



Matthews Asia

Allocating to EM: Six Sources of Alpha in Emerging Markets



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The emerging markets (“EM”) equity asset class has evolved considerably over the past decade such that many active EM equity managers may find it challenging to create long-term alpha over the benchmark. Countries such as China and India are moving to the fore, historical drivers of growth are changing and technology, innovation and health care are becoming a larger part of the opportunity set. It has been difficult for EM investment teams to keep up with these changes.

The good news is that investors can adapt their EM allocations through a thoughtful combination of strategies to enhance opportunities for long-term outperformance. The thesis for outperformance is fairly straightforward—combine exposures such that you address the largest weight biases, current shortcomings and forward-looking attributes of the MSCI Emerging Markets Index. What does that mean specifically?

The way I see it, there are six primary issues to address when creating exposure best suited to generating long-term outperformance. The first three issues address what we feel are internal weighting biases of the benchmark and the second three issues target the benchmark’s possible shortcomings. All six issues are potential sources of alpha.

1. Address the elephant in the room by getting the Asia component right
2. Build a better value portfolio to address the benchmark’s bias toward low quality
3. Acknowledge the benchmark’s increased technology bias
4. Understand the benchmark’s underweight to small-cap stocks
5. Overcome slowing growth among more developed countries in the benchmark with exposure to faster-growing economies
6. Add exposure to consumer-driven sectors to address the benchmark’s cyclicity and volatility

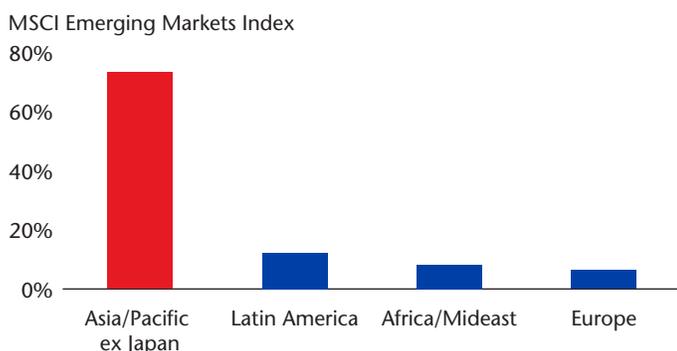
Investments involve risk. Past performance is no guarantee of future results. Investing in international and emerging markets may involve additional risks, such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation.

1. Address the elephant in the room by getting the Asia component right

Benchmark weighting bias: Asia is now 73% of the EM benchmark.

To succeed in EM, you need deep expertise in the benchmark's largest weights. Specifically, the "Big Three"—China, South Korea and India—which alone account for nearly 54% of the benchmark. An investor's biggest challenge is to find a team that has the research wherewithal to handle the China and India of tomorrow. A difficult task indeed. The universe of accessible Chinese names has more than doubled from approximately 2,700 Hong Kong and U.S.-listed Chinese companies to roughly 6,400 names, including China's locally listed companies in Shanghai and Shenzhen, as of September 30, 2018. Over 80% of these new names are small- and mid-cap stocks, a significant portion of which are not covered by analysts at present. Some have world class management teams and economic moats, while others are deficient in corporate governance and minority shareholder treatment. The point here is that most active EM investment teams just do not have the research bandwidth to handle China's expansive equity universe. For perspective, at Matthews Asia, we have 19 Mandarin speakers on our investment team and even we find it challenging to get our arms around the opportunities and risks in today's China. India will become similarly complicated as the broad Indian stock market has more than 5,000 names, over 80% of which are small caps—which creates opportunity no doubt—but also requires a level of research depth and scope that many investment teams may lack.

Figure 1. Regional Equity Weights



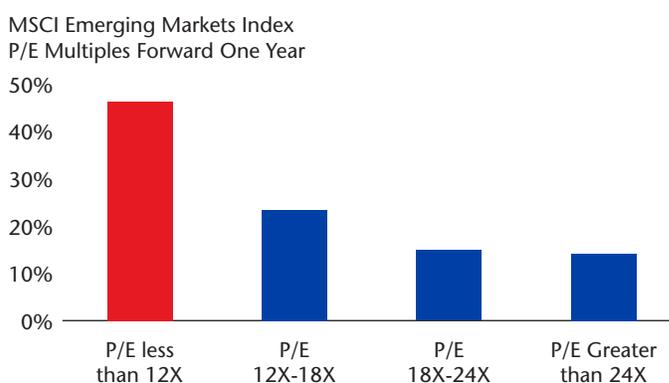
Indexes are unmanaged and it is not possible to invest directly in them. Data as of 12/31/18. Source: FactSet Research Systems, Inc.

