



Time to Rethink Emerging Markets Allocations

A Q&A with Ernest Yeung and Lowell Yura

June 2019

KEY INSIGHTS

- Many emerging markets (EMs) are in the early stages of economic recovery. This should support a higher-than-average growth premium relative to developed markets.
- EM equities have evolved. The influence of energy and other commodities has declined; inflation is relatively controlled; capital spending is more disciplined.
- Today there is greater variation between EM stocks that are tied to their local economies versus those that are linked to global growth.
- We believe an allocation to EM value potentially can improve diversification, raise risk-adjusted returns, and provide effective exposure to the growth premium.

Given the volatility in emerging markets in 2018 and the impact it had on long-term relative performance, it is somewhat understandable that institutional investor exposure to the asset class is near multiyear lows. However, emerging markets have evolved and changed over the past few years in ways that may surprise investors, particularly when they consider the benefits increased EM exposure potentially could have in their overall portfolios.

In our view, EM equity today is a broader and more dynamic opportunity set than most investors appreciate. In a recent discussion with Ernest Yeung, portfolio manager of the Emerging Markets Discovery Equity Strategy, and Lowell Yura, head of Multi-Asset Solutions, North America, we posed the question: Is now the right time to rethink EM allocations?

Q: What is your view regarding the prospects for EM equity?

Ernest Yeung: Ten years ago, people thought that EMs were tied to commodities and were very volatile. But over the last eight to 10 years, the correlation of the asset class to commodities has collapsed because the country composition of the opportunity set has drastically changed and keeps changing.

Consider that 20 years ago, Malaysia actually was the largest country in the Morgan Stanley Capital International (MSCI) Emerging Markets Index. Today, China has experienced a huge increase in weighting, as most investors see a lot of opportunity there. Conversely, there is relatively little investor interest in Malaysia—although we are uncovering interesting opportunities there today. This is a simple example of how dynamic



Ernest Yeung

*Portfolio Manager, Emerging Markets
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Lowell H. Yura

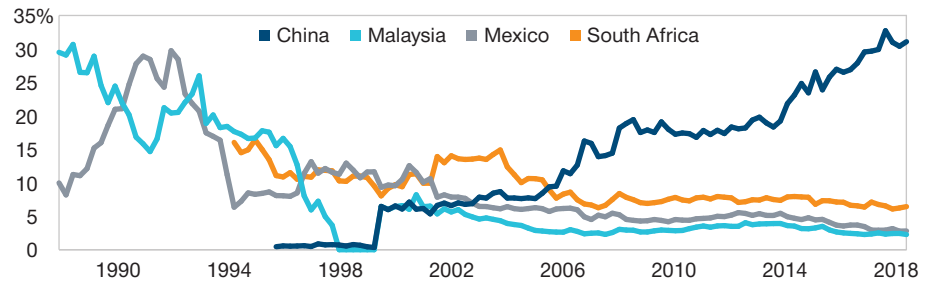
*Head of Multi-Asset Solutions,
North America*

“We believe that we are actually in the early to middle stages of an EM cycle.”

— Ernest Yeung
 Portfolio Manager, Emerging Markets Discovery Equity Strategy

(Fig. 1) The EM Opportunity Set Has Shifted Dramatically

Select Country Allocations Within the MSCI Emerging Markets Index
 December 31, 1988, Through March 31, 2019



Sources: Credit Suisse (see Additional Disclosures), FactSet (see Additional Disclosures), MSCI (see Additional Disclosures).

this EM opportunity set is and how the composition has changed over the years.

We believe that we are actually in the early to middle stages of an EM cycle. Most investors realize that emerging markets are a good place to invest, but in the past, they have collapsed roughly every 10 years. If you invested in years number eight and number nine, you potentially had a problem. So having a rough idea where we might be in that 10-year cycle is very important.

To assess where we could be in this cycle, we consider the GDP differential between EMs and developed markets. EMs hit a trough in economic activity in the first quarter of 2016, so we are just two and a half years into a fundamental upcycle.

