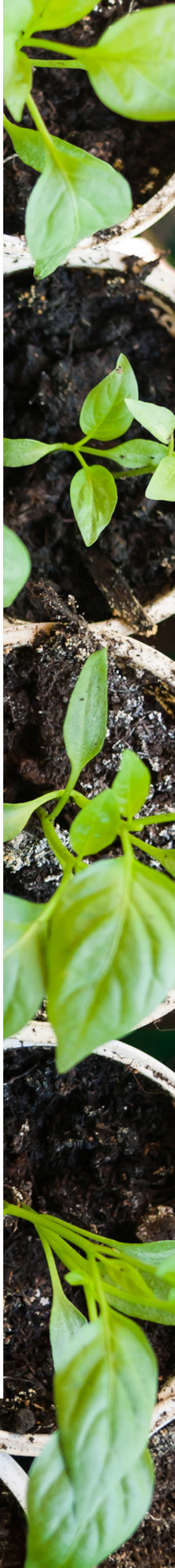
Morgan Stanley
INVESTMENT MANAGEMENT

Emerging Markets: The Future Is Small

ACTIVE FUNDAMENTAL EQUITY | GLOBAL EMERGING MARKETS TEAM | INVESTMENT INSIGHT | 2017



We believe that in the medium term, emerging markets (EM) are poised to outperform developed markets (DM), and EM small caps are poised to outperform EM large caps. Our research shows emerging market equities outperformed developed markets most significantly when emerging economies are accelerating faster than developed economies.[1] The global economy is entering just such a period, thus setting the stage for potential continued EM equity outperformance. We will show how EM small cap equities could potentially offer higher returns with surprisingly lower volatility than the EM equities as a whole.

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As the world faces greater pressure from deglobalization, we believe emerging markets growth will be increasingly driven by domestic demand. Compared to EM large caps, small caps have nearly twice the exposure to domestic sectors such as healthcare and consumer discretionary, which we believe are particularly well positioned as emerging economies move away from export-led growth models.

[1] Factset, Haver Analytics, MSIM, as of July 31, 2017.

This publication is current as of October 17, 2017.

This paper will elaborate on the current strategic advantages of investing in EM small caps and how one may do so. We will explore the opportunity to invest in dedicated EM small cap managers, who as a group have a historical track record of generating higher excess returns than their EM peers.[2] This paper will explain that effective EM small cap investing requires a top down approach integrated with a bottom up framework focused on growth and quality.

Why We Are Positive on EM versus DM

Our research shows that the relative performance of EM is best explained by the GDP growth differential—specifically the difference between the EM aggregate real GDP growth rate and the DM aggregate. This differential troughed in 2015 after five years of decelerating growth in emerging economies, and emerging stock markets materially underperformed DM during this period.[3]

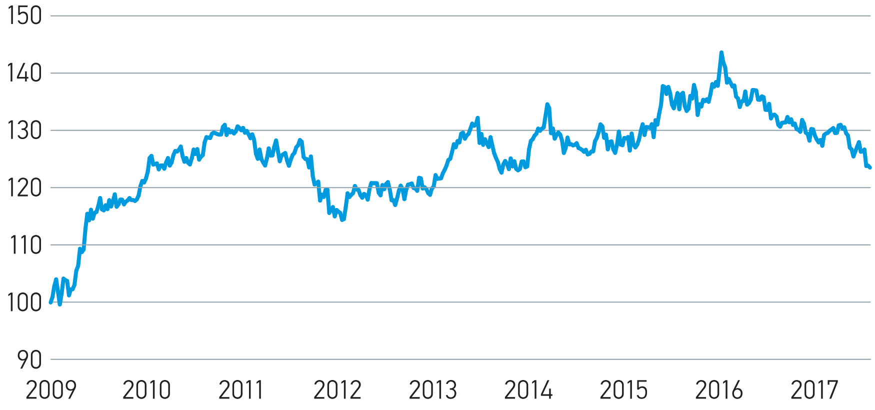
Now, a shift is underway. We expect EM growth to accelerate from 4.1% last year to 4.8% in 2017, and expect DM growth to pick up more slowly, from 1.6% to 2%.[4] This widening growth gap is a big reason why EM equities have outperformed DM equities over the past year, and we believe the gap could continue to widen.[5]

