Emerging Markets – The Growing Opportunity

By Claire Noel

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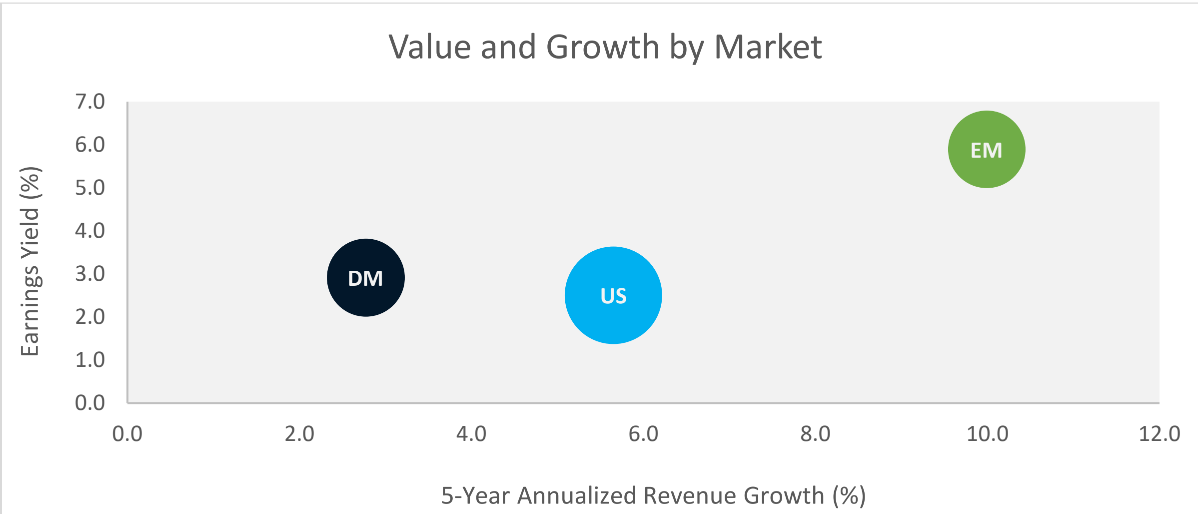

***Figure 1**: Value and growth for emerging markets (EM), developed markets ex-U.S. (DM), and the United States (U.S.). Earnings yield is computed as sum(trailing 12-month earnings)/sum(market capitalization) as of 6/30/2021. Revenue growth is a compound annual growth rate (CAGR) from 12/31/2015 through 6/30/2021 with dividends converted into share buybacks. Both measures are computed over a universe of the largest 12,000 companies world-wide. Bubble size corresponds to the relative market cap in each region.*

Introduction

This week we launched a suite of international emerging markets (EM) and developed markets (DM) ADR strategies on Canvas.

We believe there is a compelling case for investing overseas, specifically in emerging markets due to their increasing accessibility, rapid growth, attractive valuations, and diversification potential. We discuss some highlights below.

Background

Historically, emerging markets have been difficult for the average U.S. investor to access. Low liquidity, high costs, mounds of paperwork, and foreign investor restrictions were, and still are, major impediments to direct investment.

Fortunately, some of those barriers have lifted. There are now more than 400 liquid American Depository Receipts (ADRs) representing companies located in emerging markets, as well as a broad array of emerging markets ETFs.

Growth and Value Opportunities

It is difficult to find high expected returns with equity prices at all-time peaks; however, on a relative basis, emerging markets look like a bargain with a P/E multiple of 17x versus 34x and 40x in developed international and the U.S. respectively.

EM companies are not cheap for lack of fundamental earning power either. In fact, they have higher growth and profit margins than both the U.S. and developed international regions. Valuations may be suppressed for other reasons, such as policy and ESG concerns, but if (or when) they revert to long-term fundamentals, the returns could be lucrative.

