# The Frontier Line

Thought leadership and insights from Frontier

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## Active management in emerging markets



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# About us

Frontier has been at the forefront of institutional investment advice in Australia for over twenty five years and provides advice over more than $400 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Frontier's purposeis to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

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Rachel Mohr is an Associate at Frontier, having first joined in 2012 as a member of the Partners Platform Team. Her responsibilities include providing analytical support to clients, as well as undertaking manager and investment research with a focus on equities. Rachel holds a Bachelor of Business, majoring in Banking & Finance/Economics, a Master of International Business and a Masters of Applied Finance.

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Fraser joined Frontier in 2012 and is the Head of Equities. He was previously at Ibbotson Associates/Intech Investments for nearly 15 years where he held a variety of roles including five years as Head of Manager Research and five years as Head of Equities and Property. Fraser started his asset consulting career at Towers Perrin in 1994 as a Research Analyst in its Melbourne and London offices. Fraser holds a Bachelor of Commerce with Honours from the University of Melbourne and a Graduate Diploma of Applied Finance and Investments from Finsia, and is a Fellow of Finsia.

INTRODUCTION

# Active management in emerging markets

This report is part of Frontier's active management analysis and delves into emerging markets where we seek to outline what has driven past active management results in emerging markets. We also consider the outlook for active management in emerging markets in the future, noting the inefficiencies and opportunities that exist today in emerging markets.

# Long term data on active management in emerging markets

Over the past five years, Frontier has observed a decline in the median excess returns achieved by active emerging market managers relative to the long-term experience. We have observed this pattern to some extent in other equities asset classes, but think that emerging markets has its own distinct explanation.

Table 1 shows the performance of median emerging markets equities manager excess returns versus the MSCI Emerging Markets Index in five year non overlapping periods.

**Table 1:** Emerging markets equities managers excess return vs MSCI Emerging Markets Index

| | 5 years to 30 Sep 2020 % p.a. | 5 years to 30 Sep 2015 % p.a. | 5 years to 30 Sep 2010 % p.a. | 5 years to 30 Sep 2005 % p.a. |
|---|---|---|---|---|
| **Upper quartile** | +3.3 | +3.3 | +3.8 | +4.9 |
| **Median** | +0.5 | +1.6 | +1.1 | +2.4 |
| **Lower quartile** | -1.2 | +0.1 | -0.9 | +0.7 |
| **Observations** | 153 | 129 | 88 | 72 |
| **MSCI Emerging Markets Index return** | 8.5 | 2.8 | 7.5 | 6.6 |

Source: eVestment, Frontier cleansed universe, before fees

Chart 1 shows the median emerging markets managers rolling one-year excess returns versus the MSCI Emerging Markets Index.

While the median emerging markets manager outperformed the MSCI Emerging Markets Index, the outperformance has declined over time as shown by the trend line.

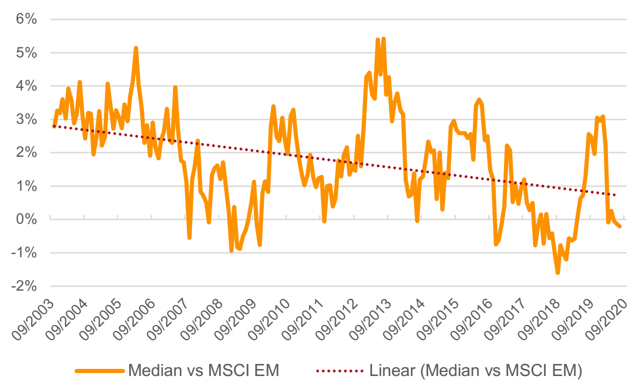
Chart 2 shows the five year rolling excess return of the median emerging markets equity manager.

We observe a similar downward trend as Chart 1. We discuss reasons for this downward trend in the emerging markets small caps section of this paper. Importantly, however, there still remains an expectation of achieving outperformance in emerging markets, above the likely management fee for an institutional client. While we are noticing a declining trend, there still appears outperformance potential in emerging markets.

