Insights
Emerging Markets

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What's Next? Building a Robust EM Equity Portfolio

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Global financial markets have shown signs of settling down after the deep sell-off of risk assets as a result of pandemic-driven economic concerns and the subsequent sharp rebound. Emerging markets assets were swept up in this turbulence and having participated in the rally, it may be timely for investors to consider how best to manage their EM equity exposures.

The rebound in emerging market equities since the COVID-19 lows recorded in March has been facilitated in part by some easing of US dollar strength and a recovery in the oil price as OPEC moved to better align supply with reduced demand. Along with the general improvement in global risk appetite, the softening of these two headwinds helped underpin the bounce of some of the assets worst affected in the initial downdraft. Given the extremely accommodative monetary policies of the US Federal Reserve, a significant rise in the dollar seems unlikely, while the reopening of economies and tighter oil supply should provide some protection for oil prices. This presents investors with a window to consider how to address their EM allocations.

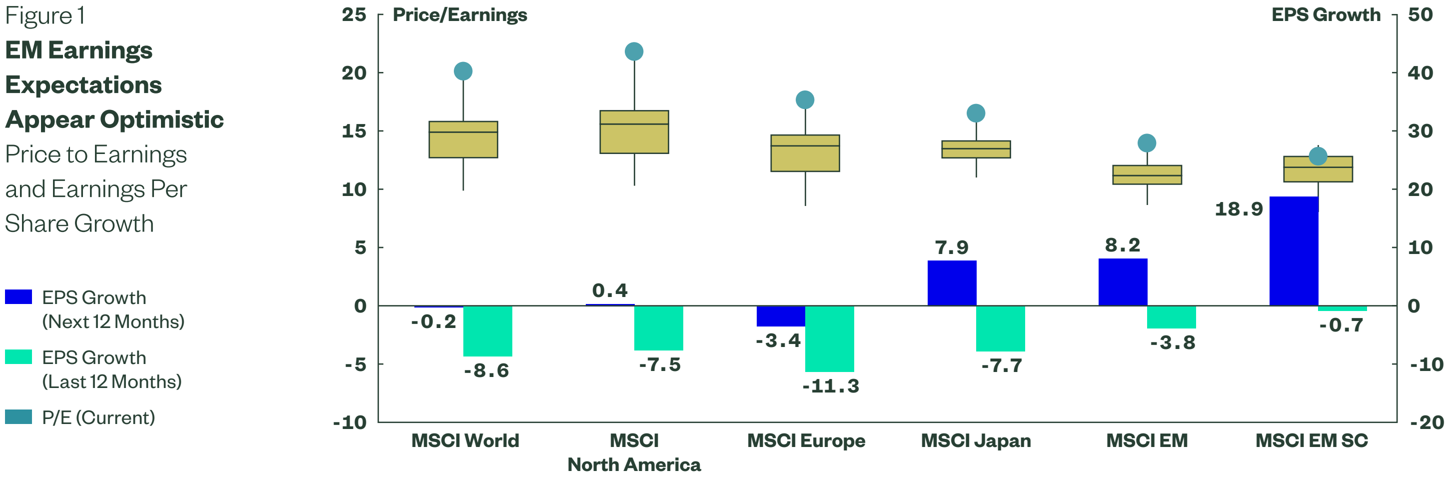
Assessing EM Equity Valuations

Equities around the globe are not cheap. Valuations were stretched heading into the COVID-19 period and the rapid stock market rebound from the lows means there isn't the same value as became available during March. But within an equity portfolio it is important to consider stocks on a relative valuation basis when it comes to making allocations.

So, while EM equities as an asset class cannot be classified as cheap, a comparison with European equities suggests that some reallocation from the latter to EM has merit. European equities had previously offered more attractive potential, largely because company earnings had recovered faster than their counterparts in the EM universe. But in a relatively short space of tine the investment case has shifted, and EM stocks now appear to have better upside potential.

But while relative EM valuations stack up well, it is worth noting there has been a considerable adjustment in earnings growth expectations. One concern would be around EM earnings per share expectations over the next 12 months. As Figure 1 illustrates, estimates for EM are high — unless there is a rapid reopening of economies from COVID-19 lockdowns and an upgrade in economic activity, these would appear to be optimistic.