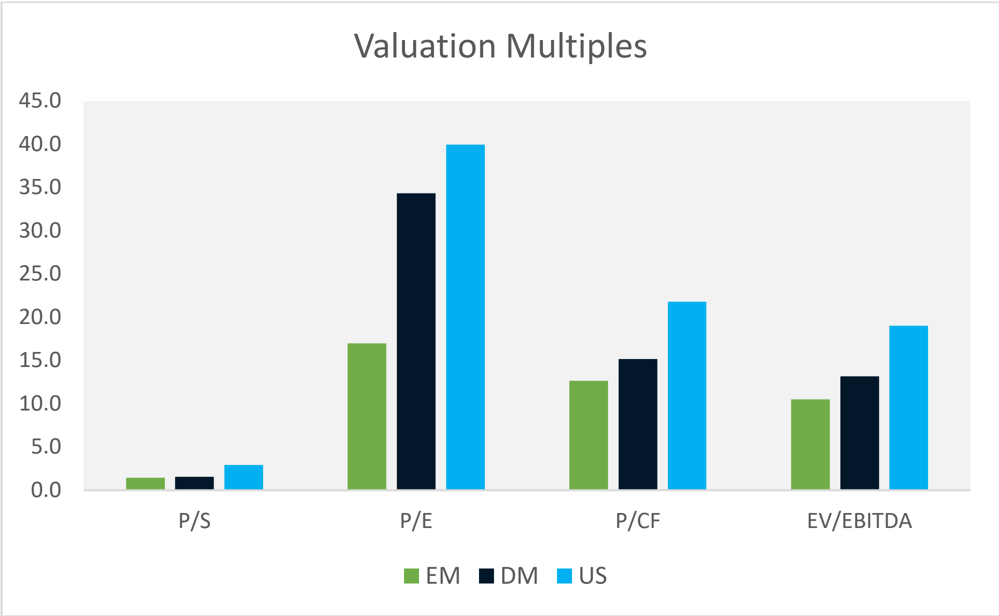

Figure 2*: Valuation multiples are computed as sum(market capitalization or enterprise value)/sum(trailing 12-month sales or earnings or cash flows or EBITDA) as of 6/30/2021. All measures are computed over a universe of the largest 12,000 companies world-wide.*

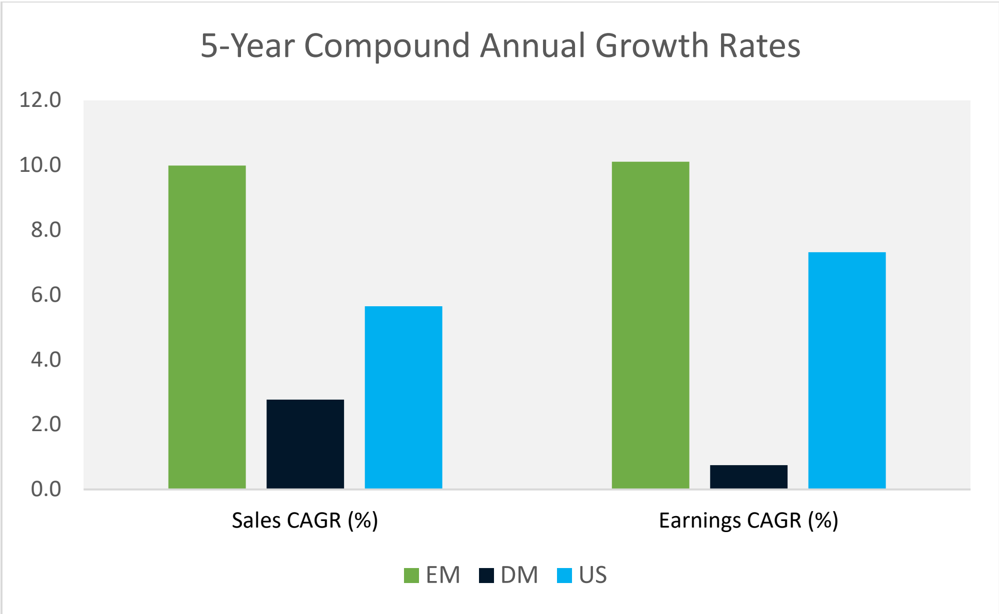

Figure 3*: Growth statistics are compound annual growth rates (CAGR) from 12/31/2015 through 6/30/2021 with dividends converted into share buybacks. Both measures are computed over a universe of the largest 12,000 companies world-wide.*

