



Resetting Expectations

The Opportunity in Actively Managed Emerging Market Investing

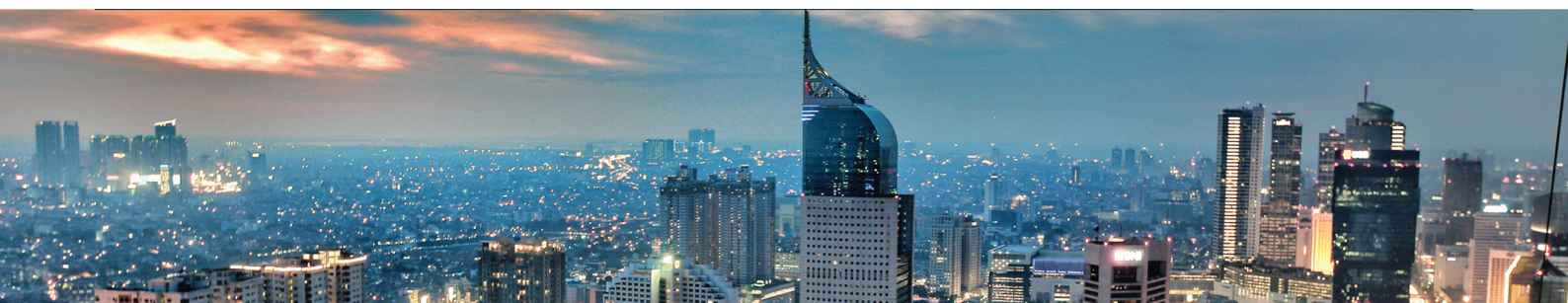
Today's Emerging Markets universe is nothing like it was when the MSCI EM Index was first conceived in 1988.

Back then, the world was one year away from the fall of the Berlin Wall. China and Vietnam were engaged in a series of conflicts that would cease in 1991. Sheikh Zayed Road in Dubai – now home to the majority of Dubai's skyscrapers – was a desert strip. Much has changed,

from how global trade is conducted to the interrelationship between nations. Everything, except for the Index's methodology.

Stefan Böttcher and Dominic Bokor-Ingram, Senior Portfolio Managers of Fiera Capital's OAKS EM Select Strategy, set out their expectations for emerging markets and frontier economies today. Noting what they describe as a "perception-reality gap", Böttcher and Bokor-Ingram suggest that shifting fundamentals driving the asset class and a growing pool

of smaller emerging markets securities presents an opportunity for active, bottom-up investors to exploit under-researched and subsequently mispriced stocks. The belief that investors allocate their capital into emerging markets to gain exposure to higher economic growth still holds true. However, through reliance on passive indexes with a flawed market capitalization methodology, investors are overlooking an entire universe of under-owned listed companies in high-growth emerging markets and frontier economies with superior return characteristics.



Understanding the Context of Emerging Markets

Over the last three-and-a-half decades, emerging markets investing has experienced explosive growth. The MSCI Emerging Markets Index is a helpful proxy. In 1998 the MSCI EM Index consisted of 10 countries with an equity market capitalisation of US\$15 billion. By 2020, this grew to 26 countries totalling an equity market capitalisation of US\$6.4 trillion representing 45% of global GDP¹, with forecasts indicating that emerging markets will surpass the U.S. market by equity market cap by 2030.²

Although emerging markets are presented as a homogeneous category, each country offers a unique opportunity set. Arguably, bundling together emerging markets into one uniform asset class has limited their investment potential. This hasn't been helped by the lack of an agreed definition. And neither are emerging markets and frontier economies fully appreciated by the MSCI EM Index, which, through a lack of recalibration, is now overweight in favour of six countries (China, India, Korea, Taiwan, Brazil and South Africa) that comprise 80% of the Index.

MSCI's assertion that it "*create[s] indexes that are designed to adapt to the dynamic nature of the emerging markets opportunity set*", overlooks the growing imbalance between the "*Big Six*" and those labelled as "*other emerging markets*".

