Insights
Active Quantitative Equity (AQE)

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Emerging Markets Small-Cap Equity: Time to Dip in?

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Emerging markets small-cap equities are a distinct slice of the market, offering opportunities for certain investors, using the right methods. We believe that employing an active, quantitative investment process with robust information is an optimal approach to capitalizing on these opportunities.

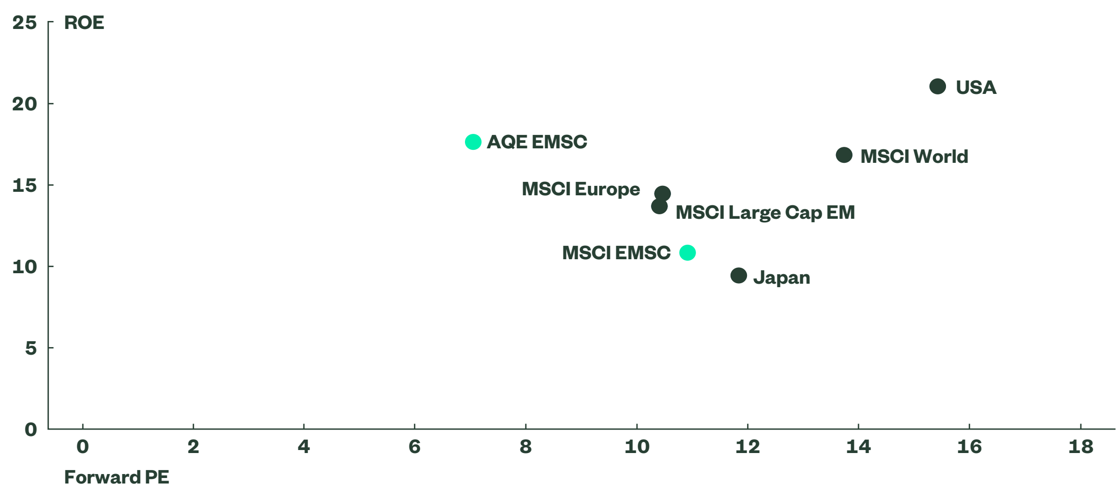
The world is changing. The emerging markets growth story over the last few decades has been a key narrative of the global economy. After a couple of years of declining growth as compared to developed economies, this trend is set to change in 2023 with growth in emerging markets re-accelerating. Investors routinely make allocations to developed markets small-capitalization companies, but often ignore their emerging markets counterparts, despite the potential return enhancement and diversification benefits. While there is much to like about emerging markets large-caps, the universe is now driven more so by global growth than economic growth in emerging markets, whereas small-cap names have greater exposure to domestic growth. The Active Quantitative Equity (AQE) team thinks it is time investors consider making an allocation to emerging markets small-cap stocks, an area of the market that we believe offers the most direct avenue to the emerging markets growth story.

Why Investors Should Consider Emerging Markets Small-Cap Stocks

Since its inception in 2007, the MSCI Emerging Markets Small Cap Index (EMSC) has changed markedly. In the past, the EMSC universe consisted almost exclusively of small, lower value-add companies which supplied the global and local firms exporting to the rest of the world. While these supply chain stocks remain an important part of the EMSC universe, more recently we have also seen a large influx of high intellectual property firms in fast-growing segments of the market. This development is particularly true in Asia where manufacturers of lithium batteries and solar power modules are becoming ever more prevalent in China. Likewise, in South Korea the health care sector has undergone a dramatic transformation, expanding beyond traditional pharmaceuticals with the addition of numerous innovative, cutting-edge biotechnology firms. We believe these changes in the constituency of the Index are in the early stages, and represent potential growth opportunities available within the emerging markets small-cap universe.

In many global markets, valuation levels are quite high currently — despite all the selling pressure in 2022. When we look at valuation to profitability in the EMSC universe, specifically on the dimensions of return-on-equity (ROE) to forward price-to-earnings (PE) levels, the prices have come down more than 2022 earnings (Figure 1). We believe this is an opportunity to find some well-valued, quality firms. For example, the State Street Global Advisors' AQE team is able to construct our Active Emerging Markets Small Cap portfolio with an ROE at attractive levels of greater than 17% and with a PE more than a third lower than the MSCI EMSC Index.

Figure 1
Profitability and Value



Source: State Street Global Advisors, MSCI, FactSet. Data as of 09/30/2022.

