Emerging Market Equities

No Longer Only Beer, Banks and Cement

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In Brief

Emerging markets still hold the luster of the opportunities of economic development, amid rising wealth, improved living conditions and increased consumption. However, “emerging market investing” has evolved. An investment team still needs to understand the traditional aspects of emerging market investment opportunities, but must also analyse a new breed of world-class global competitor arising from EMs. Understanding both company types is critical to how we seek to generate alpha in our actively managed portfolios.

New Industries Dominate Benchmark

Historically, emerging market investment opportunities could have been loosely grouped into beer, banks and cement — a tongue-in-cheek way of lumping the investment opportunities into very broad buckets. This alludes to the observation that as developing economies begin to demonstrate sustainable growth, some of the first beneficiaries are those that are closely tied to rising incomes (i.e. beer), credit growth (banks), and infrastructure (cement).

Over the past two decades we have seen the benchmark MSCI Emerging Markets Index evolve, with a significant shift away from materials, energy and telecoms and a move towards communications services (i.e., internet and e-commerce) and semi-conductors.

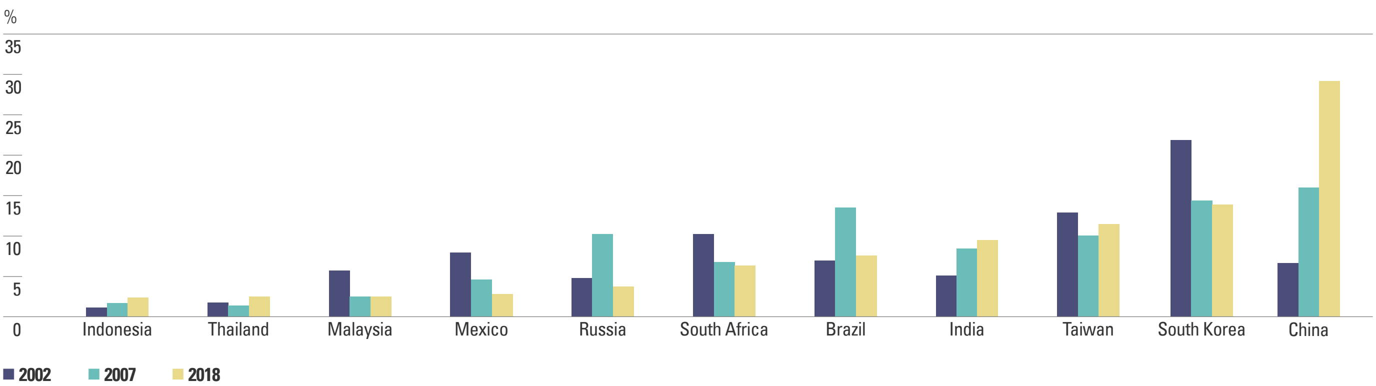
While banks still loom large, as they do in developed economies too, global leaders in sophisticated technology-oriented sectors are now among the biggest names in the EM benchmark. Analysing these companies requires a more differentiated skill set than was usual in the early days of emerging markets investing. Analysing a tech company requires an understanding of the technologies of the present day as well as being appreciative of the possible innovations that the future might bring; ultimately this requires a more forward-looking mindset. A good example of this is the Apple supply-chain, the bulk of which is largely based in emerging economies.

Evolving EM Country Weights

The MSCI EM benchmark has evolved to encompass the change in emerging markets' economic and business environments. China stands out the most — its weight in this benchmark has increased from 7% in 2002 to 16% in 2007 to a whopping 29% at the end of 2018. China's benchmark weight will increase further as MSCI has decided to include a larger percentage of A-Share listed stocks in 2019. A natural consequence of the rise in Chinese equities' share of the benchmark is the decline in the benchmark weights of other countries (Figure 1).

China's benchmark weight is not the only thing that has changed, however. Over the past decade, there has been a big shift in the weight of what we call "old economy" stocks to "new economy" stocks. China's old-economy stocks tend to be large and often inefficient state-owned enterprises (SOEs) such as oil, gas and coal companies, while new-economy stocks tend to be private sector companies such as Tencent and Alibaba.

Figure 1: MSCI EM Index — Top Country Weights



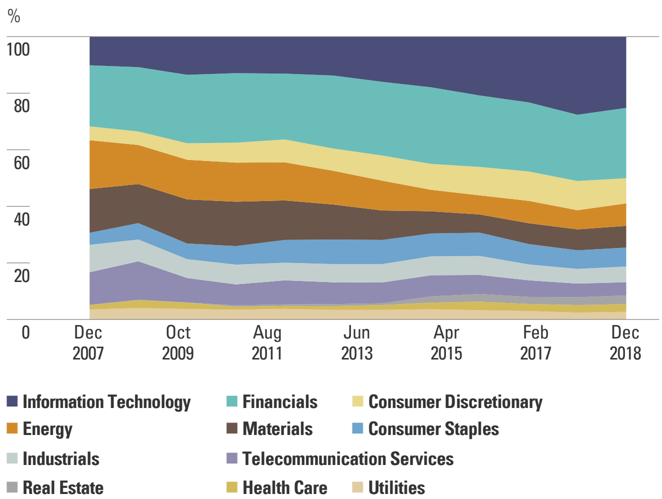
Source: MSCI, State Street Global Advisors.

CONSUMPTION PATTERNS SHIFT

Advances in technology combined with rising incomes across many emerging market countries have led to shifts in production and consumption patterns. These shifts are mirrored in the changing composition of sectors in the MSCI EM benchmark. The weight of sectors such as energy, materials and traditional telecom services have been cut in half in the past ten years alone, while the weights of information technology and consumer discretionary have more than doubled in size (Figure 2).

