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Emerging Markets:
Navigating Through Rough Waters

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- EM equity valuations are the key driver of returns over the long term. The benefit from valuation mean reversion should be substantial, as EM equities trade at a 35% discount to DM equities and a 45% discount to U.S. equities, compared to our assumed fair value discount of 10%.
- We expect EM equities to remain under pressure in the near term given a combination of further downside for EM currencies, China's rebalancing risks, and potential for deteriorating investor sentiment and outflows from the asset class.
- We do not expect a full-fledged currency crisis in the emerging world, given improved fundamentals since the 1990s and the absence of currency pegs, but further adjustments are needed to stabilize currencies and narrow current account deficits.
- Given these headwinds, investor sentiment clearly has room to deteriorate further. Mutual fund outflows have yet to reverse the net inflows from 2012 and have not reached washout levels. Similarly, momentum is not yet in oversold territory. In short, there is scope for things to get worse before they get better.
- In contrast to the last decade, which saw a boom in nearly all EM countries and sectors, looking ahead we expect increasing divergence. Therefore, a more nuanced approach to EM implementation is needed.
- Bottom line: Lower your expectations for the near term, prepare for potentially sharp drawdowns, understand how much downside risk is acceptable, and adjust exposures accordingly. However, do not decrease exposure after markets tumble and valuations become depressed. Long-term investors should maintain modest overweights and be willing to rebalance or increase exposure on meaningful declines.

In a world where most assets are fairly priced to overvalued, seemingly cheap EM equities stand out. Yet momentum and sentiment have shifted strongly and decisively away from emerging markets as macro concerns escalate. EM equities finished 2013 down 2.3% in US$ terms, lagging DM equities by nearly 30 ppts, the largest relative underperformance since 1998 (Figure 1). Underperformance has continued in early 2014.

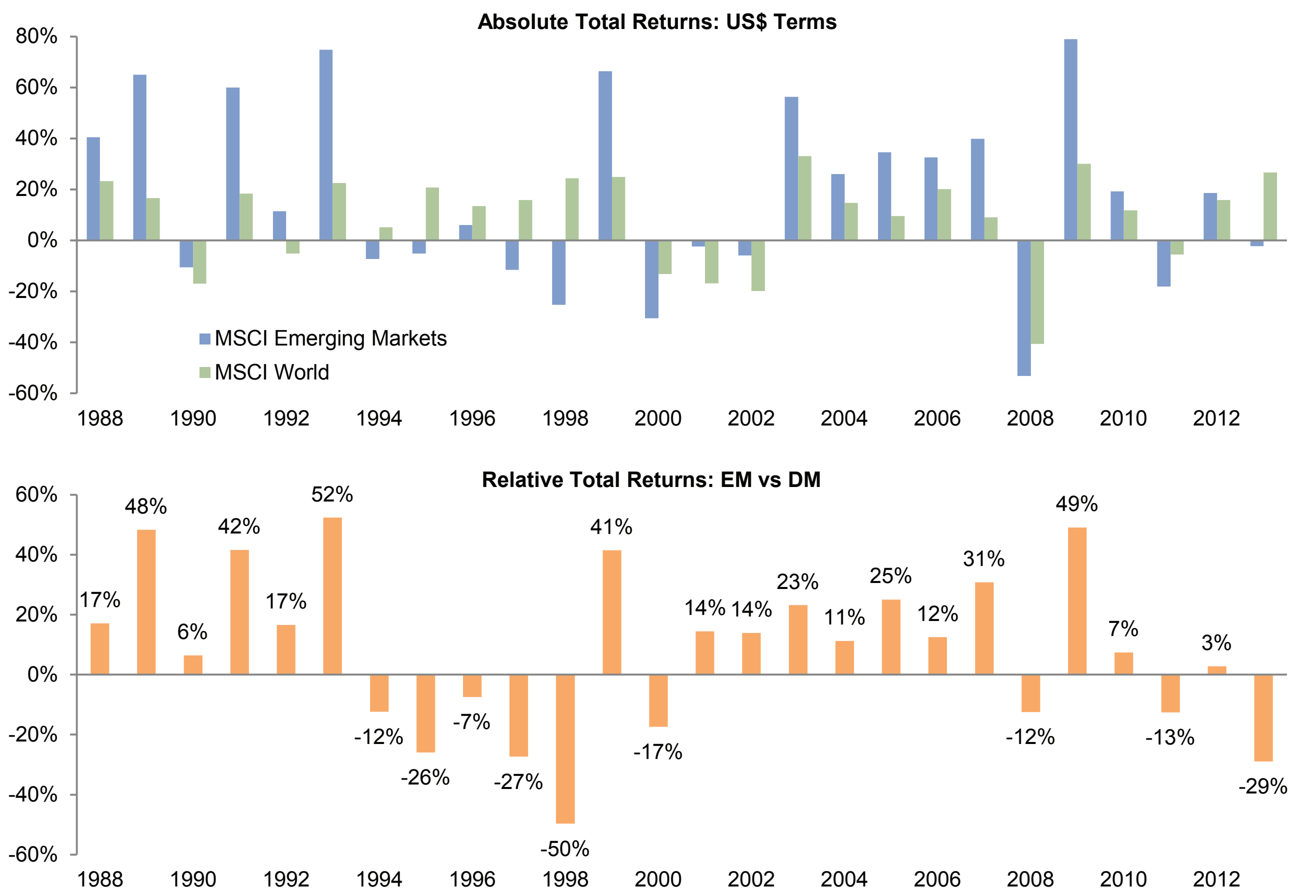
In this paper, we discuss the headwinds facing the asset class in the near term, which are offset to some degree by relatively attractive valuations, particularly compared to U.S. equities. Finally, given divergences and different themes across emerging markets, we share our recommendations for a more nuanced approach to implementing EM allocations today.

