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INVESTMENT MANAGEMENT

Emerging Market Allocations

How Much to Own?

ACTIVE FUNDAMENTAL EQUITY | GLOBAL EMERGING MARKETS TEAM | INVESTMENT INSIGHT | 2021

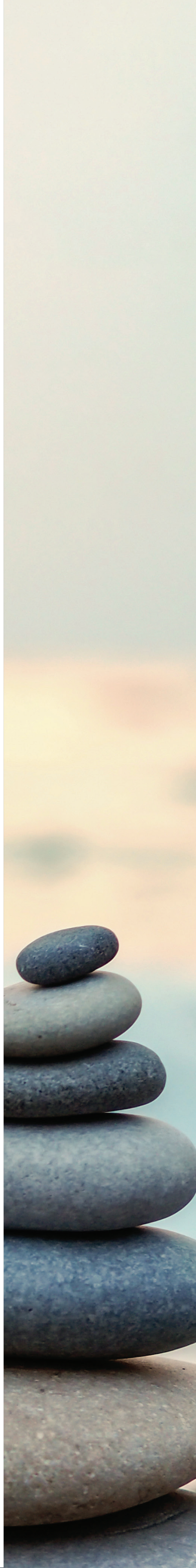
AUTHORS

GLOBAL EMERGING MARKETS TEAM

Until recent months, emerging economies had fallen off the radar, after the worst decade for emerging stock market returns since records began in the 1930s. Now, as we expected, investors are coming back, drawn by attractive valuations for both emerging market (EM) stocks and currencies, and record high valuations elsewhere. Once again, we are flooded with inquiries about EM: will this comeback endure? If so, which EMs will do best and—above all—how much to invest?

The answer, in brief, is there are many reasons to expect this EM comeback to endure for the next five to ten years. The top four reasons: a few EMs are prospering as old fashioned manufacturing success stories; the unfolding revival of commodity prices is a bright sign for the many EMs that rely on commodity exports; lacking the resources to spend their way through the pandemic, many emerging world governments have been forced to press painful economic reform, which is likely to accelerate growth in coming years; and finally, the pandemic is also accelerating the digital revolution, and one of the least understood aspects of this revolution is that it is unfolding even faster in emerging markets than in developed ones.

As for where to invest, the simple answer is in markets best positioned to prosper from one or more of the four trends outlined above. The EMs rising as export manufacturers are concentrated in Southeast Asia and Eastern Europe, led by Vietnam and Poland. Those already getting a boost from the commodity price revival include diversified exporters



like Brazil, oil and metals exporters like Russia, and exporters of metals critical to green electrification programs, like Chile. The pandemic-inspired reform efforts are widespread but perhaps most dramatic in Indonesia and India. Most intriguingly, the digital revolution is seeing new regional variants of the Chinese and American tech giants rise across every region in EM, from Latin America to Africa and East Asia.

This moment was entirely predictable. Over the last decade, investors had eyes for only two countries, the United States and China, and one sector, tech. But the hot themes of one decade rarely stay hot the next, which is why we have been expecting this revival of the rest—countries outside the superpowers, companies outside big tech—for some time. Following a historically weak decade for EM returns (see *Display 1*), the gap between EM and U.S. valuations has never been wider. And with the growth prospects of emerging economies rising relative to the United States, these extremes are likely to shift back toward balance.

The mood around EM has changed so fast, the question we get most often now cuts right to the chase: how much to invest in EM?

In this paper, we survey three key approaches used to answer this question, and we find that they suggest an ideal global equity portfolio would include an EM allocation of at least 13% but perhaps materially more. Then we compare this ideal to various sources on how much global investors currently hold in EM equities, and find that today, the actual allocation ranges from just 6% to 8%. Many investors are leaving money on the EM table, at a moment when returns have begun to pick up and—we believe—economic fundamentals suggest the revival has legs.

Three Rational Allocation Strategies

Ever since countries began opening to global capital flows in the 1970s and 80s, research shows, most people have remained not only wary of investing abroad, but wary to an extent not explained by the risks. Levy and Sarnat (1970) were among the first to identify the “home bias” that leads most investors to hold high shares of domestic equities. Since then, a vast literature has examined this bias, but it still defies rational explanation.