Figure 1
EM Earnings Expectations Appear Optimistic
Price to Earnings and Earnings Per Share Growth



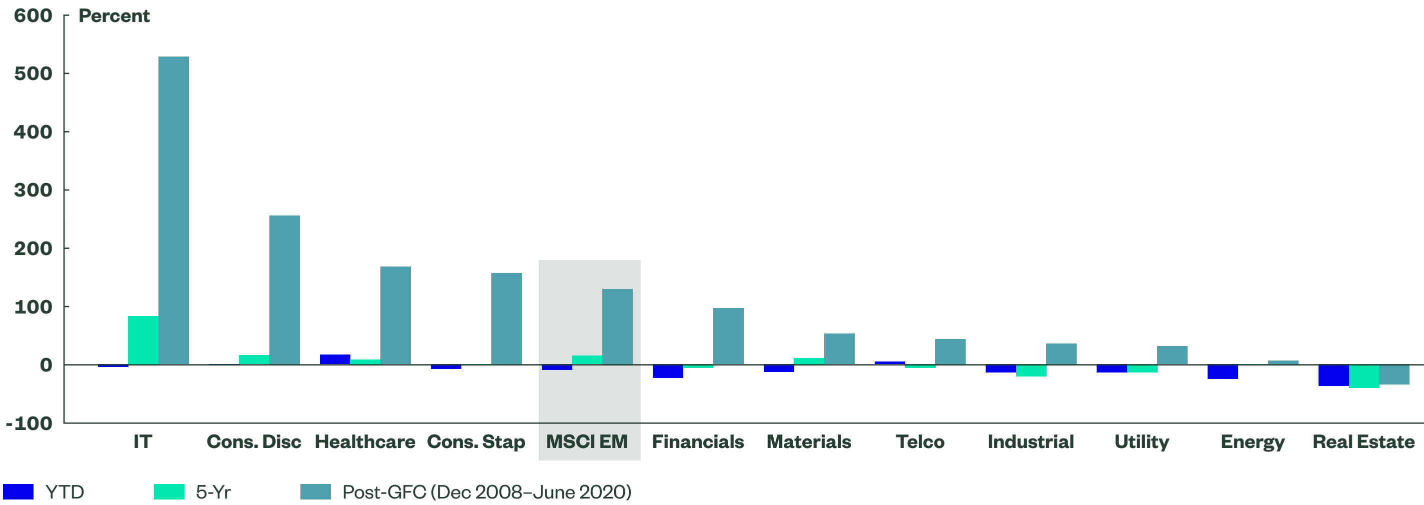
Source: State Street Global Advisors, Bloomberg Finance LP, as of 4 June 2020.

A Shift Towards Growth in EM

In terms of EM performance, one aspect of market moves that has caught the attention is the dispersion in sector returns. Within the EM equity benchmark, there is increasingly more focus on consumption, technology and growth. If we look at the aggregate behaviour of EM, in terms of what happens to EM during periods of risk aversion and how it behaves in relation to US dollar moves, we still see high levels of correlation.

In thinking about an EM equity portfolio, ensuring there is a core global exposure makes sense. But it also makes sense to be aware of the dynamic surrounding consumption, being aware of what's happening in the 'old' economy and thinking about how to be positioned to take advantage of the changes that may be occurring in the likes of China and India, where consumer spending is continuing to grow.

Figure 2
MSCI EM Index Sector Returns (Cumulative)

