Original Article

The case for emerging markets and regional versus global management considerations

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ABSTRACT This paper considers whether there is a strategic case to be made for investing in emerging markets and, if so, whether the timing is still right to invest. The question of how best to achieve emerging market exposure is then addressed, in particular whether using a collection of regional specialists is superior to using a single global emerging market manager. Independent research from Oliver Wyman supporting the case for regional specialists is then reviewed.

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EMERGING MARKET PERFORMANCE

Emerging market equities have performed relatively well over the 3 years leading up to September 2008, comfortably outperforming developed markets, with a return of 28.4 per cent versus, for example, the 0.6 per cent decline in the S&P 500 in US dollar terms (Figure 1). This relative strength had encouraged many to subscribe to the 'decoupling' argument, which suggests that emerging markets are no longer dependent on growth in the developed world to maintain their own growth rates. Over the past year, however, the decoupling thesis has been

seriously undermined, with emerging markets declining more rapidly than their developed counterparts; the MSCI EM index declined by 33 per cent versus the 26 per cent fall in the MSCI World index (performance up to the end of September 2008 in US dollar terms). In an increasingly globalised and interconnected world, total decoupling always seemed unlikely, but what is true is that emerging countries are less vulnerable to a developed world slowdown than they have been in the past. Better fiscal balance sheets, increasing domestic demand, massive public infrastructure programmes and high savings rates have all helped. Furthermore, growth in trade amongst emerging economies has risen substantially. Therefore, the dependence on the United States, Europe and Japan is less, but still important.

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Figure 1: Cumulative performance: 3 years.

Source: Datastream, Nomura. Monthly data as of 30/09/2008.

Over the longer term, the extent of outperformance has been striking. Figure 2 shows MSCI EM performance in US dollar over the 20 years up to the end of July 2008 (the longest period available, as this was the inception of the date of the index).

Another notable feature is how strongly the markets have collectively bounced back following the highly publicised market crises of the late 1990s and early 2000s, including the South East Asian crisis in 1997, followed by the Russian debt default crisis and the dot.com fallout. Despite these knocks, these markets have recovered very sharply.

What has been driving this performance?

Strong economic growth has been key in driving this outperformance. Figure 3, depicting real GDP growth rates, highlights how emerging markets have seen growth accelerate over the past few years. From the narrow growth advantage in the 1980s and 1990s, this differential has increased to unprecedented levels in the past few years. The World Bank is likely to revise down the estimated 2008 and 2009 figures in due course to reflect the impact of the credit crunch, but the overall

trend should be consistent going forward. This chart puts into perspective the fact that despite emerging countries only accounting for a quarter of world GDP, they account for 50 per cent of global GDP growth.

Growing, but is this reflected in the market?

Emerging economies are growing, but is this being reflected in their share of global market capitalisation? There is a relationship in many countries whereby their relative share of global GDP converges to a similar proportion of global market capitalisation. As an illustration of this, Figure 4 shows this relationship for Japan. In the late 1980s, during the Japanese stock market bubble, Japanese equities accounted for 50 per cent of global market capitalisation, despite the economy only accounting for 15 per cent of world GDP. After the bubble burst, the two ratios eventually came into line with Japan's market capitalisation and GDP percentage ratios, levelling off near 10 per cent.

Figure 5 highlights the fact that despite the aforementioned growth advantages, emerging market capitalisations lag far behind their contribution to the global economy. Emerging

Figure 2: Cumulative performance: 20 years.
Source: Datastream, Nomura. Monthly data as of 31/07/2008.

Figure 3: Real GDP growth rates.
Source: Global Economic Prospects 2008, The World Bank 2008.

markets are nearly 30 per cent of global GDP, but are only 11 per cent of global market capitalisation. Therefore, there is still some way to go. To highlight this point, Figure 6 illustrates how the MSCI World index is currently apportioned: the United States, Canada and Europe account for 75 per cent, whereas emerging markets account for 11 per cent of the

total. The figure also shows the allocations to the main emerging market regions: 50 per cent of emerging market capitalisation lies in Asia and approximately 25 per cent in each of Latin America and Europe, the Middle East and Africa (EMEA).

This reflects the current position, but more important is the trend behind the numbers. In

Figure 4: Japan market cap versus GDP percentage.