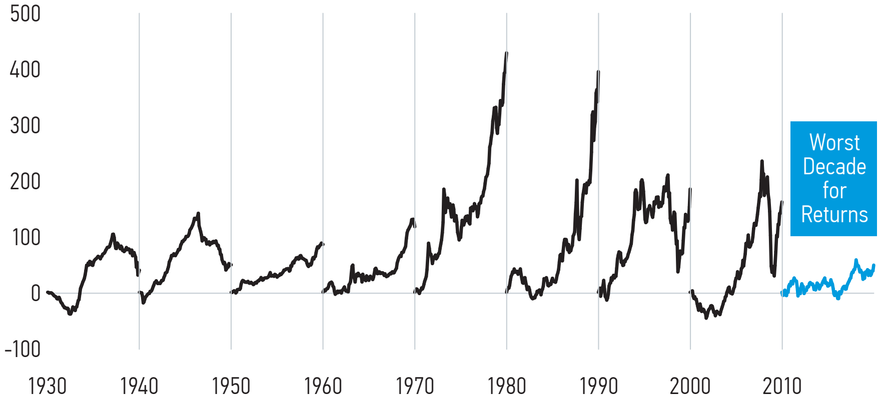
To help investors counteract home bias, we have surveyed a number of approaches to help answer the question: how much to invest abroad? There are many models, and we focus on three that we think give the best benchmark and understanding of how to think about EM allocations; each has its limitations, but also provides useful ballpark estimates of how much to sensibly allocate to EM.

GDP WEIGHTING: One approach recommends investors allocate money to foreign equity markets in proportion to each country’s share in global GDP, since this should roughly capture a country’s “relative economic importance” (FTSE Russell, 2014). Today, the 27 countries in the MSCI Emerging Markets Index account for 39% of global GDP (see *Display 2*).

DISPLAY 1

The 2010s Were Historically Weak For EM Returns

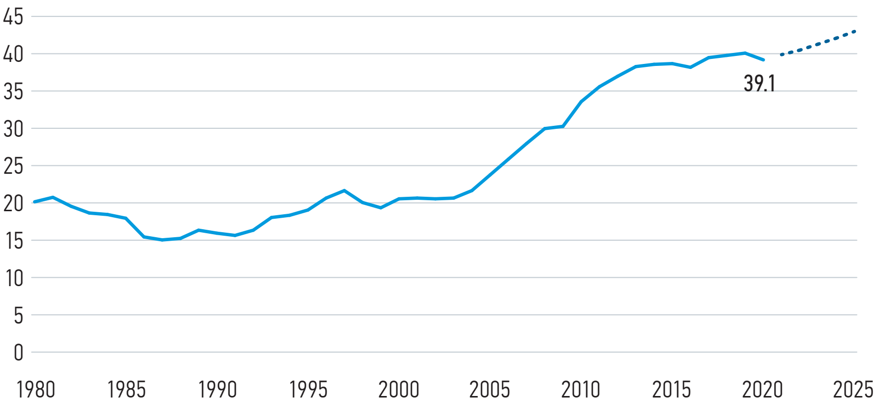
Equity Total Returns (%), USD



Source: MSIM, Bloomberg, FactSet, Haver, Global Financial Data. Data as of December 31, 2020. Represents equity total returns in USD of the Global Financial Data (GFD) emerging markets composite index from 1930 to 1988 and MSCI Emerging Markets Index thereafter.

DISPLAY 2

EM’s Rising Share of Global GDP (%)



Source: Haver, IMF, MSIM. Data as of December 2020. IMF projections shown for 2021 - 2025. Uses countries in MSCI Emerging Markets Index and MSCI AC World Index only for comparison purposes to index weights.

Even if we correct for a lower free-float share in EM equities and higher dilution, an adjusted GDP weighting approach still suggests that global equity investors should allocate 26% of their portfolio to emerging markets. If we adjust further for the fact that many investors have indirect EM exposure through developed market (DM) companies that earn revenue in EM countries, as well as indirect DM exposure through EM companies with revenue from DM countries, the ideal EM allocation is still sizable, about 17% (see *Display 3*).[1] And as the EM share in global GDP rises, we expect the ideal EM allocation under a GDP weight approach to increase.

MARKET SHARE: A second basic approach is based on share of global market capitalization (Tesar and Werner, 1992). Currently, emerging markets have a 26% share of global market cap, up from 19% in 2009. Note that this share is still lower than the EM share of global GDP (39%). Over time we expect the EM global market cap share to rise and potentially converge with its GDP share, as rising incomes give more and more people the means and need to invest in stocks through retirement funds, insurance policies, and other increasingly sophisticated financial products.

