Insights
Active Quantitative Equity (AQE)

March 2023

The Case for Enhanced in Emerging Markets Equities

Toby Warburton, CFA, Ph.D
Head of AQE Portfolio Management

Jay Siegrist
Senior Portfolio Manager
Emerging Market Equities

Timothy Herlihy, CFA
Investment Strategist

Forecasts for 2023 and beyond indicate that market uncertainty and volatility will likely persist for some time. The good news is that within emerging markets equities, volatility can create incremental alpha opportunities with only a minimal increase to the risk budget. Against this backdrop, we believe it makes sense to revisit the relative merits of enhanced strategies in emerging markets equities as an alternative to a pure passive allocation.

The last decade has been a challenging period for active investors. Prior to 2022, global markets had been a rising tide that lifted all ships — in these types of beta rallies, dispersion among individual stocks decreases and the potential for excess returns falls. The world is changing, however, and the aforementioned spike in volatility is likely to create more alpha opportunities. This is particularly true in emerging markets where information asymmetries, behavioral biases, and higher transaction costs create market inefficiencies that skilled managers are better able to exploit.

Emerging market equities, as measured by the MSCI Emerging Markets Index, have lagged MSCI World Index returns by over 35% since 2018.[1] Amid expectations for continued US dollar weakness, refocused fiscal policy to combat a global slowdown, the reopening of China, and institutional investor positioning, the asset class appears poised to be to the fore of a global recovery. Looking forward, 2023 presents what we believe to be an exciting opportunity for investors to move beyond passive solutions. Our Emerging Markets Enhanced strategy seeks to provide modest excess returns over time, while closely tracking the characteristics of the MSCI EM Index.

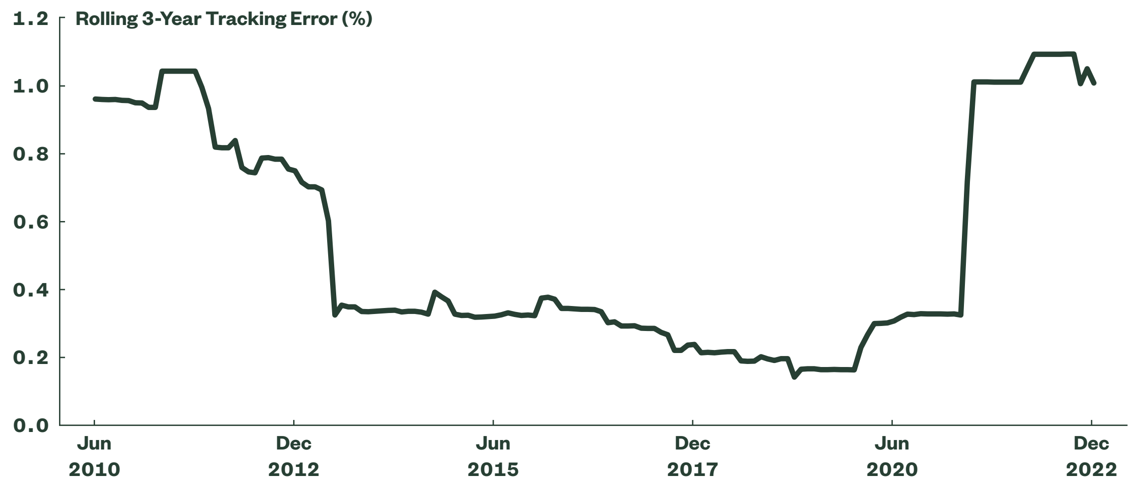
Rethinking Passive in Emerging Markets

We understand the attraction for investors of a low cost, low active risk investment in a period of rising markets. At first blush, there is a lot to like about the broad market exposure, reduced risk, and low fees that index funds offer. However, a closer examination of the track records of some long-standing passive strategies reveals that replication of emerging markets equity indices brings a unique set of challenges.

