Emerging outperformance

Seven compelling characteristics of emerging markets.

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Between 1994 and 2001, emerging markets equities performed poorly through successive financial crises and proved to be a most challenging asset class. Investors withdrew large amounts of money through a period that included devaluations of the Mexican peso (1994), Thai baht (1997), Indonesia rupiah (1997), Russian ruble (1998), and Argentinean peso (2002), as well as the implementation of capital controls in Malaysia (1998). Emerging market equities are typically a more colorful asset class than most, so the cumulative effect of these events caused a loss of confidence across emerging markets.

Currently, there are several constructive characteristics about this asset class that could be noteworthy for institutional investors. Firstly, there are fewer pegged exchange rates. Only the Hong Kong dollar is absolutely fixed, while three other countries have managed pegs. In 1997, Argentina also had a fixed peg and eleven additional countries had managed pegs. While this reduction in the number of pegged rates may imply a lack of discipline, the current lower inflationary environment probably means that it would still create less turmoil than would the damage caused by broken pegs.

Secondly, emerging markets' volatility (as measured by standard deviation) although high, has fallen significantly since the late 1990s. In fact, it is not much higher than that of the Standard & Poor's (S&P) 500 and considerably below that of the NASDAQ. Since the end of 2001, risk-adjusted returns (as measured by two-year moving average Sharpe ratios) have begun to rise above those of international equities for the first time since 1994.

Thirdly, the crises in the developing world had a useful effect in pressuring companies to improve disclosure and overall corporate governance. Although corporate governance is not as good as in the industrial world, the extraordinary growth of American Depositary Receipts—which often demand international or U.S. GAAP standards—has resulted in improvements.

A fourth characteristic which is particularly striking is that, although the financial productivity (as measured by return on equity [ROE]) of emerging markets equities to developed market equities has been higher over the past eight consecutive quarters, the valuation discount has widened over the past three years (and is currently about 40%). This is still the case despite emerging markets' outperformance of international, global, U.S. and European equities for the past four years. Should the ROEs continue to remain higher, it seems logical that the valuation discount should narrow markedly.

Three other characteristics are particularly notable. While the world economy continues to decelerate, many emerging markets are experiencing their own economic recoveries. Although these may be somewhat offset by factors like SARS in Asia, it appears that many may enjoy this phenomenon for some while before world economic activity begins to recover. Emerging markets also boast a surprising number of sophisticated companies. Finally, there has been an active discussion about how to invest in emerging markets equities—either as part of an international portfolio (using the MSCI All Country World Index [ACWI]) or on a dedicated basis (using MSCI EMF). Because international equity managers generally manage large pools of money, they are therefore restricted to liquid shares. The liquidity of emerging markets equities is usually heavily skewed to the top decile of stocks (where the international portfolio may need to focus); investors expecting to get exposure through an ACWI mandate may be disappointed to find this can be significantly different from that of a dedicated mandate.

Emerging markets equities have performed surprisingly well in the past four years, outperforming international, global, U.S. and European indices. The fact that there are far fewer pegged exchange rates than in 1997 should reduce the number of wholesale crises. The higher financial productivity and large valuation discount of the asset class augurs well for ongoing outperformance. Contrary to public perception, many emerging markets companies are technologically advanced and have significant competitive advantages. Finally, mainly because of liquidity issues, the exposure to emerging markets equities within an international (ACWI) account may be very different to that within a dedicated emerging markets equity (EMF) account. ▮