Emerging Markets

Opportunity, Trade or Value Trap?

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Investors who need high return assets to achieve high return targets have increasingly looked to emerging markets (EM). While we are less enthusiastic about the turnaround story in EM equities, where we perceive challenges relative to investing in developed markets (DM), we agree that EM debt can help close that gap.

EM Equities Face Growth, Valuation and Profitability Challenges

Growth Gap

Capturing the growth premium — that is, the faster pace of expansion as EM economies develop — has long been cited as a reason for investing in EM. But the spread between EM and DM GDP growth rates has been shrinking as China's economic expansion has slowed. The steady advance of technology and automation has powered the evolution from expensive labor to cheap labor to machines, eroding EM's primary competitive advantage. And we have seen a sharper pickup in manufacturing purchasing managers' indices (PMIs) in DM than in EM over the past four years. Based on such evidence from both longer term and higher frequency data, investors today have grounds to wonder whether EM growth will be better than DM growth going forward.

Valuation Gap

Measured by price to forward earnings (P/E), the MSCI Emerging Markets Index has become deeply discounted relative to the MSCI World Index (see Figure 1). If such a gap can be taken as a signal of market inefficiency, investors may be induced to buy EM equity. But what if markets are efficient? EM stocks could be cheap for a reason to reflect more risk relative to DM. Bear in mind that the state-owned entities (SOEs) prevalent in the energy, materials and financials sectors account for roughly half of the MSCI EM benchmark. SOEs are essentially bets on structural reform to open up closed economies and to bring in foreign investors by privatizing banks and energy companies. But such events are hard to predict. Once we adjust for SOEs, we no longer see the same depth of discount (see Figure 2). This suggests to us that on a valuation basis, EM equities may not be as attractive as they seem, and investors need to be careful to avoid stepping into value traps.

Profitability Gap

While EM margins historically exceeded DM margins, that trend has reversed as EM margins have eroded since the global financial crisis. A basic tenet for shareholders is to look for investments where the return on equity (ROE) exceeds the cost of equity (COE), but that has not been the case in EM for the past eight years — another reason why we could argue that the EM valuation discount may be justified (see Figures 3 and 4).

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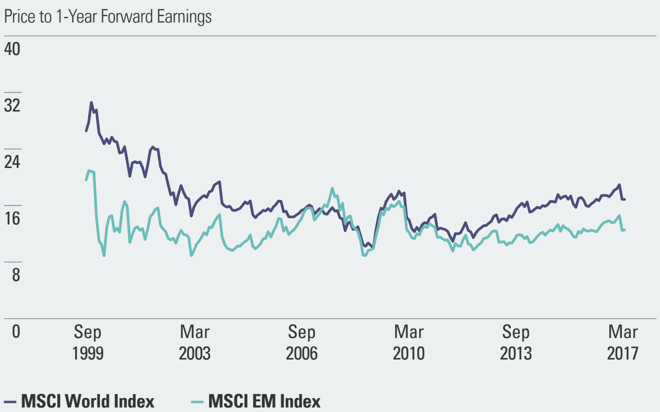
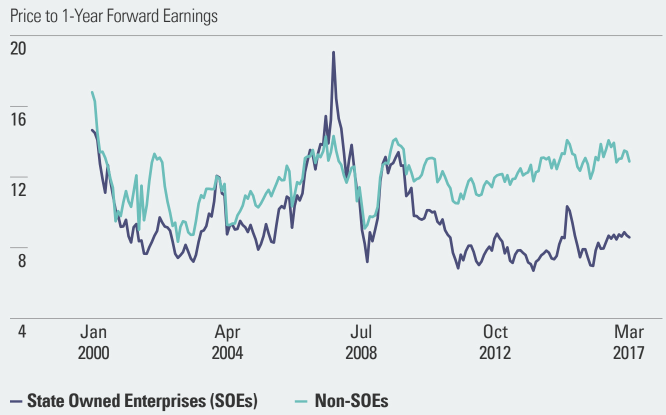
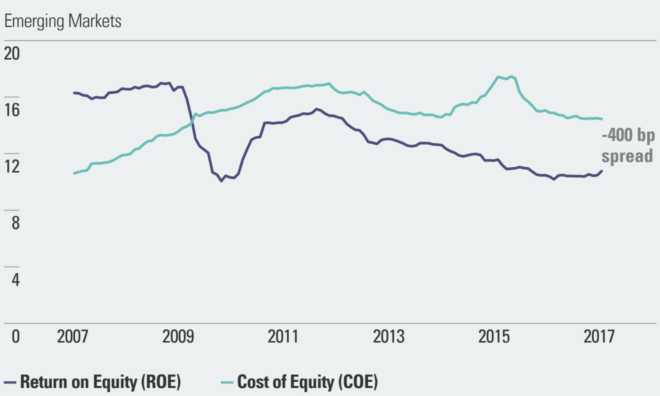
Figures 1 and 2: Are EM Valuations Attractive on a Relative Basis?