Overall, emerging countries have adjusted to the new global economic environment, marked by low growth and low commodity prices. Since the commodities peak in April 2011, EM currencies have depreciated by 24% against a strong dollar, and commodity driven economies including Brazil, Indonesia and Russia are now starting to recover.[6] In aggregate, the EM current account is in surplus and the capital account is no longer negative, leaving EM economies in better shape to weather a gradually rising US interest rate environment.[7]

DISPLAY 1

MSCI EM Small Cap Index versus MSCI EM Index Performance

Performance indexed to 100, January 1, 2009 through July 31, 2017



Source: Factset, as of July 31, 2017. **Past performance is no guarantee of future results.**

Why We Are Positive on EM Small Cap

Over the past 10 years since June 1, 2007 (when MSCI Investable Market Indexes were incepted), stock market indices have been globalized, as the rise in international trade and the opening of capital markets changed the landscape for institutional investors. Many institutional investors have adopted an all cap universe, in an effort to remove country and market cap bias. However, the all cap indexes are in fact dominated by large companies. For example, 86 percent of the companies listed on the popular MSCI EM Investable Market Index (IMI) are large- or mid-caps.[5] Investors who adopt these all cap indexes are unintentionally betting on large and mid caps against small caps. And these bets can be substantial, as all cap investors are estimated to be between 10 to 20 percentage points underweight EM small caps.[8] By our definition of small caps as any company with a market cap under $3.5 billion, we think an allocation of about 30% in EM small cap could help maintain a neutral allocation. Most all cap EM managers are underexposed to small cap companies, with less than half the MSCI EM IMI Index weight.[9]

[2] Source: MSIM calculations, eVestment as of June 30, 2017. Please refer to Display 6 for basis of calculations.

[3] Factset, Haver Analytics as of December 31, 2015.

[4] JP Morgan, MSIM, as of July 31, 2017. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

[5] Factset, as of July 31, 2017.

[6] Bloomberg, as of July 31, 2017.

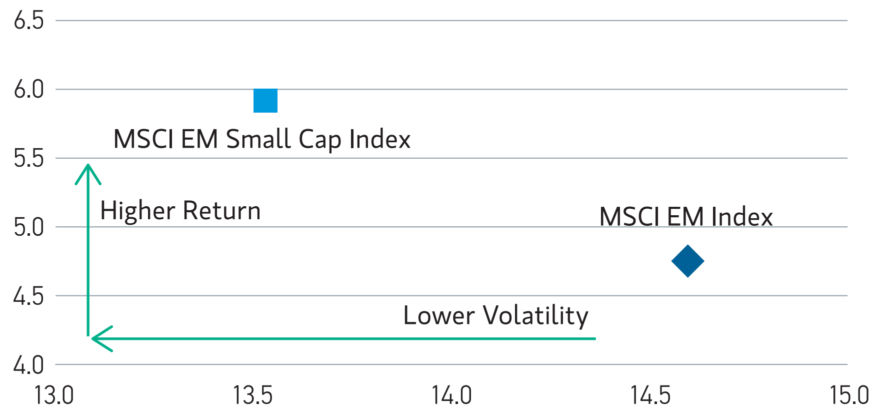
[7] MSIM, Haver Analytics, national sources, as of July 31, 2017.

[8] MSIM estimates, based on research from eVestment and Morningstar, as of July 31, 2017. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

[9] MSIM, eVestment (EM All Cap Equity universe) as of June 30, 2017. Only includes funds with assets over $50 million and more than 10 years of returns. Includes inactive funds to prevent survivorship bias. MSCI, as of July 31, 2017.

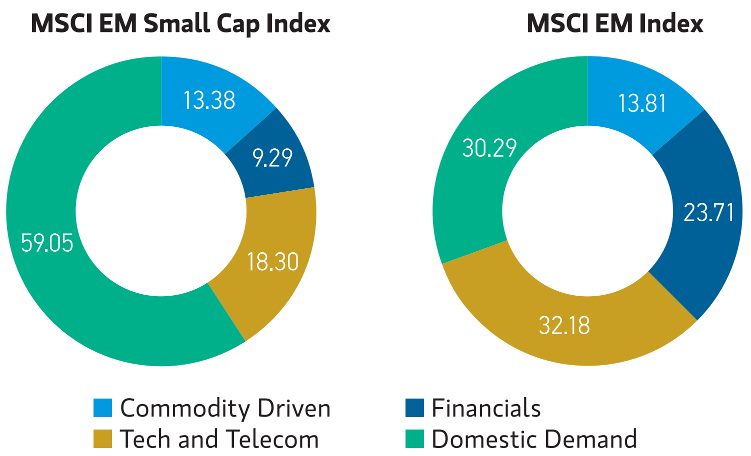
DISPLAY 2

5 Year Risk/Return Profile



Source: MSIM, MSCI, as of July 31, 2017. **Past performance is no guarantee of future results.**

DISPLAY 3



Source: Factset, as of July 31, 2017. For illustrative purposes only.

