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Building an Optimal Emerging Markets Portfolio

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The opportunity set for emerging markets investors has evolved considerably over the past three decades, as strong and sustained economic growth has underpinned increased breadth, depth and maturity in the EM capital markets. Market liquidity and access have improved significantly and flows into EM assets have increased as the excess return potential continues to attract investor interest.

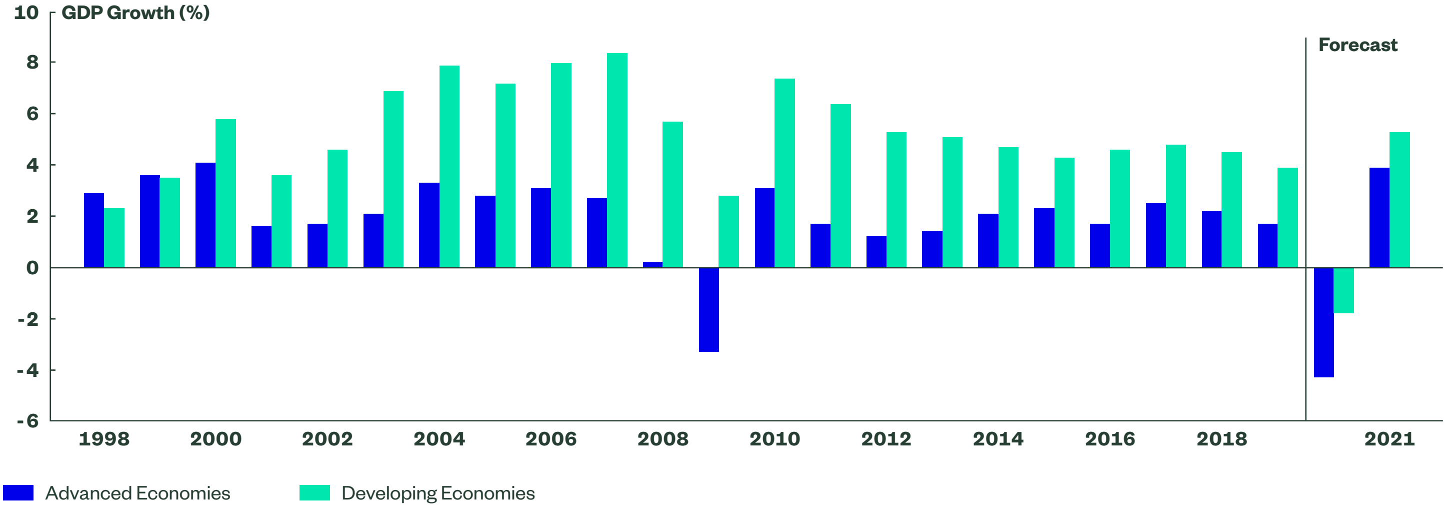
For investors, the consideration now is usually how, rather than whether, they should allocate to EM equities and bonds, and understanding the impact of differing levels of exposure. In this paper, we look at the factors to consider in order to build robust exposures to emerging markets.

Emerging Markets Growth Premium

"Emerging Markets" (EM) encompass a diverse group of countries that generally have lower per capita income, higher economic growth and favourable demographics, compared to developed markets. Over the last two decades, EM economies have consistently posted stronger growth than the more developed economies.

The impact of COVID-19 on economic activity means that, in aggregate, developing economies are forecast by the SSGA Economics team to shrink by -1.8% in 2020 before rebounding by 5.3% in 2021. The estimate for advanced economies is for a contraction of -4.3%, followed by growth of 3.9% in 2021. So while some EM countries' economic difficulties have been exacerbated by COVID-related effects and lingering trade war fears persist, the EM growth premium remains largely in place — even if diverging prospects within the EM universe itself could be a greater feature going forward.