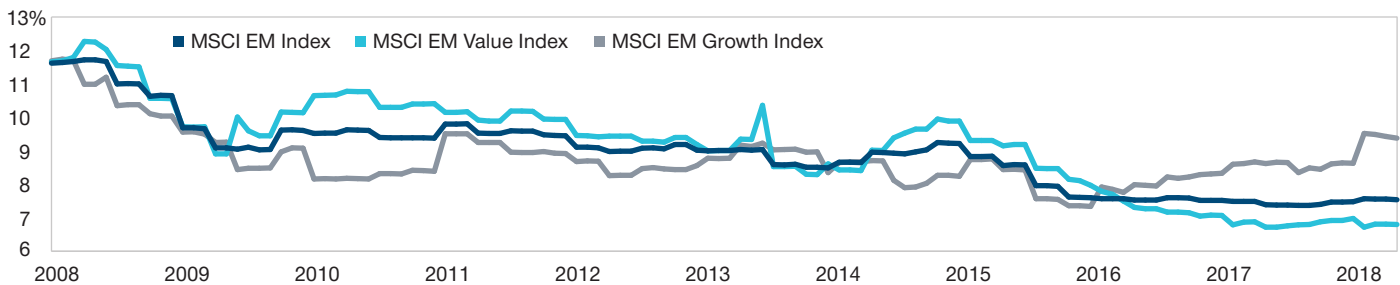
I have good confidence that EMs will continue to recover and believe that tailwind is unlikely to subside in the near term.

Q: What do you think are some of the biggest misconceptions that investors have about EM equities?

Ernest Yeung: Most investors don't realize that the ratio of capital expenditure (capex) to sales among EM companies is actually at a 15-year low. When corporations are not spending as much on capex, it suggests there are no excessive animal spirits in the asset class. Businesses today are acting very rational and very disciplined. These are signs of an early- to midcycle mentality. You would worry about reckless growth in the late stage of an economic cycle, but

(Fig. 2) EM Corporations Are Taking a Disciplined Approach to Capital Spending

Ratio of Capital Expenditure to Sales for Companies in EM Indices
 December 31, 2008, Through March 31, 2019



Sources: FactSet (see Additional Disclosures), MSCI (see Additional Disclosures).

At a macro level, there is still an opportunity to achieve economic and interest rate diversification between emerging and developed markets.

— Lowell Yura
 Head of Multi-Asset Solutions,
 North America

we do not see that currently happening in emerging markets. Companies and governments are tightening their fiscal belts and allocating capital very tightly and efficiently.

This discipline is also evident in more reasonable monetary policies, which have driven EM inflation down to near-record lows and produced relatively high real interest rates.

Q: What are the implications of low capex for EM economies and equities?

Ernest Yeung: Today, when we visit and speak to corporate executives within EM regions, they tell us that they have underspent on capex in the last few years. In fact, in many cases capital expenditures have been below depreciation and amortization. In other words, companies are spending below what would be considered normal maintenance levels.

Executives tell us that they plan to increase investment spending in the near future. This is actually a very powerful signal that could help support a virtuous cycle in the asset class: The money they spend on capex is likely to bring a higher return. It also should create more jobs, which would be good

for wages and consumer income and so good for EM economies.

Finally, companies will need to borrow to invest in capex, and we believe that will kick off a positive credit cycle. So, my conclusion is that we are still early in this economic cycle. As such, we continue to be very constructive looking forward.

Q: Lowell, what is the most effective way for investors to tap in to the benefits of these developing economies, in your view?

Lowell Yura: At a macro level, there is still an opportunity to achieve economic and interest rate diversification between emerging and developed markets. That said, EM investors need to go down to country and sector levels and look at the way the major EM equity indexes are constructed to make sure that their EM allocations actually are positioned to achieve higher growth rates and adequate diversification.

