Drivers of Returns in Emerging Markets Equities: The Growing Importance of Stock Selection

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Executive Summary

Many institutional investors believe that a top-down, macroeconomic investment approach is the most effective way to generate returns in emerging markets equities. While optimal country and sector bets can result in outperformance, QMA's research has shown that bottom-up stock selection is at least as important in exploiting inefficiencies within emerging markets equities and in driving consistent performance over the long term. This research suggests that institutional investors should include systematic, bottom-up, fundamentally based strategies within their emerging markets equities allocation. Otherwise, they risk limiting the total return of their emerging markets equities portfolio, and potentially increasing the volatility of those returns.

The Drivers of Returns Have Changed

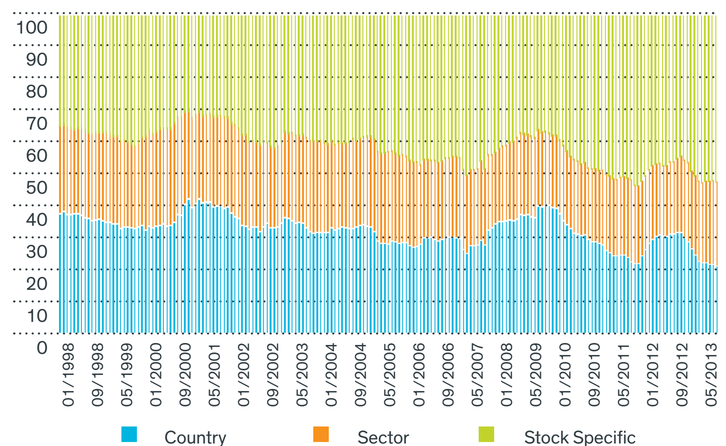
Emerging markets equities have matured as an asset class. Years ago, macroeconomic factors and country and sector bets had an outsized impact on the total return of an emerging markets equities portfolio. In 1988, when MSCI first launched its Emerging Markets Index, it was small, comprised of just 10 countries representing 1% of global market capitalization[i]. Market access was difficult, data coverage and quality weak, transparency nearly non-existent, liquidity poor, and transaction costs high. In those days, an investment process based on country and sector picks was an efficient means of delivering returns.

But much has changed in the last 25 years, including the composition of the MSCI Emerging Markets Index. Today, it covers over 800 securities across more than 20 countries and represents 11% of global market capitalization[ii]. QMA research has identified three trends revealing that the primary source of emerging markets equities' total return has been shifting from country and sector selection towards stock selection:

1. The country dispersion of returns within the Index has tightened.
2. Data coverage and quality are dramatically better, and corporate governance and transparency have improved.
3. Liquidity is higher and transaction costs across a wide range of individual stocks have dropped.

As a result of these trends, the importance of country and sector selection has declined within emerging markets equities. As recent as 2001, country and sector picks accounted for almost 70% of the MSCI Emerging Markets Index's total return. Since then, the

1 / DECOMPOSITION OF RETURNS IN EMERGING MARKETS



Source: QMA, Morgan Stanley, FactSet as of July 31, 2013

Although the global financial crisis temporarily interrupted the trend, it resumed in late 2009, and by 2013, stock-specific factors accounted for over 50% of the index's total return[ii]. While this evolution has created a challenging environment for investment managers who make country and sector bets, it has increased the opportunities for stock pickers. Accordingly, institutional investors are likely to benefit if they include systematic, bottom-up strategies in the management of their emerging markets equities investments. Otherwise, they risk limiting the total return of their emerging markets equities portfolio, and potentially increasing the volatility of those returns as well.

It is important to note that while the drivers of emerging market equity returns are changing, the overall alpha opportunity in these markets does not appear to have diminished in the last decade, as can be seen in Exhibit 2 which shows the quarterly excess returns achieved by the top quartile and median managers in the eVestment Emerging Markets Equity universe.

[i] Source: Morgan Stanley

[ii] The data was derived by decomposing the weighted stock variance into individual components (overall market, sector, and company-specific contributions) in the emerging equity markets. This approach is based on the original idea proposed by Campbell et al (2001) to disaggregate the total stock variance in a model-independent framework.