Figure 1
EM Growth Premium Remains in Place

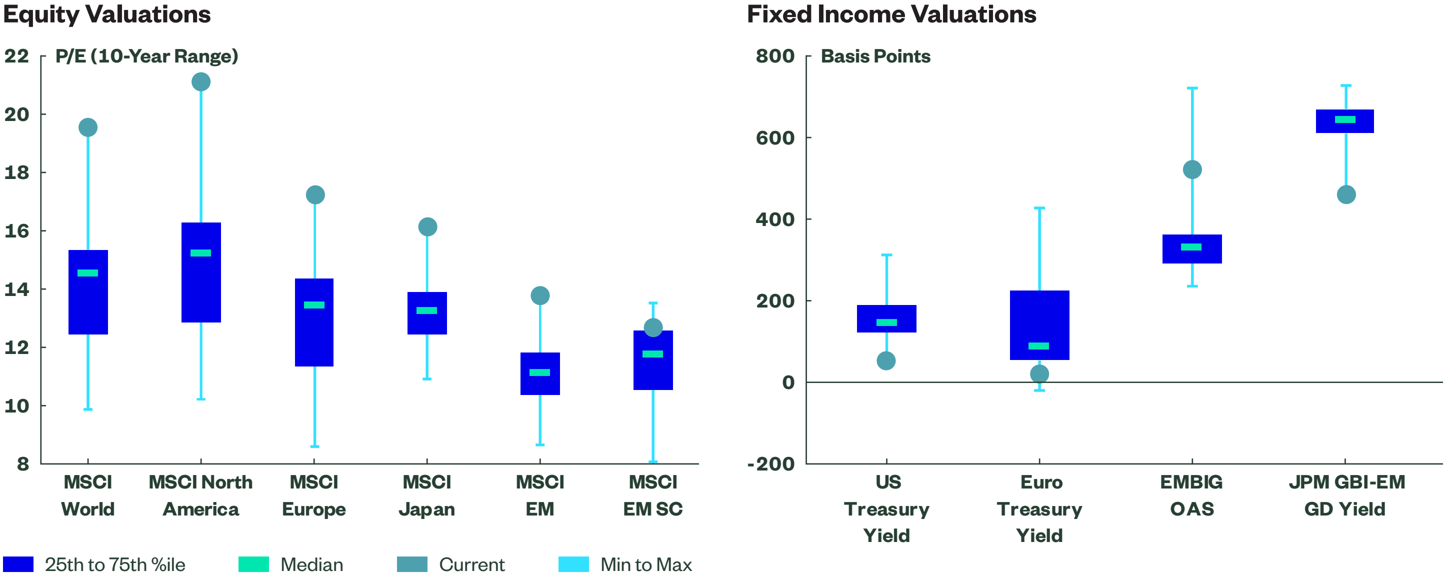


Source: State Street Global Advisors Global Macro and Policy Research, IMF as at June 2020.

Evaluating the EM Opportunity

EM assets continue to be under-represented in many investors' portfolios despite growth tailwinds. While EM valuations are no longer the opportunity they presented in the past, reflecting both the improvement over time in the structural investment environment and the reach for yield that has been a feature of the period since the great financial crisis, they still compare favourably with DM assets (Figure 3). Another factor to consider is the sensitivity of EM assets to US dollar fluctuations — EM assets rallied through 2019 as the US Federal Reserve began reversing some of the interest rate hikes implemented over the previous couple of years. This further highlighted the higher income potential from EM debt in a yield-starved world.

Figure 2
High Equity and Bond Valuations — EM and DM



Source: MSCI, JP Morgan, Bloomberg Finance LP, State Street Global Advisors as at 4 June 2020. Chart references MSCI regional indices; Fixed Income valuations refers to yield ranges of Bloomberg Barclays US and EUR Treasury indices and JPM EMBIG and GBI-EM the MSCI Emerging Markets index. PE = price to earnings ratio.

EM/DM Equity Correlations

Strong economic growth has contributed to a steady increase in the correlation of EM equity performance with DM stocks, but the benefits of diversification remain clear. Analysis of annual returns over the long term shows that average returns of EM equities when DM equity returns are negative are modestly (about 1.1 times) worse. But, when DM returns are positive, the EM/DM return ratio has been a considerably higher 1.5 times.