Lower Risk, Higher Returns

While this accidental underweight might have worked the last few years, it could potentially hurt over the long term as small caps have offered better longer term returns within EM, as shown in *Display 1*. Small caps have outperformed the MSCI EM Index by an annualized 2.6% since the global financial crisis in December 2008.[5] While it sounds counterintuitive, EM small caps have delivered this outperformance with around one percentage point lower volatility than EM (see *Display 2*).[9] Why is volatility so much lower? It is primarily a function of lower liquidity in small caps, and less institutional investment, specifically, hedge fund activity in these markets.

EM Small Caps Are More Exposed to Growth

We believe EM small caps are uniquely positioned to capitalize on major shifts in the global economy. The fall in trade since the global financial crisis has made it harder for emerging countries to export their way to prosperity, undermining the growth model many relied on for decades. In response, governments are shifting their focus from promoting exports to stimulating domestic demand, by encouraging consumption and infrastructure investment. Emerging market small cap companies are likely to benefit from this shift, because they have nearly double the exposure in domestically oriented sectors such as healthcare, industrials and consumer discretionary than companies in the MSCI EM Index, and are less focused on global cyclical sectors such as energy and IT (see *Display 3*).

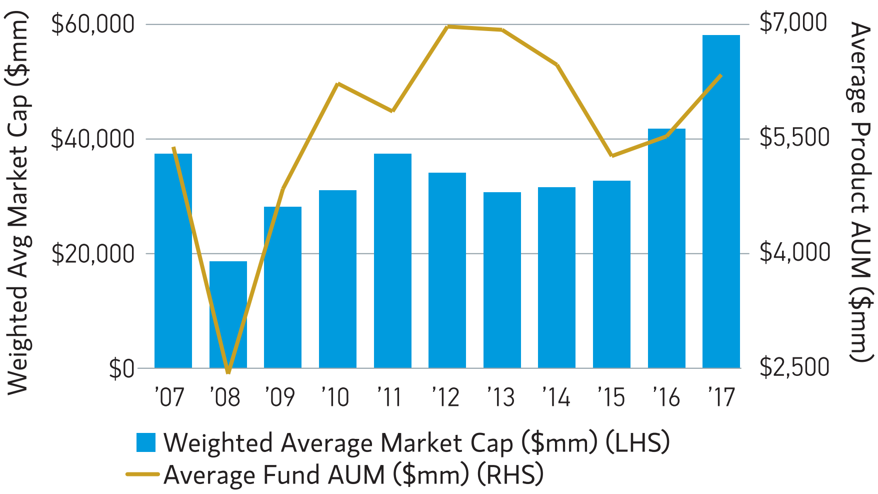
We believe EM small caps also provide a measure of protection to investors from the poor governance and low growth that commonly plague state-owned enterprises (SOEs). While SOEs account for 38% of the MSCI EM Index, the MSCI EM Small Cap Index has approximately 10% SOE exposure.[10]

Why You Need a Dedicated EM Small Cap Manager

The best way to take advantage of this opportunity, in our view, is through a manager dedicated to EM small cap. While some investors choose all cap EM managers, the increase in assets under management (AUM) of many of these managers has made it difficult for them to buy enough small cap stocks to maintain even a neutral small cap exposure versus the index. Since 2007, all cap EM managers have seen their average market cap grow from $38 billion to $58 billion, and their average product AUM grow from $5.4 billion to $6.5 billion (see *Display 4*).[11] With more and more liquidity to manage, all cap managers can find it harder and harder to spread bets among small caps. Among the all cap global managers tracked by eVestment, only 6 percent of holdings are in small caps with a market cap under $1.5 billion, compared to nearly 14 percent of the holdings in the MSCI EM IMI index as a whole.[12]

DISPLAY 4

All Cap EM Managers Can't Buy Enough Small Caps



Source: eVestment, EM All Cap Equity universe, as of June 30, 2017. Only includes funds with assets over $50 million and more than 10 years of returns. Includes inactive funds to prevent survivorship bias. Average of 39 funds per year. Actual number of managers varies per year.