One of the key objectives of index funds is to minimize tracking error to the reference index. While index managers in the developed world have historically been relatively successful in this endeavor, EM indexers face higher index turnover and higher transaction costs. Indeed, as Figure 1 shows, the median emerging market index fund has averaged tracking error of 0.74% away from the benchmark over the last decade.[2]

Figure 1
Rolling Three-Year Tracking Error of Median EM Index Fund

Median EM Index Fund



Source: State Street Global Advisors, eVestment as of December 31, 2022. Past performance is not a reliable indicator of future performance. Median of index strategies benchmarked to the MSCI Emerging Markets Index was used. A group of 15 strategies were used from eVestment Global Emerging Mkts Large Cap Equity Universe with a Passive portfolio management strategy as of December 31, 2022 with available rolling 3-year data to calculate the median rolling tracking error. Rolling methodology rolls over every months.

This high level of tracking error — the standard deviation of active returns — is indicative of active risk, and it has a relative performance effect. In fact, this same universe of index funds have underperformed their benchmark by an average of 16 basis points on a trailing three-year basis, as of December 31, 2022. Thus, while investors are enticed by the ever-decreasing costs of EM index funds, what they are often buying are unintended deviations from the index that result in higher-than-anticipated levels of risk and negative performance outcomes.

EM Enhanced: The Value of a Diversified Approach

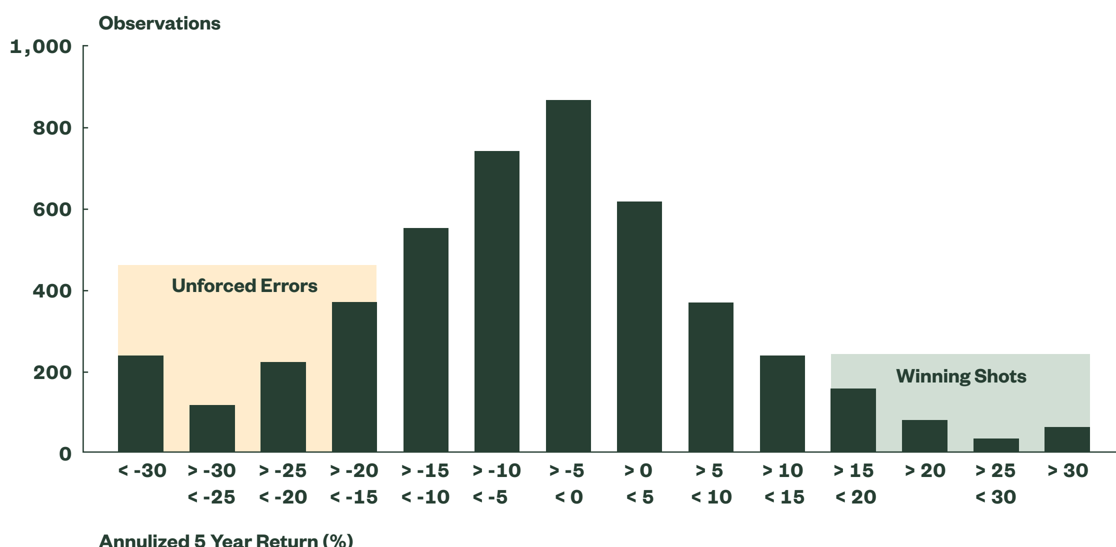
In 1973, renowned American engineer, businessman, and author Simon Ramo calculated that 80% of points in amateur tennis are lost via unforced error, and not won by valiant or aggressive shots. The conclusion one can draw is that the vast majority of tennis players will have more success by avoiding mistakes rather than by over-reaching for heroic winning shots.

This approach can be viewed as 'winning by not losing'. We believe this type of mindset is important when investing in emerging markets where there is already an abundance of systematic risk. In just the last year, we experienced a 'black swan' event in the form of the Russian invasion of Ukraine. This was in addition to unprecedented volatility in Chinese equities. Successful investors in these markets benefit from being as efficient as possible in their usage of additional nonsystematic risk (i.e. minimize big swings).