### The key questions going forward are:

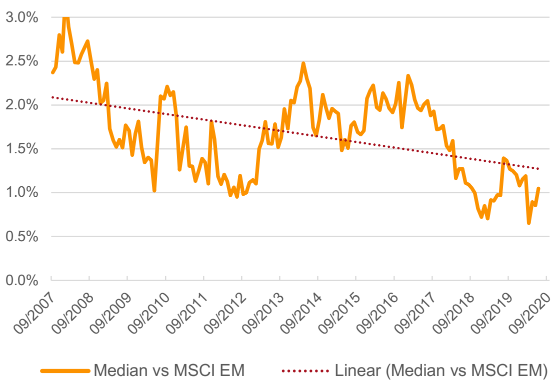
- what is a reasonable magnitude of outperformance to expect beyond 2020?
- what is the appropriate active management fee to pay in this asset class?

**Chart 1:** Emerging market equities median rolling one year excess return




Source: eVestment, Frontier, before fees

**Chart 2:** Emerging market equities median rolling five year excess return




Source: eVestment, Frontier, before fees

## Changes in emerging markets in the past 20 years

The following are some of the main changes in emerging markets we have observed in the past two decades that may have impacted outperformance potential.

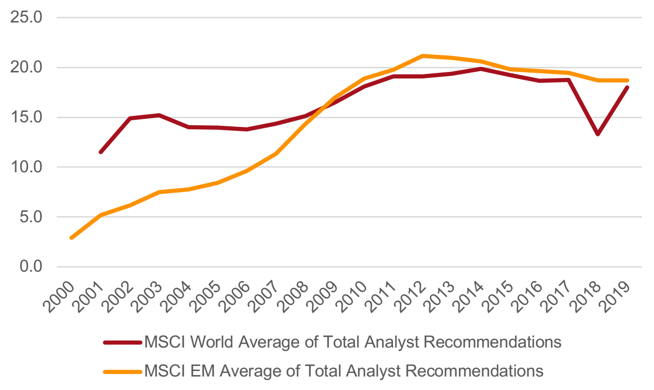
- Greater sell-side analyst coverage.
- Increased investment in emerging markets as shown by the increase in number of observations (see Table 1).
- There has been more investment in emerging markets by global equity investors.
- Greater investment by quantitatively driven investment approaches.
- An increase in passive investment.
- The creation of ETFs.

We think it is reasonable to conclude from the above structural changes that emerging markets equities are more efficient now than in previous decades. We think it is likely that, taking account of the combination of these factors above, this provides some explanation for an observed reduction in cross sectional volatility of stock returns.

## Increased coverage in emerging markets

Not only has the number of products more than tripled in the eVestment universe, the stock broking analyst coverage of emerging market companies has also significantly increased. This is highlighted in Chart 3 which shows the average analyst coverage of the MSCI Emerging Markets Index versus the MSCI World Index.

**Chart 3:** Analyst coverage per stock – developed markets vs emerging markets




Source: Bloomberg, Frontier

Since 2001, the analyst coverage of emerging markets has substantially increased. This is one of the key considerations that has formed Frontier's view that the market has undergone a structural change. Interestingly, we are aware that the stock broking industry is generally in decline around the globe, so we will watch with interest to see if this reverses to some degree over time.

## Cross sectional volatility

Cross sectional volatility can be considered a proxy for the potential to add value from active management. Over time, the cross-sectional volatility in emerging markets has declined, particularly over the past ten years since the GFC. This is shown by the blue line in Chart 4. We think this evolution of cross-sectional volatility has aligned with a lower excess return outcome over the most recent decade.

**Chart 4:** Emerging market equities cross sectional volatility


Source: MSCI

Cross sectional volatility is lower than historical levels but does appear to have stabilised at its current level and we do not anticipate another leg downwards.

There is scope for cross sectional volatility to increase with the addition of China A-shares. The China A-shares market is one of the largest markets in the world and yet it is one of the most inefficient markets globally. MSCI started to partially include China A-shares into the MSCI Emerging Markets Index on 31 May 2018. This inclusion factor increased to 20% in November 2019, resulting in a China A-shares weight of 4.1% in the MSCI EM index, raising the total China weight to 33.6% at the time. The inclusion of China A-shares currently includes large cap A-shares, reflecting those A-shares compatible with Stock Connect. Since November 2019, the market weight of China in the MSCI Emerging Markets Index has risen to around 43% as at 30 September 2020, but A-shares still remains a relatively low component of this China weight. In the event of full inclusion, China equities would significantly increase beyond the 43% it is today in the MSCI Emerging Markets Index. China A-shares represents an active management opportunity, given it is predominantly covered by retail investors.