DISPLAY 5

	% AUM IN ACTIVE	% AUM IN PASSIVE	CUMULATIVE FLOWS SINCE GFC (MM)
All Global Equity	61%	39%	$262,826
All Emerging Markets	67%	33%	$111,808
Emerging Markets Small Cap	79%	21%	$6,586

Source: EPFR, as of July 31, 2017. All Global Equity includes all DM and EM equity funds. All Emerging Markets includes all EM equity funds, covering Asia ex-Japan, EMEA, GEM or LatAm. Data does not include separate accounts.

How Dedicated EM Small Cap Managers Have Outperformed

Because of the systematic if unintended biases inherent in the way many investors allocate assets, EM small cap is a widely ignored asset class. This inefficiency is compounded by a lack of information as few sell side analysts cover the space. This makes EM small caps an area where active management thrives. The number of companies (1,825) included in the MSCI EM Small Cap Index is more than double the number of companies (829) included in the MSCI EM Index.[5] The companies in the primary MSCI EM Index are covered by 20 sell side analysts on average, while companies in the MSCI EM Small Cap Index are stated to be covered by eight analysts; however from our experience, it is one to two analysts in practice.[6,8] This gives dedicated EM small cap managers an information advantage in generating original research and insights on companies which are insufficiently covered.

Given the paucity of information about small caps, and how widely their performance can vary, it is no accident that an unusually high proportion of dedicated small cap EM funds are actively managed. As shown in *Display 5*, EM small cap has a much

[10] Bloomberg, Factset, as of July 31, 2017.

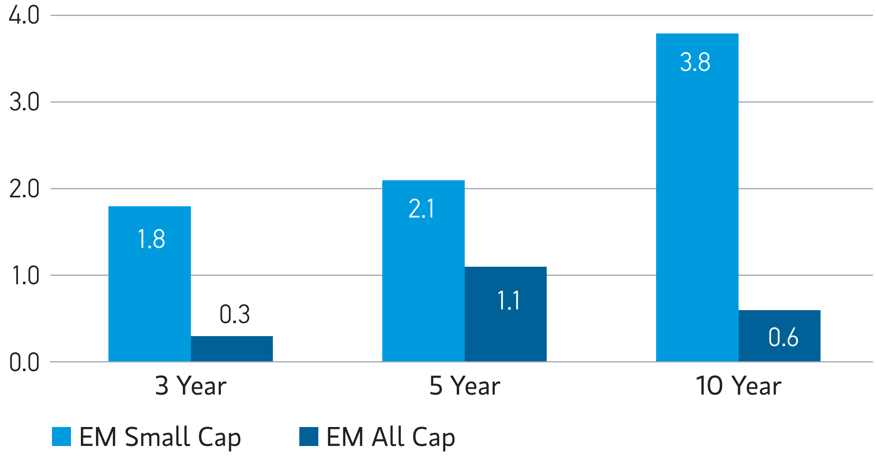
[11] eVestment, as of June 30, 2017.

[12] eVestment, as of June 30, 2017. Universe: all global EM managers in eVestment.

DISPLAY 6

Active Small Cap Managers Outperformed EM Managers

Based on Median Active Manager Excess Returns (Annualized)

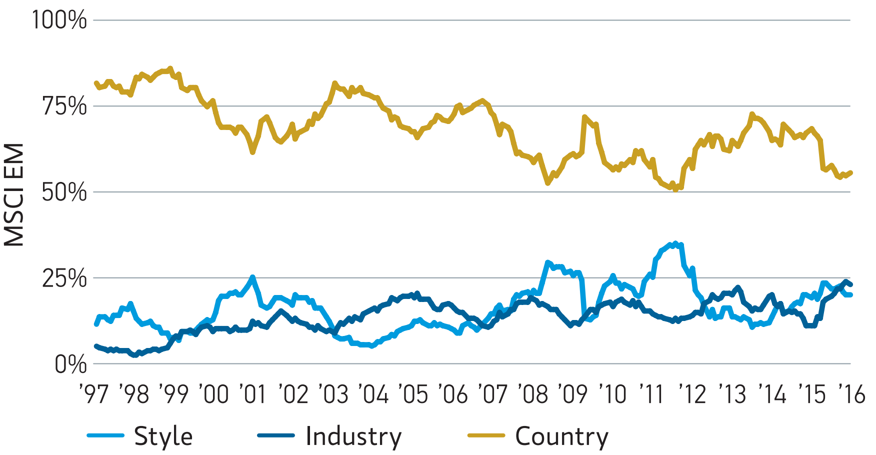


Source: MSIM calculations, eVestment as of June 30, 2017. **Past performance is no guarantee of future results.** Calculations are excess returns which are net of fees. Excess returns are calculated against the fund's specific benchmark. Includes only funds with performance over the entire period. Data shown represents the universe's median fund's annualized excess return. Number of funds for EM Small Cap universe is 36, 23 and 4 and number of funds for EM All Cap universe is 127, 107 and 48, for the 3 year, 5 year and 10 year period, respectively.

