Quarter 3, 2024

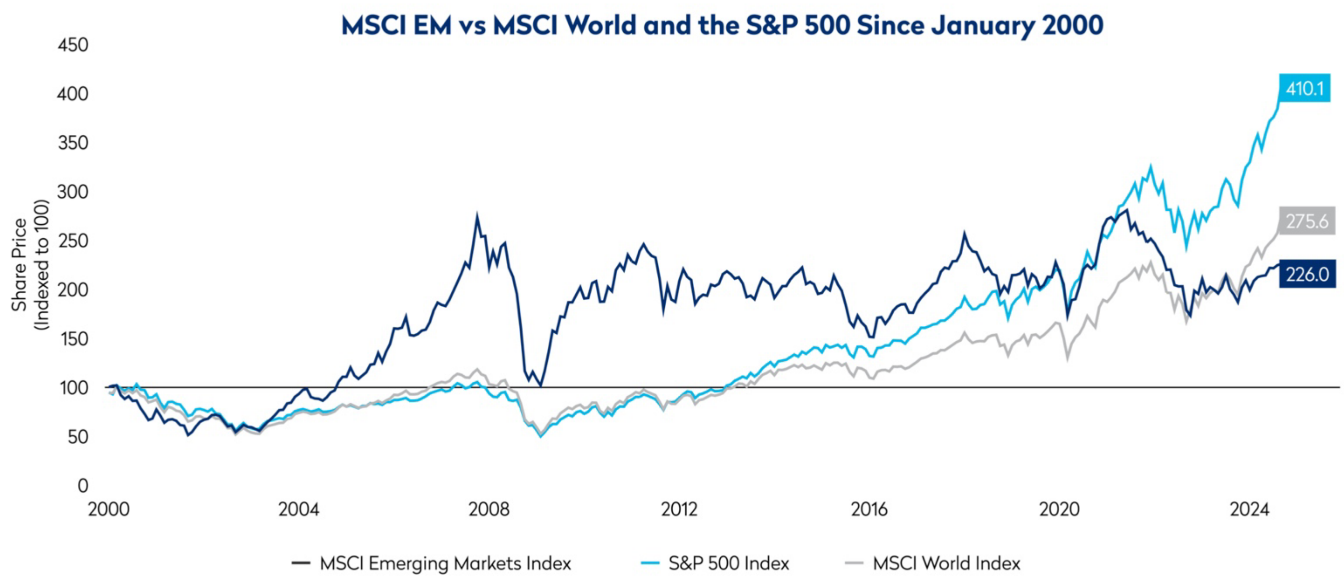
10 Reasons Why Emerging Market Equities are Worth Considering Now

While emerging markets (EM) enjoyed a strong start to the 21st century, the last 15 years have been challenging for EM returns, especially when compared to the MSCI World Index, and even more so versus the S&P 500. Since 2010, the S&P has risen over four times more than MSCI EM. This disparity has led many investors to question the value of investing in EM equities given its perceived higher risk profile.

However, there are several compelling reasons to consider EM equities, starting with diversification.

1. Mean Reversion and Diversification

Diversification is a fundamental tool in portfolio management. Although the past 15 years might suggest that investing in EM was a form of "diworsification," the underperformance of this asset class should not persist indefinitely. At some point, mean reversion is likely to occur. Although the US stock market has delivered stellar returns over this period, historical trends suggest that all asset classes tend to mean revert to some degree. Given the features outlined below, the turning point for EM equities may be approaching.