A common variation on this approach uses the EM weight in the MSCI All Country World Index (ACWI). MSCI uses screens to adjust weights for company and country sizes, free-float of equity shares, and liquidity. These screens, which tend to correct for the relatively undeveloped financial systems in emerging markets, put the EM share

[1] To account for this, we calculate the share of revenues from EM countries for specific countries in the MSCI World Index, and the share of revenues from DM countries in the MSCI EM Index. More specifically, to arrive at the EM exposure for MSCI World investors, we multiply the country weights of MSCI U.S., Europe and Japan by the respective share of total revenues from EM. We then sum this to arrive at 11.3% of MSCI World revenues coming from EM. To calculate the share of DM exposure in EM equities, we calculate the share of EM revenues coming from the U.S., Europe and Japan and multiply it by the MSCI EM Index weight in the MSCI ACWI Index to arrive at a DM exposure owned in EM of 1.8%.

DISPLAY 3

Even the Most Conservative GDP-Weighted Approach Suggests a Sizable EM Allocation

1. EM GDP Share	39.1%
2. Minus Free-float and dilution (1/3rd)	13.0%
Equals	26.1%
3. Minus EM Exposure via MSCI World	11.3%
Equals	14.8%
4. Plus DM exposure in EM to regain pure EM allocation	1.8%
5. Equals Implied Investor Allocation to EM	**16.6%**

Source: MSIM analysis, Bloomberg, FactSet, Haver. Revenue exposure estimates used to approximate EM and DM cross-exposures. Data as of December 31, 2020.

DISPLAY 4

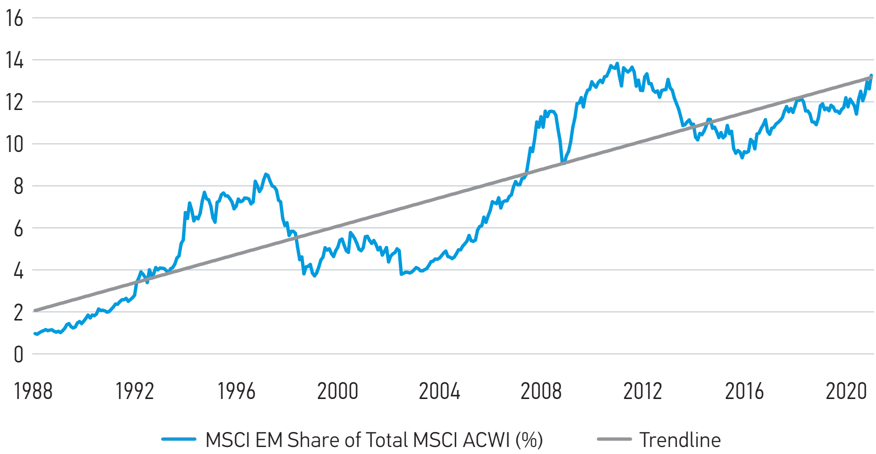
Country and Region Weights in MSCI AC World Index

MSCI AC WORLD	% WEIGHT
USA	57.3
Japan	6.8
United Kingdom	3.8
France	3.0
Canada	2.7
Switzerland	2.6
Germany	2.5
Australia	1.9
Netherlands	1.0
Other DMs	5.2
EM	**13.3**

Source: FactSet. Data as of December 31, 2020.

DISPLAY 5

EM Allocation in Global Index Rising Over the Long Term



Source: MSCI. Data as of December 31, 2020. Represents share of emerging markets in MSCI All Country World Index.

of MSCI ACWI at 13% (see *Display 4*). This share has risen from just 1% in 1988 to 13% today, as shown in *Display 5*,[2] and for the same reasons mentioned above, we believe it will rise further in the coming years.

MEAN VARIANCE: The third basic allocation strategy is based on mean variance. Otherwise known as Modern Portfolio Theory (Markowitz, 1952) (Black & Litterman, 1991), or Max Return/Risk, this approach calculates the weight of assets that maximizes expected returns for each asset in a portfolio, given the investor's tolerance for variance or risk.