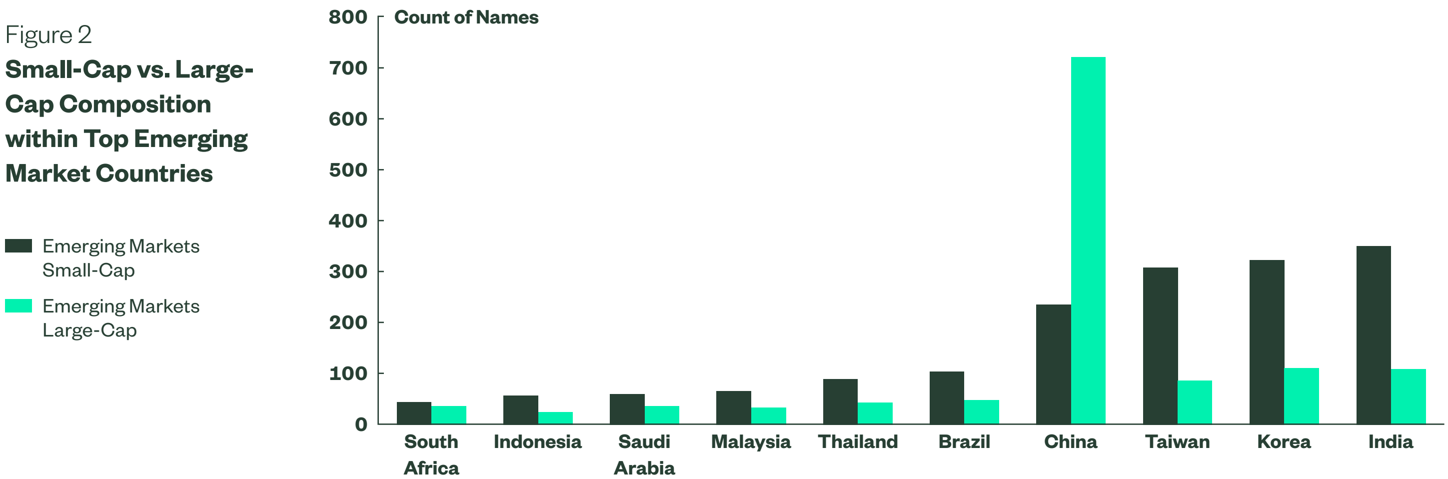
Why Active?

There are strong arguments for considering an active approach when investing in small-cap equities in emerging markets. While there are clear benefits to indexing from an overall investing perspective, indexing remains a difficult proposition for investors in the emerging markets small-cap space. Tracking a theoretical index in the EMSC arena provides added challenges due to liquidity constraints and other costs associated with full or even partial replication. The large number of names, the cost of investing in emerging markets, and the high index turnover are all strong headwinds for an indexing approach. Examining the track records of some long-standing indexing strategies in the space, we observe that there has been underperformance compared to the benchmark. We believe an active approach reliant on robust research and analysis of companies offers an effective solution to addressing these indexing constraints and optimizing potential for alpha generation.

The Importance of Balance in Investing

Emerging markets investors are also challenged by the sheer concentration of China names in the standard MSCI Emerging Markets Index (EM), largely driven by the high growth of China's composition within this EM index (China now represents nearly 40% of this index). Investors in the standard EM space are widely buffeted by the love/hate cycle surrounding Chinese assets because of COVID-19, regulatory uncertainty, and geopolitical concerns. Amazingly, over 50% of the securities in the MSCI Emerging Markets Index (EM), or over seven hundred names, resides in a single country, China. Upon closer examination of the EM benchmark's concentration, we note that approximately only 10% of the names in the EM index make up over 60% of the Index's overall market capitalization. This contrasts with the MSCI Emerging Markets Small Cap Index (EMSC), where the largest 10% of names constitutes less than 30% of the EMSC Index's market capitalization. Additionally, China is only about 10% of the total EMSC universe. (Figure 2) The added breadth in emerging markets small-caps provides a much richer and diverse set of opportunities for bottom-up stock selection.

Figure 2
Small-Cap vs. Large-Cap Composition within Top Emerging Market Countries



Source: State Street Global Advisors, MSCI, FactSet. Data as of 09/30/2022.