Source: MSCI

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2. Demographics

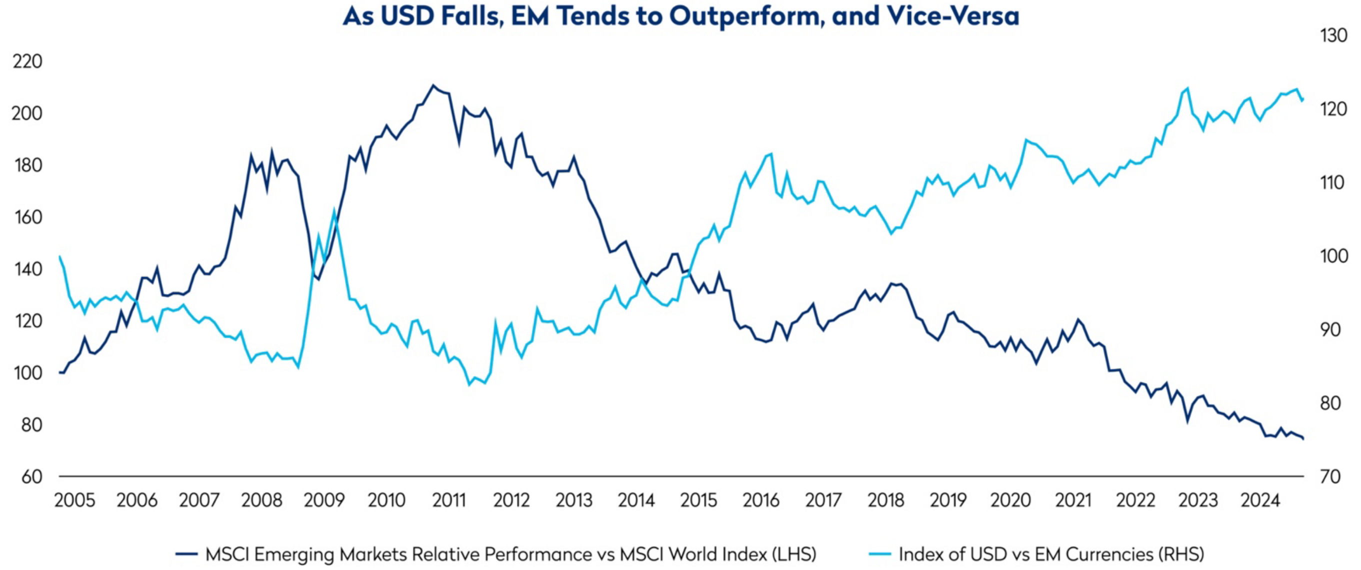
In the developed world, we often discuss aging populations, shrinking workforces, and declining tax revenues that struggle to keep up with the rising costs of healthcare. In the US, this is the first year where there are more people over 65 than under 15 years of age. Managing a shrinking workforce is costly, inhibits economic growth, and makes it increasingly difficult to manage government deficits. While China's demographic challenges are well known, many other emerging economies have young and growing populations, particularly in India, Indonesia, Mexico, Brazil, the Middle East, and Africa. In fact, almost 90% of the world's working population and two-thirds of the middle class live in emerging economies today.

Properly harnessed, this demographic advantage is a powerful driver of economic growth. A youthful and expanding workforce in these regions offers greater prospects for sustained growth compared to much of the developed world. Furthermore, the emphasis on education and skills development in these emerging markets is crucial. By investing in education, technology, and vocational training, many emerging countries are equipping their young populations with the skills needed to thrive in a modern economy, thereby enhancing productivity and fostering innovation.

3. Weak US Dollar

The US dollar has been exceptionally strong over the past decade. However, with US interest rates now declining, this trend should reverse, benefiting EM equities. A weaker dollar typically leads to higher commodity prices, as commodities are priced in USD. This is advantageous for many EM markets, particularly commodity-rich regions like Latin America and the Middle East, and countries such as South Africa and Indonesia. Additionally, lower US interest rates can reduce the cost of dollar financing and other borrowing costs for emerging markets. Lower rates on US bonds can also make assets from other countries more attractive, and the so-called 'carry trade' should favour EM currencies, where rates are typically higher. There has been a clear correlation between the USD and EM equity performance, as illustrated in the 20-year chart below.