Figure 3
EM Equities: A High Beta Version of DM Equities

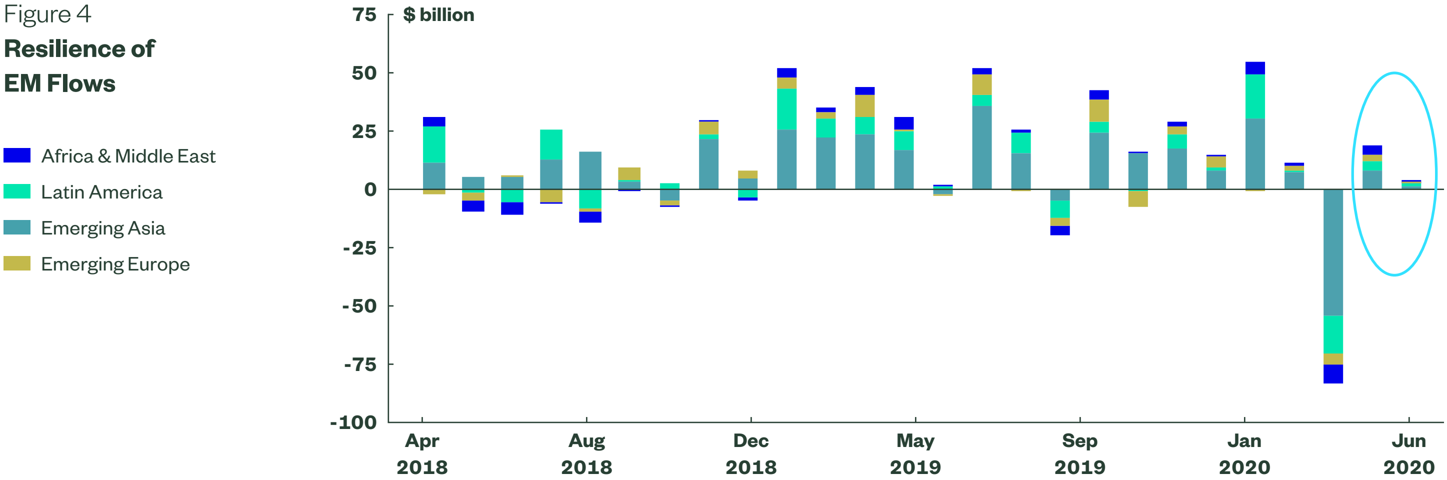
	Monthly Returns* (%)	Annual Returns** (%)
Average DM Return when DM Return is Negative	-3.40	-13.80
Average EM Return when DM Return is Negative	-3.40	-15.40
Average DM Return when DM Return in Positive	3.20	18.80
Average EM Return when DM Return in Positive	3.70	27.50

* Monthly Returns January 1988–December 2019
** Annual Returns December 1988–December 2019
Source: MSCI, State Street Global Advisors calculations as at 30 June 2020. DM=MSCI World Index. EM=MSCI Emerging Markets Index.
Past performance is not a reliable indicator of future performance.

EM Investing During COVID-19

Despite EM advances, the instinctive investor reaction during periods of market stress has often been a flight to 'quality'. The market response to the COVID-19 outbreak reflected this and the hit to emerging market assets was substantial, with DM assets experiencing less severe drawdowns in this period. However, the EM bounce back has been strong. With bond yields driven lower by the expectation of ultra-low rates for the foreseeable future, investors will invariably need to take on more risk to generate greater returns. Alongside superior EM economic growth, this should help bolster the prospects for EM assets — as Figure 4 illustrates, a partial reversal of the virus-related outflows was soon evident, reasserting the long-term trend.

Figure 4
Resilience of EM Flows



Source: State Street Global Advisors, Bloomberg Finance LP, National Sources, IIF as at 31 May 2020.

Considerations When Allocating to EM Equities

EM equities allow investors to access the companies benefiting from sustained global and EM economic growth. In building an EM equity portfolio, ensuring a core global exposure makes sense. But it also makes sense to be aware of the dynamic surrounding domestic consumption, knowing what's happening in the 'old' economy and thinking about how to be positioned to take advantage of changes that may be occurring in the likes of China and India, where consumer spending is continuing to grow.

Global equity valuations, including EM stocks, are not compellingly low, even after the pandemic-driven turbulence. But considering stocks on a relative basis, as well as for diversification purposes, is important in allocation decisions. In a world where EM accounts for about 60% of global GDP, a reallocation from some of the more expensive and highly-correlated equity segments to EM should be among key investor considerations.

Figure 5
Lower EM Correlations (June 2010–June 2020)

	China Equity	Global Developed Equity	European Equity	Japan Equity	EM Ex-China Equity
China Equity	1.00	–	–	–	–
Global Developed Equity	0.64	1.00	–	–	–
European Equity	0.60	0.94	1.00	–	–
Japan Equity	0.51	0.75	0.68	1.00	–
EM Ex-China Equity	0.68	0.83	0.81	0.62	1.00

Source: State Street Global Advisors, MSCI as at 30 June 2020.

EM Equity Allocation — A Core-Satellite Framework

In constructing EM equity portfolios, we favour a core-satellite framework that incorporates four building blocks — Index, Enhanced, Highly Active and Small Cap. At the core should be a significant allocation to index and enhanced equities as they offer liquidity and access across most markets. On top of these, consideration should be given to the themes you want to capture via a more active investment.