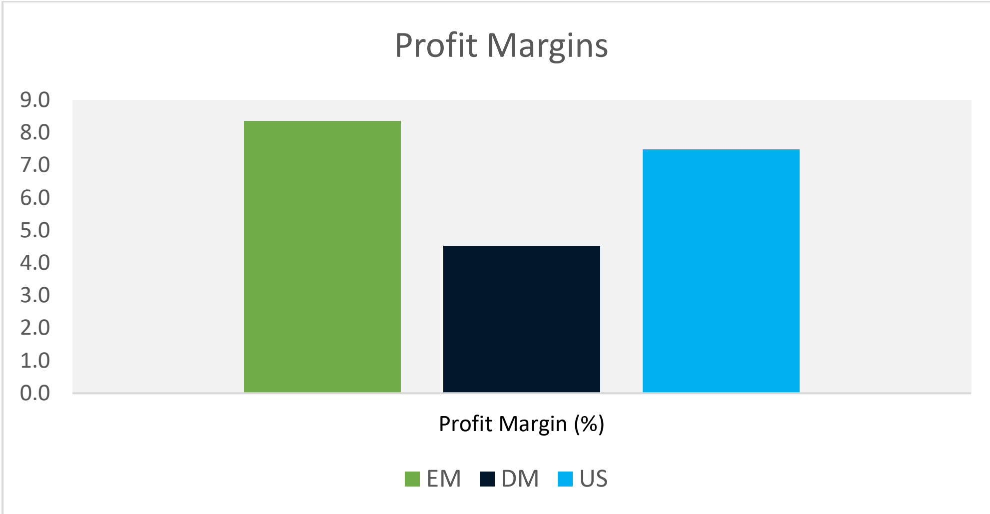

Figure 4*: Profit margin is computed as sum(trailing 12-month net income)/sum(trailing 12-month sales) as of 6/30/2021 over a universe of the largest 12,000 companies world-wide.*

Diversification

"I view diversification not only as a survival strategy but as an aggressive strategy, because the next windfall might come from a surprising place." - Peter Bernstein

Another reason to consider allocating to emerging markets is their relatively low correlation with developed markets. Many investors think about diversifying along the dimensions of U.S. and international, value and growth, and large and small cap. The MSCI Emerging Markets index has some of the lowest correlations with each of those segments, making it an effective diversification play, even for investors choosing among index-replicating equity strategies. Below we show the monthly return correlations among several major indices, representing different market caps, styles, and geographic buckets. A lighter blue color corresponds to a weaker relationship between month-to-month returns.

By extension, active EM strategies have even more diversification potential, which leads us to opportunities in active management.

Monthly Return Correlations (July 2000 through June 2021)

	Russell 1000	Russell 1000 Growth	Russell 1000 Value	Russell 2000	MSCI EAFE	MSCI EM
Russell 1000	1.00	0.96	0.94	0.86	0.82	0.71
Russell 1000 Growth	0.96	1.00	0.83	0.82	0.78	0.69
Russell 1000 Value	0.94	0.83	1.00	0.83	0.81	0.68
Russell 2000	0.86	0.82	0.83	1.00	0.71	0.66
MSCI EAFE	0.82	0.78	0.81	0.71	1.00	0.84
MSCI EM	0.71	0.69	0.68	0.66	0.84	1.00

Figure 5*: Spearman rank-order correlations of monthly index returns from July 2000 through 2021.*

CANVAS
An investment service of O'Shaughnessy Asset Management, LLC

Opportunities for Active Management

Emerging markets tend to be less efficient, and with that inefficiency comes greater opportunity for active managers to outperform. Decile return spreads to each of OSAM's factors are almost uniformly wider in EM than in other regions of the world. The long-term returns to value and growth are particularly strong, creating ripe opportunities for active managers presently.

