Sharpe contrast

Unlike the position in western markets, emerging market smaller company stocks are significantly less volatile than their larger cap peers. Coupled with their history of outperformance, they offer the potential for excellent risk-adjusted returns but European investors have been slow to seize upon the opportunity this presents.

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The world's emerging equity markets have always played host to 'hot money' and the rising liquidity of these markets coupled with the growth of exchange trade funds (ETFs) and other passive approaches has only exacerbated the problem. Hence, overseas investors who select to invest via the MSCI Emerging Market Index are not only subject to the increased country effect that is a prominent feature of emerging market (EM) equities, they're also vulnerable to the heightened political sensitivity that attaches to the largest stocks.

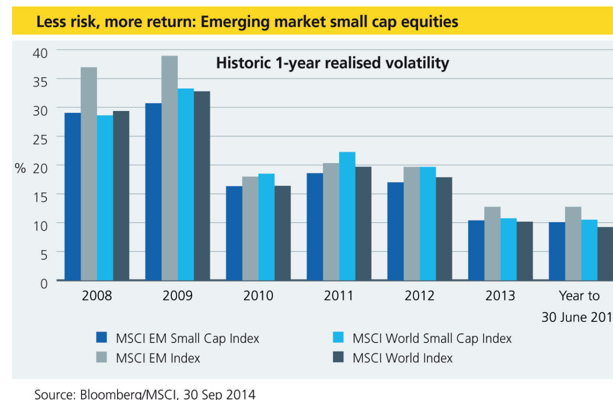
A good example of this is the Brazilian oil giant Petrobras. Its fortunes have see-sawed wildly this year at the prospect of a replacement for President Dilma Rousseff and its role in a corruption scandal linked to Rousseff's Workers Party. The volatility of its share price reflects this.

Capturing the key themes

Another important consideration is the fact that the large cap index is dominated by financial, commodity, energy and heavy industrial stocks. Indeed, financial and commodity stocks alone account for just under half the large cap market. The larger of the two, financials, is dominated by monolithic quasi-state entities such as People's Bank of China, Sberbank of Russia or Brazil's Itaú Unibanco. Meanwhile, the market's commodity stocks, like those elsewhere, are subject to the 'super-cycle' and the prospect of slowing demand from a rapidly cooling Chinese economy. This means that neither sector offers investors access to the key investment themes that are most appealing to western investors.

In recent years, emerging markets have been transformed by rising productivity and household incomes, the spread of urbanisation and the related growth of a new middle class. Indeed, figures from the World Bank forecast that around 800 million new consumers will achieve middle-class status by 2030, by which time over 90 per cent will be located within India and China.

The opportunity to invest in such consumer-driven growth is one of the key attractions of emerging markets but consumer-related stocks only account for around 17 per cent of the large cap index. By contrast, well over 25 per cent of the MSCI Emerging Market Small Cap Index is composed of consumer stocks while it also offers far greater weightings in healthcare and industrial stocks – both areas that are set to benefit from rising levels of disposable income.



Source: Bloomberg/MSCI, 30 Sep 2014

Strange but true...

This, and the fact that EM small cap stocks are understandably less liquid, accounts for why they are less volatile than their larger counterparts. As the chart shows, the average realised one-year volatility of the market is in line with, or frequently lower than, that of global equities. Over the periods shown, market volatility was significantly lower for smaller EM stocks than larger ones and, since the financial crisis, EM small caps have exhibited less volatility than global small cap equities in every year except 2008. This means that, contrary to received wisdom, an exposure to EM small cap companies offers the prospect for emerging market investors to reduce their risk exposure.

Under the radar

In total there are some 830 stocks in the emerging market large cap index, almost one thousand less than in the smaller company index. By including companies from US$150 million in size in both emerging and frontier markets, as well as western registered companies with the majority of their operations in these markets, the universe grows to well over 4,000 companies. As elsewhere, analyst coverage of smaller company stocks is far more limited than for larger stocks. We estimate that almost a quarter of all EM small caps have no analyst coverage at all, while close to 45 per cent have two analysts or less. This presents those fund managers with dedicated research capabilities with a genuine information advantage and the opportunity to generate true alpha from their portfolios.

Of course, making progress requires a patient approach. As we've seen, smaller company stocks in the emerging world are more likely to be driven by fundamentals than larger stocks where politics and international 'hot money' play a far greater part. However, the paucity of analyst coverage means that it can take longer for fundamental strengths to be recognised by the market and for a stock to re-rate. This means that it can take three years or more to see stock picks come good.

Our approach stresses fundamental factors such as barriers to entry and financial strength and is cautious of companies that frequently return to the market for additional funding. To invest, we must see evidence of high and sustainable returns, a robust balance sheet and strong cash flows. A consistent dividend is another attractive trait as it suggests a board focused on delivering shareholder value. It goes hand in hand with the consistent delivery of corporate strategy and the alignment of management with minority shareholders, which are also critical factors for us.

Clearly emerging market small caps offer the best potential to capture the long-term growth within emerging countries, so finding a manager with proven research capabilities and a disciplined approach to valuation remains the key to making the most of this overlooked asset class.

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