Figure 5: Emerging market cap versus GDP percentage.

Source: IMF, datastream.

June last year, emerging markets collectively ranked alongside Japan with approximately 9 per cent of the MSCI World index; in the past year, as a result of relative outperformance and increasing market capitalisation, this has moved to 11.4 per cent, whereas Japan has remained at around 9 per cent.

Despite the increased weight in global indices, there is anecdotal evidence that institutional

investors' weighting to this asset class on average is less than 5 per cent. Consequently, there is ample room for allocations to grow.

LONG-TERM DRIVERS: DEMOGRAPHICS, SKILLS AND PRODUCTIVITY

The medium-term growth prospects look good, but investors should focus on the long-term

Figure 6: MSCI emerging markets market capitalisation allocation.
Source: MSCI Red Book as of July 2008.

prospects: where will emerging markets be in 5, 10 or even 20 years' time? In order to obtain a perspective on these outcomes, consideration should be given to key drivers of economic growth, population demographics, skills and productivity.

Emerging markets contain 80 per cent of the world's population: this is a young and growing population both in absolute and relative terms. As an indication of the scale and numbers involved, consider the fact that in the first quarter of 2008, a period of significant economic turmoil across the world, China Mobile signed up 21 million new subscribers. This is the equivalent of about a third of the United Kingdom's population purchasing a phone contract in 3 months. If the Chinese population is buying phones, one can extrapolate the exponential growth in demand for all sorts of other consumer goods, the future demand for housing, education and anything else you care to mention.

Apart from sheer numbers, emerging markets exhibit favourable demographic profiles. Basically they have relatively young populations. Figure 7 shows the population pyramids for Indonesia and Japan. Indonesia's profile exhibits a young population, represented by the width of the bottom bars of the figure. Japan is the other extreme. Japan's fertility rate is almost half that of Indonesia. And with a tight immigration policy, the population is expected to peak around 2015.

With a declining population and labour force, growth will come under substantial pressure.

Another factor influencing growth is increasing labour productivity, a key determinant of which is skills levels and these are increasing sharply. Figure 8 shows the number of science and engineering students graduating from universities in Japan, the United States, the EU, China and India. Although the data are slightly dated, they give a good indication of trends in this area.

Between them, China and India produced 1.2 million graduates in these disciplines in 2002/2004, more than Japan, the United States and the EU combined. Although these data are open to some criticism (China and India's definition of 'engineer' can be somewhat broader than developed nations' definitions, and emerging market graduates are not necessarily educated to the same standard as those of other countries), it is clear that emerging markets are no longer just the home of low-skilled manufacturing. Increasingly, they can compete in more high-tech, complex manufacturing and in complex services, an example being the Indian IT software industry. Higher skills are also important in that they can free economies from developing in the traditional way and enable them to leapfrog some stages of development. Therefore, in many emerging regions, communities are, for example, completely by-passing fixed-line telephones, and have moved straight to mobile technology.

Source: U.S. Census Bureau, International Date Base.

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Figure 7: Population pyramids for Indonesia and Japan.
Source: US Census Bureau, International Data Base.

Figure 8: University graduates in engineering and science.
Source: Eurostat 2003 and JP Morgan – June 2005.

PRODUCTIVITY

Improving skills levels is facilitating productivity growth and is ensuring that these rates in

emerging markets remain significantly ahead of those in advanced economies. According to a recent report by the Conference Board,¹

productivity growth rates in 2007 for Europe, Japan and the United States were low, ranging from 1.1 to 1.4 per cent. For BRIC countries (Brazil, Russia, India and China) on the other hand, the average productivity growth accelerated to 8.3 per cent in 2007, from 7.9 per cent in 2006 and an average of 7.5 per cent between 2000 and 2005. What should be borne in mind, however, is that these economies are starting from a lower base and consequently general productivity levels in emerging economies are still very low, at between 10 and 40 per cent of the US level, for example. As wages are much cheaper, the labour cost per unit of output is, however, more competitive in emerging countries than developed ones. As the report highlights, 'Rapid adjustment to competitive pressures and greater innovation in emerging economies signals fundamental and lasting changes in the global competitive landscape'.¹

RISK VERSUS RETURN

When considering the addition of any asset class to a portfolio, it is important to ensure that it not only enhances returns, but does so without a commensurate increase in risk. In isolation, emerging markets have exhibited higher volatility of returns than their developed market peers, but one should consider how this return profile complements the rest of the assets in the fund. This is best understood by looking at the correlation statistics between the various equity

indices. Table 1 highlights the correlations between the MSCI EM index and some of the other developed market indices, over the past 5 and 20 years. It is clear that emerging markets have reasonably low correlations with other equity markets. Consequently, there are diversification benefits from the introduction of this asset class. And this is true both on a medium-term and on a longer-term basis.