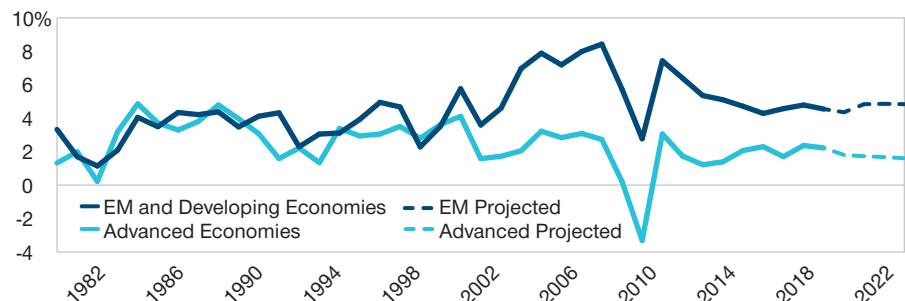
The relative weights of the technology and financials sectors in various EM indices shows the importance of analyzing index construction and underlying exposures. For example, technology makes up about 20% of the MSCI Emerging Markets Growth Index, but only 10% of the MSCI

(Fig. 3) The Growth Gap Between Developed and Emerging Markets Could Widen

Growth in Real Gross Domestic Product

Actual: December 31, 1980, Through December 31, 2018

Projected: December 31, 2018, Through December 31, 2022



Sources: China National Bureau of Statistics, Federal State Statistics Service, Instituto Brasileiro de Geografia e Estatística, European Central Bank, Bank of Japan, IMF, Haver Analytics. T. Rowe Price calculations using data from FactSet Research Systems Inc. All rights reserved.

Emerging Markets Value Index. Many of the largest technology companies in those indices are levered to the global economy, not to the growth of their underlying EM regions.

On the other hand, financial companies may be very levered to their local EM economies because they typically lend to businesses in those economies. As local economies improve, lending tends to increase, profitability tends to improve, and financials generally should benefit directly from those trends. Financial stocks make up only 12% of the MSCI Emerging Markets Growth Index, 25% of the broad MSCI Emerging Markets Index, and a bit more than 33% of the MSCI Emerging Markets Value Index. While 33% is a high concentration, it is one way to think about EM diversification and the benefits of a dedicated value allocation.

Q: How should those factors be reflected in strategic asset allocation and portfolio construction?

Lowell Yura: To answer that question, let's look at active returns and the median returns of all managers in

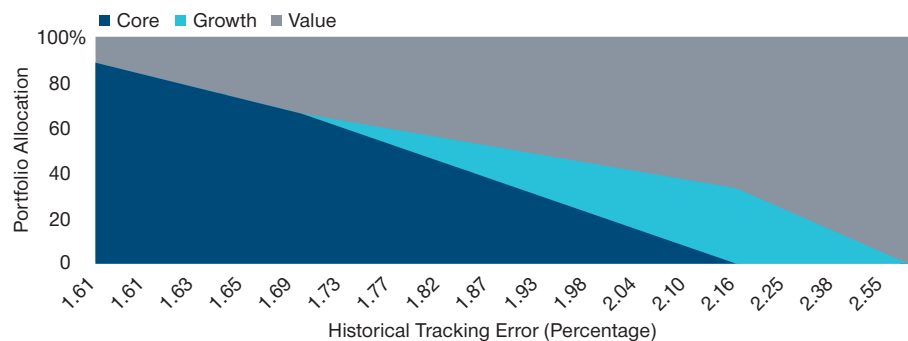
eVestment Alliance's EM core, value, and growth peer groups. If you were to look back 15 years as of December 31, 2018, what allocation among those three types of managers could have delivered the highest information ratio for the lowest tracking error?

What we found was that the lowest median tracking error over that 15-year period was for the core EM peer group—as you would expect, because the index tracked was the broad MSCI Emerging Markets Index. If your objective was to increase tracking error and excess return, you initially would have tilted toward value managers at the expense of core. However, if you desired even higher tracking error, ultimately you would have started to tilt toward growth managers.

What's interesting about our optimization study is that this growth allocation did not come at the expense of value. It increasingly came at the expense of core. In fact, over the last 15 years as of December 31, 2018, the portfolio with potentially the highest information ratio would have allocated 70% to core, 0% to growth, and 30% to value.

