

Why Emerging Markets Leaders Now?

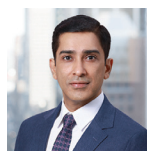
ACTIVE FUNDAMENTAL EQUITY | GLOBAL EMERGING MARKETS TEAM | INVESTMENT INSIGHT | 2021

After the worst decade ever for emerging market equity returns, investors are pouring back in, drawn to attractive growth opportunities. According to research from JP Morgan and EPFR, the inflows into emerging market equities in the first seven and a half weeks of 2021 have totaled U.S. \$47 billion or nearly 2.5% of the assets under management. And yet there is still hesitation amid this boom.

Our research shows that, in a typical global portfolio, the allocation to emerging markets is somewhere between roughly one half and one fifth of what rational allocation models would recommend. The likely explanation for this is the home bias of investors who are leery of the faraway and unfamiliar, even when opportunities beckon. They are looking for a reliable guide, which is why Emerging Markets Leaders is worth a close look right now.

Launched in 2011, the Emerging Markets Leaders strategy was designed to exploit the rich opportunities we find in emerging markets while minimizing market risks. We focus on large, quality growth, well-managed companies (e.g. firms with more than U.S. \$1 billion market capitalization, more than 15% return on invested capital and more than 15% expected CAGR earnings growth). These companies must be poised to take advantage of long-term structural themes, operating in favorable industries for market leaders.

AUTHOR



VISHAL GUPTA

*Managing Director
Portfolio Manager,
Emerging Markets
Leaders Strategy*



Our investments are focused mostly in what we termed “continental-sized” markets of China, India, Brazil and Indonesia—which all have large populations and vast domestic markets. These markets should be well positioned in an age of deglobalization and declining trade flows. We add Taiwan to the mix, as it’s a linchpin in the global tech supply chain. All of these countries also have dynamic communities of entrepreneurs, who are well positioned to benefit from the long-term structural themes.

Right now, those themes include most prominently the rise of e-commerce, food delivery, fintech penetration, athleisure, and the premiumization of consumption. In addition to the sharp jump in the adoption of these trends, the pandemic has also brought the health-care theme into focus as well.

This list is not entirely exclusive, but nearly so. We avoid stocks that don’t fit our structural themes or meet our investment criteria, even in countries we favor. For example, right now, we avoid

banks in most of the emerging markets, materials and cyclical companies and other industries that we regard as in structural decline.

The chart below (see *Display 1*) is a clear example of why we concentrate most of the investments on a relatively small set of continental-sized markets: because those markets are where the majority of the big “compounders” are found. As we noted earlier, all of our companies must meet a minimum market cap of more than U.S. \$1 billion and expect a compounded earnings growth rate of more than 15% for the next three- to five-years. This longer term investment horizon gives us the confidence to stay with these steady compounders through tremors in the markets.

While we’ve been investing mainly in structural compounders in continental-sized emerging markets, we are open to new opportunities as they arise. Although many of the Eastern European countries, such as Poland, Hungary and the Czech Republic, have recorded strong GDP

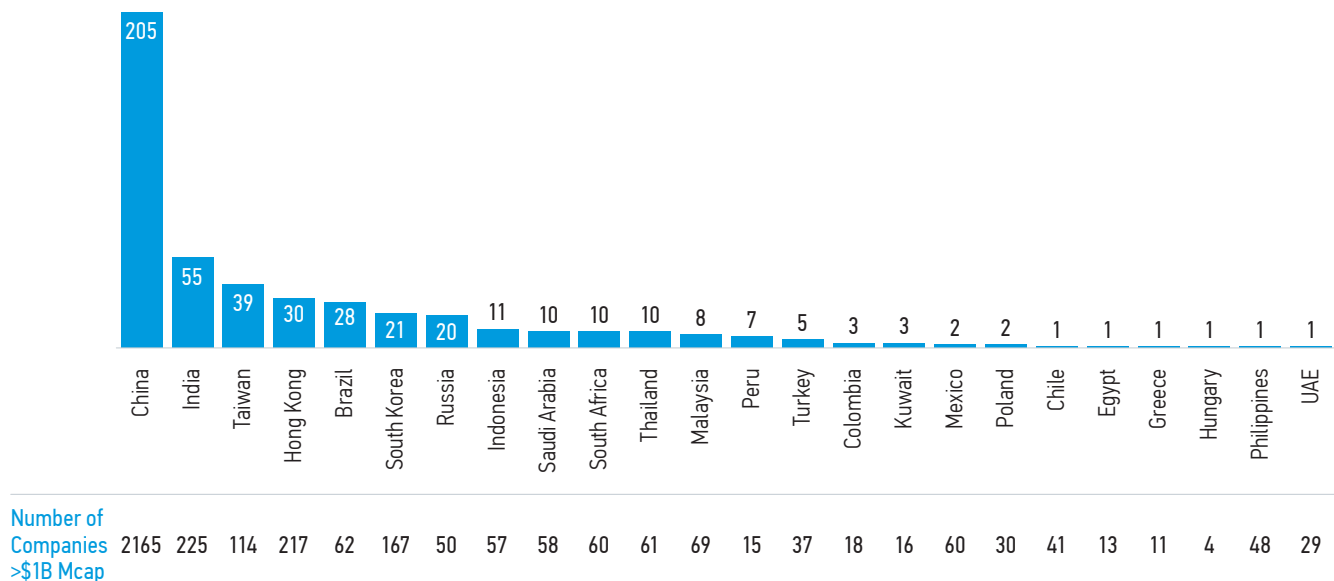
growth, we have not been able to find many investment opportunities, as many of the local consumer companies have been acquired by global multinationals. In the past, we owned retail and bank stocks as a way to get exposure to the rising middle class in Eastern Europe, but they no longer meet our growth profile. We would assess new investment opportunities as when they arise.

