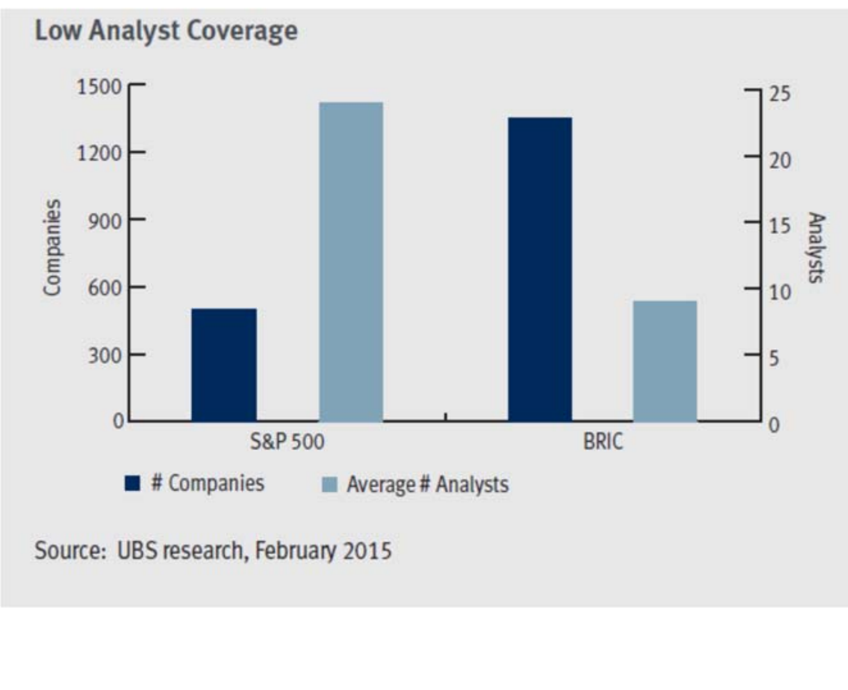
Up For Debate Yet Again: Active vs. Passive But This Time It's The Emerging Markets

When the term "emerging markets" was coined in the early 1980s it was an exciting time for those investors attracted to this young, inefficient, and rapidly growing set of markets. Earlier on in its evolution, if an investor could stomach the added risk, actively managed emerging market investments offered a very attractive and outsized return profile. Over time though, as these markets matured in size, sophistication, and popularity the differentiation between the active and passive investment approach began to narrow and as this occurred investors began to question whether it was still possible to earn alpha, or outperformance, through active management. At Lynx, we continue to believe emerging market active management is a value added proposition.

In terms of number of securities, the emerging market (EM) universe is very large, yet the interaction most passive investors have with these markets is through the MSCI Emerging Markets Index, which is a poor representation of the overall market. The index includes roughly 800 individual securities, while the overall emerging market universe has over 10,000 public companies. Additionally, there is the issue of sell-side analyst coverage or lack thereof (chart 1); while the number of companies in the BRIC countries far exceeds those of the S&P 500, the average number of analysts covering these names is less than half. More so, of the 800 securities included in the index over 650 are State Owned Enterprises or "SOEs". SOEs are companies either owned by, or greatly influenced by, their respective governments; well-known examples are Gazprom (Russia), Petrobras (Brazil), and China Mobile (China). The inherent risks associated with such companies are typically very different from private enterprises, as their balance sheets and overall strategies are most likely driven by a country's geopolitical goals rather than by financial motivation. When investors purchase an MSCI Emerging Market Index based ETF, roughly 30% of the holdings are SOEs, ultimately adding additional risks that may not be fully appreciated.