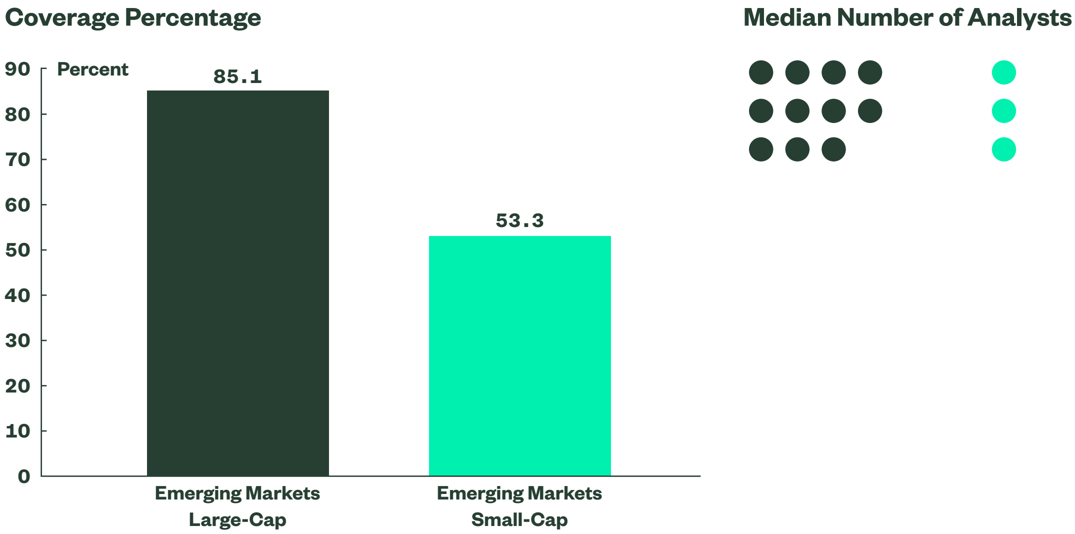
Active Emerging Markets Small-Cap — Why a Quantitative Approach is Best Suited

While we are proponents of an active investing philosophy in this space, there are strong reasons to lean into a quantitative approach. Analyst research coverage of the emerging markets small-cap equity space is low, resulting in limited information. The brokerage community has not made major investments in covering these companies. In fact, just over 50% of the names in the universe has analyst coverage (versus nearly full coverage for names in the standard MSCI Emerging Markets Index). Interestingly, this coverage issue has barely grown since we launched our Emerging Markets Small Cap Active Strategy nearly fifteen years ago. Fundamental investors often rely on sell-side support (data, forecasts) and/or investor relations departments (data, management meetings) to support their investment decisions. This potential neglect or lack of attention by other investors offers unique opportunities for active managers, especially those with information or insights across the full universe of securities.

A quantitative investment approach is much more independent. Our edge is that we have best-in-class data infrastructure that collects the latest and most important publicly-available information on nearly 4,000 emerging market stocks. On a daily basis, our models evaluate the optimal set of stocks to build a portfolio. Through this rigorous process, we minimize inertia or slippage when it comes to finding the best stocks to buy.

Additionally, sell-side analyst coverage is heavily tilted towards the (much) larger names in the universe. Many of our team's best investments are off the beaten path. Our model zeros in on firms with attractive valuations, strong quality characteristics, and signs of improving fundamentals. If we can find these names before other investors, that is an even better outcome.

Figure 3
Comparison of Analyst Coverage

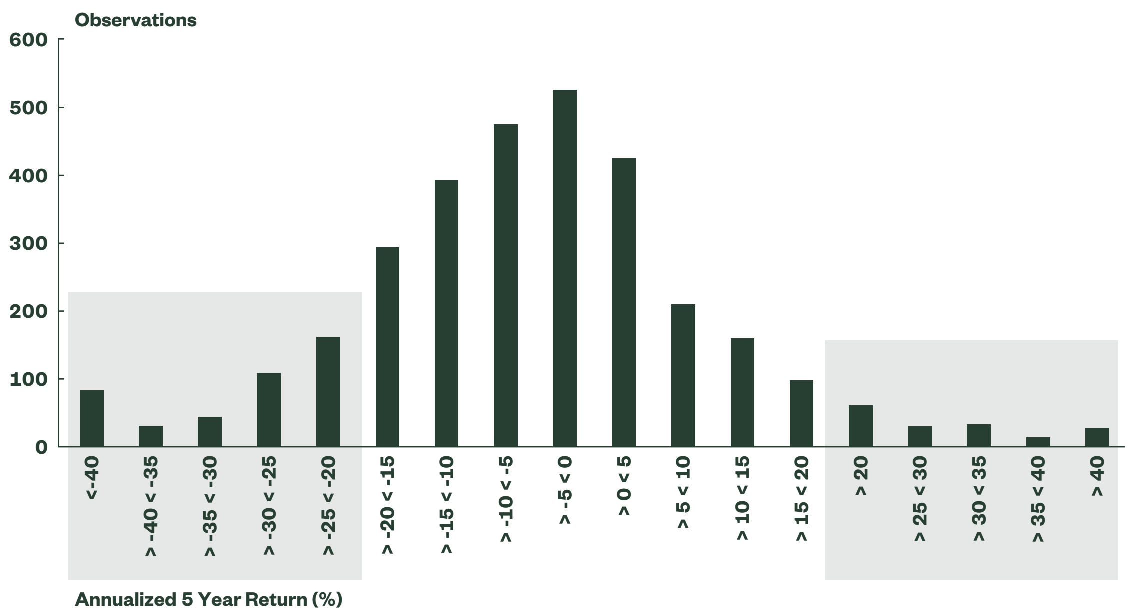


Source: State Street Global Advisors, MSCI, FactSet. Data as of 09/30/2022.

