QS Investors

Research Note
December 2014

EMERGING MARKETS: Seeing the Forest for the Trees

Key Points

Core Allocation: Emerging Market Equities have increasingly become a core equity holding as investors seek the benefits of its diverse market landscape coupled with higher expected growth potential.

To unlock these opportunities investors will need to see the forest for the trees - examine the big picture and look for the right approach to address important patterns across the EM universe.

Concentrated Macro Exposures

The Emerging Market Index has highly concentrated macro exposures**.** With just seven countries (the BRICS plus Korea and Taiwan) and three sectors (Financials, Commodities, and Technology) constituting over 75% and 63% of the index respectively. **State-Owned Enterprises (SOE):** SOEs constitute nearly a quarter of the EM index, including some of the largest companies and sectors. Investors should be conscious of such high levels of government influence, as share-holder value can often take a back seat to geopolitical and social objectives.

Vulnerability to Macro Risk

Significant exposure to a small number of countries leaves investors more vulnerable to macro risks, which can lead to increased volatility and more severe market drawdowns.

Limited Opportunity to Diversify

The EM Index offers a limited opportunity to diversify returns, as the largest countries and sectors in the EM index are the most connected to the global financial system and most highly correlated to the developed market business cycle. This has led the EM Index to have a **correlation of .86** to the MSCI World over the past 5 years.

Missed Opportunities for Growth

The EM landscape contains a diverse universe across different regions, political systems, demographics, and stages of development. But a heavy bias towards bigger and more developed countries leaves investors with many missed opportunities for growth. Over the last twenty years, the bottom two thirds of the index (based on country size) has **generated an additional 250 basis points in annualized return** over larger countries (top one third) with similar levels of volatility.

Solution: **A diversified, non-market cap driven approach can provide better exposure to the full economic potential of Emerging Markets while addressing the inherent risks, potentially leading to less severe market drawdowns.**

A Smarter Allocation

Over the last several years emerging market equities have increasingly become more of a core equity holding as investors seek the benefits of EM's diverse market landscape coupled with higher expected growth potential.

Achieving these benefits in a liquid fashion, however, has proven to be difficult for many investors, with both passive and active managers tending to be heavily concentrated in the most developed Emerging Markets. Such concentration has provided neither the diversification nor the growth investors had sought. In this research note we will analyze the challenges caused by this excessive concentration in terms of diversification, risk, and future growth prospects.

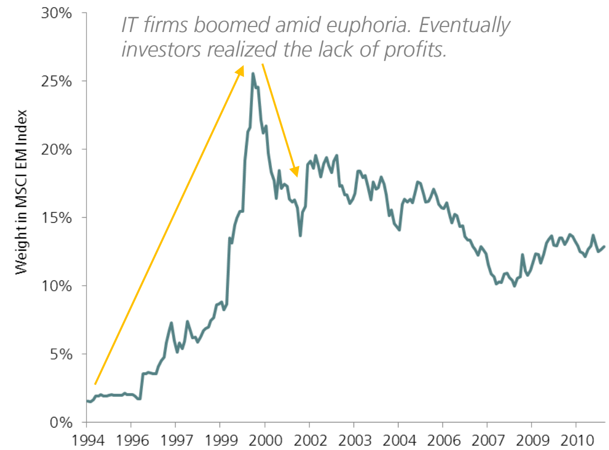
In addressing these challenges investors will need to reach outside of the standard tool box and look to new ways of unlocking value.

At QS we believe a diversified non-market cap driven approach takes advantage of different market behaviors and can provide better exposure to the full economic potential of Emerging Markets, while addressing the inherent risks, potentially leading to less severe market drawdowns.

Dangerous Concentrations

Broad equity indices are often considered diversified investments. However, investor excitement about certain parts of the market can often lead to dangerous concentrations. During the 1990s the excessive enthusiasm for technology stocks led the IT sector to rise from just under 2% of the cap weight in 1994 to over 25% in 2000, leaving investors significantly exposed to just a single sector (Exhibit 1).