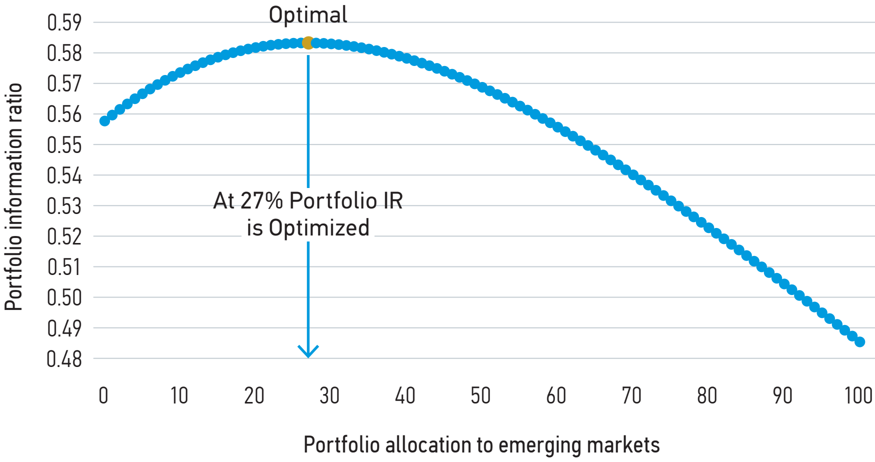
Using monthly data since 1988, the year MSCI introduced the EM index, and starting from a portfolio which is 100% allocated to DM equities (MSCI World Index), we examined the monthly returns and volatility of the MSCI World and MSCI EM Indexes and found that the optimal equity portfolio would have allocated 27% to EM and 73% to DM, as shown in *Display 6*.

One basic objection to that conclusion is that expected EM returns are exaggerated if one uses data going back to 1988 because this period was widely seen as very favorable to EM equities. We would disagree: this period included crises in emerging markets from Mexico to Russia to Southeast Asia, plus the aftermath of the global financial crisis, all of which severely impacted EM equity returns. Nonetheless, to further test our finding, we utilized a series from Global Financial Data for EM equities that goes back to 1925.[3] Surprisingly, it showed that over the longer historical period, the optimal allocation to EM equities was even higher, at 37% (see *Display 7*).

In short, a review of the three standard approaches to EM allocation suggest global equity investors should allocate somewhere in the range of 13% to 39% to EM.

DISPLAY 6

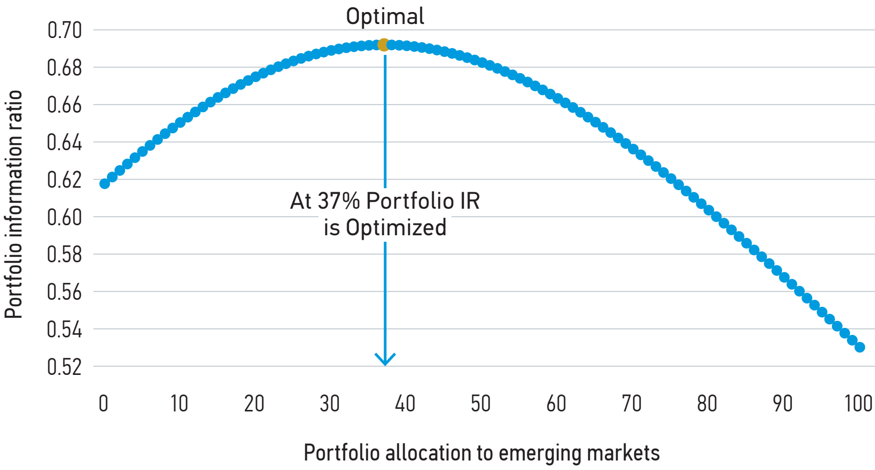
Realized Information Ratio of EM vs. DM Portfolio



Source: FactSet, MSCI, MSIM calculations. Data as of December 31, 2020.