While many global, international and balanced portfolios tend to have some emerging markets exposure, our Global Emerging Markets investment team showed recently how meager these investments are. The information from three major data providers, as shown in *Display 2*, point to emerging markets allocations ranging from 6% to 8%. In contrast, the research from our GEM team incorporating the three most well established allocation approaches (GDP weighting, market weighting, and modern portfolio theory), would recommend emerging markets allocations of between 13% and 39%.

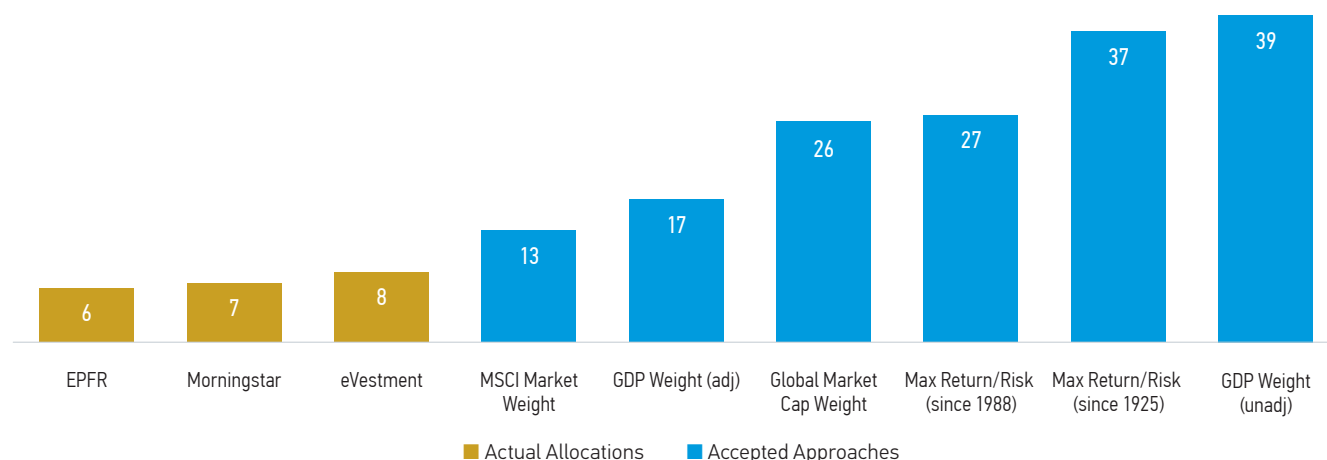
DISPLAY 1

Number of Companies Compounded by >15% CAGR (\$1BN+ Mcap)

By Entity Country, Compound Annual Growth Rate 2016 – 2020 (in USD)



Source: FactSet, MSIM calculations. Data as of December 31, 2020. CAGR represents compound annual growth rate, calculated for 2016-2020 in USD terms. Market cap calculated as of December 31, 2015. Securities grouped by country of entity in FactSet.

DISPLAY 2**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.

The GDP weight method—as it captures each country’s relative economic importance—would yield the largest potential allocation of 39%. Alternatively, using the GDP weight-adjusted method—for the lower-free float and dilution of the listed companies—would still yield an allocation of 17%, the lowest level among the allocation approaches. However, this level would still be much higher than the actual allocations reported by the data providers EPFR, Morningstar and eVestment, and higher than the weight of MSCI Emerging Market in the MSCI All Country World Index (see *Display 2*). No

matter how rational they are, our research indicates that investors are irrationally underweight emerging markets.

That may be true now more than ever. The pandemic has accelerated many structural consumer trends, including the rise of fintech and e-commerce, and Emerging Markets Leaders is well-positioned to capture these trends. The strategy is benchmark-agnostic, not beholden to a specific list of countries, or companies. When global conditions change, and new themes arise, our investments will also likely change.

“Our research indicates that investors are irrationally underweight emerging markets.”

But the process—the focus on large, quality companies, poised to capitalize on themes in the continental-sized markets—will remain. On that new investors in Emerging Markets Leaders can rest assured.

Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to **market risk**, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in **emerging market countries** are greater than the risks generally associated with investments in foreign developed countries. **Stocks of small- and medium capitalization companies** entail special risks, such as limited product lines, markets, and financial resources, and greater market volatility than securities of larger, more established companies. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the Portfolio's performance. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). **Non-diversified portfolios** often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **Privately placed and restricted securities** may be subject to resale restrictions as well as a lack of publicly available information, which will increase their illiquidity and could adversely affect the ability to value and sell them (liquidity risk).

DEFINITIONS

Compound Annual Growth Rate (CAGR) is the year-over-year growth rate of an investment over a specified period. **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.

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 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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