Chart 1



Now let's turn to active management and the opportunities it may provide. Within the developed markets, the increasing level of efficiency has made it very challenging for active managers to outperform. Originally, the lack of efficiency among the emerging markets as compared to the developed countries was a significant talking point for EM active managers, but the question today is, does this dichotomy still exist? Through the use of statistical tools such as cross-volatility, correlations, and sector, country and stock dispersions, many have attempted to answer this question. Through a joint review by Lazard, Duke University and Russell Indices, it was discovered that dispersion between EM securities has actually increased in recent years, while in past years it had been fairly static (chart 2). However, recent research also indicates that correlations between various countries in the emerging markets have been moving upwards as of the mid-2000s (chart 3). In 2006 through 2009, correlations between the countries increased, while sectors, already high, remained elevated. The overall increasing correlations in the asset class, in theory, should reduce the opportunity for active management, but let's combine the above statistical findings with today's environment. Until recently, China has been the major driver of growth for both emerging countries, as well as commodities. Today these dynamics are shifting as China's growth is slowing and transitioning to a service based economy. Commodity prices have plummeted in the last year, a sign that the rising tide that lifted all ships in EM over the last 15 years has passed. As a result, the rising correlations between countries, likely a function of the general commodity price boom, should begin to subside. This should cause the country correlations to begin to fall again, opening the door for more active management opportunities. An example that exists now is that of China and India. As Chinese growth has fallen, causing commodities to plummet, India has seen its economy expand, as it is a net importer of energy and is far more diversified than China. This kind of dichotomy should replay itself across many of the index constituents in the coming years.

To see a similar example of the relationship between a macro boom, indiscriminate asset price appreciation and the struggles of active management in such an environment, please refer to the Lynx white paper titled, "How Much is Too Much to Pay for Performance: Our Views on Active and Passive Investing," which lays out our argument for how the U.S. QE caused reduced cross-volatility between domestic stocks. In such an environment the value that active management brings to an investment universe is bound to be masked.

Chart 2

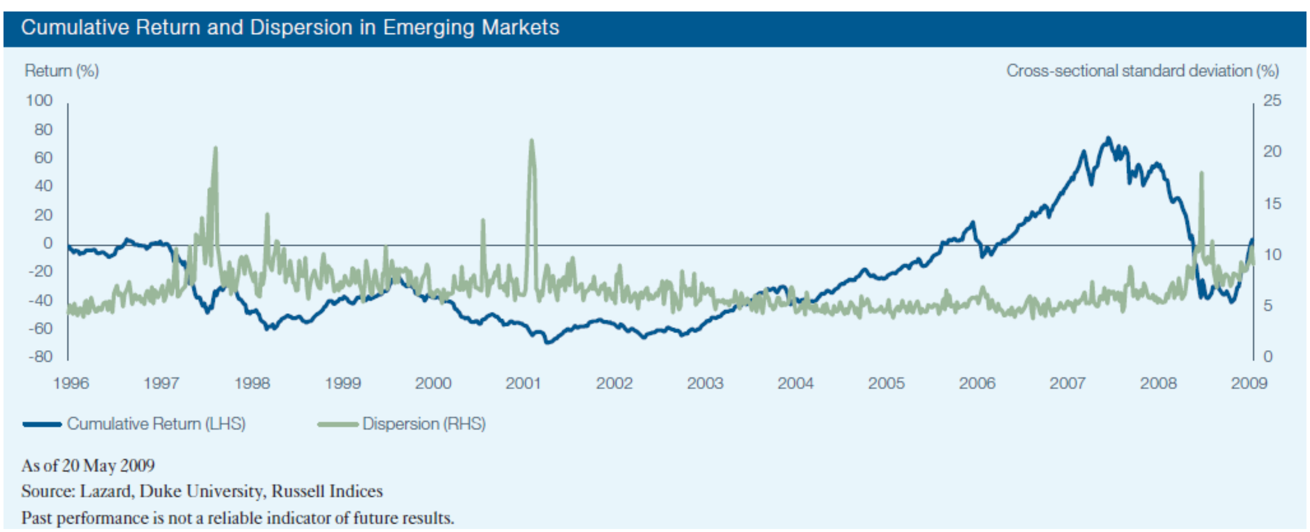


Chart 3

*Lazard, "Country and Sector Contagion in Emerging Markets"

To recap, this paper has discussed the case for active management in EM, and has provided data which suggests a reduced opportunity set for the strategy. Now let's review actual emerging market mutual fund performance. RBC conducted a study indicating that EM mutual funds have maintained 2% of outperformance over the MSCI Emerging Market Index over a 5 year rolling time period (chart 4). What is telling though is that in recent years the outperformance has narrowed from over 7% in 2000 to 3% in 2014. The tightening may reflect the increased correlations between countries discussed above. However, the argument for active management still holds as outperformance has been maintained. In addition to overall outperformance, outperformance by individual managers also proves to be persistent (chart 5). Top tercile EM Fund managers have maintained top 2 quartile performance in almost 70% of quarters over a 3 year period, indicating that it is possible to outperform the market over time.