Other contributors to this report include Francisco Aguirre, Simon Hallett, Neal Prunier, Ayla Samadova, and Jason Widjaja.

The Tide Has Gone Out: Assessing the Headwinds

While the poor performance of EM equities in 2013 has increased investor angst, the reality is that EM equities have lagged DM equities for three years (Figure 2). The end of 2010 marked the start of monetary tightening in EM economies in response to strong growth, rising inflation, and concerns over local property bubbles. This was especially the case for China, which began to cool its economy after its massive stimulus program in 2009. EM economies, which had recovered quickly following the global financial crisis, were overheating and their markets were increasingly overvalued in both absolute terms and relative to developed markets. The Federal Reserve's launch of "QE2" in late 2010 coincided with the peak in EM relative performance versus DM equities, especially U.S. equities. Diverging monetary cycles resulted in diverging markets, as EM economic growth began to cool.

Figure 1. Performance of Emerging Markets and Developed Markets
1988–2013

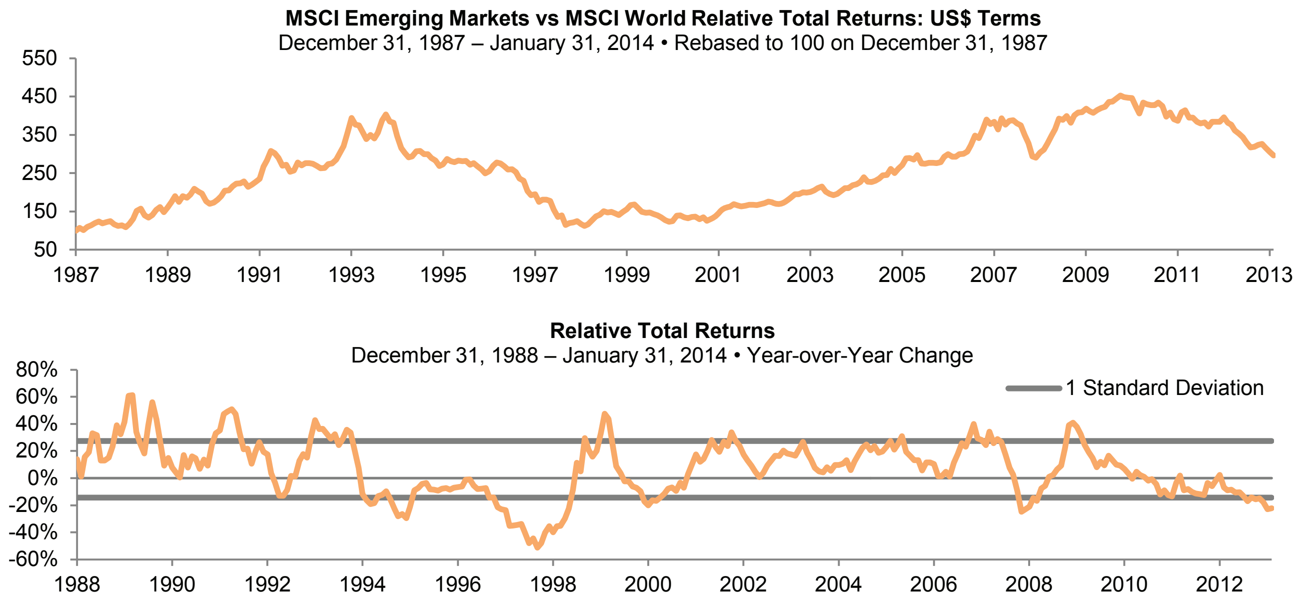


Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Figure 3 shows how the median real GDP growth rate for emerging markets peaked in 2010 and has slowed steadily to nearly the same rate as the median developed market, the narrowest "growth gap" between emerging and developed markets since the 2008 crisis (and, before that, the late 1990s). Although forecasts point to a potential cyclical rebound, EM economic growth is expected to remain well below the levels of the past few decades. Due to slowing growth and increasing concerns over economic stability, the consensus has fallen out of love with the "EM growth story."

Valuations are the key driver of returns for investors over the long run (Figure 4), and today's low valuations for EM equities partly reflect the slower growth outlook. However, in the near term, we expect EM equities to remain under pressure given a combination of further downside for EM currencies, China's rebalancing risks, and potential for deteriorating investor sentiment and outflows from the asset class. We discuss each of these factors in the following pages.