2. Build a better value portfolio to address the benchmark's bias toward low quality

Benchmark weighting bias: Overexposed to low-quality value

Today, the EM benchmark has factor exposure significantly weighted toward value. What does that mean? Simple screens show that of the 1,150 or so companies within the benchmark, roughly 46% of them have forward-looking price-to-earnings (P/E) ratios below 12X as of December 31, 2018—a significant discount or value orientation versus most developed markets, especially the S&P 500 Index. Many of these value-oriented names are deep cyclical, commodity export-oriented businesses that are perpetually cheap. Others are deeply regulated state-owned businesses or poorly managed financials that lack growth and governance standards. The bottom line is that investors can find better value. The EM benchmark does trade cheaply from time to time. Specifically, there are quality-oriented businesses that sometimes trade cheaply compared to their intrinsic value. Capturing the "quality value factor" is not easy. Two-thirds of the benchmark names trading at 12X forward P/E or below reside in Asia—the majority of which are in China and South Korea.

Figure 2. Equity Valuation Buckets



There is no guarantee any estimates or projections will be realized. Indexes are unmanaged and it is not possible to invest directly in them. Data as of 12/31/18. Source: FactSet Research Systems, Inc.

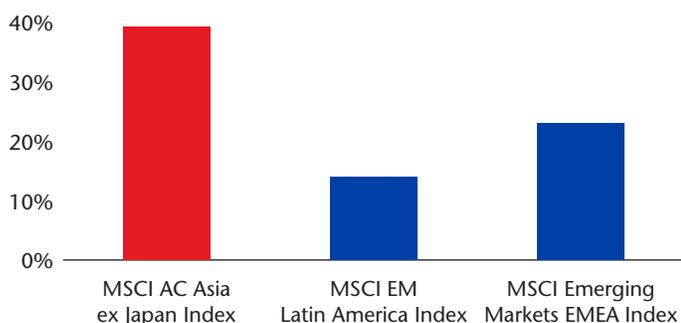
3. Acknowledge the benchmark's increased technology bias

Benchmark weighting bias: Tech-related sectors, including information technology and communication services, now make up the largest part of the benchmark

As of December 31, 2018, the information technology and communication services sectors made up more than 28% of the benchmark, up from less than 10% of the benchmark 10 years ago. This ramp up in the weight of technology demands a certain level of specialization in order to capture the increased innovation within the asset class. We also see innovation originating from the industrials and health care sectors. Innovative companies come in all shapes and sizes depending on your definition. What is interesting is where innovative companies are based. A deeper dive reveals that innovation largely resides in Asia. By comparison, if you break out the sector composition of EM Asia vs EM Latin America (LatAm) and EM Europe and Africa (EMEA) what is clear is that not only has the combination of technology, communication services, health care and industrials grown over the years but that those innovative sectors are largely an Asia story.

Figure 3. Innovative Sectors

MSCI Emerging Markets Index
Combined Weight of Information Technology, Communication Services, Industrials and Health Care



Indexes are unmanaged and it is not possible to invest directly in them. Data as of 12/31/18. Source: FactSet Research Systems, Inc.

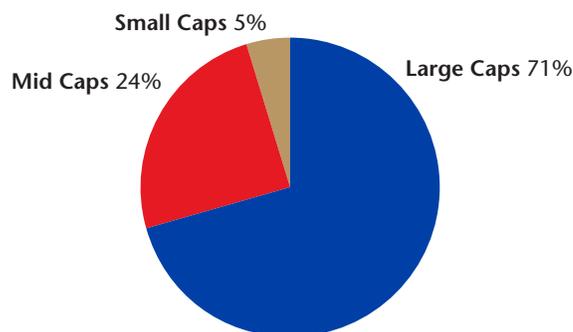
4. Understand the benchmark's underweight to small-cap stocks

Benchmark shortcoming: Not enough small caps mean investors may be missing out on the growth potential of small and midsize companies.