As mentioned, emerging markets have a higher volatility of returns than developed markets and therefore, on the face of it, look more risky. But the question that all investors should consider foremost is, do the returns compensate for this higher risk? Table 2 highlights the returns and associated volatility of the S&P 500, MSCI World and MSCI EM.

The table shows that although emerging markets have been more volatile over the past 5 and 10 years, it also is clear that returns have far outstripped those from developed markets. The key figures in the table here are the returns per unit of risk in the furthest right-hand columns. Emerging markets have consistently added more return on a risk-adjusted basis than the developed markets.

HOW BEST TO ACHIEVE EMERGING MARKET EXPOSURE?

If the case for emerging market exposure is compelling, what is the best way to achieve this exposure? One of the major challenges for any

Table 1: World market correlation figures

	MSCI EM	MSCI World	S&P 500	TOPIX	FTSE 100	MSCI Europe
<i>5-year correlation</i>						
MSCI EM	1	—	—	—	—	—
MSCI World	0.87	1	—	—	—	—
S&P 500	0.73	0.95	1	—	—	—
TOPIX	0.62	0.62	0.47	1	—	—
FTSE 100	0.83	0.91	0.78	0.54	1	—
MSCI Europe	0.85	0.96	0.86	0.54	0.96	1
<i>20-year correlation</i>						
MSCI EM	1	—	—	—	—	—
MSCI World	0.67	1	—	—	—	—
S&P 500	0.61	0.86	1	—	—	—
TOPIX	0.40	0.68	0.35	1	—	—
FTSE 100	0.52	0.83	0.69	0.46	1	—
MSCI Europe	0.61	0.89	0.74	0.47	0.90	1

Source: Datastream, Nomura. Monthly data as of 30/09/2008.

Table 2: Risk and return characteristics

<i>Look-back period</i>	<i>Returns (%)</i>	<i>SD (%)</i>	<i>Return per unit of risk</i>
<i>5 years</i>			
MSCI World	7.9	11.6	0.7
S&P 500	5.2	10.3	0.5
MSCI EM	19.0	21.5	0.9
MSCI Europe	11.5	14.5	0.8
TOPIX	3.7	15.1	0.2
<i>10 years</i>			
MSCI World	4.3	14.3	0.3
S&P 500	3.1	14.4	0.2
MSCI EM	14.8	22.5	0.7
MSCI Europe	5.2	16.4	0.3
TOPIX	4.1	18.8	0.2

Source: Datastream, Nomura. Monthly data as of 30/09/2008.

manager is how to deal with such a wide universe as the global emerging markets and how to analyse so many diverse opportunities. It is a very challenging mandate; consider the facts:

- 3 regions (Asia 50 per cent, EMEA 25 per cent and Latin America 25 per cent)
- 26 countries (MSCI)
- 27 currencies
- 79 languages; and
- over 800 stocks in the MSCI benchmark, out of a broader universe of around 14 000 stocks.

This is a lot for one manager to cover well.

REGIONAL MANAGEMENT BEST

On the basis that inefficiencies are greatest at stock level, alpha can best be generated by employing a combination of regional experts, looking for the best stock pickers in each region. The thinking is as follows:

- Regional specialists are likely to have a better understanding of their regions.
- This enhances country allocation decisions and improves stock selection – both in terms of depth of understanding of individual companies and breadth of coverage of the universe.

Key expectations are that better information should produce better investment decisions, and that this in turn should produce more alpha and

improve returns. Oliver Wyman, a management consultancy with particular expertise in the investment industry, were commissioned to carry out research to assess whether these beliefs could be supported by observable data.