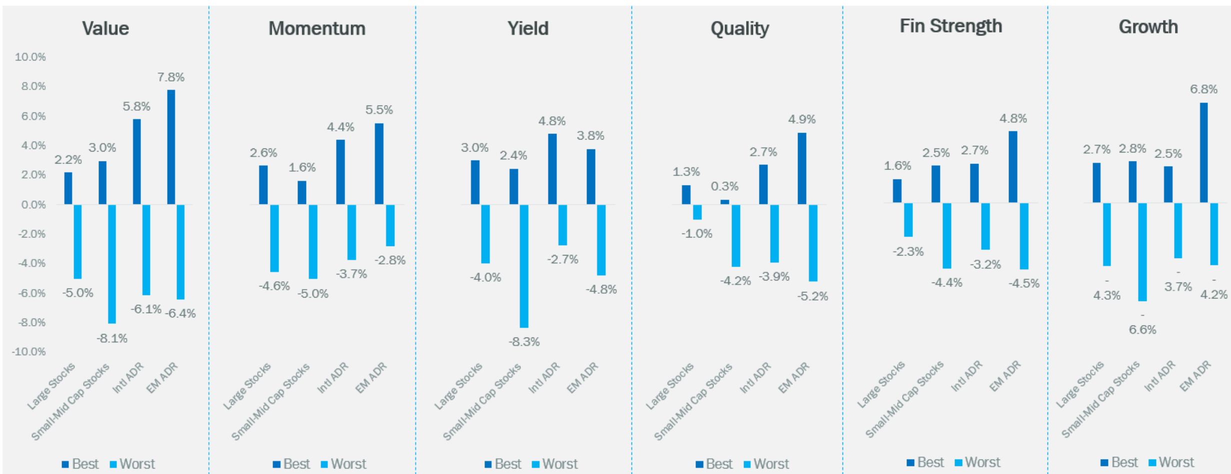

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***Figure 6**: Benchmark-relative top and bottom decile returns within OSAM's U.S. Large Cap, U.S. Small Cap, developed international ADR, and emerging markets ADR investment universes for the period spanning January 1996 through April 2021.*

China – Too Big to Ignore

Finally, a discussion of emerging markets would be incomplete without mention of China. China is by far the largest country in the MSCI EM index with a weight of 37%. It is also the most populous country in the world and second only to the United States in terms of GDP. However, it is still exceedingly under-represented in most passive equity allocations with a weight of only 4.8% in the MSCI ACWI. China's full float-adjusted market cap is closer to 10% of world markets and 50% of emerging markets. This is a big gap, by far the largest gap in country representation.

On the heels of the "China Connect"[1] access program that allows foreigners to access local Chinese markets, index providers are beginning to recognize China's influence in world markets with roadmaps for A-Shares[2] inclusion and specialized China indices[3].

Despite political tensions between the U.S. and China, at least 20 Chinese companies have already gone public in the U.S. this year, furthering the trend of improving market accessibility and demonstrating Chinese business owners' strong desire for foreign funding.

[1] https://www.hkex.com.hk/Mutual-Market/Stock-Connect?sc_lang=en
[2] China A-shares trade on the two Chinese mainland stock exchanges, the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE). Historically, only mainland citizens could own China A-shares due to restrictions on foreign investment. Now, via the China Connect mutual market access program, foreigners can invest in mainland companies.
[3] https://www.msci.com/our-solutions/indexes/china-investing
https://www.ftserussell.com/index/spotlight/china-indexes

In the near term, the mechanisms by which Chinese markets open to U.S. investment may largely depend on the U.S. and China's foreign policies, but given the heft of both countries' economies, it is almost inevitable that they will become ever-more integrated and important to investors. The increasing recognition of China's weight in passive allocations, along with improvements in foreign access, could provide a strong structural tailwind for Chinese equities.

