Powering up Emerging Markets

Does your emerging markets strategies include small caps?

Most investors understand the allure of emerging markets and the long-term secular demographic and consumption trends that offer patient investors the potential of attractive returns. In addition, some of today's smaller, less-established frontier markets may eventually be added to the emerging market country list and thereby expand the opportunity set even further.

With this as a point of departure, the real question becomes: What is the best way to capture the full diversification benefits and growth potential of emerging market equities?

Michael Reynal, chief investment officer of Sophus Capital, and Laurence Siegel, the Gary P. Brinson director of research at the CFA Institute Research Foundation, have studied emerging markets extensively.* Empirical evidence, they argue, advocates for a broad approach that includes an allocation to all market capitalizations, including smaller companies within the emerging markets universe.

According to analysis by Reynal and Siegel, emerging market small and large caps typically behave quite differently, each offering unique characteristics to a global multi-asset-class portfolio. Allocating to smaller emerging market companies exposes investors to different sectors and competitive forces than emerging market large caps.

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Correlations of monthly total returns (in U.S dollars) of major global indexes. December 1994 - February 2017

	SP500	MSCI EAFE	MSCI ACWI	MSCI EM SMALL CAP	MSCI EM LARGE CAP
MSCI EMERGING MARKETS SMALL CAP	0.54	0.72	0.71	1.00	0.89
MSCI EMERGING MARKETS LARGE CAP	0.66	0.79	0.81	0.89	1.00

Source: Sophus Capital, Bloomberg, as of Febraury 28, 2017

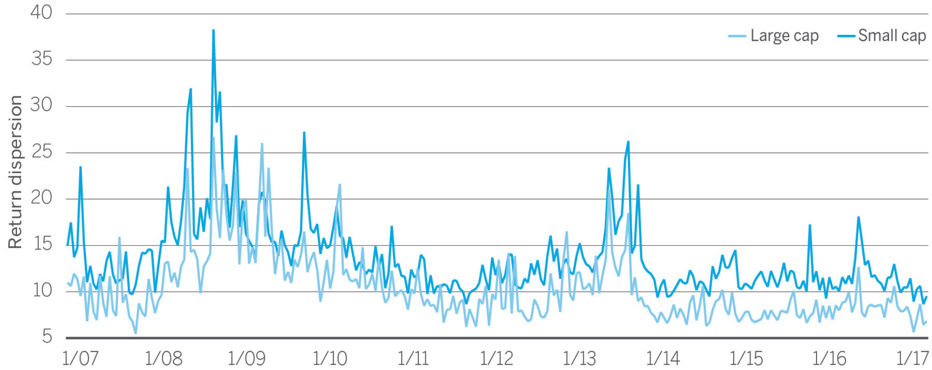
Reynal and Siegel also point out that emerging market small caps have historically had more dispersed returns, less analyst coverage, and larger payoffs attributable to skillful factor analysis than their large-cap counterparts. All these factors make smaller companies an attractive playing field for potential alpha generation, particularly for active managers willing to veer away from the largest cap stocks that tend to dominate popular emerging markets indexes.

Small company, large alpha?

One indicator of the amount of alpha generation opportunity an asset class affords its investors is the cross-sectional dispersion of the returns of the stocks in the asset class. If all the stocks were perfectly correlated with one another, the asset class would in effect consist of one security and there would be no opportunity to add value through security selection. As these correlations decrease, the opportunity to add alpha increases.

* Source: "How Emerging is Your Emerging Markets Manager?," Michael Reynal and Laurence Siegel, June 2017.

Month-by-month cross-sectional standard deviations of one-month returns on stocks in the emerging markets small cap and emerging market long cap benchmarks, 2007 - 2017 (as of January 31, 2017).



Past performance is no gaurantee of future results. Indexes are unmanaged. It is not possible to invest directly in an index.
Sources: Sophus Capital, FactSet, as of January 31, 2107.
Large- and small-cap universes include MSCI Emerging Markets Index and S&P Emerging Plus BMI constituents.
Diversion is standard deviation of monthly returns.