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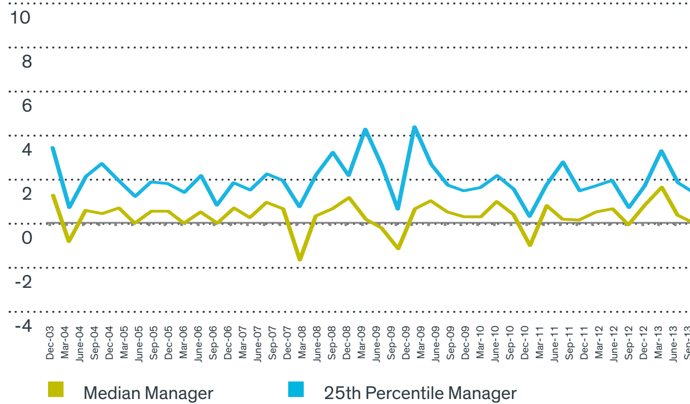
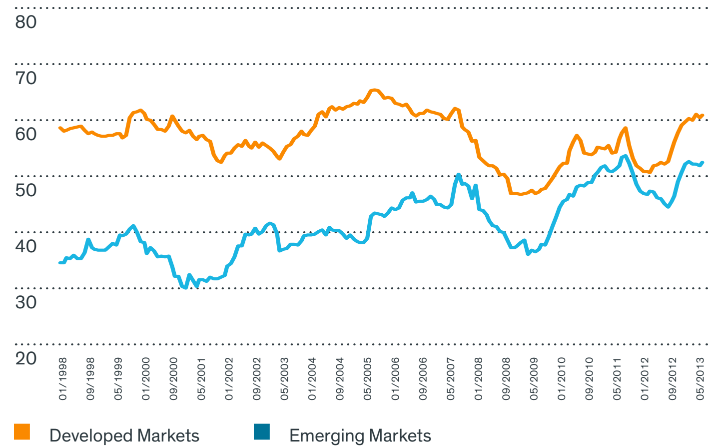
2 / EMERGING MARKETS EQUITY UNIVERSE[iii1] QUARTERLY EXCESS RETURNS



Source: eVestment, as of September 30, 2013.

4 /SPECIFIC STOCK RETURN CONTRIBUTION



Source: QMA, Morgan Stanley, FactSet as of July 31, 2013

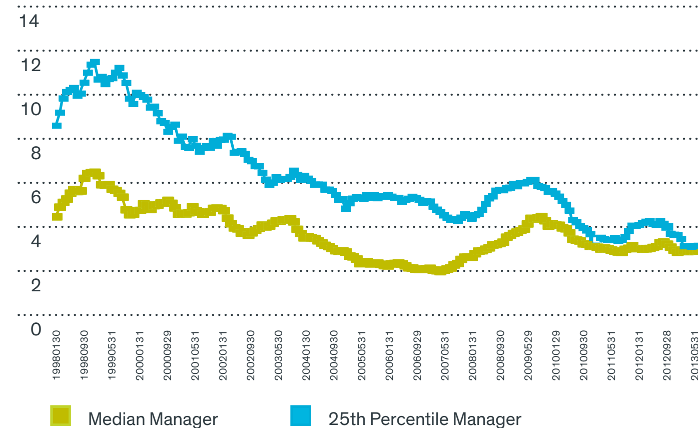
Trend One: Country Return Dispersion Has Narrowed

The dispersion of country returns within emerging markets equities has steadily narrowed since 1990 (see Exhibit 3). When dispersion between country returns was wider, there was significant opportunity for investment managers to make country calls. As dispersion narrowed, the opportunity set and return potential of country picking dwindled. Interestingly, as the trend lines in Exhibit 4 depicts, as stock-specific performance in emerging markets equities has increased, the drivers of performance of the asset class have begun to resemble that of developed markets equities where stock selection accounts for approximately 60% of the total return.

Trend Two: Data Coverage and Quality Have Improved

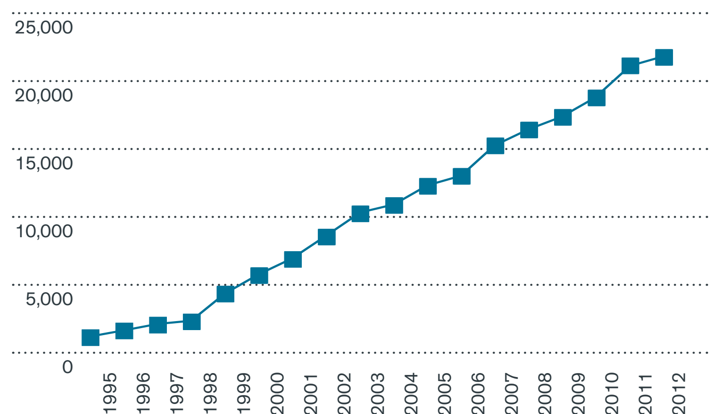
Bottom-up stock selection is fueled by company-level analysis, which requires both data availability and data quality. In 1995, Thomson Reuters Worldscope covered just 2,000 emerging markets companies (see Exhibit 5), 700 of which were large-cap names. But in the two decades since, data coverage has increased dramatically. By the end of 2012, Worldscope provided annual and interim/quarterly data, detailed historical financial statement content, per share data, calculated ratios, pricing and textual information on more than 20,000 names across the emerging markets capitalization spectrum. Moreover, 99% of emerging markets large-cap companies were covered.