As USD Falls, EM Tends to Outperform, and Vice-Versa



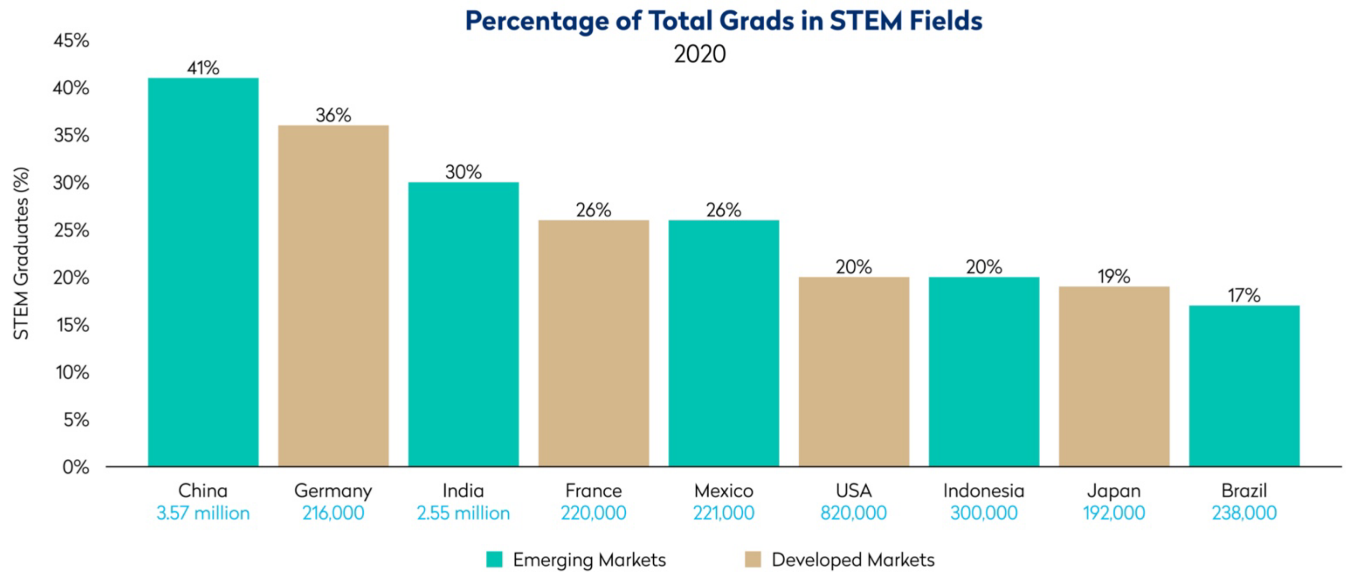
Source: MSCI, FactSet

4. A Net Zero World Needs Emerging Markets

To move closer to achieving net zero targets, the world will require an abundance of raw materials such as copper, cobalt, lithium, and polysilicon. Emerging market countries can help bridge the potential gap between supply and demand due to their dominance in the supply chain. Outside of Australia, few countries can match the natural resources found in Latin America and Africa. Additionally, many emerging market companies hold leading positions in key renewable technologies. China leads the world in electric vehicle sales and is home to major solar innovators, while along with South Korea, are favourably recognised for their leading electric vehicle battery manufacturers. Natural gas will also play a pivotal role in adapting the energy landscape, and Middle Eastern countries, with 40% of global reserves, are crucial to meeting the likely demand.

5. Key Components in the AI Supply Chain

Technological innovation knows no boundaries. Over the past 20 years and beyond, technology has profoundly transformed our everyday lives. The next frontier in this advancement is Artificial Intelligence (AI). Semiconductors, the essential building blocks of computing infrastructure, are predominantly produced by world leaders in emerging markets. Companies like TSMC, Samsung Electronics, and SK Hynix have been pivotal in enabling global technological adoption, driving innovation, and maintaining affordability through their vast scale. These Taiwanese and Korean firms will be crucial to the future growth of AI and the broader technology spectrum, including advancements in chips, robotics, solar energy, batteries, and electric vehicles. Furthermore, China and other major emerging markets are producing large numbers of STEM graduates each year to enable them to remain at the heart of technological advancement.