(Fig. 4) A Tilt Toward Value May Produce a More Efficient EM Portfolio

Composition of an Efficient Frontier EM Portfolio at Different Levels of Tracking Error* 15 Years Ended December 31, 2018



Maximum Information Ratio: 70% Core, 30% Value, 0% Growth

Sources: T. Rowe Price, eVestment Alliance, LLC. All data analysis by T. Rowe Price.
 * Values represent gross returns. Median excess returns were calculated against the MSCI Emerging Markets Index. Hypothetical portfolios were rebalanced monthly. Portfolio blend represents active equity strategies within the eVestment Alliance database, separated into emerging markets subcategories based on manager investment style: core, growth, or value. See appendix for additional information on the methodology.

0.55

The median correlation of excess returns between the eVestment core and value peer groups over the 15 years ended December 31, 2018

Now as asset allocators, we're born skeptics, and we have very little confidence in historical returns because we know there's a lot of bias. So we looked at this analysis through multiple lenses (such as using resampling and statistical methods to remove factor and time-period bias) and found similar patterns of results.

Q: What has driven this phenomenon?

Lowell Yura: Excess returns for core and growth managers historically have had structurally higher degrees of correlation compared with core and value managers. Over the 15-year period ended December 31, 2018, for example, we found that the median correlation between excess returns within the eVestment growth and core peer groups was 0.82, versus 0.55 between the core and value peer groups. This and other factor analysis tells us that core managers often had a meaningful growth bias, which resulted in structural tilts that investors were not being compensated to take.

On the value side, you see a much more cyclical scenario, and we actually neared historical lows in the correlation between the EM value and core peer groups in late 2018, which tells us that this potentially may

be a good time to seek to improve diversification with EM value.

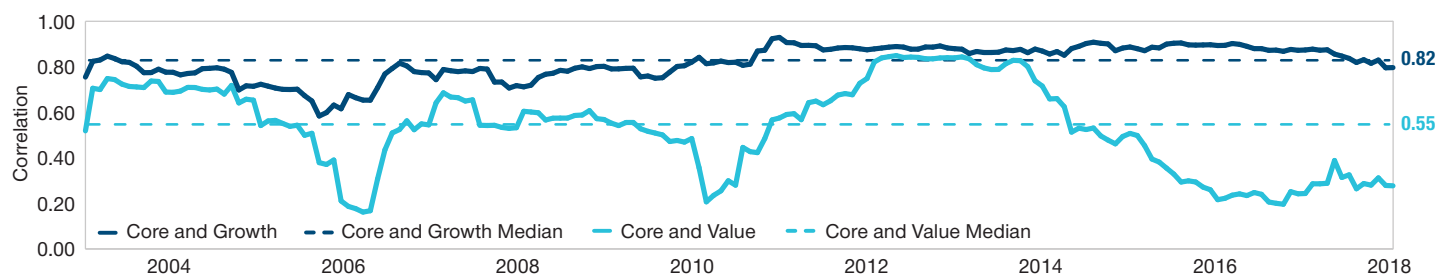
Q: Are institutional investors revisiting how they size and implement their EM exposures?

Lowell Yura: Yes. A number of the institutional clients we speak with are rethinking their EM allocations. In many cases where implementation is through core EM strategies, our proprietary diagnostic tools have found a meaningful bias to growth that warrants considering reallocating a portion of the client's EM core allocation to an EM value equity strategy.

