Insights
Systemic Equity-Active

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Emerging Markets: Don’t Get Skewed

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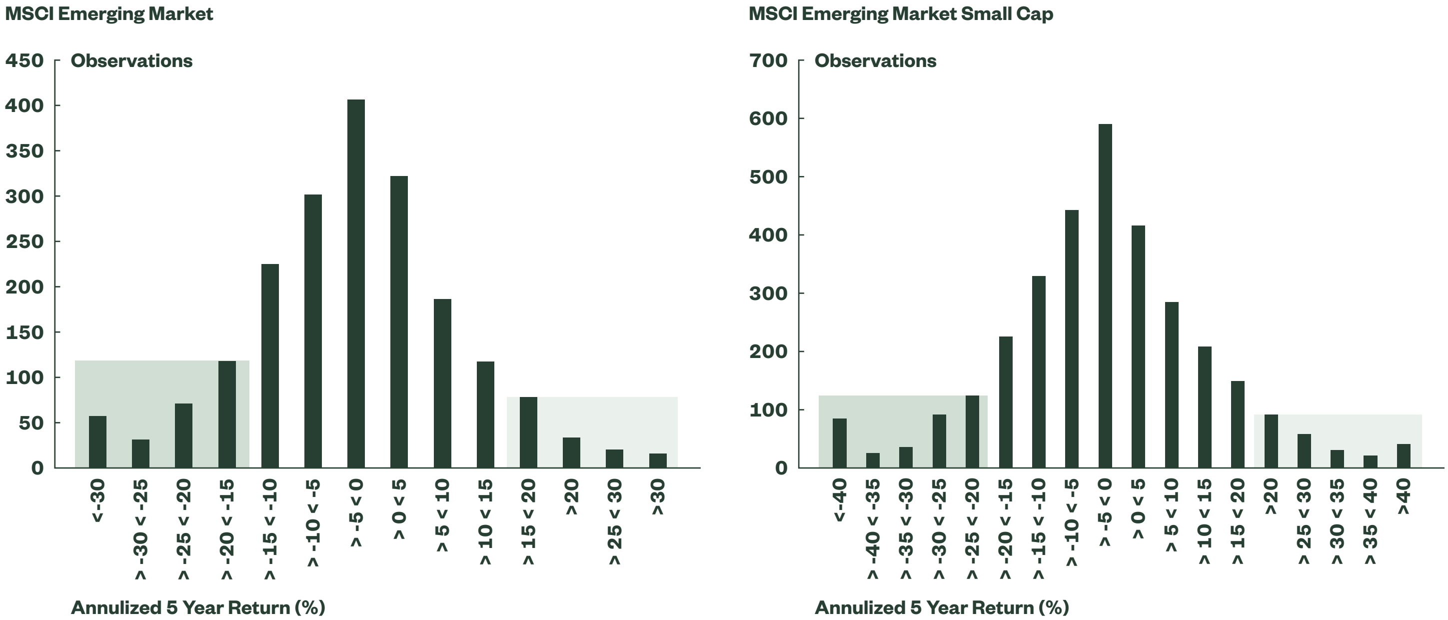
A higher-for-longer interest rate environment has been priced into emerging market (EM) stocks. As a result, we have been witnessing a textbook script on stock performance in a rising rate environment: EM risk assets have underperformed, EM currencies have sold off, earnings expectations have come down, and interest expense has been rising, with value/quality equities outperforming. However, this should be expected and the fact that we have (mostly) crossed the river without significant stress indicates that we may be getting closer to an entry point. Other asset classes (such as US equities) have defied gravity for too long and relative positioning (developed markets versus emerging markets) has become fairly extreme.

Investors Win by Not Losing

Our review of emerging market equities begins with a single word: **skew**. Skew refers to the measure of asymmetry in the distribution of market returns. In a ‘normal distribution,’ skew is zero. What a nice and neat world it would be if market returns exhibited normal distributions! While we recognize that ‘normal’ doesn’t often exist in the “real” world, it most certainly does not happen in emerging market equities. As investors, we are thankful that this is the case for this dynamic drives active alpha generation. A return distribution that shows ‘fat tails’ is a blessing for it increases the opportunity set for investment managers to add value. However, negative skew (more common jargon), or where outliers on the downside outweigh the upside, is not a blessing. While a large right tail of the distribution suggests that managers who have real skill can generate meaningful excess returns in emerging markets, one must be careful. (Figure 1).

