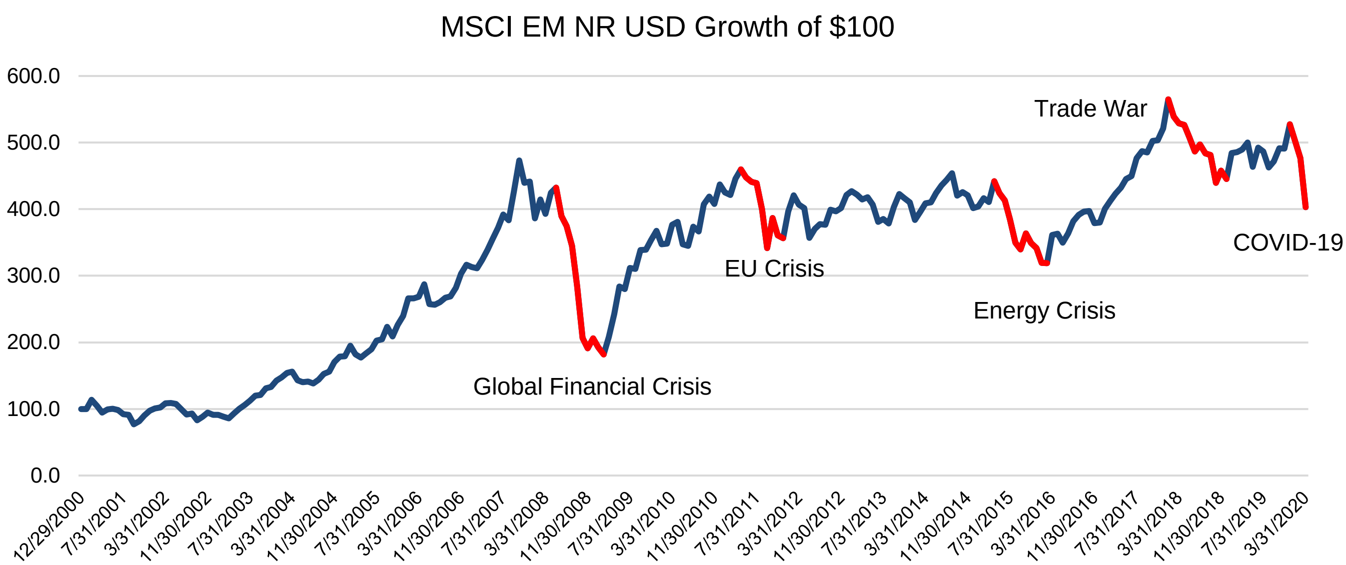
Emerging Markets – Better Than Expected?

April 2020

Examining the Outcomes of Market Capitalization Weighted Indices

- Emerging markets equities performance has held up amid global concerns over the novel Coronavirus
- This is due to large country concentrations within the index relative to international developed markets
- Within countries with the largest index allocations, significant concentration in technology and healthcare has buoyed returns

In the wake of the sharp declines across global markets driven by the uncertain and virulent spread of novel coronavirus, investors may have concern over the impact in countries where the pandemic originated; namely, emerging markets. To assess, we will look at performance of emerging markets in context to historical crises.

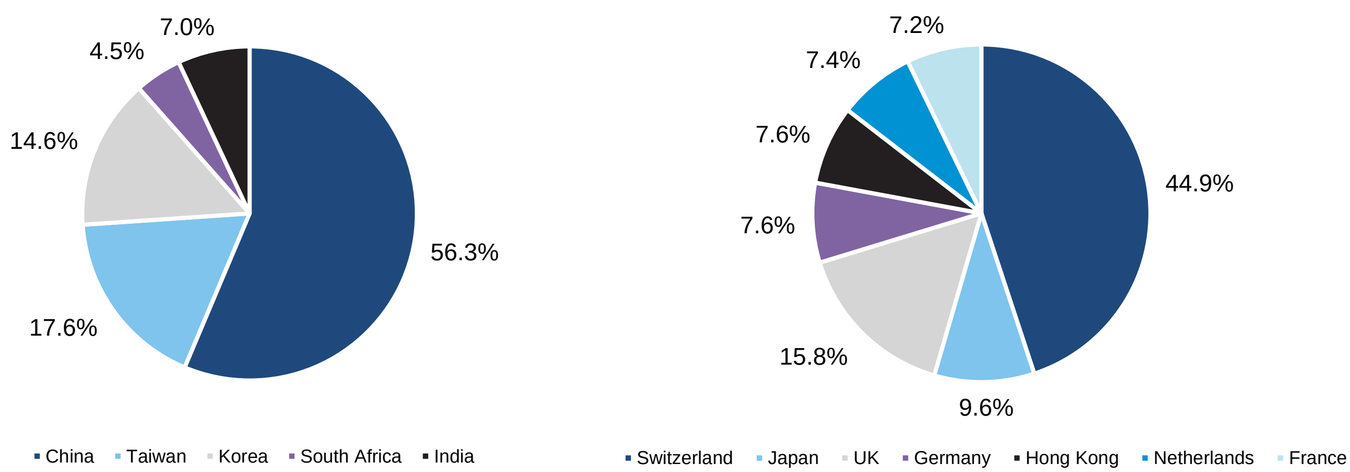


Source: Morningstar

We observe while the recent downturn has been steep and fast, emerging markets have held up more than most would presume. When comparing year-to-date returns to their developed market counterparts, the MSCI EM and MSCI EAFE index closed the quarter at -23.6 and -22.8 percent, respectively. The results have largely been in-line with each other. Even from the market's peak on February 19, the results are quite similar with the MSCI EM and MSCI EAFE index ending at -22.3 and -22.0 percent, respectively. Given the higher historical volatility in the emerging markets asset class, this begs the question: why hasn't the recent downturn been worse? We answer this question by looking under the hood of the two indices.