It's difficult to generate alpha when 100% of the stocks within your benchmark are covered by analysts. Discovery premia becomes difficult to harvest. Talented, bottom-up fundamental research-driven investment teams can create long-term value by finding smaller undiscovered companies that grow up to be industry-leading powerhouses. But this approach requires kissing a lot of frogs. In emerging markets, small-cap opportunities are almost endless for a talented stock picker. Using basic screens, there are more than 14,000 investable companies in the EM universe—over 74% are small caps. Yet the benchmark today is comprised of less than 5% small caps. Unfortunately, this is one of the largest shortcomings of the EM benchmark but one that talented investment teams can exploit. Again, the challenge for investors is to find strategies managed by investment teams that have the bandwidth to adequately cover the small-cap universe. This challenge is magnified when looking for small caps in China A-shares and fast-growing “Next 7” markets like India and Indonesia not to mention in non-benchmark countries like Vietnam.

Figure 4. Weights by Market Cap

MSCI Emerging Markets Index



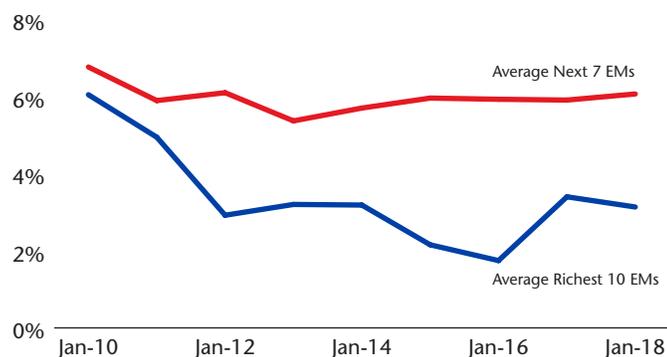
Small caps represented by stocks under US\$3 billion in market cap. Mid caps represented by stocks from US\$3-10 billion in market cap. Large caps represented by stocks from US\$10-25 billion in market cap. Data as of 12/31/18. Source: FactSet Research Systems, Inc.

5. Overcome slowing growth among more developed countries in the benchmark with exposure to faster-growing economies

Benchmark shortcoming: Secular decline of EM growth

Most investors look to emerging markets as a source of growth within their asset allocation. Investors in EM and Asia have been rewarded with outsize returns over the last 15 years of investing in fast-growing, developing economies. The economic growth engines within EM, however, are changing. Many emerging economies have become largely developed or have failed to enact reforms necessary to sustain high levels of growth. The problem is that the benchmark, and the ETFs that track it, hold substantial allocations to historical drivers of growth instead of the next generation of economic leaders. For example, many fast-growing economies that drove the benchmark higher over the past 15 years are still large weights within the benchmark today. Their respective growth rates, however, have fallen dramatically. Great examples of this in EM are South Korea, Taiwan, Brazil, Russia, Mexico, Poland, Hungary and Turkey. **The point here is that the wealthiest countries in EM are no longer driving the growth of the asset class.** In 2018, the wealthiest 10 EM economies (which include some of the largest in the benchmark) are expected to grow in aggregate just above 3.1%. In contrast, for the Next 7 (inclusive of India, Indonesia, Vietnam, Pakistan, Bangladesh, Sri Lanka and the Philippines) the expected GDP growth in aggregate is just over 6%! The problem for investors is that these fast-growing, Next 7 economies represent only about 12% of the benchmark—a trivial allocation to growth, in my opinion.