Figure 1 **Downside vs. Upside Risk in Emerging Markets**



Source: FactSet, as of September 30, 2023.

The graph above shows the annualized 5-year returns of all the stocks in the MSCI Emerging Market index. The index exhibits significant “down-side skew” — that is, the winners are outweighed by the losers by approximately 2.5–1 (in the second chart above one can see this **skew** is even worse in emerging market small caps). Again, for skilled investment managers, there are plenty of stocks that can generate strong alpha (more so that one could find in developed markets). However, like in most avenues of life, there are no freebies. The cost here is that if one takes concentrated positions and does not bring skill (or more charitably, gets unlucky), the impact of falling into the left side of the distribution can be quite painful (when one has high single-stocks portfolio positions). If we recall our algebra, if one has a 50% draw down in a specific position, one will need to a 100% gain to get back to where you were. **Math is just so unfair like that**.

And the portfolio implication will be felt — at best — by total portfolio volatility and at even worse, by index underperformance — and quite likely both.

How Best to Manage Portfolios with Negative Skew

Harry Markowitz was reported to have said that “Diversification is the only free lunch in finance.” This is true in most cases, yet when dealing with downside risks, it really is the best way to preserve your capital. It is almost inevitable that any active manager can make a mistake, whether he or she follows a fundamental or quantitative approach. However, quantitative managers generally understand this is their portfolio construction and often will hold several hundred positions. They know that their signals are less powerful at the single security level, but robust at the portfolio level. Therefore, quantitative managers prefer to limit the amount of idiosyncratic risks. We prefer to keep our risk diversified to the broad underlying themes — whether it be value, quality, or the like — that generate **portfolio alpha. We focus more on the broad forest, less on the single tree**.

How This Works in a Hypothetical Portfolio

If a manager is running a portfolio at a tracking error of 3%, for example, we can run a scenario to see how many "bad stocks" it will take to reach their tracking error limit. The concentrated manager, holding 40 names, can reach this limit with three poorly performing stocks — assuming all else is constant. One can imagine the concentrated manager hitting this limit with some degree of frequency when there is a whiff of sector volatility or simply bad news. For the diversified manager, that number rises to 37 — making it less a case of pure idiosyncratic risk versus style/factor positioning. The question of bad luck versus bad skill does begin to blend, but if a manager has a 3% excess return target, wouldn't one simply prefer to take that with greater diversification? This should provide a better information ratio. **In this, the math is really fair**.

Figure 2
Bad Luck or Bad Skill?

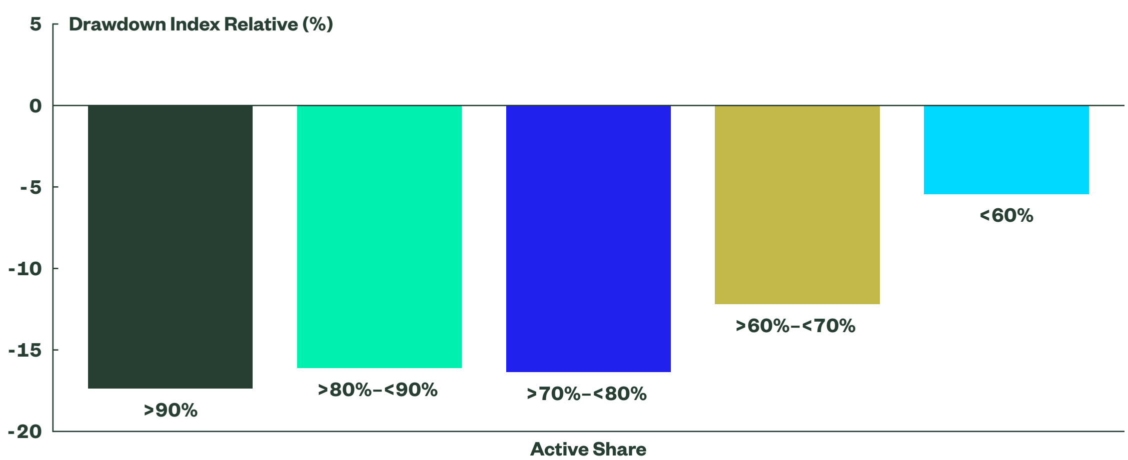
Number of stocks in a portfolio	40.0	150.0	300.0	600.0
Average portfolio weight assumption (%)	2.5	0.7	0.3	0.2
Number of stocks with a 50% drawdown required to have a 3%+ underperformance	3.0	10.0	19.0	37.0

