

Emerging Markets

EM equities: beware of the benchmark

beyondbrics

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Emerging equity markets have cumulatively under-performed developed equity markets by 70 per cent over the past six years¹. Most investors are now underweight EM equities as a result. But, based on the record number of queries we are receiving from institutional investors, it appears that large asset owners around the world are looking to rebuild these positions. We encourage investors to maintain a strategic allocation to the asset class.

It's possible that emerging markets are finally poised to outperform: growth opportunities are superior and valuations less demanding. More importantly, we believe that EM is amongst the richest of all equity markets in alpha opportunities, or the potential to generate excess return.

Alpha matters a lot in a low return world. That brings us to our highest conviction view on EM equity investing: beware of the benchmark and go active. Like all benchmarks weighted by market cap, the EM index suffers from being backward-looking: it is overweight yesterday's winners and under exposed to the biggest opportunities of the future. But the EM index also has unique challenges.

To begin with, state-owned enterprises (SOEs) comprise 28 per cent of the MSCI EM benchmark². In China, the largest country in the MSCI EM index, SOEs comprise roughly two-thirds

of the exposure. These companies are effectively an extension of the state and often serve government or public interests, rather than those of minority shareholders. This misalignment of interests can undermine corporate governance, resulting in severe misallocations of capital and poor returns. Unsurprisingly, we have found that over the past five years, SOEs have cumulatively under-performed stocks of private sector companies by 40 per cent³.

Another issue is the heavy weighting of energy and materials companies, which comprise close to 15 per cent of the index. Most are either state-owned or state-influenced. When commodity prices rise, these companies have a long track record of channelling higher revenues to areas that support the state but not necessarily shareholder returns. Even if one had an edge in predicting commodity prices, the link between prices and shareholder returns is simply broken. We currently invest less than 2 per cent of our global EM portfolios in materials and energy companies.

EM banks (17 per cent of the index) are similarly burdened with high levels of government ownership or intervention. Across Asia, the majority of listed banks are state-owned; in China, virtually 100 per cent. Chinese banks have been directing credit to strategically important sectors for years, in line with their goal of promoting economic stability rather than profitability. But banks could now bear the brunt of China's slower growth and the risk of all that credit creation. The challenge for market-cap weighted passive strategies is that Chinese banks represent nearly 5 per cent of the MSCI EM -a larger component of the index than the entirety of Russia or Mexico.

Government influence isn't the only problem. The telecom sector, which accounts for 7 per cent of the market cap-weighted index, is full of privately run companies. But they face cut-throat competitive dynamics, limited pricing power and a persistent inability to earn above their cost of capital. We struggle to find opportunities in the sector.

As an active manager, we look at an investible EM equity universe of about 6,000 companies, versus roughly 800 companies in the MSCI EM benchmark⁴. Expanding the EM universe provides a lot more flexibility to avoid unattractive businesses that dominate the index and invest in companies with higher return potential. We invest 50 per cent of our global EM portfolios in companies outside the standard index.

Where are we investing that capital?

In the financials sector, we see stock exchanges as much more attractive alternatives to SOE banks. We like these businesses because they have limited competition. They also require little capital and have strong cash-flow generation. We have over 10 per cent of our global EM portfolios invested in shares of exchanges around the world from Hong Kong to South Africa to Mexico. Unfortunately for market-cap weighted ETF investors, exchanges represent less than 0.4 per cent of the EM benchmark.

We do think the expansion of mobile data usage in EM is an attractive theme, but not via the telecoms. Data usage could grow tenfold in the next five years⁵, and we think the better way to invest in this explosive growth is through companies with strong ecommerce and online platforms or related logistics businesses. They are benefiting from rapid growth in smartphone penetration, but

don't face the same competitive pressures as the telecom operators that dominate the index.

Even beyond ecommerce, we think the consumer-related sectors more broadly are the most attractive opportunity within EM. Over the next 10 years, 1.5bn people are likely to exit poverty and enter the middle class⁶. Spending on everything from biscuits to washing machines to medicine could dramatically increase.

As the telco example illustrates, growth alone is certainly not enough to drive investment returns. We can find many companies exposed to this high growth that also offer sustainably high returns on incremental capital and sound corporate governance while trading at a substantial discount to intrinsic value. In our global EM portfolios, we have invested 50 per cent more capital in consumer-oriented companies than the benchmark allocation.

EM economies are young, dynamic and growing. We think all investors should maintain a strategic allocation. But those looking to gain exposure should beware of the benchmark. EM equity investing is not the place to be passive.

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¹ Source: GSAM, MSCI, as of 31-May-16. Calculated for MSCI World vs MSCI EM.

² Source: GSAM, UBS, as of 31-May-16.

³ Source: Shown for MSCI EM. Average local currency return for SOE companies over 5 years is equal to 2.5% annualised; average local currency return for non-SOE companies over 5 years is equal to 9.5% annualised.

⁴ Source: Includes all companies in EM that have a market cap above \$200mn.

⁵ Source: Ericsson Mobility Report 2016, GSAM Calculations. GSAM's and Ericsson's products are not related, and Ericsson has not endorsed either GSAM or its products

⁶ Source: GS Global Investment Research. Calculated for 2015-2025.

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