Exhibit 1
Investor Behavior Drives Markets
Information Technology Sector 1994-2009

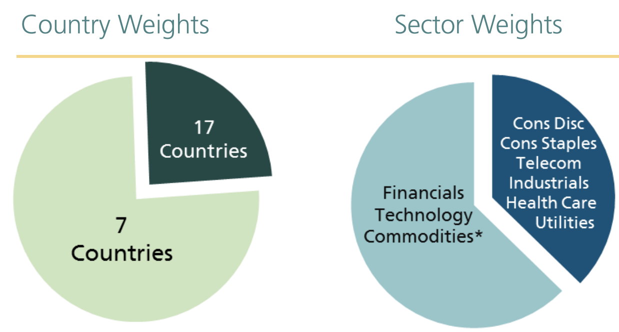


Source: MSCI, QS Investors

This behavior may vary in size over time, but is often repeated in different parts of the market at different times. More recently the excitement about the growth prospects in the BRICS as well as the commodity super cycle in the mid-2000s has left the Emerging Market index highly concentrated from a geographic and sector perspective.

Seven countries (the BRICS, Korea and Taiwan) and three sectors (Financials, Commodities, and Technology) constitute over 75% and 63% of the index respectively (Exhibit 2).

Exhibit 2
Concentration in Emerging Markets



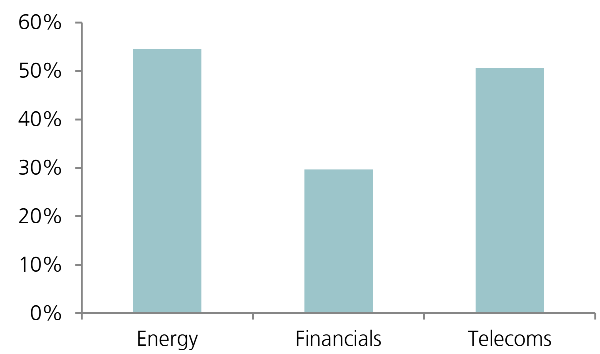
As of September 30, 2014
Source: Datastream, MSCI, QS Investors
*Energy & Basic Materials

These concentrated positions also have a significant exposure to state-owned enterprises (SOEs), constituting nearly a quarter of the EM Index. SOEs are particularly dominant in the Financial, Energy, and Telecom sectors, with 30-55% of companies being SOEs (Exhibit 3). Investors should be conscious of such high levels of government influence, as share-holder value can often take a back seat to geopolitical and social objectives. This can make valuing companies particularly difficult with traditional metrics.

Exhibit 3

State-owned Enterprises

Constituent large shares of several sectors



As of September 30, 2014
Source: QS Investors; MSCI, Bloomberg

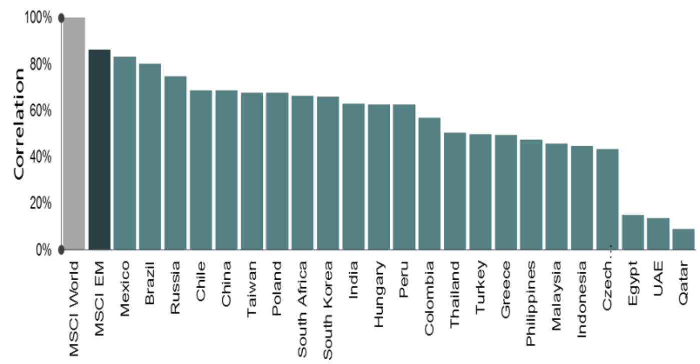
True Diversification

One of the primary objectives investors seek when entering Emerging Markets is a differentiated return stream -- something that will help diversify their equity portfolio. Yet with globalization, and the continued integration of financial markets, this goal has become ever more difficult to achieve. When looking at the EM Index in particular investors often realize there is limited opportunity to diversify returns from developed markets, as the largest countries and sectors in the EM Index are the most connected to the global financial system and most highly correlated to the developed market business cycle. The EM Index has had a correlation of .86 to the MSCI World over the past 5 years (Exhibit 4).

Exhibit 4

Limited Opportunity to Diversify

5-Year correlation to MSCI World



As of September 30, 2014
Source: Bloomberg; MSCI Country Indices

While the larger, more developed countries in the EM Index are more dependent on events in the developed world, there is still a large number of countries who are indeed acting differently, with much more focus on their regional and domestic markets.

Investors need to broaden their geographic exposures in order to fully capture the diversification benefits offered in the asset class.