Chart 4

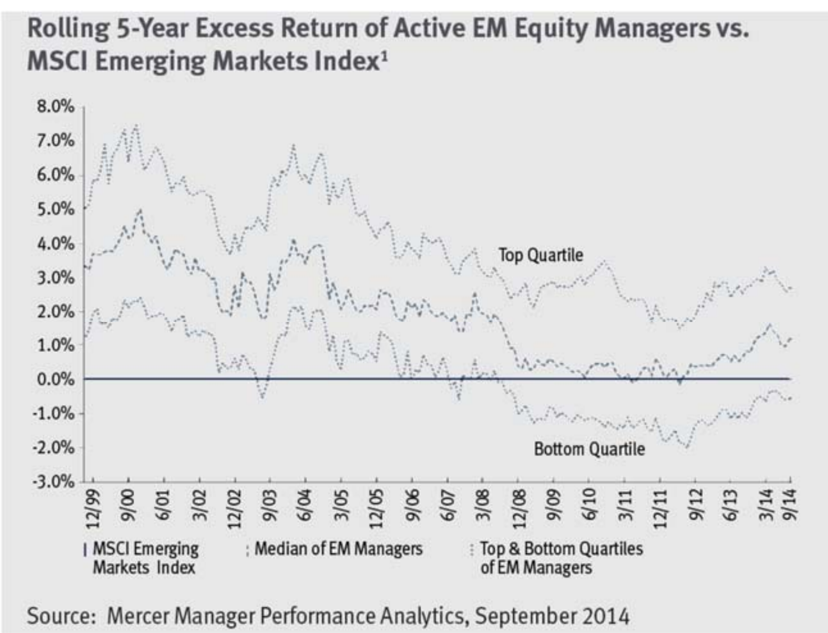
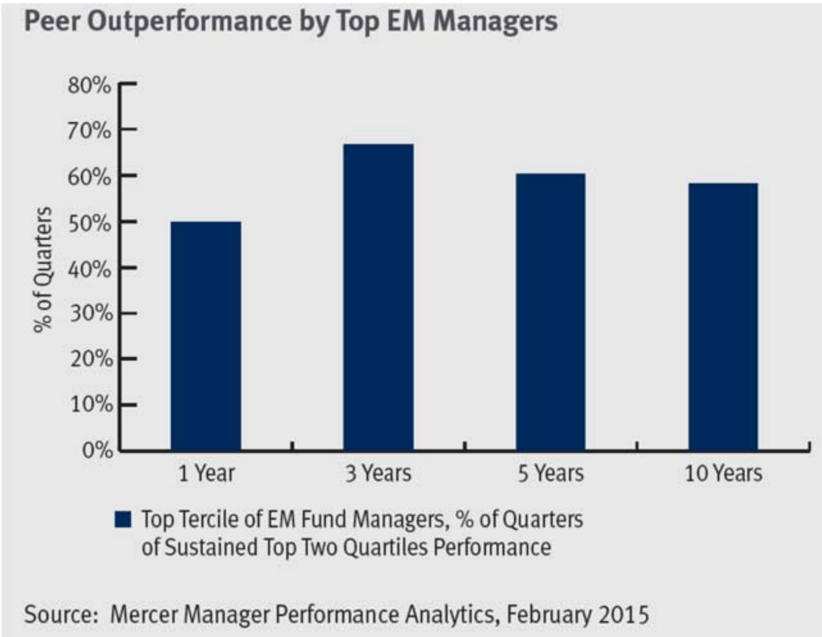


Chart 5



In conclusion, though we have shown issues associated with both the active and passive approach, all told we do not believe investing passively in emerging markets is the ideal option. Active management, which comes in various forms, not only better maneuvers through these markets' associated risks, but it takes advantage of shifting market dynamics and individual opportunities that a quantitative, market cap weighted index approach is likely to overlook. It is also important to emphasize that the most successful emerging market allocations will be those made by investors who are comfortable and accepting of a long-term investment period.