Figure 5. GDP Growth Comparison



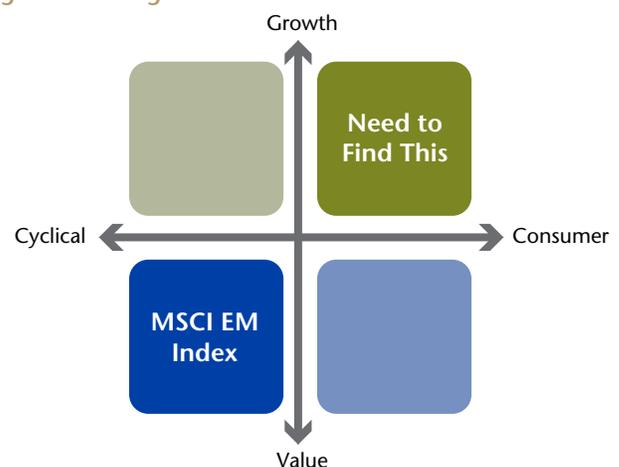
Source: IMF World Economic Outlook, October 2016. Data for 2016 through 2019 is estimated. There is no guarantee any estimates or projections will be realized. The 10 richest EM economies are represented by Brazil, Chile, Hungary, Korea, Malaysia, Mexico, Poland, Russia, Taiwan and Turkey. The Next 7 EM countries are represented by Bangladesh, India, Indonesia, Pakistan, Philippines, Sri Lanka and Vietnam.

6. Add exposure to consumer-driven sectors to address the benchmark's cyclicality and volatility

Benchmark shortcoming: Overexposed to cyclical sectors

For me, one of the single-best things an investor can do to build “all weather” emerging markets exposure is to purposefully attempt to offset the cyclical factor within the benchmark. By no means do I believe you should eliminate cyclicality in its entirety. There are times when cyclical exposure outperforms. Balancing that cyclicality, however, is critical to building long-term outperformance—not to mention a potentially smoother ride. As mentioned earlier, the benchmark is value-oriented but it is also fairly cyclical. As of December 31, 2018, almost 46% of the MSCI Emerging Markets Index was comprised of financials, materials, real estate and consumer discretionary—all cyclical sectors. If you add technology, which regresses as largely cyclical, then the benchmark is almost 70% cyclical exposure, making it very susceptible to the peaks and troughs of the global economic cycle. An investor can mitigate this cyclicality by adding the consumer and growth factors. Consumer exposure typically has been less volatile than cyclical exposure. Consumer exposure tends to contain domestically oriented businesses whose assets and liabilities are largely in local currency, not exposed to global trade or cross-border financing risks. Not only can the lower consumer beta be additive to an EM allocation but we have also found that the historical returns of EM consumer sectors have outperformed the more cyclically oriented sectors for the 10 years ending December 31, 2018, which is also additive.

Figure 6. Finding the Consumer



Allocation note: The good news is that finding growth in EM is pretty straightforward. Many successful active EM investment teams employ a GARP (growth at a reasonable price) approach. **Finding the consumer factor, however, is not as simple.** As of December 31, 2018, the MSCI Emerging Markets Index held less than 20% in consumer staples, health care and consumer discretionaries combined. Finding actively managed strategies that carry consumer exposure in excess of 35% to 40% is difficult but necessary to help mitigate the volatility of emerging markets.

CONCLUSION: SO WHAT CAN YOU DO?

Unfortunately, there is no longer a “one size fits all” approach to emerging markets that works. The vast majority of EM investment teams are not built to address all six challenges within the EM benchmark. It is tough to find the unicorn. Therefore, investors need to build their

emerging markets exposure from scratch. The challenge is to build the exposure without becoming too “benchmark-like.” The final objective is choosing strategies for the exposure they deliver and the building blocks they create to address the six challenges of the asset class.

One approach could be to start with what you have and add what you don’t. In my experience, most investors I speak with lack three things within their EM exposure. First, investment teams managing some of their current EM strategies simply don’t have the bandwidth to cover Asia and what the China and India of tomorrow may mean to investors going forward. Secondly, most EM exposures lack the alpha generation of small caps. And lastly, and potentially most important, almost all portfolios I see allocate inadequately to arguably the best diversifier—the consumer.

Definitions

Forward Price-to-Earnings (P/E): A measure of the price-to-earnings ratio (P/E) using forecasted earnings for the P/E calculation. While the earnings used are just an estimate and are not as reliable as current earnings data, there still may be benefit in estimated P/E analysis. The forecasted earnings used in the formula can either be for the next 12 months or for the next full-year fiscal period.

MSCI Emerging Markets Index: Captures large and mid cap representation across 24 Emerging Markets (EM) countries including Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, South Korea, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates. With 1,125 constituents, the Index covers approximately 85% of the free float-adjusted market capitalization in each country.

Price-to-Earnings (P/E) Ratio: Price-to-Earnings Ratio (P/E Ratio) is a valuation ratio of a company’s current share price compared to its per-share earnings.

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