An active approach allows targeted exposure to themes such as, for example, growing EM consumption or growth/quality allocations. We also believe attention should be given to EM small cap stocks; there has been a tendency towards more nationalistic policies that help (typically smaller) domestic-oriented industries and the creation of national champions.

There is also a strong case for a disciplined long-term active fundamental approach to Chinese equities. Notwithstanding the 2020 growth shock from COVID-19, the world's second-largest economy offers considerable investment return and diversification potential. High market turnover and volatility, along with concentration of stock ownership among retail investors can lead to a less efficient market, creating opportunities for active investors.

Based on our own investment experience, we can establish what an optimal EM equity portfolio would look like (Figure 6).

Figure 6
Optimal EM Equity Portfolio

Strategy	Alpha (%)	Tracking Error (%)	Min Weight (%)	Max Weight (%)	Optimal EM Portfolio Weights (%)
Index	0.0	0.1	20	50	24
Enhanced	1.0	1.0	30	50	50
Highly Active	2.0	4.0	0	50	10
Small Cap	2.5	5.0	0	10	4
China	3.0	4.0	10	20	12

Source: State Street Global Advisors as at 30 June 2020. The above estimates are based on certain assumptions and analysis. There is no guarantee that the estimates will be achieved. For illustrative purposes only.

An Optimal EM Debt Portfolio

Emerging market debt (EMD) offers equity investors risk mitigation potential with minimal return dilution as well as a yield pick-up opportunity for fixed income investors willing to move along the risk spectrum. As the turbulence generated by the impact of COVID-19 illustrated, EMD carries greater headline as well as idiosyncratic risk, but in a low (and increasingly negative) global yield environment, the asset class offers significant potential. With inflation at low levels in most countries, EM central banks have the necessary flexibility to ease monetary policy, a key support for EM bond yields.

The EM debt market has grown significantly, with the total market size approaching US$20 trillion in 2018[1]. Its proportion of the global bond market has increased, from 2% in 2000 to over 25%. Even if we exclude less accessible EM local currency corporates, EMD still accounts for 16% of the global market.

EMD Investment Considerations

For investors seeking to exploit the EMD opportunity, there are three broad investible assets within the universe: hard currency (HC) sovereign, hard currency corporate (HCC) and local currency (LC) sovereign. HC sovereign and corporate EMD indices are comprised of US dollar-denominated bonds issued by emerging market sovereigns and corporates, while LC sovereign EMD includes local currency denominated debt issued by emerging market governments.

Quality The three EMD segments offer varying degrees of credit quality exposure: local currency sovereign EMD has the highest proportion of bonds with an investment grade rating (77%), while hard currency sovereign EMD has the lowest proportion (54%).[2]

Diversification Hard currency sovereign and corporate EMD indices are relatively well diversified by country and region. Local currency sovereign EMD, however, is more concentrated — the representative index contains only 18 countries, with the largest 10 making up 83%.[3]

Risks The risks for HC sovereign and corporate EMD assets are driven mainly by movements in US interest rates and credit risk in EM sovereign and corporates. A euro-based investor also has the additional consideration of US dollar fluctuation. The LC sovereign EMD asset is sensitive to movements in local rates and currencies, along with the credit risk of the underlying sovereigns.

Indexing Where EMD investing was once considered the preserve of active investment managers, more cost-efficient and transparent index approaches are now recognised as highly effective and are increasingly used by institutional investors to access the asset class.

Shift in EMD Returns

Historically, HC sovereign debt has outperformed the two other segments, although this trend was upended by the impact of COVID-19. Given weaker credit profiles and foreign borrowing, some countries (e.g. Argentina, Venezuela, Lebanon) with weak currencies and already-high debt obligations face challenges in averting a debt restructuring.

The timing of pandemic-related lockdowns was unfortunate as EM bonds had drawn strong support through 2019, with the rally bolstered by a decline in US rates as the Fed reversed the rate hikes of 2018 that had contributed to EMD underperformance in that year. However, the recovery has been uneven, with hard currency spreads remaining wide on worries about the severe near-term difficulties some countries face. On the other hand, local currency bond yields declined to new lows amid the disinflationary effects of the crisis and the significant monetary policy response by central banks.

Correlations Highlight Diversification Benefits

Emerging market debt returns have shown moderate correlation with both global bonds and global equities, highlighting potential diversification benefits. Within EMD segments, HC corporate debt has offered the best diversification benefit with global aggregate bonds due to its lower duration and more growth exposure. But, for investors combining global high yield and EM debt, LC sovereign debt offered the best diversification benefits (Figure 7).