To better understand our disciplined approach to risk management and diversification, it is helpful to review the historical returns in emerging markets over the last five years. In Figure 2, we see that volatility results in stock returns that exhibit a non-normal distribution, with heavily-concentrated tails. To extend our tennis analogy, the skew towards the negative tails in this figure represents unforced errors. Highly-skilled investment managers that take on aggressive positions may be able to generate superior returns from landing their shots in the shaded area on the right of the chart. This is a commendable achievement for the few that accomplish it. However, the relative scale of observations in the shaded areas is to be noted — managers of concentrated strategies that land shots in the shaded area on the left will find that it can take a very long time to recover from their mishits.

Our EM Enhanced strategy sidesteps this dilemma via diversification, and limiting the position in any one name. This minimizes the impact of unforced errors on the overall portfolio.

Figure 2
Diversified EM Portfolio Avoids Risk From Concentrated Positions
(MSCI Emerging Markets Investable Market Index, Jan 2018–Dec 2022)



Source: State Street Global Advisors, MSCI as of 31 December 2022. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

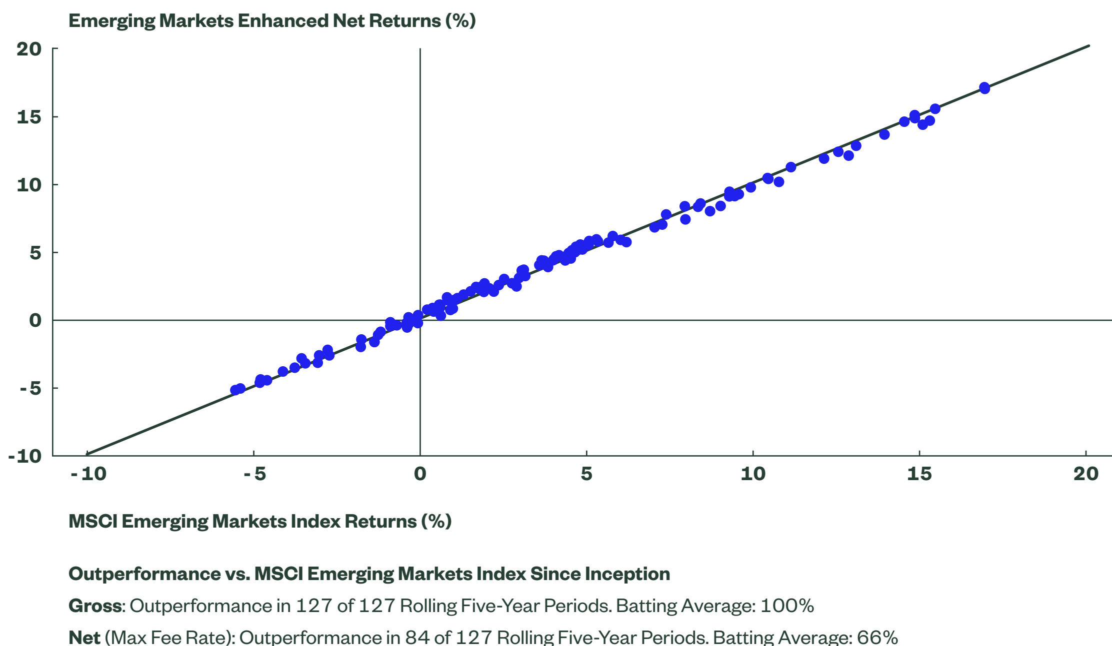
EM Enhanced: The Sweet Spot!

The SSGA Emerging Markets Enhanced strategy seeks to provide modestly superior returns relative to the benchmark MSCI EM index consistently over time, while closely tracking the index characteristics. We accept small amounts of risk spread across hundreds of securities in order to position the portfolio for outperformance. At the same time, we aim to avoid performance shocks through the use of tight constraints at the country, sector, industry, and stock level.

