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).
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). 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

---

**DISPLAY 3**

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

<table>
<thead>
<tr>
<th>Step</th>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>EM GDP Share</td>
<td>39.1%</td>
</tr>
<tr>
<td>2.</td>
<td>Minus Free-float and dilution (1/3rd)</td>
<td>13.0%</td>
</tr>
<tr>
<td></td>
<td>Equals</td>
<td>26.1%</td>
</tr>
<tr>
<td>3.</td>
<td>Minus EM Exposure via MSCI World</td>
<td>11.3%</td>
</tr>
<tr>
<td></td>
<td>Equals</td>
<td>14.8%</td>
</tr>
<tr>
<td>4.</td>
<td>Plus DM exposure in EM to regain pure EM allocation</td>
<td>1.8%</td>
</tr>
<tr>
<td>5.</td>
<td>Equals Implied Investor Allocation to EM</td>
<td>16.6%</td>
</tr>
</tbody>
</table>


---

**DISPLAY 4**

**Country and Region Weights in MSCI AC World Index**

<table>
<thead>
<tr>
<th>Region</th>
<th>% Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>57.3</td>
</tr>
<tr>
<td>Japan</td>
<td>6.8</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>3.8</td>
</tr>
<tr>
<td>France</td>
<td>3.0</td>
</tr>
<tr>
<td>Canada</td>
<td>2.7</td>
</tr>
<tr>
<td>Switzerland</td>
<td>2.6</td>
</tr>
<tr>
<td>Germany</td>
<td>2.5</td>
</tr>
<tr>
<td>Australia</td>
<td>1.9</td>
</tr>
<tr>
<td>Netherlands</td>
<td>1.0</td>
</tr>
<tr>
<td>Other DMs</td>
<td>5.2</td>
</tr>
<tr>
<td>EM</td>
<td>13.3</td>
</tr>
</tbody>
</table>


---

**DISPLAY 5**

**EM Allocation in Global Index Rising Over the Long Term**


---

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%.
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, 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. 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.

---

2 FactSet, data as of December 31, 2020.

3 Contact Global Financial Data for questions regarding their methodology in creating an EM equity index.
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 (MSCIEM) 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.

DISTRIBUTION

This communication is only intended for and will only be distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.

Ireland: MSIM Fund Management (Ireland) Limited. Registered Office: The Observatory, 7-11 Sir John Rogerson’s Quay, Dublin 2, D02 VC42, Ireland. Registered in Ireland as a private company limited by shares under company number 616661. MSIM Fund Management (Ireland) Limited is regulated by the Central Bank of Ireland. United Kingdom: Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 1981121. Office: 25 Cabot Square, Canary Wharf, London E14 4QA, authorised and regulated by the Financial Conduct Authority. Dublin: Morgan Stanley Investment Management Limited (Representative Office, Unit Precinct 3:7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158. Germany: MSIM Fund Management (Ireland) Limited Niederlassung Deutschland, Grosse Gallusstrasse 18, 60312 Frankfurt am Main, Germany (Kattegat Zweigniederlassung (FDI) gem. § 53b KWG). Italy: MSIM Fund Management (Ireland) Limited, Milan Branch (Sede Secondaria di Milano) is a branch of MSIM Fund Management (Ireland) Limited, a company registered in Italy, regulated by the Central Bank of Ireland and whose registered office is at The Observatory, 7-11 Sir John Rogerson’s Quay, Dublin 2, D02 VC42, Ireland. MSIM Fund Management (Ireland) Limited Milan Branch (Sede Secondaria di Milano) with seat in Palazzo Serbelloni Corso Venezia, 16 20121 Milan, is registered in Italy with company number and VAT number 1148828096A. The Netherlands: MSIM Fund Management (Ireland) Limited, Rembrandt Tower, 11th Floor Amstelplein 11096HA, Netherlands. Telephone: 31 2-0462-1300. Morgan Stanley Investment Management is a branch office of MSIM Fund Management (Ireland) Limited. MSIM Fund Management (Ireland) Limited is regulated by the Central Bank of Ireland. France: MSIM Fund Management (Ireland) Limited, Paris Branch is a branch of MSIM Fund Management (Ireland) Limited, a company registered in Ireland, regulated by the Central Bank of Ireland and whose registered office is at The Observatory, 7-11 Sir John Rogerson’s Quay, Dublin 2, D02 VC42, Ireland. MSIM Fund Management (Ireland) Limited Paris Branch with seat at 61 rue de Monceau 75008 Paris, France, is registered in France with company number 850 718 863 RCS. Spain: MSIM Fund Management (Ireland) Limited, Sucursal en España is a branch of MSIM Fund Management (Ireland) Limited, a company registered in Ireland, regulated by the Central Bank of Ireland and whose registered office is at The Observatory, 7-11 Sir John Rogerson’s Quay, Dublin 2, D02 VC42, Ireland. MSIM Fund Management (Ireland) Limited, Sucursal en España with seat in Calle Serrano 55, 28006, Madrid, Spain, is registered in Spain with tax identification number W0058820B. Switzerland: Morgan Stanley & Co. International plc, London, Zurich Branch Authorised and regulated by the Eidgenössische Finanzmarktaufsicht (‘FINMA’). Registered with the Register of Commerce Zurich CHE-115.415.770. Registered Office: Beethovenstrasse 33, 8002 Zurich, Switzerland, Telephone +41 (0) 44 588 1000. Facsimile Fax: +41(0) 44 588 1074.

