INSTITUTIONAL INVESTMENT & FIDUCIARY SERVICES:
Investment Basics: A Primer on Emerging Markets Equities

By Philip M. Fabrizio, CFA, CFP, Area Assistant Vice President
and
Allen Liu, Analyst

Introduction

Emerging market equities have been the focus of much investor attention recently. Current tailwinds in emerging markets investing, including cheap valuations and high country growth rates relative to many developed countries, are being balanced against a number of potential impediments, including the U.S. Federal Reserve’s tapering initiatives and various geopolitical risks. Regardless of the current environment, emerging market equities historically have offered investors a differentiated risk and return profile compared to developed markets, while also providing a source of diversification. As emerging market countries continue to grow in terms of their impact on global economic output as well as overall population, we believe investors could benefit from a greater understanding of this often misunderstood segment of global equity markets.

The goal of this Practice Update is to provide a broad overview of investing in emerging market equities. We start by defining how countries are classified as “emerging markets” by leading index providers. Then we highlight various benefits and risks associated with investing in this asset class. Finally, we examine the historical performance of emerging markets equities and provide various options for gaining exposure to this asset class.

Emerging Markets Classification

There is often confusion among investors about which countries are classified as emerging markets, stemming partly from uncertainty about the criteria used to define the differences between developed and emerging (or even frontier) markets. Many countries that intuitively might be considered developed markets—or, alternatively, emerging markets—are often misclassified.
For instance, China, which produced the world’s second largest gross domestic product (“GDP”) in 2013\(^1\), is considered by index providers to be an emerging market country while New Zealand (ranked 55\(^1\)) is classified as a developed market country. Leading index providers such as MSCI, S&P and FTSE all use different criteria for country classification in their indexes, adding an additional element of confusion in the definition process. In general, however, index providers and other institutions typically consider the following factors in differentiating developed markets from emerging markets:

- Rate of economic growth - Emerging markets tend to exhibit higher economic growth rates.
- Individual household income levels - Household income levels in emerging markets tend to be lower.
- Development of capital markets - Emerging market countries’ stock and bond markets tend to exhibit lesser degrees of sophistication, size, accessibility, liquidity and/or regulation.

Figure 1 highlights the countries currently listed as emerging markets by MSCI.

**Figure 1: MSCI Emerging Market Countries**

<table>
<thead>
<tr>
<th>Americas</th>
<th>Europe, Middle East &amp; Africa</th>
<th>Asia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>Czech Republic</td>
<td>China</td>
</tr>
<tr>
<td>Chile</td>
<td>Egypt</td>
<td>India</td>
</tr>
<tr>
<td>Colombia</td>
<td>Greece</td>
<td>Indonesia</td>
</tr>
<tr>
<td>Mexico</td>
<td>Hungary</td>
<td>Korea</td>
</tr>
<tr>
<td>Peru</td>
<td>Poland</td>
<td>Malaysia</td>
</tr>
<tr>
<td></td>
<td>Qatar</td>
<td>Philippines</td>
</tr>
<tr>
<td></td>
<td>Russia</td>
<td>Taiwan</td>
</tr>
<tr>
<td></td>
<td>South Africa</td>
<td>Thailand</td>
</tr>
<tr>
<td></td>
<td>Turkey</td>
<td></td>
</tr>
<tr>
<td></td>
<td>United Arab Emirates</td>
<td></td>
</tr>
</tbody>
</table>

*Source: MSCI*

Considerations for Investing in Emerging Markets

Emerging market countries exhibit a number of attractive investment qualities which investors should weigh against the risks inherent in these countries. Key considerations for investing in this asset class include:

Benefits

- Higher Country Growth Rates – Since the mid-1990’s emerging markets have experienced significantly higher annual growth rates, as measured by real GDP, than developed markets (Figure 2). While rates have slowed recently, emerging countries are still experiencing growth rates significantly higher than those of most developed countries.