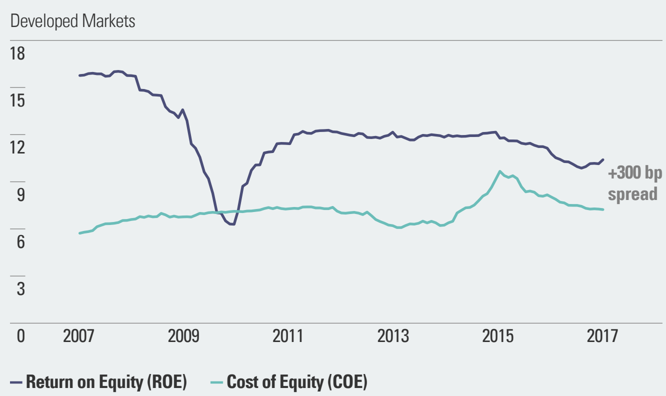




Source: FactSet, MSCI, UBS as of March 31, 2017 and UBS as of April 30, 2017.
Index returns reflect capital gains and losses, income and the reinvestment of dividends. Past performance is a not a guarantee of future results.

Figures 3 and 4: Comparing the Cost of Equity





Source: FactSet, MSCI, Bank of America Merrill Lynch as of March 31, 2017.

Finding Strategic Opportunities in EM Equities

For investors who allocate to EM equities as part of a long-term strategy to capitalize on powerful demographic trends and structural reforms in developing nations, these three challenges highlight the need for a thoughtful approach. The MSCI EM Index itself has some idiosyncratic challenges, but there is good news as the problematic materials and energy sectors have been shrinking in share, while information technology has expanded to roughly the same weight as in the S&P 500 Index.

Notably, MSCI has just announced the inclusion of shares trading on mainland Chinese exchanges into the benchmark. This is a major milestone along the country's path to open its domestic financial markets and attract capital flows from foreign investors. We believe managers with the most experience in the region will be in the best position to help investors review their options for accessing the growth potential of China in the newly re-weighted index.

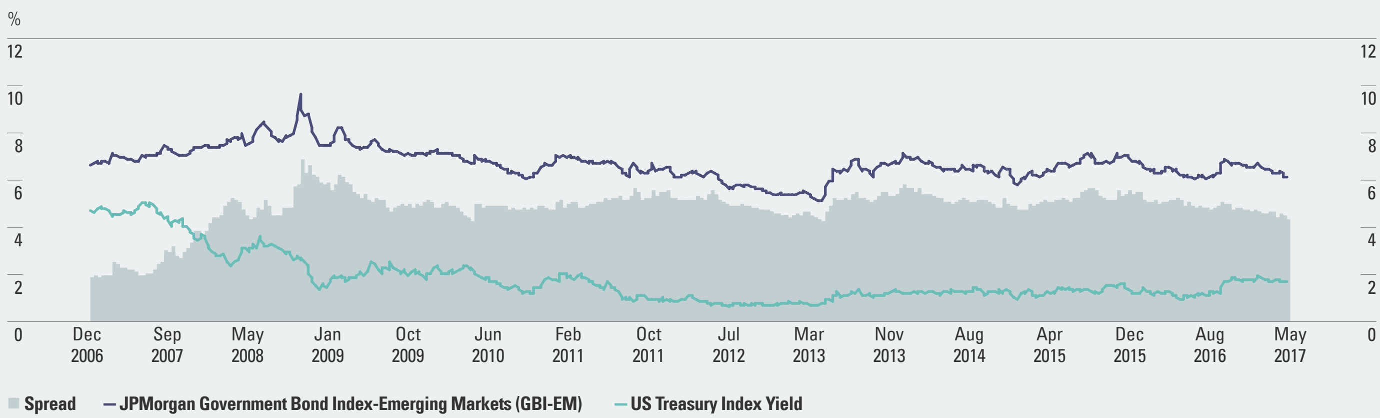
Other investors who are willing to move beyond the benchmark may benefit from a selective approach to EM equities, taking the time to conduct thorough analyses and identify attractive opportunities. For example, we expect companies that have more exposure to domestic economies and less of a multinational focus to reap the greatest benefit from the promise of a reflationary environment.

