INVESTMENT BRIEF

Q1 2014

Strategic Investment Group®

The Evolving Case For Emerging Market Equity

Three pillars underpin the traditional case for investing in emerging market equity: higher returns, diversification benefits, and inefficiency. Returns were expected to exceed those of developed market counterparts, as compensation for the inherently greater risk of owning emerging market equities. Higher expectations for return on capital in emerging economies reflected scarcity of capital and a higher potential growth rate. Diversification benefits arose from emerging markets' imperfect integration in the global financial system. The inefficiency of emerging markets increased the potential for skilled managers to add value, complementing the advantages of higher expected return and low correlation.

The traditional case for emerging markets remains sound — it is the three traditional pillars that have evolved. Although expected returns of emerging markets are still higher than those in developed ones, the gap has narrowed. Labor costs and the prices of other inputs have increased, shrinking profit margins. The potential economic growth rate of emerging markets, while still enviable, has moderated. The risk premium demanded by investors has declined as the fundamentals of many emerging markets have improved, including healthier fiscal and external current account positions, stronger credit ratings, and enhanced economic resilience. As proof of this transformation, the developed world looked to emerging markets to be the global growth engine in the wake of the 2008 financial crisis.

Globalization has undoubtedly diminished the diversification benefits afforded by emerging markets. Strategic's forward looking capital market expectations take this into account by assigning higher correlation coefficients to emerging markets. Nevertheless, despite globalization, emerging markets still help to diversify developed market risk.

Although reduced, inefficiencies in emerging markets persist, partly because of the limited coverage of emerging markets by asset managers and the markets' under-representation in global portfolios. Skilled active managers are still needed to identify inefficiencies among emerging markets, as their fundamentals have improved unevenly.

Emerging markets were never for the faint of heart. High volatility, bouts of contagion, geopolitical risk, low liquidity, and cumbersome trading and custody arrangements always demanded caution and skill, for when things went awry, they could go very wrong indeed. Nevertheless, these are not markets to be neglected. Importantly, as the case for investing in emerging markets has evolved, these markets have grown to represent an increasingly large share of the world's economic and corporate activity and to encompass some of the world's leading corporations.

The recent underperformance of emerging markets, especially since the "taper tantrum" of May 2013, is partly attributable to cyclical factors. The tantrum was an over-correction of investor expectations regarding the timing of the Fed's tapering of bond purchases. The prospect of tighter external funding conditions hit emerging economies with large external deficits especially hard. Of course, when tightening eventually does occur, it is likely to be in response to improved global growth, which should help dampen tapering's adverse effects.

Declining growth expectations for China and other key emerging markets have also weighed on investors. Spillovers from China to other markets have increased with its growing importance in global output, foreign trade, and commodity consumption. Questions about whether slowing Chinese growth will expose financial vulnerabilities from years of rapid credit growth and excess investment have hurt investor sentiment. For the present, we consider these concerns overblown. China's net debt levels are relatively low, its capital account is closed, its current account is in surplus, its currency is not convertible, its banking system is tightly regulated, and its foreign exchange reserves are massive. Given these conditions, it is difficult to see how the typical self-reinforcing crisis of confidence that has bedeviled emerging markets in the past would emerge in China.

Emerging markets continue to move more into the mainstream, but this process is far from complete. Thus, the three traditional arguments supporting the case for emerging markets remain valid. From a secular perspective, emerging market economies and their exchanges are set to continue growing in significance. From a cyclical perspective, emerging market equities are attractively valued, although these valuations are in part a reflection of short-term headwinds in the form of Fed tapering and slowing growth in China. Given these finely balanced forces, we are maintaining a neutral allocation to emerging market equities relative to a policy portfolio in which they are amply represented. Over the long run, we expect these markets to become more fully represented in the portfolios of institutional investors as emerging markets move increasingly into the mainstream.

1001 Nineteenth Street North, 16th Floor
Arlington, VA 22209 USA

+1 703.243.4433 TEL
+1 703.243.2266 FAX

strategicgroup.com