Based on historical results shown in Figure 6, if investors had eliminated EM core entirely and split their allocations equally between EM growth and EM value, they potentially could have experienced a neutral beta, meaning no additional market risk exposure, and achieved higher excess returns over the 15 years that ended December 31, 2018. These historical data indicate that if investors had shifted just 30% of their dedicated EM core exposure to value, they potentially still could have experienced higher excess returns and a higher information ratio. So history suggests that investors may be able to pick up meaningful return without adding

(Fig. 5) Correlation of EM Value and EM Core Is Near a Historical Low

Rolling Correlations of Three-Year Excess Returns Among eVestment Peer Groups*
15-Year Period Ended December 31, 2018

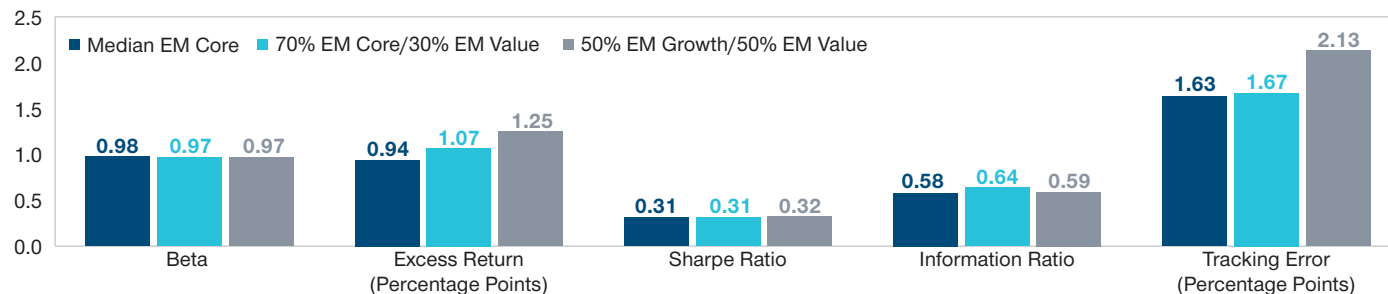


Sources: T. Rowe Price; eVestment Alliance, LLC; FactSet (see Additional Disclosures); and MSCI (see Additional Disclosures). All data analysis by T. Rowe Price.
*Excess returns relative to the MSCI Emerging Markets Index

(Fig. 6) A Dedicated Allocation to EM Value Would Have Improved Portfolio Performance

Hypothetical Results for Portfolio Blends Versus the MSCI EM Index*

15 Years Ended December 31, 2018



Sources: T. Rowe Price, eVestment Alliance, LLC. All data analysis by T. Rowe Price.

*Median excess returns calculated against the MSCI Emerging Markets Index. Hypothetical portfolios were rebalanced monthly. Values represent gross returns, which would be lower as a result of the deduction of applicable fees. Portfolio blends represent active equity strategies within the eVestment Alliance database, separated into emerging markets subcategories based on manager investment style: core, growth, or value. See appendix for important information regarding hypothetical portfolios and on the methodology.

80%+

Share of actively managed EM equity assets that are invested in core and growth strategies

to meaningful risk by introducing a dedicated allocation to EM value.

Q: As an investor, Ernest, where do you see compelling value in emerging markets now?

Ernest Yeung: I'm currently focusing on opportunities in EM that I would characterize as "old economy." Many people don't realize that this sub-universe appears very cheap in historical terms. As of March 31, 2019, the price-to-book value ratio within the old-economy opportunity set was roughly the same as at its trough in 2015, at the low point of the global financial crisis, and at the trough of the Asian financial crisis nearly 20 years ago. I don't think you can find another asset class today that appears that cheap versus its previous valuation lows.

Meanwhile, many of these businesses are experiencing positive free cash flow levels that are near 10-year historical highs. This tells me that fundamentals have improved and that these companies are generating a lot of cash. Also, while the term "old economy" normally is associated with very high leverage and poor balance sheets, because these businesses are generating so much free cash flow, they

do not need to borrow substantially for future investments. They also are deleveraging their own balance sheets.

We believe that we are well positioned to take advantage of these valuation anomalies. If we look at EM price-to-book multiples by industry, the areas that are trading at 20-year lows include, in our view, some of the best insurance franchises, capital goods franchises, and industrial companies. My daily battle is to distill all of these compelling opportunities into a 60-stock portfolio of actionable investment ideas.

Q: Why do you think such appealing investment opportunities are being overlooked?