INDEPENDENT RESEARCH ON REGIONAL VERSUS GLOBAL MANAGEMENT

Oliver Wyman's project objectives were firstly to examine whether, based on historical performance, there was evidence to support that a product composed of specialist regional managers had the potential to outperform global emerging market funds. Secondly, they considered whether combinations of regional specialists were more risky than single global managers. Their report entitled 'Emerging Market Product Analysis Year end 2007' issued on 22 February 2008 is available on request, and represents the third annual update to their analysis originally conducted for the end of 2005.

Oliver Wyman reviewed fund data sourced from Bloomberg for the 7-year period ending in December 2007. Starting with a comprehensive universe of just over one thousand funds, this was screened to exclude duplicate funds, single country or region funds, and so on, to end with a cleansed universe of 403 funds, representing over \$300 billion of assets under management (AUM), one-third of which came from regional specialist managers.

They then captured all the return data and constructed composites comprising the averages of each quartile for each region and globally. The regional averages were linked together using neutral MSCI weights, and then compared against the global peer averages. For the third year in a row, the analysis revealed that there was a clear alpha advantage for the combination of regional specialists over the generalist global emerging managers. Over the 7-year period, the average top quartile regional managers in combination outperformed the average top quartile global manager by more than 2.3 per cent on an annualised basis up to the end of December 2007, as shown in Figure 9. On an individual calendar-year basis, the analysis also

Figure 9: Oliver Wyman: GEM Universe 7-year annualised return spectrum.
Source: Bloomberg, MSCI, Nomura, Oliver Wyman analysis.

highlighted the fact that regional specialists outperformed in 6 out of the past 7 years.

The analysis also highlighted a risk advantage when going the regionalist route. Running a Monte Carlo analysis, which entailed generating random combinations of regional specialists, Oliver Wyman concluded that although individual regional managers had higher active risk than global managers (Figure 10, first panel), a combination of them diversifies this risk away, so that on average they presented the same level of risk as the global managers (Figure 10, second panel).

Moreover, when looking at above-average managers, that is those managers who have outperformed over the mean over the period, which is presumably what any selector of managers would probably be focusing on, the combination of regional managers showed a clear risk advantage as compared to global managers, as highlighted on the simplified scatter in Figure 11. Considering returns and tracking errors over 5 years up to the end of 2007, the regional specialist combinations delivered 2 per cent more

return per annum at a lower tracking error, 4.9 per cent versus 5.6 per cent, compared with the global managers, as depicted by the blue shaded area.

OLIVER WYMAN FINDINGS: REGIONAL SPECIALISTS OFFER BETTER RISK-ADJUSTED RETURNS

Drawing all this together, Oliver Wyman's research supported the rationale for co-ordinating the expertise of regional specialists into a single product. Not only was there a clear alpha advantage, there was also no increase in tracking error associated with these combinations. Furthermore, if better-than-average managers were considered, then there was clear risk reduction, in terms of tracking errors.

CONCLUSION

As highlighted, there is a growing economic case in favour of a strategic allocation to emerging markets in most pension funds. The fundamentals are solid and are supportive of long-term growth

Figure 10: Oliver Wyman: regional and global tracking error data – 5-year horizon.

Figure 11: Oliver Wyman: global versus regional risk return chart.

exceeding that of developed nations. The valuations given earnings growth potential are reasonable and, as the asset class provides diversification benefits, the key long-term incentive is that current emerging market capitalisation does not reflect the global share of activity that these economies represent.

The range and diversity of the underlying regions and countries means, however, that

managing a global emerging mandate is a challenge. Especially if you consider that the main alpha-generating opportunities are at the stock level. Evidence suggests the fact that regional managers are best placed to exploit these stock-level inefficiencies. Consequently, a combination of regional specialists should bring added benefits over a global approach. Independent research by Oliver Wyman supports this rationale: their

findings were that, on average, regional specialists in combination offer better risk-adjusted returns than single global managers. Another argument in favour of considering regional specialists is that many of the best global managers are facing capacity constraints, whereas specialists have not seen their capacity tapped to a large degree.

This is an approach that Nomura Asset Management have implemented to good effect. They have developed a structure harnessing the advantages of regional specialists, but with the administrative benefits of a single point of contact for reporting, client servicing and management oversight.

RISK WARNING

This paper has been prepared by David da Silva, who is employed by Nomura Asset Management UK Limited (NAM UK), the investment specialist in the marketing department in October 2008.

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