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Despite Global Turmoil, Here's Why Investors Shouldn't Write Ofi Emerging Markets: Meketa

By EDITORIAL

By: Alison Adams, Hayley Tran and Larry Witt, Meketa Investment Group

The blunt shock of Russia's invasion of Ukraine has made the risk of emerging markets (EM) more starkly obvious, roiling markets and compelling asset owners to reassess EM exposures across their portfolios. Add to the list of concerns of a global recession, rising tensions between China and Taiwan and increasing chatter of collaboration between China and Russia (potentially accelerating Moscow's so-called "pivot to Asia"), and observers have begun to question if EM might carry more risk than institutions can tolerate.

Moreover, since the global financial crisis of 2008-2009, emerging markets equities have generally lagged U.S. equities fueling EM fatigue, disappointing institutional investors who have historically expected more attractive relative returns.

As the alternating risk-on/risk-off behavior of investors tends to be amplified amid political and economic stress, recent market swings are accentuating the perceived vulnerability of developing economies. At the same time, emerging markets equity valuations look attractive as multiples trade at levels well below their own history — a PE multiple of 15.4 in early 2022 compared to an average of 17.1 since 2000 — and those of the U.S. and developed markets. Since the inception of the asset class in the 1980s, emerging markets equities have weathered wars, energy crises, defaults and financial crises where the overall price rise over time reflects the resiliency of the asset class.

To be sure, the core of the investment thesis remains largely intact. On the macro level, EM economies are expected to grow faster for the next 10 years than their developed-market counterparts, according to the Conference Board. Moreover, emerging markets continue to be underrepresented from a market capitalization and GDP-weighted standpoint. Through much of the 1990s, legacy quasi-state-owned companies in the energy and financial services

sectors dominated the EM story. But today, EM is a dynamic asset class where technology, communications and consumer services are gaining market share and successful investing may require nimble strategies to adapt and capture the same growth that underpinned EM prior to the global financial crisis.

The urbanization and rapid technological advancement of the general population in developing economies adds another catalyst that could accelerate growth. The relatively younger populations of EM countries, perhaps not surprisingly, are also faster adopters of new technology. Looking at the broader Asia-Pacific region, for instance, 60% of consumers use digital wallets, and in China, 72% of payments are conducted through leading digital platforms, according to the Payment Almanac published by PPRO.

This is not to say there aren't question marks. As it relates to the traditional role of EM exposures within a portfolio, for instance, some are uncertain it will offer the same level of diversification. Globalization has provided a tailwind to asset growth over the past two decades but has also led to increased correlation between EM equities and developed markets. Some might argue that deglobalization is now underway given current geopolitical landscape. Furthermore, emerging markets companies have become much less export dependent and much more domestic demand-driven than in the past. Both bode well for increasing diversification benefits going forward.

It's against this backdrop a few strategic considerations are surfacing. China, for instance, continues to provide a source of growth to EM investors, but rising concentration is a material risk. From an index perspective, much of the emerging markets growth will be generated from Asia. China, Taiwan, Korea and India together represent 73% of the **MSCI** EM index while Asia accounts for 77% of the index, as of March 2022. The MSCI EM index, some might argue, essentially serves as an Asia ex-Japan proxy.

This, in turn, is influencing where and how institutions build out EM exposures. At the top-down level, some asset owners are outsourcing EM weighting decisions to nimble global or international equity managers who are more able to tactically dial up or dial down their EM exposures against the MSCI ACWI and ACWI-ex US benchmarks. For context, emerging market stocks comprise roughly 11% of the ACWI index and 29% of the ACWI-ex U.S as of March 31.

Those with a strategic asset allocation to emerging markets equity could look to reconstruct the building blocks to fine tune their exposures within EM. Some, for instance, opt for all-cap strategies benchmarking against MSCI EM IMI or add dedicated small cap-exposures to balance large cap top-heavy MSCI EM allocations. Alternatively, some deconstruct the benchmark into dedicated China and EM ex-China exposures to better control their concentration risk and give the institutions more say in tactical bets. And others will have a core-satellite approach with the use of a passive index or a low tracking error (or low vol) mandate as core, preferring to deploy their risk budgets on regional or niche approaches more broadly.

Both active and passive management can be appropriate portfolio construction options. Given the complexity and expertise required in this space — and the wide divergence between the top and bottom quartiles of active managers, manager selection can take on heightened importance.

If there's one universal truth in emerging markets investing, it's that there is no single "right way" to access the asset class.

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