3 / CROSS-SECTIONAL DISPERSION OF COUNTRY RETURNS



Source: QMA, Morgan Stanley, FactSet as of July 31, 2013

5 /NUMBER OF EM COMPANIES COVERED BY WORLD-SCOPE



Source: QMA, Worldscope as of as of July 31, 2013

[iii] Universe includes all active managers benchmarked to the MSCI Emerging Markets (Net) Index.

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The quality of the coverage has also improved, with a steady increase in sell-side analysts providing earnings estimates and revisions on most emerging markets companies. Though all stock pickers have benefited from this development, those in the small-cap and mid-cap space have been helped the most. In addition, during the last 15 years, corporate governance and information disclosure have improved. At one time, there was little to no transparency. Today, many companies issue financial statements on a regular schedule and their statements are often audited by recognized accounting firms. Furthermore, in a number of emerging nations, shareholder rights are now protected by law.

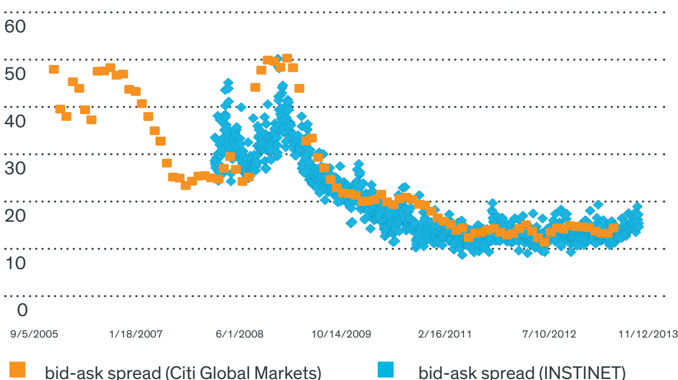
Trend Three: Liquidity Has Improved and Transaction Costs Have Declined

Trading volume has steadily increased since 2003-2004, improving liquidity conditions and pushing down transaction costs for hundreds of emerging markets equities. With lower transaction costs, it is much more feasible to exploit investment opportunities driven by bottom-up stock selection.

In 2000, about $5 billion of emerging markets equities traded daily. However, significant investment flows—in response to the growth of emerging economies, expanded data coverage, and the recognition that emerging markets equity investments offer return and diversification benefits — have boosted daily trading volume. By 2013, more than $20 billion a day was traded in emerging markets equities, on average.

As market liquidity improved, the bid-ask spread for emerging markets equities narrowed, driving down transaction costs. The bid-ask spread for emerging markets equities, which was between 40 and 50 basis points in 2005, tightened to between 10 and 20 basis points in 2010. It has remained at that level ever since. (See Exhibit 6.)

6 / BID-ASK SPREAD IN EMERGING MARKETS



Source: QMA, Citigroup, Instinet as of as of July 31, 2013

In our opinion, positive investment inflows will continue to support emerging markets equities for the foreseeable future. Our view is supported by the growing contribution of emerging countries to global GDP. In 2013, that contribution was 30% to 35%, yet emerging markets equities accounted for only about 11% of global market capitalization. By 2023, the International Monetary Fund predicts emerging economies will contribute approximately 40% of global GDP. If so, emerging markets equities will come to represent a larger percentage of global market cap and institutional investors are likely to increase their allocation to the asset class—currently at about 10%—further improving liquidity conditions and reducing transaction costs.

Conclusion

As these trends demonstrate, the environment for emerging markets equities investing has become more challenging for investment managers who make country and sector bets. We expect these trends to continue in the years ahead. Ultimately, we believe stock selection could drive up to 60% of the total return in emerging markets equities, as it now does in developed markets equities. This will be advantageous for investment managers who express their views through bottom-up stock selection. Furthermore, we believe stock pickers who employ a systematic process—those who have the capacity to evaluate a substantial number of stocks, instead of concentrating on a handful of large market capitalization names—are particularly well-suited to navigate and exploit investment universes that continue to exhibit relative inefficiencies, such as emerging markets equities. In our opinion, these types of investment managers are well-positioned to deliver consistent, long-term returns to institutional investors within this asset class.

For more information

To learn more about QMA's emerging markets capabilities, please contact Pavlos Alexandrakis, Managing Director and Product Specialist, at Pavlos.Alexandrakis@qmassociates.com or 973.802.9297.

About QMA

Since 1975, QMA has served investors by combining experienced judgment with detailed investment research in an attempt to capture repeatable long-term outperformance. Today, we manage approximately $110 billion in assets globally for institutions, sub-advisory clients and individual investors through a broad mix of asset allocation, core equity, value equity and indexing solutions.

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