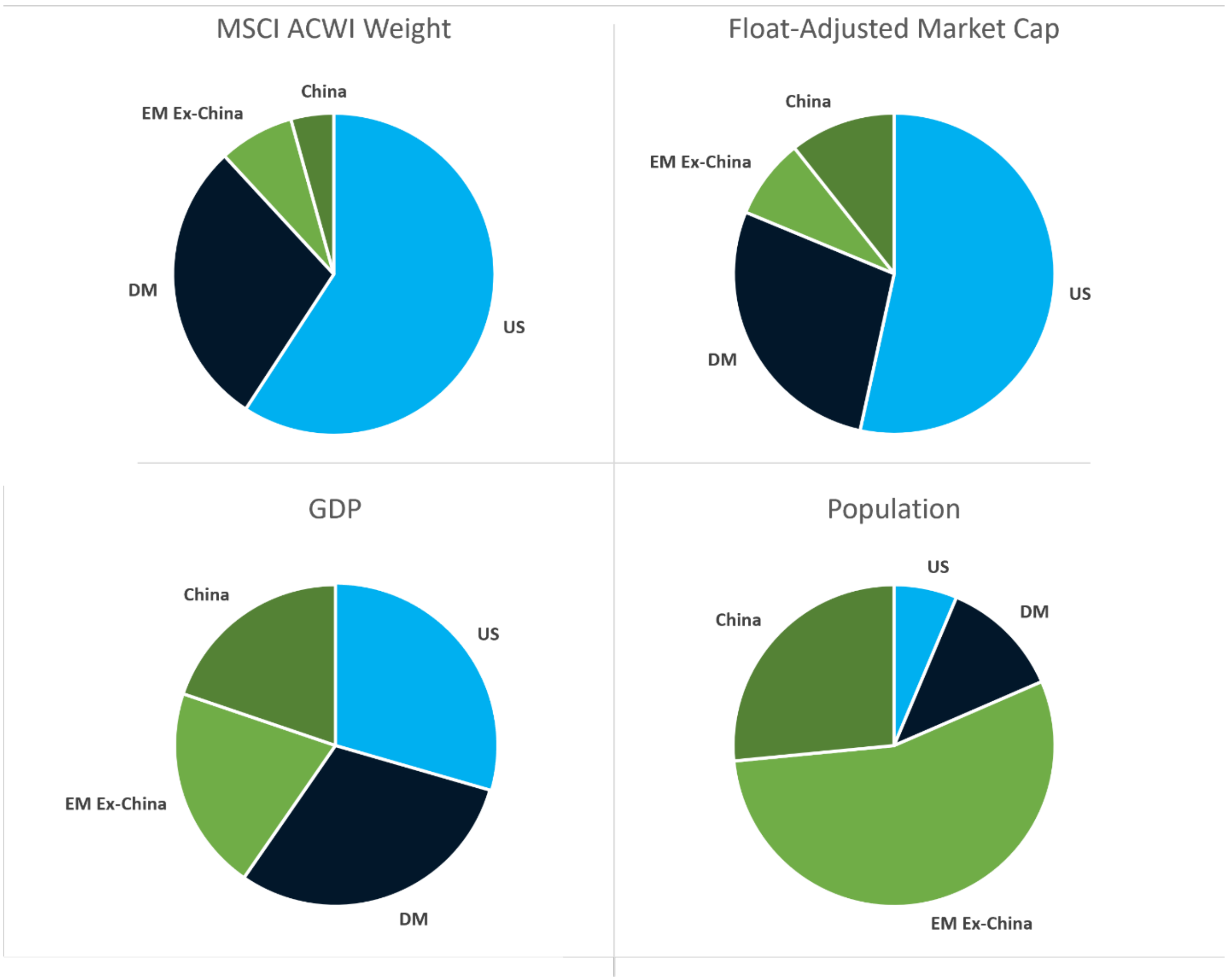

Figure 7: *MSCI weights and float-adjusted market caps as of 6/30/2021. The break-down of float-adjusted market cap is based on a universe of the largest 12,000 companies world-wide. GDP and population are sourced from the World Bank (https://data.worldbank.org/indicator/NY.GDP.MKTP.CD and https://data.worldbank.org/indicator/SP.POP.TOTL).*

Conclusion

We have outlined several reasons to invest in emerging markets, namely high expected returns and diversification; however, there is inherent risk. We believe that current prices reflect more risk than warranted, but it is risk, nonetheless. Canvas empowers investors to decide how to precisely allocate to developed, emerging, and U.S. markets while also managing for taxes and ESG preferences. Armed with a customizable toolset, we leave the decision to our partner clients and look forward to the feedback.

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For the full composite performance summary of this strategy. please follow this link: http://www.osam.com

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