Risk Management and Diversification — Keys to Our Strategy

Most investors understand that the returns of financial assets are often skewed. What this means is that there are scenarios of outcomes, or "fat tails," that are larger than otherwise anticipated, and there are extremely unlikely scenarios, or "black swans." While this is true across nearly all segments of the market, it is doubly so in emerging markets small-cap equities. In Figure 4 below, stock returns in the emerging markets small-cap space exhibit a non-normal distribution, specifically concentrated tails. However, the weight in the negative tail is much fatter than the weight in the positive one. For managers who have the skills to pick a few good stocks, they can generate strong returns. However, if a manager running a concentrated portfolio gets a position wrong, there can be a very long recovery period. Our philosophy is to be diversified and to carefully limit the position in any one name, an approach which can only help a portfolio with this distribution profile.

Figure 4
Five-Year Annualized Stock Performance Histogram of MSCI Emerging Markets Small-Cap Index

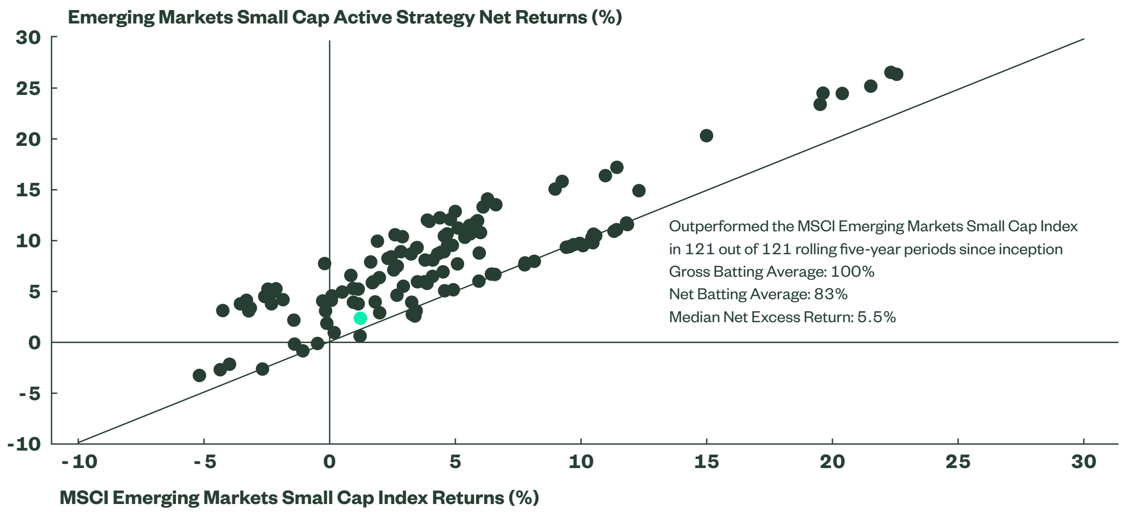


Source: State Street Global Advisors, MSCI, FactSet. Data as of 09/30/2022. Past performance is not a reliable indicator of future performance.
Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

Our recommendation is simple: be diversified. State Street Global Advisors' AQE team believes incorporating, as exhaustive as possible, security level risk and return factors into the portfolio optimization process is one of the most effective ways to mitigate idiosyncratic tail risk.

The AQE team's approach in the EMSC space has experienced many market cycles and we can confidently state it has delivered a track record of 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 Emerging Markets Small Cap Active Strategy (Figure 5). The scatter illustrates the strategy's trailing five-year excess return against its respective benchmark rolling back monthly to its inception on October 1, 2007. On a net basis (max fee rate methodology), our Emerging Markets Small Cap Active Strategy has delivered a 83% net batting average, outperforming the index in over 80% of the five-year periods since its inception. On a gross basis the strategy has a 100% batting average, outperforming the index in every five-year period.

Figure 5
Rolling Five-Year Excess Return of State Street Global Advisors' Emerging Markets Small Cap Strategy



Source: State Street Global Advisors, MSCI. Data as of 09/30/2022. 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.

The Bottom Line

Emerging markets small-cap equities are a distinct universe of securities with an abundance of opportunities for the right investor, using the right method. Due to the greater breadth, lower concentration, lack of analyst attention, and non-normal returns, we believe that employing a quantitative investment process with a breadth of information is the optimal approach to capitalizing on these opportunities.

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 index and active 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 fourth-largest asset manager* with US $3.26 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2021.
† This figure is presented as of September 30, 2022 and includes approximately $55.12 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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Investments in small-sized companies may involve greater risks than in those of larger, better known companies.

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