Key countries have larger influence over broader outcomes in emerging markets compared to their developed markets counterpart. This is a consequence of the market capitalization construction methodology for the two indices. We highlight this by looking at the top 10 holdings of each index below.

Emerging vs. Developed Markets Top 10 Holdings Diversification



Source: Morningstar

MSCI EM

MSCI EAFE

We can observe the composition of each index's top 10 holdings are quite different. In emerging markets, China comprises over 56 percent of the top 10 holdings, followed by large weights in Taiwan and South Korea. The weight distribution in developed markets is much more homogenous. While developed international markets also have a significant concentration in Swiss stocks at 45 percent, its influence is muted due to the overall weighting of the top 10 holdings in the EAFE index. The MSCI EM index's top 10 holdings comprise of 26 percent of the total index's weight, compared to 12 percent for EAFE. Further, the top 10 holdings in China make up almost 15 percent of the total index weight, compared to top Swiss stocks at just five percent. Finally, China plus Hong Kong make up a total of 36 percent of the emerging markets index weight. Thus, returns of countries with a larger index representation are a much stronger force in emerging markets relative to developed.

Amid the global pandemic, the results this year have been congruent with the findings of our 2019 white paper, *Country Selection – A Fool's Errand*, highlighting the influence of country level returns in emerging markets. Year-to-date, country returns have been the largest performance driver, with top/bottom return spreads of 38 percent. Myriad idiosyncrasies have driven the variation in country returns this year. Similar to vital statistics commonly assessed by healthcare professionals, we can inspect economic vitals at the country level in emerging markets, as shown below.

Country	Index % Weight	YTD Return	% of Total Crude Oil Exports	Govt. Debt/GDP	FX Reserves $USD (mm)	Current Account Deficit/GDP	GDP Growth
China	35.9%	-11.3%	--	50.5%	$3,106,700	--	1.5%
Taiwan	11.8%	-18.9%	--	30.9%	$ 479,680	--	1.9%
South Korea	11.7%	-23.0%	--	36.6%	$ 408,800	--	1.3%
Russia	3.8%	-39.8%	11%	14.6%	$ 581,000	--	0.8%
India	8.7%	-30.8%	--	69.6%	$ 481,892	-2.1%	1.1%
Brazil	6.8%	-49.3%	2%	77.2%	$ 356,844	-0.8%	0.5%
Mexico	2.3%	-36.5%	2%	46.0%	$ 189,158	-0.2%	-0.1%
Small EM	14.6%	-30.8%	3%	40.0%	$ 183,764	-2.8%	-0.1%
South Africa	4.4%	-41.2%	--	62.2%	$ 54,855	-3.0%	-1.4%
MSCI EM	**100%**	**-23.6%**					
EAFE	**--**	**-22.8%**					

Source: Trading Economics

Our findings show larger countries as a percentage of the index have outperformed the smaller ones. This is partly due to smaller countries like Brazil and Mexico being significantly tied to oil exports and the negative impact on those countries from OPEC+'s decisions to increase oil production. Further, smaller countries in the index came into the crisis from a position of economic weakness relative to larger regions, with higher leverage as measured by government debt/GDP, lower foreign currency reserves and weak to negative GDP growth. Non-economic factors are at play as well. Progress towards suppressing COVID-19 has had an effect on investor sentiment, with countries like China and South Korea seeing a decline in cases. Because of the buoy provided by the larger countries in the index, the results show performance in-line with international developed markets.

Sector allocations also have a significant effect on the magnitude of downside experienced in emerging markets because of the idiosyncrasies of crisis. Specifically, as countries enhance mitigation efforts, the "new normal" environment has driven outperformance in technology and healthcare sectors. E-commerce, social media and mobile gaming have benefitted as global consumers are complying to shelter-in-place guidelines to help prevent the spread of the virus. This has had a profound effect in emerging markets, as some of the largest names in the index are corporations within these sectors, as shown below.

MSCI EM			
Name	**Weight**	**Country**	**Sector**
Alibaba	6.3%	China	Consumer Cyclical
Tencent	5.1%	China	Communication Services
Taiwan Semiconductor	4.6%	Taiwan	Technology
Samsung	3.8%	Korea	Technology
China Construction Bank	1.4%	China	Financial Services
Naspers	1.2%	South Africa	Communication Services
Ping An Insurance	1.1%	China	Financial Services
Reliance Industries	0.9%	India	Energy
Housing Development Fin. Co.	0.9%	India	Financial Services
China Mobile	0.9%	China	Communication Services
Total Top Ten	**26.0%**		

Source: Morningstar

Meanwhile, utilities, consumer, financials and energy have underperformed, resulting in growth outperforming value for the quarter. Active management has broadly underperformed year-to-date with the index ranking 36th in the Morningstar category peer group. This is largely due to active managers underweighting countries/stocks with rich valuations, such as Chinese companies Alibaba and Tencent. Additionally, Brazil and Mexico have dragged on falling oil prices.

Despite the historically higher volatility in emerging markets relative to developed, performance so far this year has been nearly equal. This is due to larger benchmark weightings to Asian countries that have been laboring with the complications of COVID-19's outbreak since the beginning of the year. These countries were the first to see the number of infections decline while coming into the crisis from a relative position of economic strength.

Emerging markets are still a widely inefficient asset class where active management has historically outperformed the index over the long-run. As a result of the crisis, managers are looking to add quality names to their portfolio with an eye on "wish list" stocks that were previously at high valuations.

As such, we expect active management to rebound as we work through the crisis and return to normalcy and believe investors should stick to their long-term strategic allocations.