DISPLAY 8

Country Effect Dominates in Emerging Markets

Contribution of Risk Factors



Source: Contribution of Risk Factors to Explained Cross Sectional Volatility (BARRA, GEM2). MSCI, data as of December 2016. Performance data quoted represents past performance which is no guarantee of future results. This for illustrative purposes only and is not meant to depict the performance of a specific investment.

higher share of active management at 79% than in global equity or emerging markets.

These fundamental advantages help explain why active EM small cap managers have generated higher excess returns than all cap managers. As *Display 6* shows, over the 3 year period (based on median active manager excess returns), an EM small cap manager generated over 1.5% more excess returns than an EM all cap manager. This outperformance is even more impressive on a 10-year period with 3.2% more excess returns.

Our Approach to EM Small Cap Management: Top Down, Bottom Up

Formalized top down country analysis, coupled with vigorous bottom up stock selection, can give active managers an even greater advantage when investing in EM small caps.

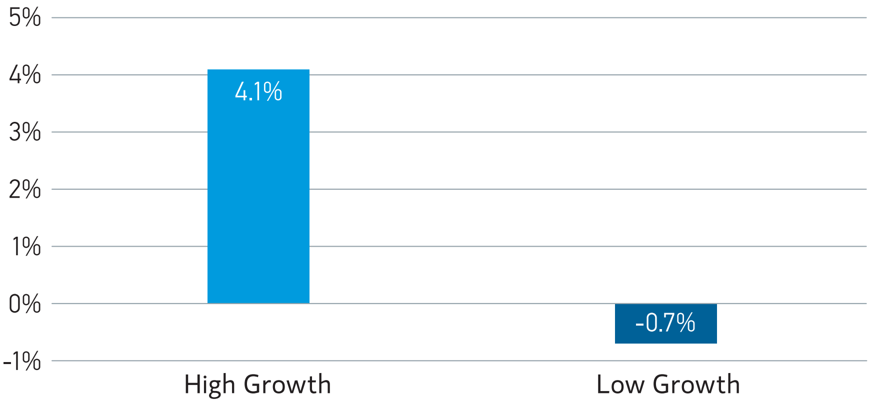
Our research shows (in *Display 7*) that EM equity returns are greatest when managers invest in countries with high or accelerating GDP growth.[3] Similarly, MSCI Barra has found that the country effect drives nearly 60% of risk in EM, as opposed to approximately 30% in Developed Markets as shown in *Display 8*. Divergences in country returns have increased since the global slowdown, making it increasingly vital to focus on individual country and currency factors as part of the investment process. This is especially true in EM Small Caps, since these companies tend to be more domestically driven.

Equally important to generating excess returns is a robust bottom-up stock selection framework focused on company quality. We consider a quality company to have ROE (Return on Equity) of over 10%, to have net debt to EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) below 2.5 times, ex financials and

DISPLAY 7

In EM, It's All about Growth

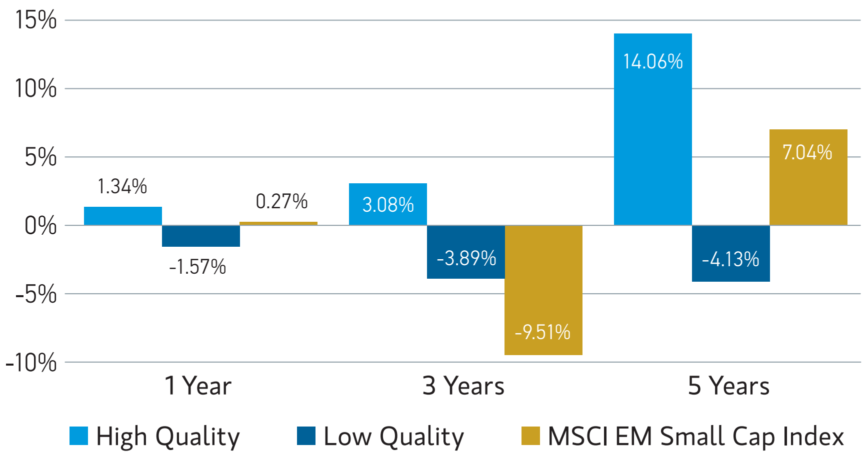
3 year annualized market returns relative to MSCI EM Index



Methodology: spread between highest quintile and lowest quintile = +480 bps/yr on average. High growth refers to the top 20% of countries in terms of GDP growth, low growth refers to the bottom 20%. MSIM, Factset, includes countries only in the MSCI Emerging Markets Index as of December 2015.