Our quantitative investment approach incorporates best-in-class infrastructure that collects the latest and most important publicly-available information on nearly 4000 emerging markets stocks. The types of information that we are analyzing run the gamut of fundamental, technical indicators, macroeconomic, and earnings expectations to derive investment expectations on each security. Our models are able to evaluate this output on a daily basis to build an optimal portfolio within the desired constraints. Through this rigorous process, we minimize inertia or slippage when it comes to finding the best stocks to buy. The end result of this process is a well-diversified portfolio with an emphasis on minimizing idiosyncratic tail risk and maximizing the information ratio.

The approach of the Active Quantitative Equity team in the emerging markets space has been through many market cycles and delivered attractive and consistent risk-adjusted returns for investors. This record can be demonstrated by viewing a scatter plot of rolling five-year excess returns for our EM Enhanced strategy. The scatter illustrates the strategy's five-year excess return against its benchmark, rolling back monthly to its inception date of July 2007. Over a time frame that includes disruptive events such as the global financial crisis (GFC), Arab Spring, the Covid-19 pandemic, and the Russian invasion of Ukraine, our strategy has delivered a 100% gross batting average (in terms of outperforming the MSCI EM Index)! And a net maximum fee batting average of 66% (Figure 3).

Figure 3
EM Enhanced Strategy Performance Over 127 Rolling Five-Year Periods
(Jul 2007–Dec 2022)



Outperformance vs. MSCI Emerging Markets Index Since Inception
Gross: Outperformance in 127 of 127 Rolling Five-Year Periods. Batting Average: 100%
Net (Max Fee Rate): Outperformance in 84 of 127 Rolling Five-Year Periods. Batting Average: 66%

Source: State Street Global Advisors, MSCI as of 31 December 2022. Past performance is not a reliable indicator of future performance. Net fee calculations are used, based on the Global Investment Performance Standards (GIPS). Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

Our Outlook for Emerging Markets

The difference that a couple of months can have on emerging markets equities is evident in the turnaround of fortunes near the end of 2022. For most of the year, sentiment towards the asset class had tracked lower as investors weighed the impact of the Russian invasion of Ukraine, tightening financial conditions driven by inflation concerns, and the double whammy coming from China's zero tolerance response to COVID and the near-meltdown of that country's property sector. The MSCI EM Index failed to even keep pace in 2022 with disappointing US and EAFE (Europe, Australasia, Far East) market returns, as measured by the S&P 500 Index and MSCI EAFE Index, of -19.4% and -16.8%, respectively. Against this backdrop, it's easy to understand why there were persistent outflows from EM equities through the second half of 2022. A closer look, however, at some of the recent developments across the EM landscape lead us to believe that prospects for 2023 have brightened considerably.

1. The Impact of Chinese Reopening

For better or worse, China has an oversized impact on the direction of EM equities. At the end of 2022, China accounted for over 32% of the MSCI EM Index but its influence on the global economy extends far beyond market capitalization. The aggressive lockdowns implemented by Chinese authorities during the pandemic reverberated across global financial markets, trade and logistics, and manufacturing and technology sectors. While the relaxation of restrictions and broad reopening of the economy will likely bring their own challenges, we foresee it as potentially the most impactful economic event of 2023. We anticipate that it will provide tailwinds for economic growth, commodity prices, and currency appreciation across emerging markets.

Over the last 20 years, investors have been able to look to EM to deliver reliable economic growth relative to their developed counterparts, irrespective of other challenges that the asset class faced throughout this period. While Covid-related shutdowns have somewhat tempered this narrative, we are encouraged by lead indicators (Figure 4) that appear to show that China's reopening is poised to revive the EM growth story.

Figure 4

EM (BRICK*) Leading Indicators Underpin Growth Outlook Relative to DM (G3)**

Source: CLSA, S&P Global as of January 31, 2023.
* Brazil, Russia, India, China, Korea (excluding Russia since March 2022). **US, Japan, euro area.