## Fees for active emerging markets managers

Overall, fees in emerging markets have reduced slightly over the past 20 years, however managers still charge a premium for investing in emerging markets versus Australian equities and global equities. We see emerging markets fees that are regularly 0.60-0.80% p.a. The justification has historically been due to the high historic alpha potential and the scarcity of capacity with the best managers. We do not believe the current alpha potential and the number of options available to investors warrants far higher fees and believe a reduction in fees paid for mainstream emerging market strategies is the most appropriate direction for active emerging markets to remain an attractive proposition into the future.

Active emerging markets managers have generally been resistant to lowering fees materially. However, we believe managers will need to confront this reality in future if lower outperformance levels are a permanent feature of emerging markets in future.

In the absence of emerging markets fees moving downwards, Frontier believes there is a stronger argument than historically to implement a passive strategy in emerging markets with the decline in alpha over time as the market becomes more efficient.

# Areas of greater inefficiencies in emerging markets

The following section looks at areas in emerging markets where we believe there is more inefficiencies in the market and hence a greater potential for active management outperformance.

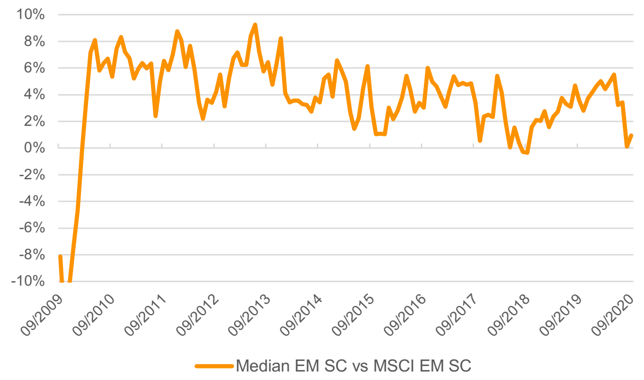
## Emerging markets small caps

The MSCI EM Small Caps Index was launched on 1 June 2007. The small cap segment of the market tends to have greater exposure to more local economies relative to larger emerging markets constituents. Therefore, exposure to emerging markets small caps arguably better captures demographic or consumption changes and should more effectively benefit from the growing purchasing power of the emerging market population. Consistent with this, the sector weight dispersion of the MSCI EM Small Caps Index is meaningfully different to the MSCI Emerging Markets Index.

Active managers in emerging markets small caps have the added advantage of the lack of sell-side research. There is significantly less analyst coverage of emerging markets small caps stocks, if there is any coverage at all. This creates inefficiencies and mispricing in the market which creates a prime opportunity for active management.

Chart 5 shows the median emerging markets small caps managers rolling one-year excess return versus the MSCI EM Small Caps Index.

**Chart 5: Emerging market equities small caps median rolling one year excess return vs MSCI EM Small Caps**




Source: eVestment, Frontier, before fees

The median emerging markets small caps manager has been able to meaningfully outperform the MSCI EM Small Caps Index. We believe emerging markets small caps provides clients an opportunity to invest in a more inefficient and under-researched segment of the market that is likely to deliver alpha in excess of mainstream emerging markets going forward. We recognise that the opportunity to invest in emerging markets small caps comes with capacity constraints and is unlikely to be suitable for large clients.

Table 2 shows the median emerging markets small caps manager excess return over five year non-overlapping periods. The number of observations in 2010 were statistically immaterial, however when looking at the five years to 30 September 2020, we observe meaningful outperformance for the median manager and a statistically significant level of observations.