Ernest Yeung: If we survey the universe of active investors within EM, we find that more than 80% of the assets under management are now invested in core and growth strategies. Very few are focused on these value-oriented opportunities. This value universe largely includes quantitative funds, so fundamental stock pickers are actually a minority among the managers in this space. In our view, this explains why so many stocks in the

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— Ernest Yeung

Portfolio Manager, Emerging Markets Discovery Equity Strategy

old-economy segments are trading at multiples near 20-year lows.

Q: Ernest, can you talk about your discovery of investment opportunities beyond Tencent and Alibaba?

Ernest Yeung: We do not own Tencent. We do not own Alibaba. We also do not own Taiwan Semiconductor. I'm not here to make a case that these are bad stocks. I think they are very good companies, but we don't need to be there. We think you can capture growth from other areas of the emerging markets, and we are trying to give clients a different exposure.

For example, consider the long-term investing case for the domestic economy of South Africa. They have a very young demographic and the region is rich in resources. The country has some of the best-managed companies within the emerging markets, in our opinion. Most of these management teams have been through multiple market cycles, and they know how to manage their businesses through volatility.

After peaking in 2010, South Africa has had eight years of economic slowdown due to corruption and collapsing business and consumer confidence. However, we are contrarian investors. We are finding a lot of good ideas, unlike most EM active managers who have a large underweight in South Africa. If we exclude Naspers, which has a low dividend yield because of its enormous investment in Tencent, from the MSCI South Africa Index, the dividend yield for the market is actually very high, over 4%. So, in our view, the downside in South Africa is limited.

We think South Africa's current president understands the problems his country faces and is working behind the scenes to improve business confidence and fight corruption. We believe that in time we should see tangible changes in

politics and macro sentiment in South Africa. The country potentially could be where Brazil was three years ago or India in 2013. It currently is one of our largest country overweights.

Q: Are there other national markets you find especially interesting at this time?

Ernest Yeung: Chinese state-owned enterprises (SOEs) are another area of interest. If you look back to the period from 2000 to 2008, that was China's supercycle. Everyone wanted to own Chinese SOEs, not just because China's economy was growing rapidly, but because those companies were delivering earnings and improving free cash flow and return on equity. They had stock incentives for the management that were aligned with minority shareholders.

However, coming out of the global financial crisis, the Chinese government took more control of the economy. As part of that shift, they began to roll back SOE stock incentives. Subsequently, over the next eight or 10 years, these stocks performed very poorly. Companies allocated capital poorly, and they wasted the money they generated internally by fueling overcapacity. You read about ghost towns driven by an oversupply of steel mills and so forth.

Today, by contrast, Beijing is actually being very smart. Since 2017, it has reinstated stock incentive programs in these SOEs. In our view, this theme is not well understood by mainstream investors, and we are finding bottom-up stories that potentially could deliver good risk/reward results. Chinese SOEs still have a toxic image, but if managements change their behavior and start using cash flow to grow their companies more efficiently, we think the rewards from owning some of these companies could be very attractive over the next three years.

Appendix: Methodology for Figures 4 and 6

Objective: Identify the combination of equity approaches that potentially could provide the optimal risk-adjusted return over time.

Method: The study utilized historical monthly excess returns for active strategies and resampled efficient frontier analysis to solve for the combination of investment approaches that potentially maximized the hypothetical allocation's information ratio (IR).

Opportunity set: Active equity strategies within the eVestment Alliance database, separated into subcategories. Non-U.S. and EM strategies were sorted by their categorization in the eVestment Alliance database based on the strategy's investment style: core, growth, or value. Information in the eVestment Alliance database is self-reported by managers. Median returns were calculated for each subcategory gross of fees.

Resampling methodology: To improve optimization robustness, the analysis was performed on resampled time periods with the following parameters:

- The model randomly selected 1,000 five-year periods from the 15 years ending December 31, 2018.
- The IR-maximizing allocation for each period was calculated and recorded.
- Median growth and value returns were capped at 50% of any potential allocation.

- Once the 1,000 maximum IR allocations were calculated, further analysis was performed on the entire group.

Hypothetical Results

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