DISPLAY 9

Performance by Quality



Source: Factset, as of December 31, 2016 (due to company reporting). Performance was calculated on stocks in the MSCI EM Small Cap Index. High quality was defined as a return on equity (ROE) of 10% or greater and a net debt to EBITDA ratio of less than 2.5x. Low quality was defined as ROE of less than 5% and a net debt to EBITDA ratio of greater than or equal to 4x. The composites were rebalanced each calendar year and scaled up to a 100% portfolio based on the original weight in the index. Returns were geometrically linked. **Past performance is no guarantee of future results.**

to be focused on its core business.

In the periods ending on December 31, 2016, high quality EM small cap stocks outperformed low quality by 2.9% over one year, 7.0% over three years, and 18.2% over 5 years (see *Display 9*). The MSCI EM Small Cap Index is highly diversified, making it even more important to be selective about which companies to invest in. The largest stock weight in the MSCI EM Small Cap Index is only 50 bps while in concentrated, actively managed small cap portfolios, stock positions are usually 100 to 200 bps.[1] This clearly increases tracking error and active share, but it also increases stock selection risk. We believe it is crucial for managers to incorporate bottom-up, quality-biased stock selection based on on-the-ground research in the investment process.

Conclusion

We believe EM returns are poised to continue outperforming developed markets over the next 3 to 5 year period with small caps benefitting more than large caps. EM small caps offer the potential of better risk-adjusted return with lower volatility. EM small caps are more domestically focused and therefore will likely benefit from the rebalancing of emerging economies' growth models toward domestic consumption.

Many investors are underweight EM small caps as an accidental byproduct of their allocation process, creating a ripe opportunity for those who allocate to this overlooked asset class. EM small cap benefits from information inefficiencies allowing dedicated active managers to potentially generate more alpha than all cap managers. In order to outperform, we believe it is crucial to distinguish between countries and within each country, invest in growing companies with quality management.

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DEFINITIONS

Active share is a measure of the percentage of stock holdings in a managers portfolio that differ from the benchmark index (based on holdings and weight of holdings). Active share scores range from 0%-100%. A score of 100% means you are completely different from the benchmark. **Alpha** is the excess return or value added (positive or negative) of the portfolio's return relative to the return of the benchmark. **Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)** is essentially net income with interest, taxes, depreciation, and amortization added back to it, and can be used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions. **Excess return** is widely used as a measure of the value added by the portfolio or investment manager, or the manager's ability to "beat the market." Also known as alpha. **Gross Domestic Product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. It includes all private and public consumption, government outlays, investments and net exports. **Market Capitalization** is the total dollar market value of all of a company's outstanding shares. **Net debt** is a measure of a company's ability to repay all debt if it were called immediately. It is calculated by adding short-term and long-term debt and subtracting all cash and cash equivalents. **Return On Equity (ROE)** is the amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested. **Tracking error** is the amount by which the performance of the portfolio differs from that of the benchmark. **Volatility** is a statistical measure of the dispersion of returns for a given security or market index. **Weighted Average Market Capitalization** is a stock market index weighted by the market capitalization of each stock in the index. In such a weighting scheme, larger companies account for a greater portion of the index. Most indexes are constructed in this manner, with the best example being the S&P 500.

The **MSCI Investable Market Indexes** cover all investable large-, mid- and small-cap securities across the Developed, Emerging and Frontier Markets, targeting approximately 99% of each market's free-float adjusted market capitalization.

The **MSCI Emerging Markets Investable Market Index (IMI)** captures large, mid and small cap representation across 24 Emerging Markets countries.

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 Emerging Markets Small Cap Index** includes small cap representation across 23 Emerging Markets countries. With 1,864 constituents, the index covers approximately 14% of the free float-adjusted market capitalization in each country. The small cap segment tends to capture more local economic and sector characteristics relative to larger Emerging Markets capitalization segments.

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