QS Investors

Research Note
September 2013

Emerging Markets: Made of More than Just BRICs

The Importance of Diversification in Emerging Markets

Introduction

Volatility and underperformance have cast a dark shadow over the first half of 2013 in emerging markets indices, causing concern over its investment potential going forward. Though emerging market fundamentals are still strong compared to developed markets, (see QS Investors "Emerging Markets: We have a Fundamental Problem with Weak Sentiment" August 2013) we believe that making a successful investment in emerging markets is more likely to be achieved if investors choose the type of exposure that supports their specific investment objectives and rationale.

We see two important rationales for investing in emerging markets. They offer:

1. **Higher return potential linked to higher economic and productivity growth**

2. **Portfolio diversification benefit as they are less linked to developed markets**

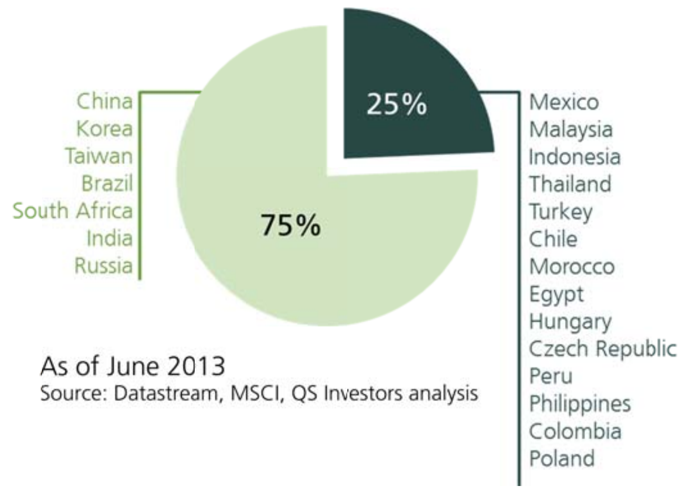
Based on these objectives, it is important to examine the country diversification benefit inherent in the investment approach. Emerging markets indices, like other market capitalization weighted indices, have a high concentration in a small number of the largest countries which may counter our objectives of finding diversification and higher returns. Larger emerging market countries tend to have the highest correlation to developed economies as they are closer to becoming developed markets and are more integrated with developed economies thereby not offering the best opportunity to diversify. During volatile times – and when developed markets are undergoing a slow growth phase – some of the other, less integrated countries, have the potential to outperform and also help to diversify overall portfolio performance. In this research note we examine concentration, recent performance and correlations of various emerging market countries during the most recent time period to illustrate the importance of country diversification within emerging markets.

The Problem of Concentration in Emerging Markets

Like most market capitalization weighted indices, the MSCI Emerging Markets (EM) Index carries a large weight to the largest countries. As of the end of June 2013, seven countries made up 75% of the index (see Figure 1) and Asia represented over 45%.

Brazil (11%) and South Africa (7%) also have large weights in the index. These countries are generally highly correlated with China as they are large commodity producers and export to China.

Figure 1: Index Country Weights



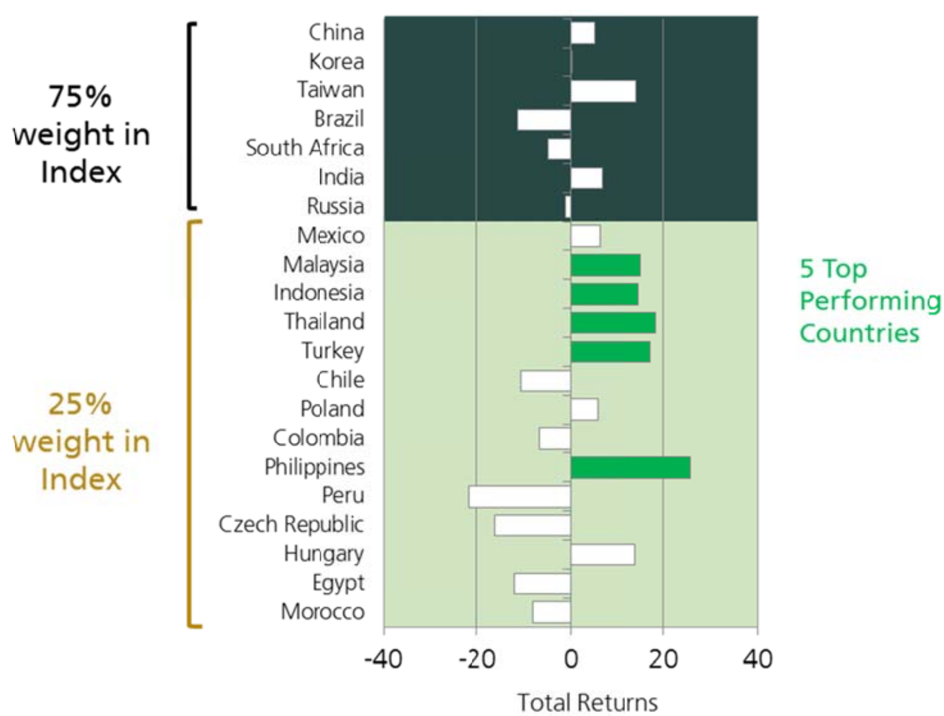
As of June 2013
Source: Datastream, MSCI, QS Investors analysis