Making the Case for Emerging Market Debt

In the large, diverse and relatively liquid EM debt market — with roughly USD 4 trillion of assets, about two times the size of the global high yield market — investors have come looking for income, the main reason that the record inflows into EM have been mostly on the debt side. The low yield environment has made EM debt valuations particularly compelling (see Figure 5). So far the inflows have been relatively small in comparison to the outflows in previous years, suggesting to us that this trade has not become overcrowded.

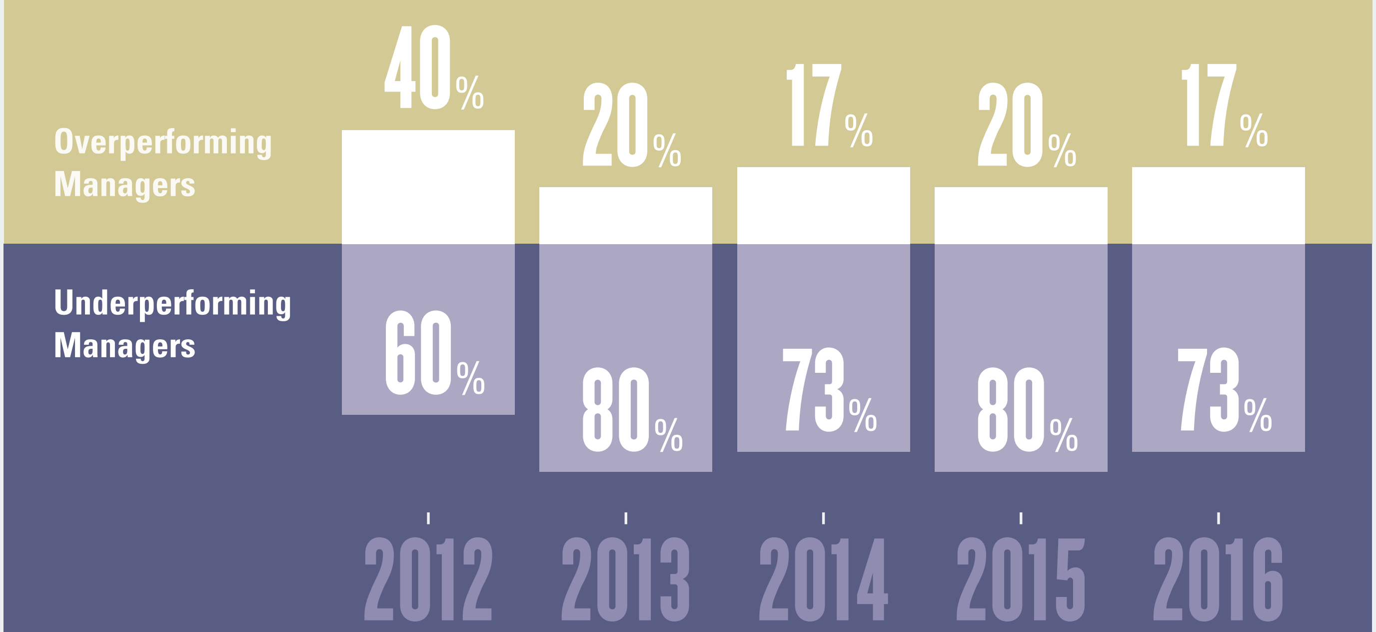
Given the unattractive return forecasts we have for sectors such as global government and investment grade bonds, investors may need to move out along the risk spectrum to meet their income targets. Yet when we consider performance in terms of return per unit of risk, we find that EM debt at the index level has provided more income than DM bonds while also acting enough like a growth asset to outpace EM equities. And investing in EM debt has provided diversification, thanks to the low-to-moderate correlation with equities and fixed income across the globe.