Source: State Street Global Advisors. This is a stylized example that assumes the value of the other stocks in the portfolio and the corresponding index remain unchanged.

How This Works in "Real Life"

The stylized example above is useful, to a point. The next question one should ask is how this affects managers more broadly. We can think about this as such: firstly, what is the relationship between active share and portfolio (relative) drawdowns. Intuitively, one might think there is a linear relationship here, but as Figure 3 shows, this is not the case. The last five years have been 'peculiar' with pandemic, war, and rising geopolitical tensions. However, it is likely we will continue to see heightened risk in the years ahead. In short, this active share/ drawdown relationship could remain unpredictable.

Figure 3
Max Drawdown Over 5-Year Period



Source: State Street Global Advisors, Evestments. Data as of June 30, 2023. If a fund has an active share of 60%, then 40% of the holdings of the fund is identical to the holdings of the benchmark, and 60% of the holdings is different (constituting either over-weights or under-weights relative to the holdings of the benchmark). Excludes index/passive funds.

The Bottom Line

The wise words from a long-ago mentor ring as true as ever in today's markets: "Concentrated portfolios work — until they don't" And for emerging markets, it is not enough simply to be diversified. Identifying names to avoid is as critically important as selecting names to hold in a portfolio. In the long run, one often wins by not losing.

Outlook

As we begin to look out to 2024, we see a relative value play in EM returning with higher rates. We think shorter duration assets are the best play, ideally ones without a strong cyclical exposure. Controversially, we are starting to add positions in China — but selectively. Our strategy is to avoid crowded trades, be careful on the quality dynamics, and do not try to catch any falling knives. The information technology (IT) and energy sectors in China look attractive at current valuations in the large cap space. The 2024 outlook for IT in Taiwan looks stellar across the capitalization spectrum, as do the consumer names in Korea. As always, stay diversified and keep looking for balance in your positions.

Current Positioning

Figure 4
Current Positioning

Country	Sector/Industry	Factor
Emerging Markets Large Cap		
China	Information Technology	Focus on high Quality; Industry has attractive relative valuations with strong sentiment
	Energy	Strong on all core factors
	Health Care/Pharmaceuticals	Good Value; Quality is key
Taiwan	Information Technology/Hardware and Semiconductors	Good Value; Strong Sentiment
Korea	Financials	Great Value; Positive Sentiment
	Consumer Discretionary/Autos and Components	Attractive on all metrics
Emerging Markets Small Cap		
India	Utilities	Terrific Value; Remain vigilant on Quality
	Industrials/Machinery	Strong Sentiment; Focus on Quality at a good price
	Health Care/Pharmaceuticals	Good Value; High Sentiment: Quality is key
Taiwan	Information Technology	Attractive Valuation; Focus on Quality
	Communication Services	Strong Sentiment; Focus on Quality at a good price
Korea	Financials	Great Value; High Quality is critical
	Consumer Discretionary/Textiles	Good Value; Strong Sentiment
	Consumer Discretionary/Auto Components	Attractive on all metrics

Source: State Street Global Advisors. Data as of September 30, 2023.

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* Pensions & Investments Research Center, as of December 31, 2022.
† This figure is presented as of September 30, 2023 and includes approximately $58.13 billion USD of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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This document provides summary information regarding the Strategy. This document should be read in conjunction with the Strategy's Disclosure Document, which is available from SSGA. The Strategy Disclosure Document contains important information about the Strategy, including a description of a number of risks.

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