The Importance of Dispersion: Recent Performance

The underperformance of the MSCI EM index – including some of the largest countries in the index during the last year – illustrates the importance of country diversification within emerging markets equities. For the 1-year period ending June 30, 2013, performance dispersion was high with over a 48% spread between the best and worst performing countries. Five of the top performing countries made up only 13% of the weight in the index, all falling in the bottom 25% of country weight within the index (see Figure 2)

Figure 2: One-Year Return of each Country in the MSCI Emerging Markets Index

Time period: July 1, 2012 to June 30, 2013

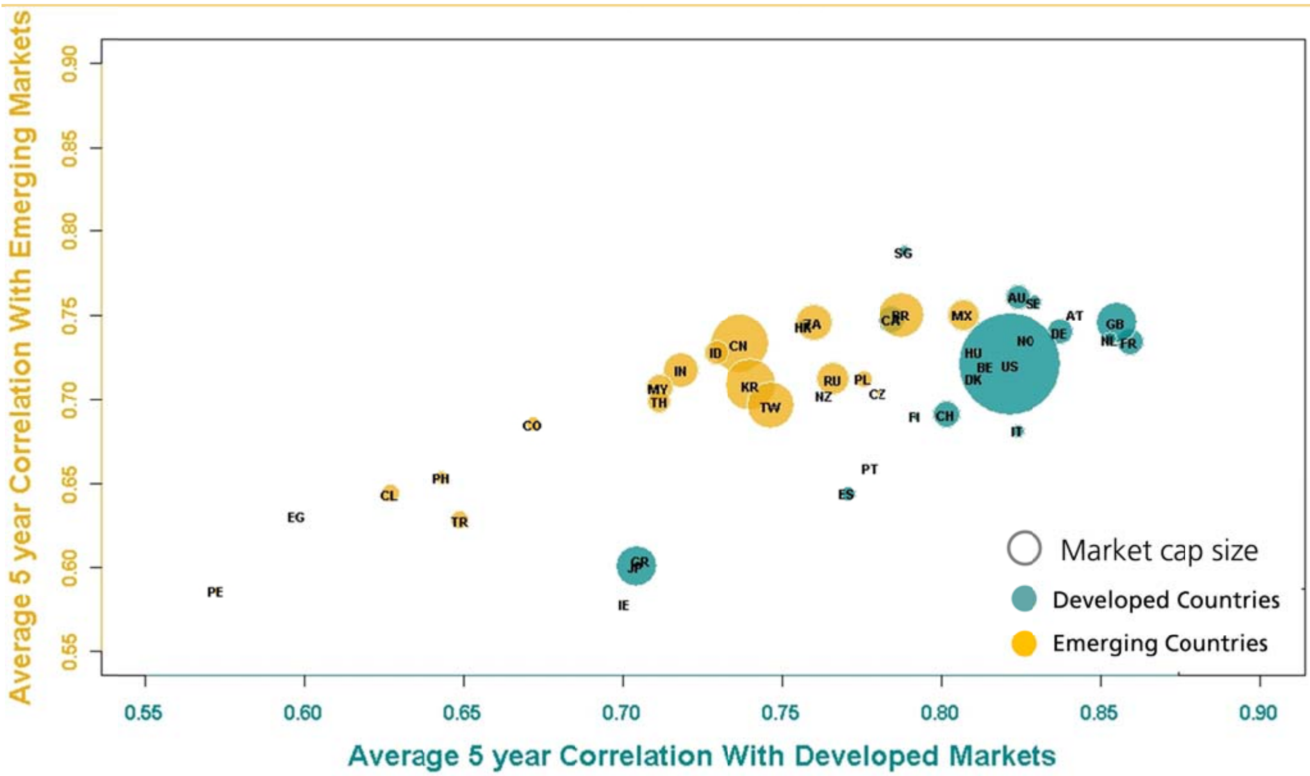


Source: Datastream, MSCI, QS Investors analysis

Correlations

In addition to return opportunities, one of the reasons for investing in emerging markets is that they offer low correlation to developed markets which continues to be the case even as correlations have increased over the last five years. This can be seen in Figure 3; it shows the correlation between developed and emerging market countries over the last five years. Not surprising, developed countries (in blue) have generally had a higher correlation to developed markets on the horizontal axis than emerging markets (in yellow). Developed countries also had a much tighter relationship to each other overall as can be seen from the tighter clustering of developed countries. In contrast, emerging countries have generally had much lower correlation to developed markets, but also to emerging markets as a whole on the vertical axis. The dispersion within emerging markets is also much higher as illustrated by the wider spread of emerging countries. Many of the countries that have the lowest correlations to developed – and other emerging markets – have the lowest weight in the index since they have smaller market capitalizations (represented by the size of the blue and yellow bubbles). One of the challenges with the market capitalization indices is a diversification opportunity is lost by having most of the weight in the largest market cap countries that are more correlated to both developed and emerging markets.