Figure 2: Advanced Economies vs. Emerging Market & Developing Economies

Source: International Monetary Fund as of April 2014

- Favorable Demographics – Emerging market country populations tend to have younger workforces than those of developed markets. This trend generally leads to greater economic output, as younger workforces are contributing to the economy for longer periods of time. In contrast, countries with older workforces, such as Japan, are typically burdened with less economic productivity and may also experience a greater economic drag due to higher spending costs for healthcare and related services for their aging populations.
• Improving Infrastructure – Over the last two decades, emerging market countries have been the recipients of vast capital flows, from both foreign and domestic sources, which have helped to modernize the infrastructure in these countries. The goals for such investment include helping to shift countries away from agriculture and commodity-driven economies, attracting foreign investment and building more industrialized cities to support population growth. The improvement in infrastructure and change in the nature of these economies have helped enhance economic productivity in these countries.

• Low Levels of Sovereign and External Debt – Relative to developed markets, emerging markets generally have lower levels of sovereign and private debt. In 2013, emerging markets had a weighted average gross sovereign debt-to-GDP ratio of 34.5% while developed markets had a ratio of 106.3%\(^2\). Lower debt levels allow for greater potential economic expansion as less capital is dedicated to paying borrowing costs.

**Risks**

• Geopolitical Risks – While many emerging market countries have made great strides in stabilizing their political environments, there are still many countries that present large geopolitical risks. Recent tensions between Ukraine and Russia, and the fallout to their respective economies as a result, serve as an example of this specific type of risk that is more prevalent among emerging market countries. Such instability can deter foreign investment, stunt economic growth and make the operating environment for companies in affected countries more difficult and unpredictable.

• Reliance on Developed Market Economies – Traditionally, emerging market economies have fueled their growth through exports to developed economies (commodities being a primary export) and benefited from the related foreign capital inflows. While emerging markets continue to work to reduce this reliance on foreign consumer demand, most countries are still not mature enough to sustain economic independence. For instance, previous emerging market financial crises have usually coincided with larger global economic turmoil.

• Weaker Corporate Governance – Strong corporate governance is often lacking among emerging market companies. Such governance issues of concern in these countries include financial transparency, executive compensation, board of director formation policies, internal controls, shareholder rights, and social and environmental responsibility. Weaker government regulation of corporations in some emerging market countries can further add to a poor governance environment.

• Currency Fluctuations – The performance of an investment to an investor domiciled outside of a particular emerging market country can be affected by fluctuations in the emerging market currency relative to the investor’s home currency. This issue, which is not a consideration when investing domestically, adds an additional layer of complexity to this asset class.

**Investment Characteristics**

Historically, emerging market equities have produced higher annualized returns than both U.S. equities and international developed market equities. However, the higher returns have come with considerably greater amounts of volatility.

On a 10-year annualized basis, as of 06/30/14, emerging markets (represented by the MSCI Emerging Markets Index) returned 11.9%, outpacing U.S. equities (Russell 3000 Index) and developed international equities (MSCI EAFE Index) by 3.7% and 5.0%, respectively. Going further back, over a 25-year time frame emerging market equities have produced higher annualized returns than both U.S. equities and international developed equities but have also exhibited greater volatility than both of these asset classes (Figure 3).
Figure 3: Annualized Global Equity Return and Standard Deviation since 1988

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Return</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russell 3000</td>
<td>10.7%</td>
<td>14.8%</td>
</tr>
<tr>
<td>MSCI EAFE</td>
<td>5.8%</td>
<td>17.4%</td>
</tr>
<tr>
<td>MSCI Emerging Markets</td>
<td>12.1%</td>
<td>23.5%</td>
</tr>
</tbody>
</table>

Data sourced through eVestment. Data as of 6/30/14.

This asset class has also historically provided some degree of diversification in relation to U.S. and developed market international equities. However, as seen in Figure 4, the correlation between these asset classes has risen significantly over the last twenty-five years, negating some of the diversification benefits over time. Much of the rise in correlations can be attributable to the globalization of the world’s economies in which global commerce has become more interconnected.