Figure 7
EMD Asset Correlations (Jan 2003–Jun 2020, in EUR)

	EM HC Sovereign Debt	EM HC Corporate Debt	EM LC Sovereign	Global Aggregate Hedged	Global High Yield
EM HC Sovereign Debt	1.00	0.95	0.70	0.39	0.85
EM HC Corporate Debt	0.95	1.00	0.60	0.31	0.86
EM LC Sovereign	0.70	0.60	1.00	0.31	0.63
Global Aggregate Hedged	**0.39**	**0.31**	**0.31**	1.00	0.13
Global High Yield	**0.85**	**0.86**	**0.63**	0.13	1.00

Source: State Street Global Advisors, Bloomberg Barclays, JP Morgan as at 30 June 2020.

Building Exposures to EM Debt

In pulling together what an optimal EMD portfolio might look like, we established the long-term expected returns and risks of hard currency sovereign, local currency sovereign and corporate EMD, as well as four blended strategies (see table below). Our long-term fixed income return forecasts incorporate the current yield-to-worst of the respective bond segments, adjusted insofar as the local currencies are at a discount or premium to fair value versus the euro. Our long-term fixed income risk estimates, on the other hand, are based on historic risks.

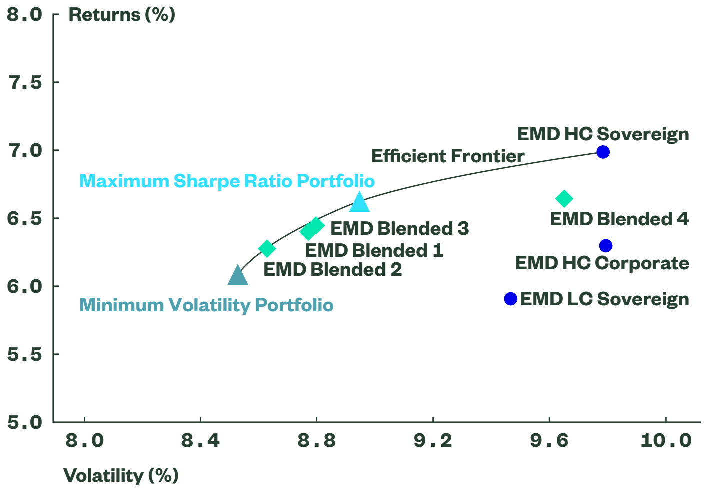
EMD Blended 1	33% EMD HC Sovereign + 33% EMD HC Corporate + 33% EMD LC Sovereign
EMD Blended 2	25% EMD HC Sovereign + 25% EMD HC Corporate + 50% EMD LC Sovereign
EMD Blended 3	50% EMD HC Sovereign + 50% EMD LC Sovereign
EMD Blended 4	50% EMD HC Sovereign + 50% EMD HC Corporate

Based on our forward return estimates, the EMD segments are expected to generate lower returns than in the past. This is due to lower yield levels (which have fallen sharply across markets) despite estimated aggregate undervaluation of EM currencies versus the euro.

Blending the EMD segments can provide attractive returns while reducing the risk profile compared to holding a single EMD asset. Moreover, blends that include local currency EMD (Blends 1, 2 & 3) have reduced volatility compared to a hard currency only blend. This is due to the FX component, which results in superior diversification benefits. By combining these components of EMD we can generate points along or near the efficient frontier, as shown in Figure 8.

Figure 8
Optimising EMD Portfolios for EUR Investors

Asset Class	Min Vol Portfolio	Max Sharpe Ratio Portfolio
	Weight (%)	Weight (%)
EMD HC Sovereign	0.00	23.70
EMD HC Corporate	46.30	2.50
EMD LC Sovereign	53.70	73.70
Total	**100**	**100**
Portfolio Expected Return	6.76	7.27
Portfolio Volatility	8.87	9.26
Reward to Risk	0.76	0.79
Yield to Worst	5.10	5.43
Duration	4.59	5.3
Yield to Worst per Duration	1.11	1.03



Source: State Street Global Advisors, MSCI, JP Morgan as at 30 June 2020. Returns do not represent those of EMD HC Sovereign, EMD HC Corporate, EMD LC Sovereign Developed Markets Equity, EM Equity, Global Aggregate (Hedged) and Global High Yield but were achieved by mathematically combining the actual performance data of these instruments. The performance assumes no transaction and rebalancing costs, so actual results will differ.
Past performance is not a reliable indicator of future performance.