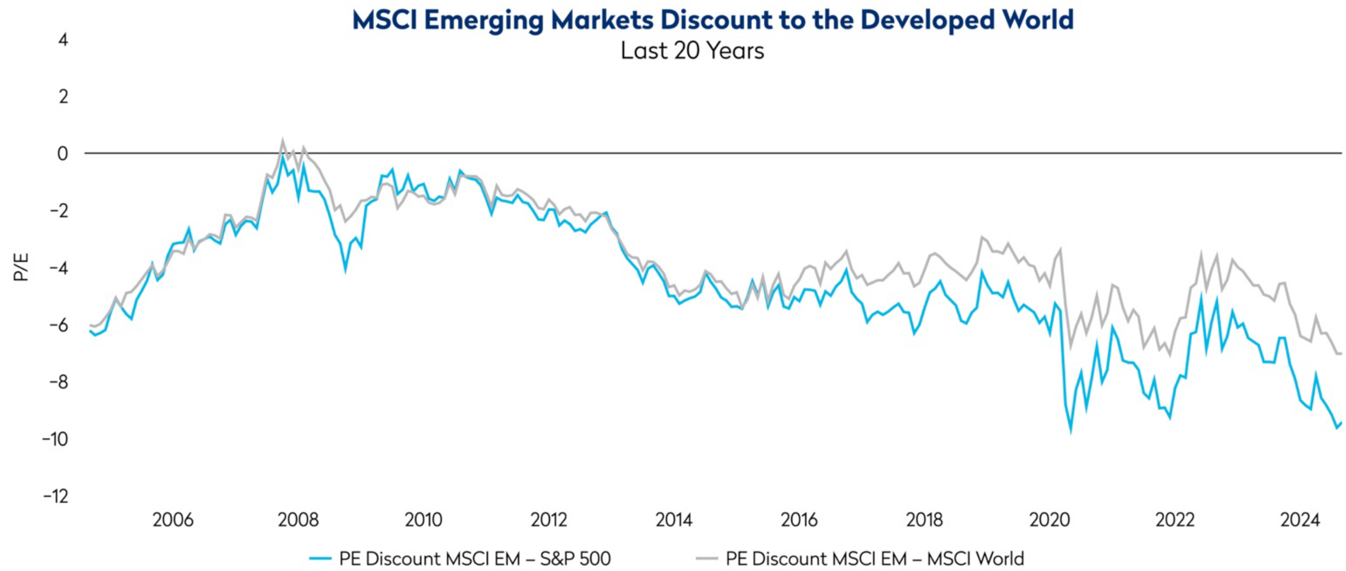
Source: OECD, Statistical Yearbooks

6. Low Investor Positioning

EM equities are currently under-owned and data indicates an average global allocation of approximately 5.3%, compared to a 20-year average closer to 8.4%. If allocations were to revert to the past average, this would equate to about $900 billion in inflows into EM. This amount is equivalent to 58% of the current EM assets under management and would clearly have a profound impact on the performance of the asset class.

7. Low and Attractive Absolute and Relative Valuations

MSCI Emerging Markets trades at approximately 12x forward P/E, compared to MSCI World at around 18x and the S&P 500 at about 21x. This substantial discount is currently at its widest level in the last 20 years, and 2 standard deviations. Not only is EM trading at a significantly above-average discount to the rest of the world, but earnings growth expectations over the next two years are also slightly higher. According to FactSet Market Aggregates, EM EPS is forecast to grow 31% over the next two years, compared to 24% for MSCI World and 27% for the S&P 500. In absolute terms, a 12x PE for 30% forecast earnings growth over the next two years suggests a particularly attractive entry point for EM.