Figure 4: Rolling 3 Year Correlation of the MSCI EM Index to Russell 3000 and MSCI EAFE Index

Data sourced through eVestment. Data as of 6/30/14.
Accessing Emerging Markets

Investors seeking to gain exposure to emerging markets have a number of different options available for accessing this asset class. The most direct route is to invest, either actively or passively, with a dedicated emerging markets manager. Active managers can play an important role in this space as their ability to screen companies with favorable fundamentals and assess country operating environments may help them avoid certain risks that cannot be avoided when investing passively. Active managers that offer dedicated emerging market strategies often have resources (analysts, portfolio managers) working in these countries to gain a more in-depth understanding of company and country dynamics. One of the tradeoffs, however, is that management fees can be larger than those typically charged for active managers invested in developed markets.

The median fee for an emerging market equity mutual fund, as measured by industry software, eVestment’s All Emerging Markets Equity manager universe, is 125 basis points. In contrast, the median fee for an international developed mutual fund, as measured by eVestment’s All EAFE Equity manager universe, is 100 basis points. Yet, because of the larger number of risks associated with emerging markets it is, in our opinion, less advantageous to be a passive investor in this asset class than it would be to invest passively in domestic or international developed equities.

Another option for investors seeking access to emerging markets is through investing in an international ex-U.S. or global equity mandate. Most portfolio guidelines allow managers in these spaces to invest up to a certain percentage of the portfolio’s assets in emerging markets companies—typically anywhere from 5% - 30% of the total portfolio. Under this framework, managers have the flexibility to increase or decrease emerging markets exposure based on relative attractiveness. Given their broader investment universe, however, these managers naturally have less of a focus on emerging markets as compared to a dedicated emerging market fund.

One additional method of gaining emerging markets exposure is investing in companies that are domiciled outside an emerging market country but which derive a portion of their revenue through sales in emerging markets. As companies continue to expand their reach and develop a more global focus the prevalence of such companies should grow.
As an example, many U.S. equity funds hold stock in Kentucky-based Yum! Brands, Inc. Yum! owns and operates various restaurant chains including KFC, Pizza Hut and Taco Bell. While domestically based, Yum! generates a large portion of its revenue abroad. For instance, the company’s most recent 10Q filing revealed that approximately 55% of its third quarter 2014 revenue came from China. Clearly, the profitability of global corporations such as Yum! is partially influenced by the operations they have in emerging market countries.

**Conclusion**

Emerging market equities typically represent a small portion of an investor’s overall equity allocation given the greater risks and complexity associated with investing in this asset class. Yet, as domestic investors continue shifting to more balanced allocations between U.S. and international equities, emerging markets likely will be an area of greater investor focus in the coming years.

For their part, many emerging market countries have made progress in improving areas of historic investor concern at a time when these markets are growing in impact on the global economy. Investors considering exposure to emerging markets, whether directly or indirectly, should ensure they are aware of the many considerations involved in this asset class. Historical return patterns have shown that this asset class has the potential for outsized returns, but at the same time has exhibited significantly more risk than developed markets.
About the Team

Philip M. Fabrizio, CFA, CFP, Area Assistant Vice President, and Allen Liu, Analyst, are part of the Institutional Investment & Fiduciary Services team of Arthur J. Gallagher & Co., Gallagher Fiduciary Advisors, LLC (“Gallagher”), focused on improving the investment program of your benefit plan and other investment pools. Gallagher’s Institutional Investment & Fiduciary Services team is a group of established, experienced investment professionals who provide objective insights, analysis and oversight on asset allocation, investment managers, and investment risks, along with fiduciary responsibility for investment decisions as an independent fiduciary or outsourced CIO.

Philip M. Fabrizio, CFA, CFP
Area Assistant President
Institutional Investment & Fiduciary Services
phil_fabrizio@ajg.com
202.312.5422
www.ajg.com

Allen Liu
Analyst
Institutional Investment & Fiduciary Services
allen_liu@ajg.com
202.312.5430
www.ajg.com

© 2015 Gallagher Fiduciary Advisors, LLC

Investment advisory, named and independent fiduciary services are offered through Gallagher Fiduciary Advisors, LLC, an SEC Registered Investment Adviser. Gallagher Fiduciary Advisors, LLC is a single-member, limited-liability company, with Gallagher Benefit Services, Inc. as its single member. Neither Arthur J. Gallagher & Co., Gallagher Fiduciary Advisors, LLC nor their affiliates provide accounting, legal or tax advice.