2. Measured Monetary and Fiscal Policy Responses in EM

EM economies have been largely resilient in a tightening environment that would have previously had devastating consequences. It was only a decade ago that the US Federal Reserve's (Fed) attempt to normalize monetary policy after the global financial crisis proved crippling for emerging markets that were running large current account deficits. Given the similarities with that period, why would the outcome be any different this time? At the heart of this more upbeat prognosis is that EM economies appear to have evolved and policymakers seem to have learned from previous mistakes.

Central banks are better managed than in the past. Moreover, emerging markets governments proved to be effective in tightening monetary and fiscal policies throughout 2022 in a measured fashion to keep inflation from accelerating too fast. Brazil and South Africa — previously tagged as members of the ignominious Fragile Five economies[3] — were ahead of the US in terms of tightening last year. Furthermore, EM economies have shifted away from some of the policy mistakes that historically foreshadowed crises. Governments are less likely to intervene in currency markets, and foreign reserve stockpiles have increased. Perhaps most importantly, the level of foreign currency denominated debt issued by EM governments has fallen precipitously. This practice, sometimes referred to as 'original sin', all too frequently in the past resulted in a ruinous cycle of capital outflows, depreciating currency, and ineffective regimes that ended in default.

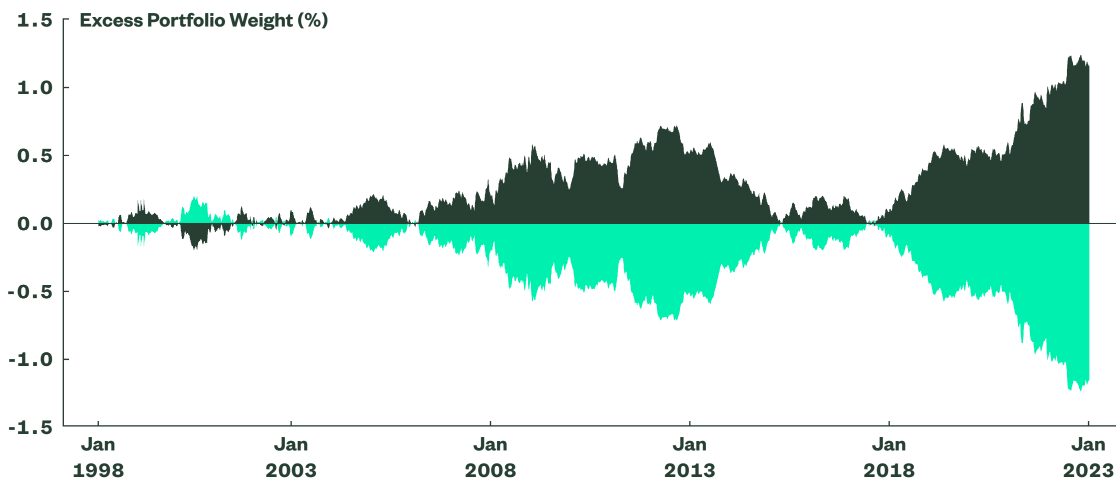
Of course there remains an element of vulnerability in some of the lower-income economies to further tightening or a global slowdown. But the measures taken to promote economic stability, and the resilience shown by the broader asset class over the last year, underpin our optimism that the larger emerging markets economies are well positioned for recovery.

3. Institutional Investors Underweight EM

Finally, institutional positioning may provide a potential tailwind for the asset class given the current allocations of institutional investors. Research by State Street Global Markets shows that institutional investors are the most overweight to developed market (DM) equities than at any time since 1998 and are the most underweight EM over the same period. Capital flows from a shift in the allocation of institutional investors towards long-term trend weights could deliver added support for EM equities in the near and long term.

Figure 5
Institutional Equity Holdings: Overweight/ Underweight (1998–2023)

Developed Market Equities
Emerging Market Equities



Source: State Street Global Markets Research as of January 2023.

EM Equities: The Bottom Line

Global markets appear to be at an inflection point. The global economy is rapidly slowing as the current monetary tightening cycle unfolds. We believe a turbulent journey lies ahead with the prospect of elevated volatility in rates and inflation.

