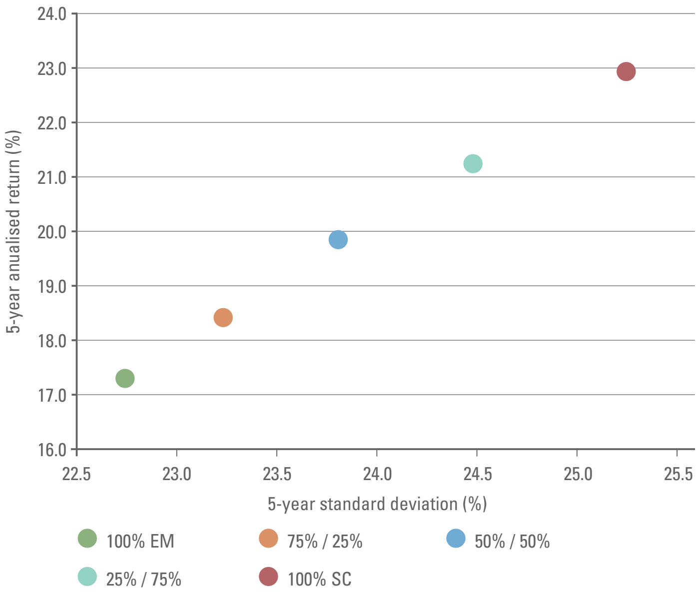
It would probably be a welcome addition, as evidenced by small cap returns over the past 5 years. Investors would have benefitted then from splitting their allocation between traditional and small cap EM portfolios. Given that EM small caps have higher historical returns and similar volatility to broad EM indices, plus lower correlations to developed equities, they're likely to dominate a large cap EM portfolio in a fair fight. For the sake of illustration, consider an investment in a portfolio split evenly (50/50) between the MSCI EM index and the MSCI EM Small Cap index. The blended allocation outperformed the former by about 2.5% per annum over the past five years with only slightly more volatility (about 1% higher, see figure 7). The slope of the improvement is steep and suggests that only an investor with a very high risk aversion would prefer the single broad market allocation.

Fig 7: **5 year risk/return efficient frontier**




Source: MSCI, Morningstar Direct as at 30 September 2013.

### The risk of missing out

It's time investors took emerging small cap stocks seriously.

By systematically ignoring smaller companies within Emerging Markets, we run the risk of missing out on the very types of investments that attracted us to the asset class in the first place: high growth companies with diversification benefits. Investors need to give their EM allocations a little room to spread their wings.

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