The changes go beyond what size alone suggests. Access to global technology in the past two decades, combined with access to cheap labour at home created an increasingly competitive production advantage for emerging market countries and the companies based there. Rising income levels fueled an increase in demand for discretionary goods and services. Large, growing and more educated and wealthy populations across emerging market countries should ensure steady long-term demand for internet access, online applications and smartphones, as well as healthcare, financial services and higher education.

Figure 2: Evolution of Sector Weights in EM Benchmark

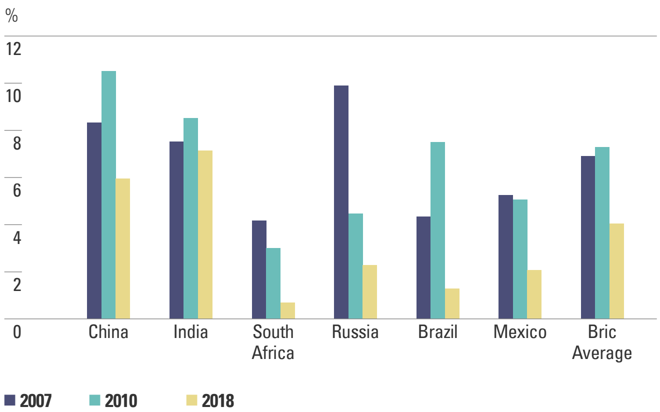


Source: MSCI, State Street Global Advisors.

MACRO CHANGES IN EM

It is essential that investors understand both the global and domestic macro and political environment in which emerging market companies operate. A backdrop of strong and improving global growth and trade is always preferred, but not always assured; this makes it very important to understand the macro opportunities, risks and vulnerabilities of individual emerging market countries. Economic growth in emerging market countries, while generally higher than that prevailing in developed market countries, is lower today than in the past (Figure 3).

Figure 3: EM GDP Growth Trending Lower



Source: Bloomberg Finance LP, State Street Global Advisors.

Notwithstanding the evolving backdrop, some key characteristics persist. A successful EM investment team still needs to manage the material risks arising from macro/currency factors, regardless of whether they are fiscal or political. Most importantly, the bulk of EM benchmark risk is still represented by the developing stories that spring to mind when we think EM.

Capturing Alpha

Macro and political factors across emerging markets change continuously, with consequent impacts on capital flows, currency stability and asset values. Our macro process includes assessing the sustainability of economic growth, fiscal soundness, and strength of institutions such as rule of law, policy credibility and political stability. We believe identifying and understanding the macro risks to be an important factor in making country allocation decisions.

We believe the key ingredients for a successful active EM investment team include:

- an ability to discern core development trends in emerging economies;
- discrete insight into technology and communication services trends and competitive factors; and
- a macro input to understand exposure risk to countries and currencies.

We believe that investment opportunities still exist in emerging markets, but legacy analytical tactics alone are no longer enough to uncover them. Our focus on stock research is driven by a determination to capture the underlying trend improvements in technology, communication services, banking, and consumer products as the EM middle class expands and big EM players move onto the global stage.

STATE STREET GLOBAL ADVISORS — EMERGING MARKET EQUITY CAPABILITIES

We began money management in EM equities in 1991 and today oversee $70bn in assets across a number of disciplines — Active Quantitative, Active Fundamental, Traditional & Smart Beta. These Strategies include:

Strategy	Investment Universe	Strategy Inception
Active Quantitative Equity		
Emerging Market Asia	MSCI Emerging Markets Asia Index	May 1993
Emerging Market Enhanced	MSCI Emerging Markets Index	July 2007
Emerging Market Small Cap	MSCI Emerging Markets Small Cap Index	October 2007
Emerging Markets Active	MSCI Emerging Markets Index	April 2000
Emerging Markets Defensive	MSCI Emerging Markets Index	March 2016
Fundamental Growth/Core		
China	MSCI China/MSCI China Capped 10%	July 2002
Emerging Markets Equity Select	MSCI Emerging Markets Index	Jan 2015
Fundamental Value		
Asia Pacific Value Spotlight	Asia Pacific stocks with Market Cap greater than US$2bn	June 2012
Global Value Spotlight	MSCI All Countries. The strategy has no limit on its ability to invest in EM and has been as high as 29%	December 2012
International Value Spotlight	MSCI All Countries. The strategy has no limit on its ability to invest in EM and has been as high as 27%	January 2012
Cap-Weighted Beta		
MSCI Emerging Markets	MSCI Emerging Markets Index	Jan 1996
MSCI Emerging Market Small Cap	MSCI Emerging Markets Small Cap Index	April 2008
FSTE Greater China	FTSE Greater China HKD Index	September 2013
China A ESG	MSCI China A Index	July 2018
SPDR S&P China ETF	S&P China BMI Index	April 2007
Smart Beta		
EM Minimum Volatility	MSCI Emerging Markets Index	January 2013
RAFI Fundamental Emerging Markets	RAFI Global Equity Index	July 2017
EM Liquidity Tier	MSCI Emerging Markets Index	March 2017
SPDR S&P Emerging Markets Dividend	S&P Emerging BMI Index	February 2011
MSCI EM Value Weighted	MSCI Emerging Markets Index	June 2008

OUR TRADING DESK

We have 6 dedicated Emerging Markets equity traders located in Boston, London and Hong Kong. The team is highly focused on market events, controlling exposure, monitoring country risk, security inventories and liquidity. In 2018, we traded ~$28 billion in EM equities across 173,000 tickets, with an aggregated cost of approximately 11bps. We ensure a wide breadth of counterparties with 55% of our panel made up of non-US domiciled brokers.

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Currency Risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Foreign investments involve greater risks than US investments, including political and economic risks and the risk of currency fluctuations, all of which may be magnified in emerging markets.

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.

Investing involves risk including the risk of loss of principal.

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