DISPLAY 7

Realized Information Ratio of EM vs. DM



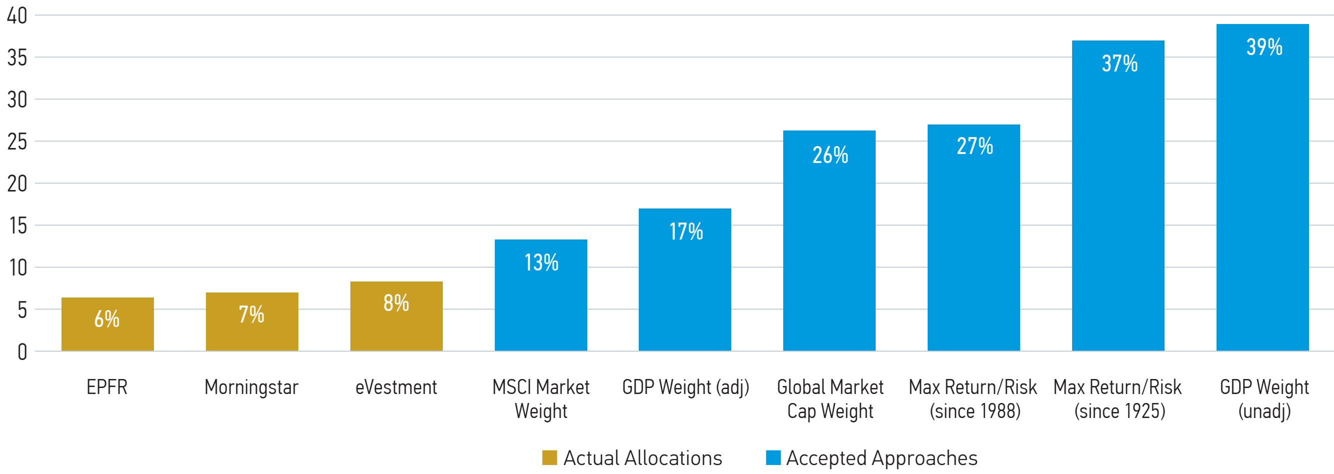
Source: FactSet, MSCI, Global Financial Data, MSIM calculations. Data as of December 31, 2020.

[2] FactSet, data as of December 31, 2020.

[3] Contact Global Financial Data for questions regarding their methodology in creating an EM equity index.

DISPLAY 8

Optimal vs. Actual Allocations to EM Equities (%)



Source: FactSet, Haver, IMF, Global Financial Data, eVestment, Morningstar, EPFR, MSIM calculations. Data as of December 31, 2020.

So How Much Do Investors Actually Hold in EM?

There are many sources of data on how much global investors have allocated to emerging market equities, but no matter which one we use, it shows that current allocations represent a low share of overall portfolios, between 6 and 8%.

The EPFR flows database, which covers 346 global equity funds, suggests that the median fund has only 6.4% allocated to emerging markets *(Display 8)*. Morningstar, which reports actual allocation data, yields a similar picture, with the median fund reporting an allocation of 7% to EM equities. And the numbers from eVestment, which aggregates reported holdings for 1,406 global equity funds, suggests the median global fund allocation to EM equities is 8.3%.

Clearly, this 6 to 8% range is significantly lower than any practical theory might suggest, including the 39% suggested by GDP weighting, the 13 to 17% implied by market weighting, or the 27 to 37% suggested by modern portfolio theory.

Summary: The Irony of Underweighting EM Right Now

It would appear then, that most global equity portfolios, no matter how sophisticated, are still guilty of home bias. For decades, they have been missing an opportunity to earn higher risk-adjusted returns by allocating too low a share of their portfolios to international equity. We think their EM allocations are still too low. The analysis above suggests that the typical EM allocation is at most about half, and perhaps as little as one sixth, of what a rational approach would recommend.

The broad paradox of savvy global investors shunning markets that are far from home is very likely to grow over time. As emerging markets continue to gain share in global GDP and global market cap, and to advance in financial depth and sophistication, they will continue to be increasingly attractive, based on the most important allocation models. This gap, between opportunity and allocation, seems to us especially acute today, when an emerging market comeback has already begun, and the economic fundamentals suggest many reasons to believe that it could last. To those wondering where EM growth will come from, the possibilities begin with manufacturing, commodity prices, economic reforms, and the rise of major new internet service industries and companies outside China.

In general, we think the logical answer to “how much” to invest in emerging markets is more. For a host of fundamental and structural reasons, that answer has rarely been more true than it is right now.

DEFINITIONS

Gross Domestic Product (GDP) is a monetary measure of the market value of all final goods and services produced in a period (quarterly or yearly) of time. **Volatility** is a statistical measure of the dispersion of returns for a given security or market index. **Information ratio** is the portfolio's alpha or excess return per unit of risk, as measured by tracking error, versus the portfolio's benchmark.

INDEX DEFINITIONS

The **MSCI Emerging Markets Index (MSCI EM)** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets. The **MSCI World Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends. The **MSCI All Country World Index (ACWI)** is a free float-adjusted market capitalization weighted index designed to measure the equity market performance of developed and emerging markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

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