One way to visualize the difference in alpha generation opportunities between the emerging market small- and large-cap asset classes is to look at the dispersion (standard deviation) of monthly security returns for the two categories. Reynal and Siegel conducted such an analysis in the exhibit above, with each month from January 2007 to January 2017 shown separately. The monthly results are then connected by a light blue line (emerging market large caps) or a dark blue line (emerging market small caps).

Note that there is nothing in this analysis that says a particular manager is going to come out in the top half of the distribution of alphas. No matter how inefficient a market is, or how much opportunity is afforded by the cross-sectional dispersion of returns, active management versus a properly chosen benchmark is still a zero-sum game, with half of all managers underperforming the benchmark before costs, and more than half underperforming after costs.

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Taking the MSCI Emerging Markets Large Cap Index as the measure of large caps and the MSCI Emerging Markets Mid Cap Index and Emerging Markets Small Cap Index combined to represent smaller caps, large caps comprise 456 names, while smaller caps comprise 2,164 names. So an active manager in emerging market smaller caps has almost five times as many stocks to choose from, or (applying the square root rule) 2.2 times as much opportunity to apply his or her skill, just based on the number of names. In addition, the emerging market smaller stocks have lower cross-correlations and significantly higher volatility. So there are many more opportunities for emerging market small-cap managers to differentiate themselves from the benchmark and from other managers, relative to large-cap managers.

However, it may be difficult for emerging market managers with substantial assets under management to take advantage of opportunities in smaller-cap emerging market stocks. Such managers typically hold mostly, or only, emerging market large-cap companies, and may also invest in developed market companies believed to offer emerging market exposure. This could be problematic, particularly for investors believing they are getting pure and diverse emerging market exposure.

Avoid large biases

It’s important to remember that largest emerging market country at any given time may dominate an emerging market index in a way that is disproportionate to that country’s importance in world markets. This mirrors the more general large-cap bias prevalent in popular emerging market benchmarks and suggests that such benchmarks should be viewed skeptically as a guide to portfolio construction. Rather, Reynal believes active emerging market managers should use as broad an opportunity set as possible, even if it means making off-benchmark bets.

Consider that South Korea has been on the threshold between emerging and developed market status for a long time. Because index providers disagree, different emerging market indexes have materially different country weights depending on whether South Korea is included in the index or not. Similarly, Greece and Malaysia have floated in and out of the various emerging market indexes at different times. Taiwan has a highly developed economy but is categorized as emerging because of restrictions on foreign ownership of shares. Some investors have even questioned China's status as an emerging market index constituent because such a significant percentage of the country's market cap consists of state-owned enterprises (SOEs). Yet despite all this, China, Korea, and Taiwan now make up nearly half of the MSCI Emerging Markets Index.

Because of these considerations, the returns of emerging market benchmarks can be driven by a few large countries and a few large companies. These returns tend to be correlated to the global economy and to other factors that drive developed market equity returns. That's why emerging market benchmarks may not be an effective diversifier of developed market equity risk.

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Choose wisely

Investors would be prudent to fully understand their emerging market equities allocation. Those who choose an active, fundamental approach to emerging markets must look closely to ensure that their portfolios are not unduly biased toward large caps. And even those investors who select a passive approach to emerging markets should realize what they are gaining and omitting from a portfolio construction viewpoint.

Ultimately, failure to include an adequate small-cap allocation could cause investors to miss out on what Reynal and Siegel believe is the most interesting part of the emerging markets story: the diversifiers–companies that are typically more exposed to home-country economies and less exposed to global factors and developed-country competition. Incidentally, these are often innovative, nimble and locally focused companies at the lower end of the capitalization spectrum.

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All investing involves risk, including potential loss of principal. International investing involves special risks, which include changes in currency rates, foreign taxation, differences in auditing standards and securities regulations, political uncertainty, and greater volatility. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume. Investments in small and mid-size companies can involve risks such as less publicly available information, higher volatility, and less liquidity than larger companies.

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