**Table 2: Emerging markets small caps managers excess return vs MSCI EM Small Caps Index**

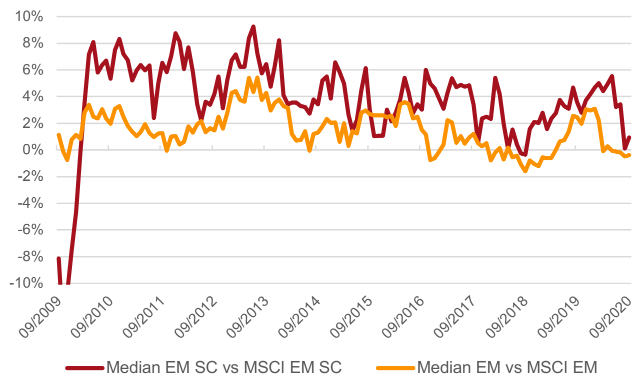
| Percentiles | 5 years to 30 Sep 2020 % p.a. | 5 years to 30 Sep 2015 % p.a. |
|---|---|---|
| Upper quartile | +4.7 | +5.5 |
| Median | +2.6 | +4.0 |
| Lower quartile | +1.1 | +2.8 |
| Observations | 40 | 16 |
| MSCI EM Small Caps return | 4.2 | 4.0 |

Source: eVestment, Frontier cleansed universe, before fees

## Emerging markets small caps versus the broader emerging markets universe

Chart 6 shows the emerging markets median excess return versus the MSCI Emerging Markets Index and the emerging markets small cap median excess return versus the MSCI EM Small Caps Index.

**Chart 6: Rolling one year excess return for emerging markets and emerging markets small caps**




Source: eVestment, Frontier, before fees



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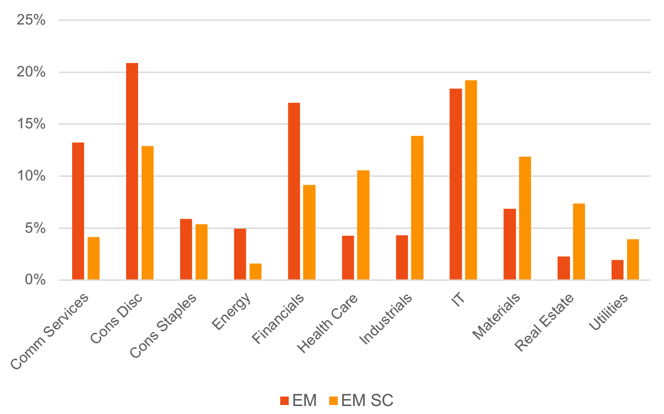
## The median emerging markets small caps manager seems to be able to add value above its benchmark in excess of the outperformance generated by the median emerging markets manager.

Chart 7 illustrates the different sector allocation between the MSCI EM Small Caps Index and the MSCI EM Index.

In comparison to the MSCI EM Small Caps Index, the MSCI EM Index is dominated by the communication services, energy and financials sector, while MSCI EM Small Caps Index has a higher exposure to the health care, materials, real estate and utilities sectors.

**Chart 7:** **Sector allocation of MSCI EM Small Caps Index vs MSCI EM Index**

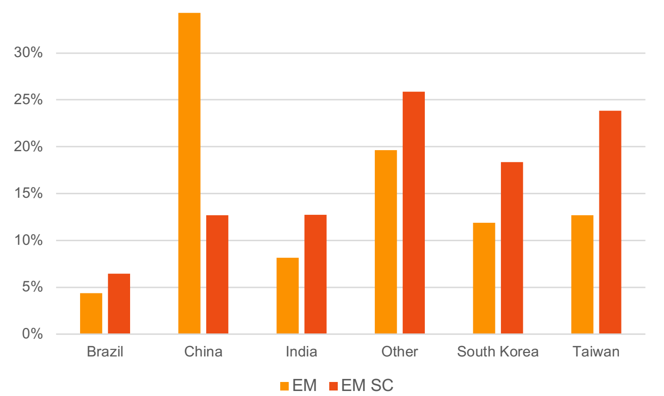



Source: eVestment, Frontier, before fees

Chart 8 illustrates the different country allocation between the MSCI EM Small Caps Index and the MSCI EM Index.

The key difference between the two indices is the allocation to China. The MSCI EM Small Caps Index has a 12.7% weight to China while in comparison, the MSCI EM Index presently has a 43.2% weight to China.