Passive v Active

It is our view that passive exposure to emerging markets is fundamentally misaligned with what investors in emerging markets want, which is to allocate capital to geographies posting stronger economic growth. The corollary is that investors looking to diversify their portfolio through exposure to emerging markets are, in fact, highly exposed to the Big Six.

This imbalance presents an opportunity for active investment managers and capital providers. Outside of the Big Six markets, in smaller emerging and frontier markets, there are some 19,700 listed stocks across 78 exchanges that are increasingly under-researched and under-owned by virtue of their obscurity. The introduction of MiFID II regulations has deepened these two trends.³

Investors are overlooking opportunities beyond major markets to generate alpha where stocks are inappropriately valued, either through short-term or thematic considerations.

When we refer to "short-term or thematic considerations", we're also describing a perception-reality gap within investment biases. Investors look to allocate to emerging markets in the recognition that a strong correlation exists between economic growth and political, economic and/or financial market reform. Despite this, reform in smaller emerging and frontier markets and its effect on economic growth has not seen to be correlated with the growth of companies that can take advantage of it.

Exploiting Market Inefficiencies

These factors, broadly:

1. A disproportionate weighting of the MSCI EM Index in favour of the Big Six;
2. A failure of passive indexation to track exposure to relative GDP growth and company earnings growth;
3. Under-research and under-ownership of smaller emerging market securities, influenced by MiFID II; and
4. A perception-reality gap in the relationship between economic growth, corporate growth and reform.

Have coincided to create inefficiencies within the emerging and frontier markets universe.

"*Inefficiencies*" translate as mispricing within smaller emerging market securities. The function of active investing in these under-owned listed stocks is that – on a granular level – we can identify a dislocation in valuation where well-managed companies with robust business models, sustainable growth in cashflow and earnings; that are capable of generating attractive returns on invested capital, are priced at a discount.

1 MSCI / Acadian

2 Goldman Sachs

3 University of Bath

The Reform Thesis – FED-Proof Emerging Markets

Not every small emerging market or frontier economy will exhibit the same opportunity set at a similar frequency or intensity. It is our house view that companies *growing strong* in economies that are *growing strongly* will exhibit the greatest mispricing.

For that reason, our special interest is in emerging markets and frontier economies that are actively pursuing reform. These are countries where a “*catch-up*” is occurring as a result of delayed or artificially suppressed economic growth, or a process of divestment and diversification creates opportunity.

There are numerous examples: Polish equities have grown by 42% despite the Russia-Ukraine Crisis. This growth is due to its low labour cost base, which has attracted global businesses relocating from China. Similarly, Mexico has experienced a 35% growth fuelled by the trend of nearshoring. Saudi Arabia’s market has grown by 28.5% due to the successful execution of their Vision 2030 plan, while Indonesia has experienced a growth of 33% following an effective fiscal and monetary policy aimed at curbing inflation and revamping consumption rates.

In particular, these countries tend to be relatively insulated from the effects of lower Federal Reserve rate changes by virtue of control over their monetary and fiscal policies, currency denomination, economic diversification and their foundational role in global supply chains.

House Focus for 2024

2024 brings a new series of challenges for public markets. At the same time, there are trends that we are seeing that we believe have been so-far overlooked, notably:

1. **The economic recovery in Greece**, spearheaded by its banking sector
2. **The non-oil economic development in the Middle East** throughout the United Arab Emirates and Saudi Arabia, underpinned by social and government reform
3. **The rise of Kazakhstan in the energy transition**, benefitting from its role in uranium extraction
4. **Urbanisation in ASEAN nations**, growing financial and consumer industries in Indonesia, Vietnam, and the Philippines.

We will also closely monitor emerging market geographies where rapid reform is occurring, including:

5. **Mexico**, due to the nearshoring activities taking place there and increasing rental rates for the currently limited industrial property capacity
6. **Poland**, as it is set to achieve GDP of over \$1 trillion by 2028 from its comparative advantage in skilled labour costs, industrial capabilities and growing middle class
7. **The maritime sector**, as the day rates for leasing ships will be supported by the growing age of global fleets navigating through our markets
8. **Turkey**, if the Turkish Central Bank can improve the current top-down picture, boosting investor appeal for attractive businesses present from a bottom-up perspective.

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