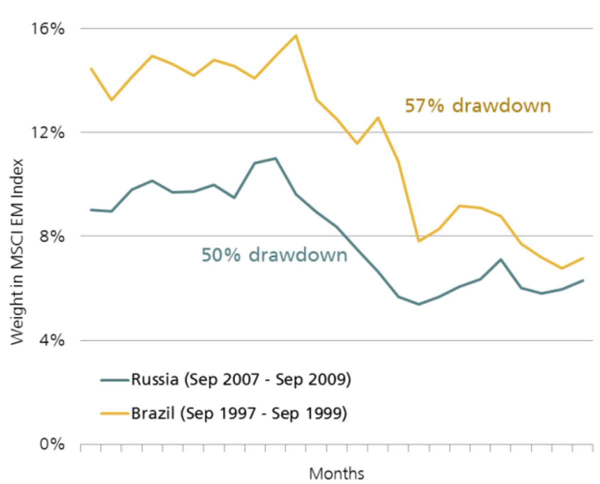
Risk: Allocate Wisely

It should come as no surprise that Emerging Markets tend to experience greater volatility with the increased level of political, economic, and social risk. Whether it's Russian saber rattling, protests in China, or Brazilian elections, these macro events are unpredictable and can often have significant impact on individual countries or sectors. Exhibit 5 highlights two examples, with Brazil (late 1990s) and Russia (late 2000s) experiencing drawdowns of over 50% within just a few months. A significant exposure to a small number of countries, as we see in the EM Index, leaves investors much more vulnerable to these macro risks, which can lead to increased volatility and more severe market drawdowns.

Predicting the outcome or timing of macro risks has proven to be difficult, with many investors typically reacting to news already ingrained in the market price.

Investors should instead proactively look to better manage their geographic and sector exposures through true diversification.

Exhibit 5
Country Drawdowns
Vulnerable to Macro Risks

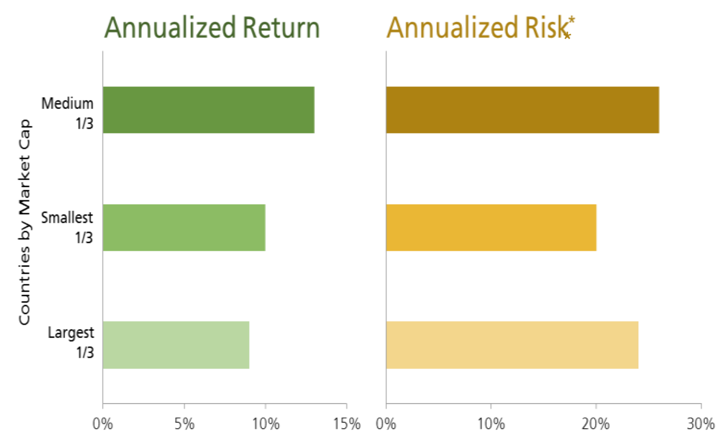


Source: QS Investors; MSCI

Growth: Don't Miss Out

Emerging Markets are a diverse universe spanning different regions, political systems, demographics, and stages of development. But a heavy bias towards bigger and more developed countries leaves investors with many missed opportunities for growth. **Larger countries have already experienced significant growth, which is why they have such a large cap weight in the first place.** As we can see in Exhibit 6, over the last twenty years, the bottom two thirds of the index (based on country size) has generated an additional 250 basis points annually over larger countries (top one third) at similar levels of volatility.

Exhibit 6
Missed Return Opportunities
Annualized returns and risk over last 20 years



Twenty Years Ending May 31, 2014
20 year annualized risk and return
*Risk is measured as standard deviation
Please refer to important disclosure information at the end of this publication.

A key driver of opportunities for higher returns seems to come from smaller countries having more room to develop. As a country advances and inherently increases in size, opportunities to achieve above average levels of growth recede. From a risk stand point the medium and smaller sized countries tend to have much lower correlations both to each other, as well as to developed markets. While any one of these smaller markets may have higher levels of volatility on its own, if properly diversified, its low correlation can be used to bring down volatility significantly in the overall portfolio, allowing the portfolio to take advantage of higher expected returns at similar levels of risk.

Solution

As Emerging Market Equities increasingly become more of a core holding, investors will have to pay close attention to how that exposure is achieved. While a differentiated return stream and higher expected growth can be achieved within the asset class, many off the shelf products may not be the best tools for unlocking this potential.

Concentrated macro exposures pose significant challenges for portfolio diversification, risk, and future growth prospects. In dealing with these challenges investors will need to see the forest for the trees - examine the big picture and address important patterns across the universe to unlock value.

At QS we believe a diversified non-market cap driven approach takes advantage of different market behaviors and can provide better exposure to the full economic potential of Emerging Markets, while addressing the inherent risks, potentially leading to less severe market drawdowns.

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