Figure 3: Correlation with Developed and Emerging Markets



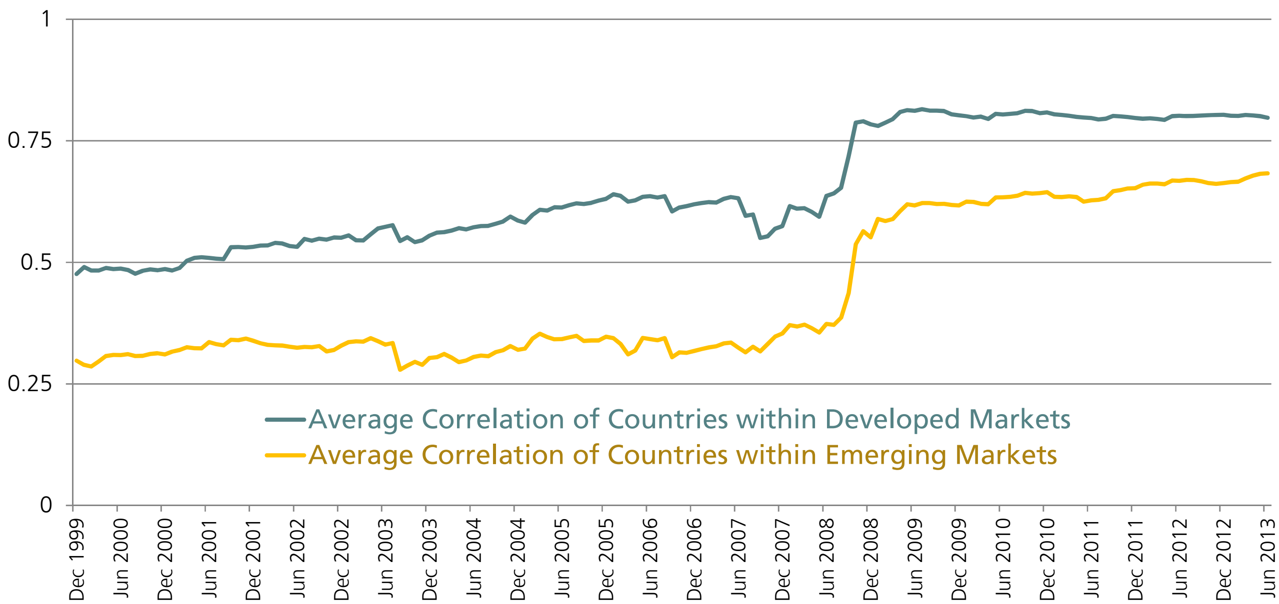
As of June 2013

Source: Datastream, MSCI, QS Investors analysis

This lower intra-country correlation within emerging markets countries has been persistent since the beginning of the century. This is illustrated in Figure 4 that illustrates the average correlation of countries within developed and emerging markets over time. Though average correlations have increased for both developed and emerging equities, emerging market equities have continued to have a persistently lower correlation to each other.

Figure 4: Average Rolling Five-Year Correlation

Time period: December 1999 to June 2013



Source: Datastream, MSCI, QS Investors analysis

Conclusion

Diversification across emerging market equities is critical in order to achieve investors' objectives;

Higher return potential linked to higher economic and productivity growth

Portfolio diversification benefit as they are less linked to developed markets

Emerging market indices are concentrated in a small number of the largest countries and these countries have not been the best performers during the last year. The larger emerging countries tend to have the highest correlation to developed economies thereby limiting the diversification benefit of investing in emerging markets. In addition, emerging markets tend to have lower correlation to each other, with some of the mid-sized and smaller countries having the lowest correlation to each other. When deciding how to get exposure to emerging market equities, it is important to examine the country diversification inherent in the investment approach.

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