**Chart 8:** **Country allocation of MSCI EM Small Caps Index vs MSCI EM Index**




Source: eVestment, Frontier, before fees

Table 3 compares the emerging markets small caps median excess return as at 30 September 2020 to emerging markets excess return as at 30 September 2005. The rationale for this table is to highlight that emerging markets small caps today exhibits a similar alpha profile to mainstream emerging markets 15 years ago. In our view, the discussion around inefficiencies and structural changes in emerging markets over time suggests there is a logic to this similarity of active management outcomes, rather than this being a coincidence.

**Table 3:** **Emerging markets small caps excess return vs MSCI EM Small Caps and emerging markets excess return vs MSCI EM**

| Percentiles | 5 years to 30 Sep 2020 % p.a. | 5 years to 30 Sep 2005 % p.a. |
|---|---|---|
| Upper quartile | +4.7 | +4.9 |
| Median | +2.6 | +2.4 |
| Lower quartile | +1.1 | +0.7 |
| Observations | 40 | 72 |

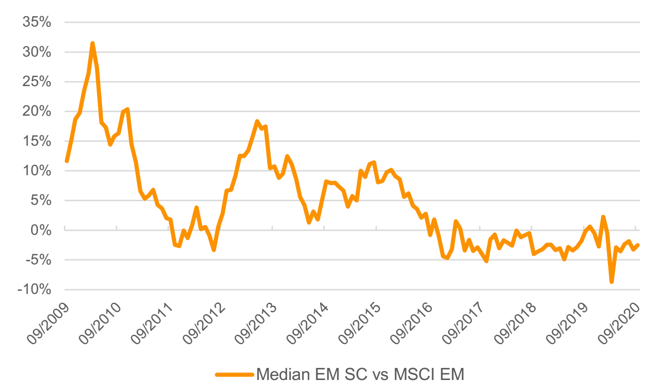
Source: eVestment, Frontier cleansed universe, before fees

While there remains alpha to be gained in mainstream emerging markets, Frontier no longer believes mainstream emerging markets can deliver that same level of outperformance going forward.

Instead, we think emerging markets small caps could be a good substitute to generate the high levels of alpha that we saw in emerging markets in the past.

However, emerging markets small caps will bring fluctuations in market returns through time. There will be periods where there is alpha being generated, but the emerging markets small caps beta may be weak. This occurred in the most recent financial years with the MSCI EM Index performing well ahead of the MSCI EM Small Cap Index. Chart 9 shows the median emerging markets small cap manager versus the MSCI Emerging Markets Index.

**Chart 9:** **Emerging Markets Small Cap median rolling one year excess return versus MSCI EM Index**




Source: eVestment, Frontier, before fees



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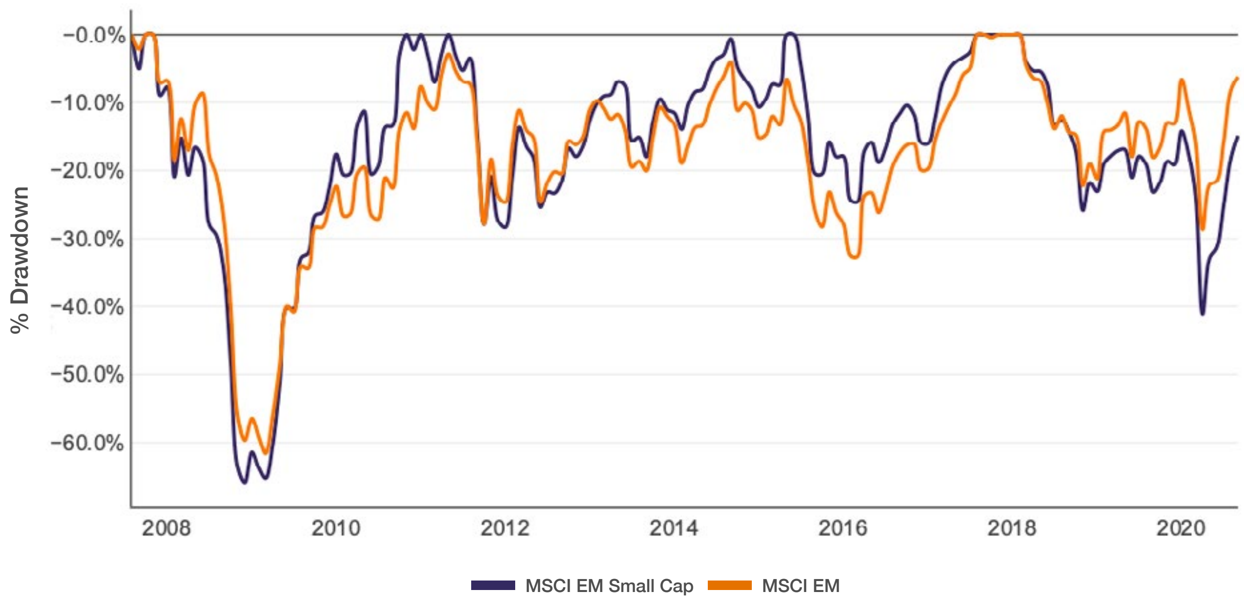
**Chart 10:** Drawdown of MSCI EM Small Cap




