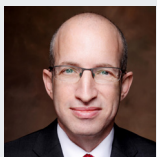




Q&A

How to harness the emerging market 'triple premium'



Yoram Lustig
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In this quickfire Q&A, Yoram Lustig, Head of Multi-Asset Solutions, EMEA, outlines the compelling reasons why investors should consider a strategic allocation to emerging market equities – as well as the benefits of employing active management in this increasingly diverse universe.

“A major drawcard for owning emerging market equities today is quite simply the expected rate of return.”

Firstly, if you had to point to one primary reason why investors should allocate to emerging market equities today, what would it be?

Emerging markets currently possess numerous appealing qualities, so it is difficult to choose just one. Nevertheless, a major drawcard for owning emerging market equities today is quite simply the expected rate of return likely to be achieved over the next five years. According to T. Rowe Price's capital market assumptions, emerging market equities are forecasted to deliver a 7.2% annualised return over the next five years, versus just 5.3% for developed markets. While an annual premium of just under 2% may not sound overly significant, we all understand the magic of compounding. We certainly encourage investors to hold emerging market equities within a diversified portfolio.



How much of an allocation should an equity investor have in emerging market assets?

Emerging market equities currently make up about 12% of the MSCI All Country World Index¹, which is often used as a reference point in the construction of global equity portfolios. While our Multi-Asset team is currently overweight emerging market equities, investors should consider an allocation in line with the MSCI All Country World Index as a good starting point. It is important to remember emerging markets remain far less efficient than what we are accustomed to in developed markets and will continue to exhibit heightened volatility. This provides a tremendous opportunity for skilled active managers to add value.

What is your view on China, the world's second largest economy and largest market in the emerging world?

While China is currently the world's second largest economy, it will not be for long. It will likely overtake the US before the end of the

current decade. China is displaying particular strength as it emerges from the pandemic, and we expect its decade-long economic, social and financial transformation to further accelerate in the years ahead. However, even though the Chinese dragon is poised to continue its rise, this will not be a straight-line move. While the exit of Donald Trump from the US presidency has cooled the heated rhetoric between the US and China, trade tensions are likely to remain elevated and we may see further bouts of volatility moving forward. In addition, Chinese regulators are increasingly clamping down on its domestic tech giants – companies widely held by foreign investors.

How important is China in the context of an emerging market equity investor?

There is currently a major disconnect between the size of the Chinese economy and its weighting in the global equity indices. While US stocks currently make up about 58% of the MSCI All Country World Index, China's weighting is less than 5%. Although the development of China is moving full steam ahead, and the country is set to dominate the global economic and geopolitical landscape for the decades to come, its capital markets still have significant scope to catch up. Nevertheless, there are numerous areas of opportunity to extract alpha in the Chinese stock market today – in themes tied to the burgeoning middle-class consumer, increased expenditure on healthcare, continued leadership in technological innovation and ambitions to promote sustainability.

“We could be on the cusp of a decade of falling rates across emerging markets.”

What is the outlook for monetary policy in emerging markets, and will this have an impact on equities?

If we look at developed markets, monetary policy clearly played a major role in the sharp rise of risk assets, like equities, since the global financial crisis. While the Federal Reserve and the European Central Bank, as well as many other developed market banks, have had to persist with historically depressed rates, we still see interest rates in the region of 4-5% across emerging markets. Inflation is under control across the emerging world today, so there is scope for sustained rate cuts in the coming years. In fact, we could be on the cusp of a decade of falling rates across emerging markets. This would have an enormously positive impact on equity markets – similar to what was witnessed in the West.

“Our analysts are deeply experienced in identifying truly compelling opportunities on the right side of change.”

¹ Source: MSCI. See additional disclosures information.

You touched on active management earlier, why is this important in emerging markets?

As I mentioned, emerging markets are not as efficient as developed markets, and it remains a heterogeneous universe. Many economies are commodity importers, while others are exporters. A number of countries are skilled in high tech areas, while many still focus on basic manufacturing. Even in the context of Covid-19, the differences are stark. While China has largely suppressed Covid-19 and administered more than a billion vaccine doses so far, its emerging market peers India and Brazil have suffered devastation due to insufficient medical infrastructure and reduced access to vaccines. With such varied characteristics, as well as divergent near and long-term prospects, there is no substitute to having experienced analysts undertaking fundamental research on the ground in the emerging regions of the world. Our analysts are deeply experienced in identifying truly compelling opportunities on the right side of change.

Is ESG a major factor within emerging markets?

Definitely. Again, this is where active management adds significant value. There have been many examples of poor corporate governance in the emerging world – such as business models with opaque family ownership structures. We are also witnessing heightened investor focus on the environmental and social elements of ESG, which have long been of concern within emerging markets. Disclosures and data vary widely across the emerging universe, so it can be somewhat difficult for screening tools to identify negative practices. This is where active management and dedicated teams focused on responsible investment can provide deeper analysis and undertake engagement to improve behaviours and operations – which is ultimately positive for all stakeholders.

Growth versus value is always a hot debate in investment circles – what is your view in relation to emerging market stocks?

Most of the investor attention in the emerging world over recent years has been focused on rapidly-expanding growth stocks – such as tech giants Alibaba and Tencent. Indeed, growth has witnessed more than a decade of dominance over value, in emerging markets and beyond, opening up a valuation divergence as wide as I have seen over my career. This was exacerbated by the onset of the pandemic in early 2020, as economically-sensitive value stocks understandably underperformed during the enforced lockdowns in most parts of the world. However, sparked by the quickfire development of the Covid-19 vaccine, the value style finally turned a corner late last year. While most investor exposure to emerging markets has been concentrated on a small group of high-quality growth names, we at T. Rowe Price have long argued for a more balanced approach to growth and value – as we felt a large part of the emerging market equity opportunity set

was being ignored. Even after the recent rally in more cyclical areas, we believe many of these 'forgotten' value-oriented companies remain inexpensive relative to the strong long-term growth potential.

Finally, what is your key takeaway for investors considering opening, or increasing, an allocation to emerging market equities?

Emerging markets offer what I like to call the 'triple premium' – superior economic growth, a younger demographic and accelerating fundamental change. Emerging markets will remain the engine of global growth, and we wholeheartedly believe investors will be rewarded for actively exploring the many hidden gems on offer.

Will history repeat itself? Value in emerging markets

While the growth style of investing has dominated over value in developed markets since the turn of the millennium, value markedly outperformed growth in emerging markets between 2000 and 2010 – largely due to impressive amounts of Chinese infrastructure investment.

Now, with global carbon neutral targets set for 2050-2060, increased spend on copper, aluminum and gas will once again support traditional industries. This is particularly true in the emerging world, where renewable energies are not available, and gas will be needed to power the early stages of the fossil fuel transition. Along with a raft of government support measures directly targeting consumers, this should sustain the recent rally in cyclicals across emerging markets – where we could witness another decade of value dominance.



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Emerging markets are less established than developed markets and therefore involve higher risks.

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