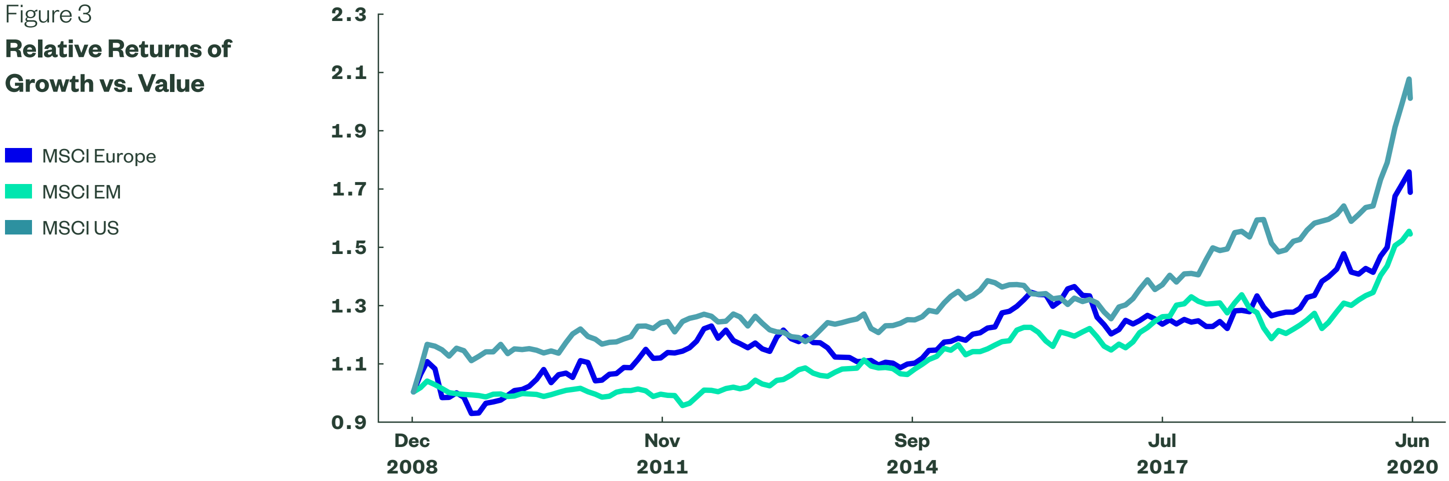


Source: Bloomberg Finance, L.P as of 4 June 2020. Past performance is not a guarantee of future results. Performance of an index is not illustrative of any particular investment. It is not possible to invest directly in an index.

Value Performs Relatively Well in EM

There is also a notable differential between the performance of growth and value in EM and DM markets. While there is a segment of EM growth companies that have done very well, there has been a relatively small performance gap between growth and value (at an index level) over the longer term. In the period since the GFC, all markets have seen growth companies typically do better than their old economy peers, but the effect in DM has been greater. This is evident in Figure 3, where the US growth benchmark has outstripped the US value benchmark by 110% on a cumulative basis since 2008. The comparative EM growth index outperformance over EM value is about 50%, or half that of the US.

Figure 3
Relative Returns of Growth vs. Value



Source: Bloomberg Finance LP, State Street Global Advisors as of 4 June 2020. Past performance is not a guarantee of future results. Performance of an index is not illustrative of any particular investment. It is not possible to invest directly in an index.

Building an Optimal EM Equity Portfolio

In constructing an EM equity portfolio, it is important to establish how best to gain exposure to the themes you believe will be rewarded over the long term. We believe that utilising four key building blocks can help achieve this this — Index, Enhanced, Highly Active and Small Cap. Additionally, it is worth considering more regional investments to take advantage of specific opportunities.

We favour a core-satellite framework that incorporates these building blocks. At the core should be a significant allocation to index and enhanced equities as this offers good liquidity across most markets and trading is easier than it would be within an active equity book. After that, consideration should be given to what trends you want to capture via a more active investment. Investors should look at this approach to gain targeted exposure to themes such as growing EM consumption and for 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 seeks to create national champions.

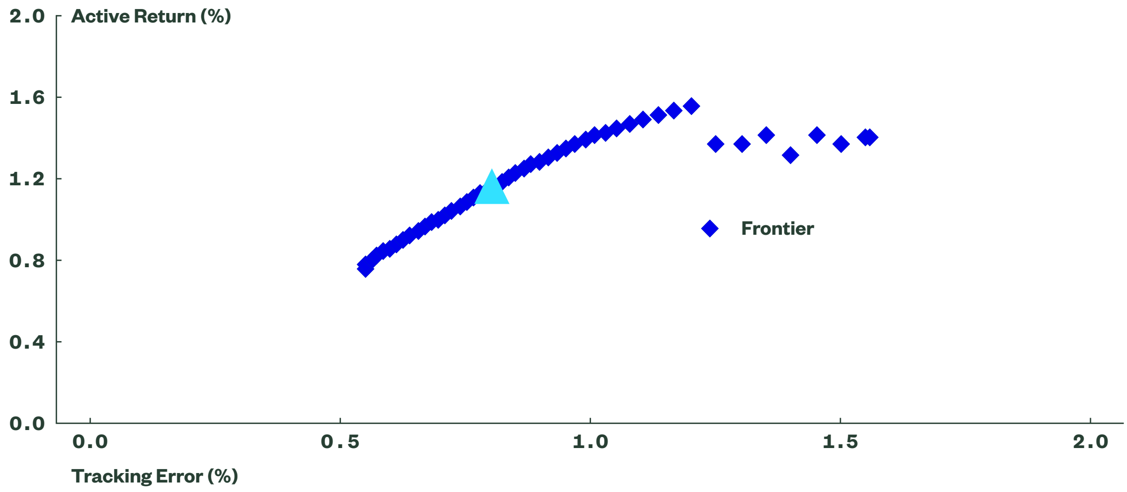
In creating an 'optimal' EM equity portfolio, we set out assumptions used in the table in Figure 4 to determine the allocations to the building blocks, which are included in the final column. This optimal portfolio (highlighted on the efficient frontier in Figure 5) would have a tracking error of 0.80%, excess return of 1.16% with an information ratio of 1.44%.

Figure 4
Assumptions Used to Create the EM Efficient Frontier

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: MSCI, State Street Global Advisors. The above estimates are based on certain assumptions and analysis. There is no guarantee that the estimates will be achieved.

Figure 5
The EM Equity Efficient Frontier



Source: State Street Global Advisors Calculations. For illustrative purposes only.

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