Source: eVestment, Frontier Manager Analytics

So, while we are very encouraged by the outperformance potential on offer in emerging markets small caps, we believe there will be some volatility in market beta. This would suggest emerging markets small caps is likely to be most suitable as a partial exposure in emerging markets, rather than replacing all mainstream emerging markets exposure.

Chart 10 shows the drawdowns of the MSCI EM Index versus the MSCI EM Small Caps Index in USD.

The drawdown profile of the two indices (in base currency) is relatively similar since the launch of MSCI EM Small Caps Index on 1 June 2007.

## Fees for active EM small caps managers

Fees tend to be higher for active management in emerging markets small caps than mainstream emerging markets managers, however the difference is not stark. We would expect institutional investors to pay around 0.80-0.90% p.a. for an active emerging markets small cap manager versus the 0.60-0.80% p.a. for mainstream emerging markets.

# Responsible investment

We continue to observe industry recognition of the importance of incorporating responsible investment considerations into investment decisions and its ability to drive risks and returns.

## We believe responsible investment is particularly important in emerging markets with heightened ESG risks, such as governance and modern slavery.

This is something that active management can navigate through engagement with its investments.

A potential ESG benefit of investing in active emerging markets small caps managers is the greater access to companies and management due to the small scale and structure of the small cap segment of the market (and the limited partial ownership of stocks by governments). There is, therefore, greater scope to influence companies on ESG matters. However, the integration of responsible investment varies from manager to manager and there are still managers which remain weak in this area.

# The final word

## Overall, Frontier has observed a decline in the median excess returns achieved by active emerging market managers relative to the longer-term experience.

While it is difficult to attribute specific drivers for overall excess returns trends and infer future outcomes with certainty, we believe the emerging market universe has experienced some structural changes which have led to the market being more efficient over time.

The greater sell-side analyst coverage and increased manager products are two key elements that contribute to Frontier's view emerging markets have undergone structural change. In aggregate, we believe the increased investment in emerging markets is the most enduring impact on the longer-term outperformance potential for emerging markets.

We still believe active management data supports the justification for active management in emerging markets, despite the decline in alpha observed over time. Factors that should prove positive for active management over time include:

- China A-shares being progressively added to the MSCI Emerging Markets Index over the next decade. This market is dominated by retail investors and is highly inefficient.
- There remains considerable opportunity for active managers to take off-benchmark positions in small caps and frontier markets that are not included in the MSCI Emerging Markets Index.
- Meaningful secular trends such as disruption, climate change and demographics are likely to be impactful on individual company outcomes.

However, we believe high alpha outcomes in mainstream emerging markets will be harder to achieve. The significant inefficiencies that were prevalent in mainstream emerging markets 15 years ago are only prevalent in emerging markets small caps. Emerging markets small caps provides clients an opportunity to invest in a more inefficient and under-researched segment of the market that is likely to deliver strong outperformance going forward. The opportunity to invest in emerging markets small caps comes with capacity constraints and is unlikely to be suitable for large clients. Fees may also be moderately higher.

**Want to learn more?**

Please reach out to Frontier if you have any questions or visit frontieradvisors.com.au for more information.

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