Emerging market equities – navigating a bumpy but attractive route

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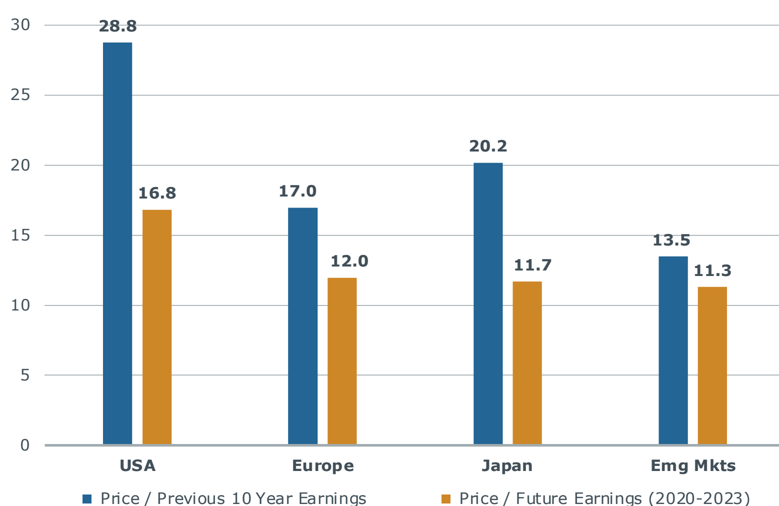
In 1990, developed markets accounted for just over 60% of global GDP and emerging markets for just under 40%. Today, the ratio is reversed.[1] At the same time, the weighting of emerging markets in the MSCI All Country World Index has only risen from less than 5% to just over 10%[2], showing room for expansion. For asset owners, a meaningful allocation to emerging market equities is justified by the likelihood that market capitalisation will continue to rise.

Not only does long-term GDP growth support an investment in EM equities, but current valuation levels suggest that the past outperformance of developed markets is unlikely to be repeated over the next decade. While many emerging markets remain cheap relative to past and forward earnings, developed markets look overvalued. The chart below shows the current P/E ratios of different markets. With a P/E ratio of 11, emerging markets look much more attractive than, for example, the US equity market at almost 17.

Global equity valuations



Source: Datastream, IBES; as of February 2023

At the same time, geopolitical crises tend to hit emerging markets first. Emerging markets are often characterised by political instability and often experience higher levels of inflation and currency volatility than developed markets. In addition, there tends to be less intervention in capital flows in times of crisis, which increases the risk for investors who focus on isolated, concentrated positions. If we look at the realised volatility of the market capitalisation index, we see that the average annualised volatility in emerging markets from 1987 to the present is 22%, while the same figure for developed markets is only 15% annualised. The resulting volatility can lead to a bumpy road for institutional investors and critical questions from stakeholders.

The holes in the road: cluster risks

An easy way to increase exposure to emerging markets would be to add a broad index position to the overall portfolio, but cluster risks are guaranteed. The first cluster risk is size - the top 10 of over 1300 stocks of the main emerging market equity index account for 23% of the index weight. In addition, two-thirds of the index is invested in global cyclicals, which include technology, materials, energy and financials. Finally, investors are exposed to single-sector risk: 20% of the index is invested in large-cap technology stocks. The tipping point for this overweighting came in October 2021, when the combined weight of the top 10 index constituents approached 30%. Since then, the combined weight has fallen substantially as these large-cap tech stocks

Top 10 stock weights in MSCI EM over time

Source: MSCI Inc.

have corrected sharply, bringing astronomical valuations back to still-elevated levels. Buying the index in emerging market stocks leaves investors with only a third of their portfolio exposed to local growth stocks.[2]

If volatility and cluster risk are two of the main obstacles to investing in emerging market equities, how can these challenges be overcome? We suggest a highly diversified defensive equity strategy with a low volatility approach. Such an approach requires investors to be willing to accept a high active share. This means reducing weightings in the top 10 stocks and extreme positions in global cyclicals and technology, while increasing positions in local companies.

To diversify the portfolio and take advantage of smaller stocks and local opportunities, the manager needs to cover the global EM universe beyond the 1300+ stocks in the standard benchmark. For example, using a data-driven systematic investment process, we can generate alpha, risk and liquidity forecasts for over 3000 EM stocks and actively invest in 200-300 stocks, depending on the size of the portfolio. The resulting portfolio has only 16% in the top 10 stocks and 10% in large cap technology, but the position in local companies investing in infrastructure, consumer goods and healthcare rises to 45%.

In addition to increasing the diversity of the portfolio, we propose an investment approach that exploits the low-risk anomaly, the observation that lower-risk stocks often generate higher risk-adjusted returns. The main benefit of a low-volatility approach is to achieve market-like returns with lower drawdowns. It is a tool to achieve market exposure with lower risk and the compounding effect will lead to higher returns over the long term.

A diversified approach provides a smoother ride

Moreover, in an overall environment where the money supply is shrinking and the equity returns are expected to be lower, the compounding effect becomes even more important as it has a greater relative impact on total return. Avoiding outsized losses is critical. If two stocks have the same average expected return and are held for several periods, the stock with the lower volatility will have the higher cumulative return. This effect is known as volatility drag. Therefore, a systematic approach to investing in emerging market equities that focuses on risk mitigation and high levels of diversification can provide a smoother ride.

FOOTNOTES:
1 Source: Bloomberg
2 Source: MSCI Inc.

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