Putting It all Together — Incorporating EM Equity and Debt Exposures

Having looked at how to construct "optimal" portfolios of either EM Equity and Debt alone, we now want to see how both EM Equity and EM Debt should have a place in investors' multi-asset portfolios given their higher expected risk-adjusted return and diversification to DM asset classes, as shown by the correlations in Figure 9 below.

Figure 9
EMD Returns Show Moderate Correlations with Global Bonds and Equity

	EM HC Sovereign Debt	EM HC Corporate Debt	EM LC Sovereign	MSCI World	MSCI EM	Global Aggregate Hedged	Global High Yield
EM HC Sovereign Debt	1.00	0.95	0.70	0.51	0.40	0.39	0.85
EM HC Corporate Debt	0.95	1.00	0.60	0.51	0.36	0.31	0.86
EM LC Sovereign	0.70	0.60	1.00	0.55	0.65	0.31	0.63
MSCI World	**0.51**	**0.51**	**0.55**	1.00	0.77	-0.05	0.69
MSCI EM	**0.40**	**0.36**	**0.65**	0.77	1.00	0.03	0.56
Global Aggregate Hedged	**0.39**	**0.31**	**0.31**	-0.05	0.03	1.00	0.13
Global High Yield	**0.85**	**0.86**	**0.63**	0.69	0.56	0.13	1.00

Source: State Street Global Advisors, MSCI, JP Morgan, Bloomberg Barclays, as at 30 June 2020.

Using the correlation structure in Figure 9 above, as well as the expected asset class returns and volatilities we used to generate the optimal EM Equity and Debt portfolios in Figures 6 and 8, we show below how adding 20% EM Equity and Debt to a DM 60/40 portfolio can improve its efficiency (measured by Reward to Risk). Figure 10 shows an example of what an improved portfolio could look like, based on incorporating State Street Global Advisors' strategies as building blocks. Once again, we could move along the efficient frontier by combining different proportions of EM and DM building blocks.

Figure 10
Incorporating Emerging Markets Exposures

Asset Class	60% Eq./40% FI Portfolio	Improved Portfolio
	Weight (%)	Weight (%)
EMD HC Sovereign	0.00	5.00
EMD HC Corporate	0.00	5.00
EMD LC Sovereign	0.00	5.00
Developed Markets Equity	60.00	45.00
EM Equity	0.00	5.00
Global Aggregate (Hedged)	30.00	28.50
Global High Yield	10.00	6.50
Total	**100**	**100**
Model Portfolio Historical Return	6.90	6.80
Model Portfolio Volatility	8.40	7.90
Reward to Risk	0.82	0.86
Yield to Worst	1.00	1.50
Duration	2.70	3.30
Yield to Worst per Duration	0.40	0.50

Source: State Street Global Advisors, MSCI, JP Morgan as at 30 June 2020. Returns do not represent those of EMD HC Sovereign, EMD HC Corporate, EMD LC Sovereign Developed Markets Equity, EM Equity, Global Aggregate (Hedged) and Global High Yield but were achieved by mathematically combining the actual performance data of these instruments. The performance assumes no transaction and rebalancing costs, so actual results will differ.

Summary

Emerging market assets offer investors a relatively attractive growth exposure at a time when developed economies' growth prospects have come under pressure. The superior growth dynamics and lower debt levels of many EM countries underpin the case for holding both EM equities and bonds, as does increasing affluence, favourable demographics and rising consumer spending in many countries. Balancing the return and diversification benefits against the headline and idiosyncratic risk attaching to EM assets is important when determining allocations and how to access the opportunities. We believe that adding EM equity and debt exposures to a DM balanced portfolio can improve efficiency and help enhance investment return potential.

Endnotes

1 Source: JP Morgan.

2 Source: JP Morgan as at 31 December 2019.

3 Source: JP Morgan as at 31 December 2019.

About State Street Global Advisors

For four decades, State Street Global Advisors has served the world's governments, institutions and financial advisors. With a rigorous, risk-aware approach built on research, analysis and market-tested experience, we build from a breadth of active and index strategies to create cost-effective solutions. As stewards, we help portfolio companies see that what is fair for people and sustainable for the planet can deliver long-term performance. And, as pioneers in index, ETF, and ESG investing, we are always inventing new ways to invest. As a result, we have become the world's third-largest asset manager with US $3.05 trillion* under our care..

* This figure is presented as of June 30, 2020 and includes approximately $69.52 billion 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.