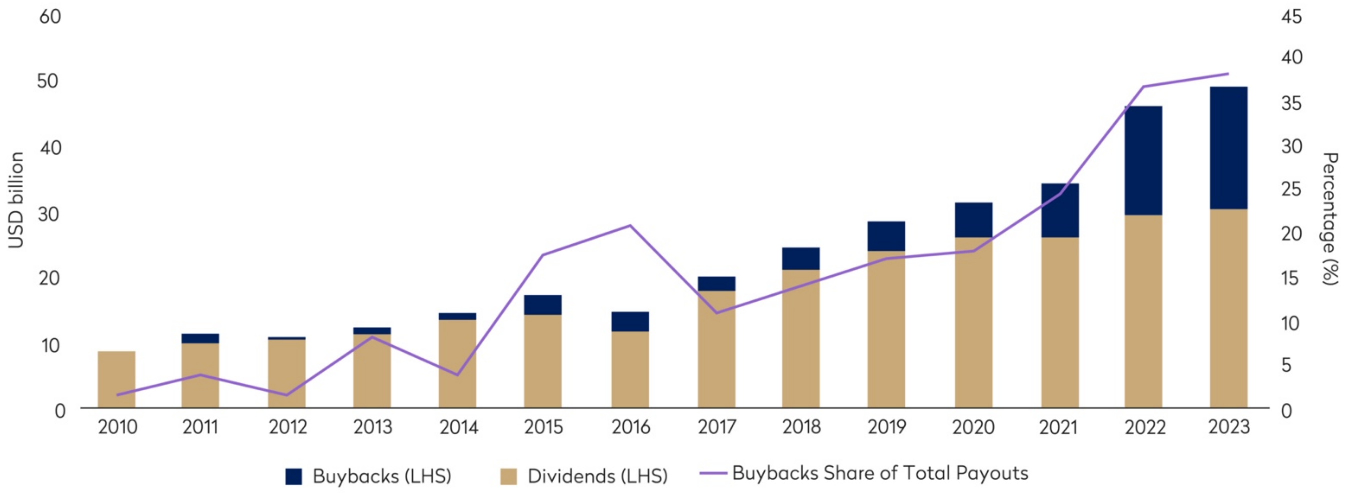


Source: MSCI

8. Improving Shareholder Returns

For a long time, many investors did not associate EM with dividends or shareholder returns, viewing them primarily as growth oriented with poor accountability and governance. However, this perception has been changing. For example, over the past 12 months, significant developments have occurred in two of EM's largest markets - China and Korea. China is currently experiencing an economic slowdown, and its shares have underperformed. To support stock prices, the Chinese securities regulator (CSRC) has encouraged state-owned enterprises (SOEs) to increase pay-out ratios. Many private companies have also initiated substantial share buyback programs and improved dividend policies. Several companies are now distributing most of their free cash flow or net profits to shareholders through buybacks and dividends. These improvements in China have advanced even further this year.

MSCI China Total Payouts by Dividends and Buybacks
2010 - 2023



Source: CSLA, FactSet, MSCI

In Korea, inspired by the turnaround in the Japanese stock market following a focus on corporate governance, the government has launched its own "value up" program. In February, the Financial Services Commission (FSC) issued guidelines aimed at strengthening shareholder protection. The goal is to create a positive feedback loop in the capital markets, where listed companies receive proper valuations for sound growth, and investors share in the profits of that growth. Several Korean companies have already announced new and improved shareholder return policies, and more are expected to follow. Over time, this should positively impact the valuation of the Korean stock market, which currently trades at a clear discount with a forward P/E of c.8x and a price-to-book ratio of 1x, compared to MSCI World at 3.5x.

Overall, the dividend payout ratio of MSCI EM has risen to 42% (before accounting for share buybacks) from 32% twenty years ago, which compares favourably with MSCI World at 40%. Further improvements in shareholder return should help put a floor under many EM stock prices.

9. Inefficiency Creates Opportunity

Emerging market equities continue to offer clear inefficiencies, as highlighted above. This piece has focused on more generic pricing inefficiencies related to the broad asset class, but these can be even more pronounced at the stock level in companies that are often under researched. Such inefficiencies create significant opportunities for active managers, particularly those with a long-term fundamental value-oriented approach. For example, consider a stock in Mondrian's portfolio whose market capitalization is effectively equivalent to the net cash on its balance sheet. Despite this, the business remains profitable, cash-generative, and pays a dividend yield of approximately 6%, supplemented by a buyback of another 6% over the next 12 months. Outsized returns are possible with thorough due diligence and a disciplined process.

10. Imagine a World Without Emerging Markets

In conclusion, take a moment to imagine a world without emerging markets. The world suddenly becomes a much smaller place, both optically (see below) and statistically, with only 1 billion people and roughly half the global GDP. Emerging markets in their entirety have an enormous amount to contribute to the global economy and society. Having lagged for so long and trading at such low valuations, surely it can't be much longer before their actual contribution is more fairly reflected in global stock markets.

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Unless otherwise stated, all returns are in USD

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