In the five year period to February 28, 2023, EM equities have lagged the MSCI All Country World Index by over 40% in USD terms.[4] We are encouraged by a number of cyclical drivers that indicate emerging markets are positioned to lead equity markets out of the global slowdown, with the China reopening story serving as the growth engine.

Passive investors should consider an incremental increase to risk as index strategies are burdened by increased tracking error that can lead to compounding underperformance, and increased volatility can lead to additional alpha opportunities. We believe our quantitative investment process using a breadth of information is the optimal approach to capitalizing on these opportunities.

Endnotes

1 Source: MSCI. Period from 01/01/2018–12/31/2022.

2 Source: State Street Global Advisors, eVestment for period 06/30/2010 to 12/31/2022.

3 Fragile Five — a term coined by Morgan Stanley to refer to five countries (Brazil, India, Indonesia, South Africa, and Turkey) that appeared most at risk from the effects of the 'Taper Tantrum'. All five had balance of payment imbalances and relied heavily on US dollar inflows buying local bonds.

4 Source: FactSet as of February 28, 2023. Total return in USD.

About State Street Global Advisors

Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 29 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's fourth-largest asset manager* with US $3.48 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2021.
† This figure is presented as of December 31, 2022 and includes approximately $58.60 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.

ssga.com

Marketing communication.

State Street Global Advisors Worldwide Entities

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without State Street Global Advisors' express written consent.

The views expressed in this material are the views of Timothy Herlihy and Jay Siegrist through 27 February 2023 and are subject to change based on market and other conditions. This document contains certain statements that may be deemed forward looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected.

The information provided does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. You should consult your tax and financial advisor.

All information is from State Street Global Advisors unless otherwise noted and has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy, reliability or completeness of, nor liability for, decisions based on such information and it should not be relied on as such.

Past performance is not a reliable indicator of future performance.

Investing involves risk including the risk of loss of principal.

Investing in foreign domiciled securities may involve risk of capital loss from unfavorable fluctuation in currency values, withholding taxes, from differences in generally accepted accounting principles or from economic or political instability in other nations.

Investments in emerging or developing markets may be more volatile and less liquid than investing in developed markets and may involve exposure to economic structures that are generally less diverse and mature and to political systems which have less stability than those of more developed countries.

Equity securities may fluctuate in value in response to the activities of individual companies and general market and economic conditions.

Quantitative investing assumes that future performance of a security relative to other securities may be predicted based on historical economic and financial factors, however, any errors in a model used might not be detected until the fund has sustained a loss or reduced performance related to such errors.

SSGA uses quantitative models in an effort to enhance returns and manage risk. While SSGA expects these models to perform as expected, deviation between the forecasts and the actual events can result in either no advantage or in results opposite to those desired by SSGA. In particular, these models may draw from unique historical data that may not predict future trades or market performance adequately. There can be no assurance that the models will behave as expected in all market conditions. In addition, computer programming used to create quantitative models, or the data on which such models operate, might contain one or more errors. Such errors might never be detected, or might be detected only after the Portfolio has sustained a loss (or reduced performance) related to such errors. Availability of third-party models could be reduced or eliminated in the future.

The trademarks and service marks referenced herein are the property of their respective owners. Third party data providers make no warranties or representations of any kind relating to the accuracy, completeness or timeliness of the data and have no liability for damages of any kind relating to the use of such data.

For EMEA Distribution: The information contained in this communication is not a research recommendation or 'investment research' and is classified as a 'Marketing Communication' in accordance with the Markets in Financial Instruments Directive (2014/65/EU) or applicable Swiss regulation. This means that this marketing communication (a) has not been prepared in accordance with legal requirements designed to promote the independence of investment research (b) is not subject to any prohibition on dealing ahead of the dissemination of investment research.

© 2023 State Street Corporation.
All Rights Reserved.
ID1439650-5487188.1.1.GBL.RTL 0323
Exp. Date: 03/31/2024