U.S.

A separately managed account may not be appropriate for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks, fees of the Strategy carefully before investing. A minimum asset level is required. For important information about the investment manager, please refer to Form ADV Part 2.

Please consider the investment objectives, risks, charges and expenses of the funds carefully before investing. The prospectuses contain this and other information about the funds. To obtain a prospectus please download one at morganstanley.com/im or call 1-800-548-7786. Please read the prospectus carefully before investing.

Morgan Stanley Distribution, Inc. serves as the distributor for Morgan Stanley Funds.

NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A BANK DEPOSIT

Australia: This publication is disseminated in Australia by Morgan Stanley Investment Management (Australia) Pty Limited ACN: 12204-037, AFSL No. 317412, which accept responsibility for its contents. This publication, and any access to it, is intended only for ‘wholesale clients’ within the meaning of the Australian Corporations Act.

Hong Kong: This document has been issued by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to ‘professional investors’ as defined under the Securities and Futures Ordinance of Hong Kong (Cap 571). The contents of this document have not been reviewed nor approved by any regulatory authority including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this document shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong.

Singapore: This publication should not be considered to be the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor under section 304 of the Securities and Futures Act, Chapter 289 of Singapore ("SFA"); (ii) to a "relevant person" (which includes an accredited investor) pursuant to section 305 of the SFA, and such distribution is in accordance with the conditions specified in section 305 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. In particular, for investment funds that are not authorized or recognized by the MAS, units in such funds are not allowed to be offered to the retail public; any written material issued to persons as aforementioned in connection with an offer is not a prospectus as defined in the SFA and, accordingly, statutory liability under the SFA in relation to the content of prospectuses does not apply, and investors should consider carefully whether the investment is suitable for them. This publication has not been reviewed by the Monetary Authority of Singapore.

IMPORTANT INFORMATION

EMEA: This marketing communication has been issued by MSIM Fund Management (Ireland) Limited. MSIM Fund Management (Ireland) Limited is regulated by the Central Bank of Ireland. MSIM Fund Management (Ireland) Limited is incorporated in Ireland as a private company limited by shares with company registration number 616661 and has its registered address at The Observatory, 7-11 Sir John Rogerson’s Quay, Dublin 2, D02 VC42, Ireland.

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Prior to investing, investors should carefully review the strategy’s/product’s relevant offering document. There are important differences in how the strategy is carried out in each of the investment vehicles.

The views and opinions are those of the author as of the date of publication and are subject to change at any time due to market or economic conditions and may not necessarily come to pass. Furthermore, the views will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date of publication. The views expressed do not reflect the opinions of all portfolio managers at Morgan Stanley Investment Management (MSIM) or the views of the firm as a whole, and may not be reflected in all the strategies and products that the Firm offers.

MORGAN STANLEY INVESTMENT MANAGEMENT | ACTIVE FUNDAMENTAL EQUITY
Forecasts and/or estimates provided herein are subject to change and may not actually come to pass. Information regarding expected market returns and market outlooks is based on the research, analysis and opinions of the authors. These conclusions are speculative in nature, may not come to pass and are not intended to predict the future performance of any specific Morgan Stanley Investment Management product.

Certain information herein is based on data obtained from third party sources believed to be reliable. However, we have not verified this information, and we make no representations whatsoever as to its accuracy or completeness. The information herein is a general communications which is not impartial and has been prepared solely for information and educational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The material contained herein has not been based on a consideration of any individual client circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

Past performance is no guarantee of future results. Charts and graphs provided herein are for illustrative purposes only.

This communication is not a product of Morgan Stanley’s Research Department and should not be regarded as a research recommendation. The information contained herein has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Prior to investing, investors should carefully review the strategy/product’s relevant offering document. There are important differences in how the strategy is carried out in each of the investment vehicles.

Indexes are unmanaged and do not include any expenses, fees or sales charges. It is not possible to invest directly in an index. Any index referred to herein is the intellectual property (including registered trademarks) of the applicable licensor. Any product based on an index is in no way sponsored, endorsed, sold or promoted by the applicable licensor and it shall not have any liability with respect thereto.

All investments involve risks, including the possible loss of principal. The material contained herein has not been based on a consideration of any individual client circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

The views and opinions expressed are those of the portfolio management team at the time of writing/of this presentation and are subject to change at any time due to market, economic, or other conditions, and may not necessarily come to pass. These comments are not representative of the opinions and views of the firm as a whole.

MSIM has not authorized financial intermediaries to use and to distribute this document, unless such use and distribution is made in accordance with applicable law and regulation. MSIM shall not be liable for, and accepts no liability for, the use or misuse of this document by any such financial intermediary. If you are a distributor of the Morgan Stanley Investment Funds, some or all of the funds or shares in individual funds may be available for distribution. Please refer to your sub-distribution agreement for these details before forwarding fund information to your clients.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without MSIM’ express written consent.

All information contained herein is proprietary and is protected under copyright law.

Morgan Stanley Investment Management is the asset management division of Morgan Stanley.

This document may be translated into other languages. Where such a translation is made this English version remains definitive. If there are any discrepancies between the English version and any version of this document in another language, the English version shall prevail.