Figure 5: Emerging Market Debt (EMD)



Source: SSGA, Bloomberg Barclays, JP Morgan as of June 9, 2017.
Past performance is not a guarantee of future results.

Figure 6: EM Debt in Local Currency Challenging for Active Managers



Source: Morningstar Direct data as of December 31, 2016. The universe is generated by selecting the 30 largest active funds as of December 31, 2016 with the primary prospectus benchmark of JP Morgan GBI-EM Global Diversified Index with an available track record history of 5 years. Past performance is not a guarantee of future results. Performance is stated net of fees.

Behavioral Bias of Traditional Active Managers

Yet for investors in actively managed EM debt, persistent shortfalls have not made a compelling case for this approach. Over the past five years, only a small proportion of active funds have returns exceeding the index (see Figure 6). Our analysis of return per unit of risk taken by active managers relative to the underlying index highlights what we call the *style problem*: Active managers have tended to take more risk and get less return than the benchmark.

Consider Intelligent Indexing in EM Debt

The lackluster track records of most active managers have prompted investors to reconsider more passive or systematic EM debt managers. At SSGA, we welcome this trend, as we consider indexing to be a truly credible alternative that can address the behavioral biases exhibited by traditional active EM debt managers.
By designing an approach that aims to minimize turnover and trading costs, we have sought to add value for our indexing clients consistently over a 10-year track record. And with EM currencies moving from being overvalued to moderately undervalued as global growth improves, we view this as an attractive entry point for new investors and a great way to get exposure to EM.

Additional Reading

China A-Shares Added to EM Index
By Kevin D. Anderson
SSGA Blog, June 20, 2017

Emerging Market Debt: Passive Management on the Rise
By Konstantin Nemnov and Niall O'Leary
SSGA IQ Insights, June 2017.

Factors at Play for Local Currency Emerging Market Debt
By Abhishek Kumar and Niall O'Leary
SSGA IQ Insights, April 2017.

Primer on China's Onshore Bond Market: Third Largest Debt Market Opening to Foreign Investors
By David Furey and Bruce Zhang
SSGA IQ Insights, March 2017.

Glossary

Active vs. Passive Management An actively managed approach involves a manager choosing securities based on qualitative and quantitative attributes to build, say, a fixed income portfolio. A passive approach involves managing a portfolio so that it tracks an index, such as the Bloomberg Barclays US Aggregate Bond Index.

Cost of Equity (COE) A firm's cost of equity represents the compensation the market demands in exchange for owning the asset and bearing the risk of ownership; it is often used as a capital budgeting threshold — that is, the rate of return a company requires to determine if an investment meets capital return requirements.

JPMorgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversification Indices are comprehensive emerging market debt benchmarks that track local currency bonds issued by EM governments. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect capital gains and losses, income, and reinvestment of dividends.

Last Twelve Months (LTM) The immediately preceding 12 months in reference to a financial metric used to evaluate a company's performance, such as revenue or debt to equity (D/E). Although a relatively short time span for examining a given equity evaluation measure, a 12-month period is considered useful because it represents a company's most recent performance, and therefore may be indicative of the current trend. It is also known as trailing twelve months (TTM).

MSCI Emerging Markets (EM) Index A free float-adjusted market capitalization index designed to measure equity market performance in 23 global emerging market economies: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and the United Arab Emirates.

MSCI World Index A broad global equity benchmark that represents large and mid-cap equity performance across 23 developed market countries, covering approximately 85% of the free float-adjusted market capitalization in each country; the MSCI World Index does not offer exposure to emerging markets.

Return on Equity (ROE) The amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

S&P 500 Index A market value weighted index of 500 stocks reflects the performance of a large cap universe that is made up of companies selected by economists; the S&P 500 is one of the common benchmarks for the US stock market, and investment products based on the S&P 500 include index funds and exchange-traded funds.

Yield The income return on an investment, such as the interest or dividends received from holding a particular security.

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