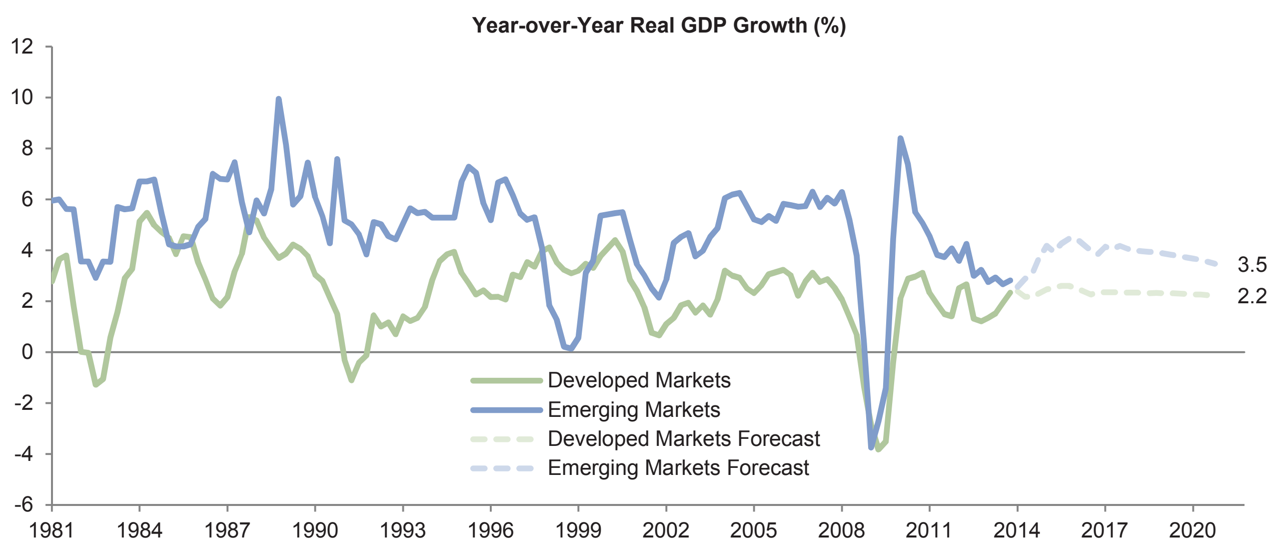
Figure 2. Relative Performance of Emerging Markets and Developed Markets



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

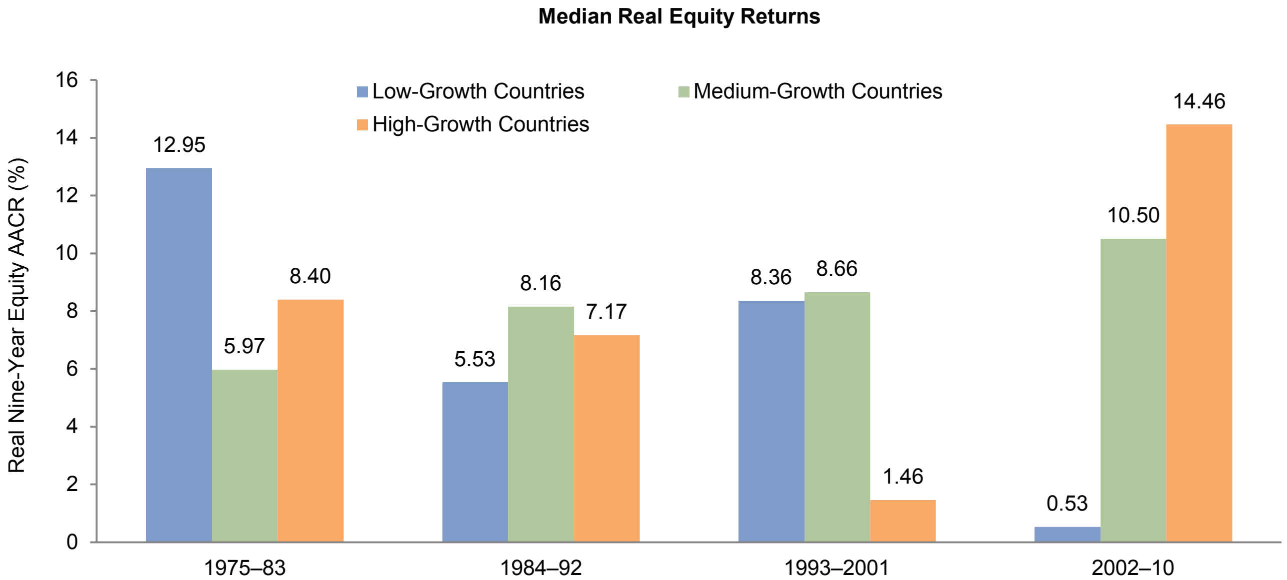
Figure 3. Median Real GDP Growth of Emerging Markets and Developed Markets

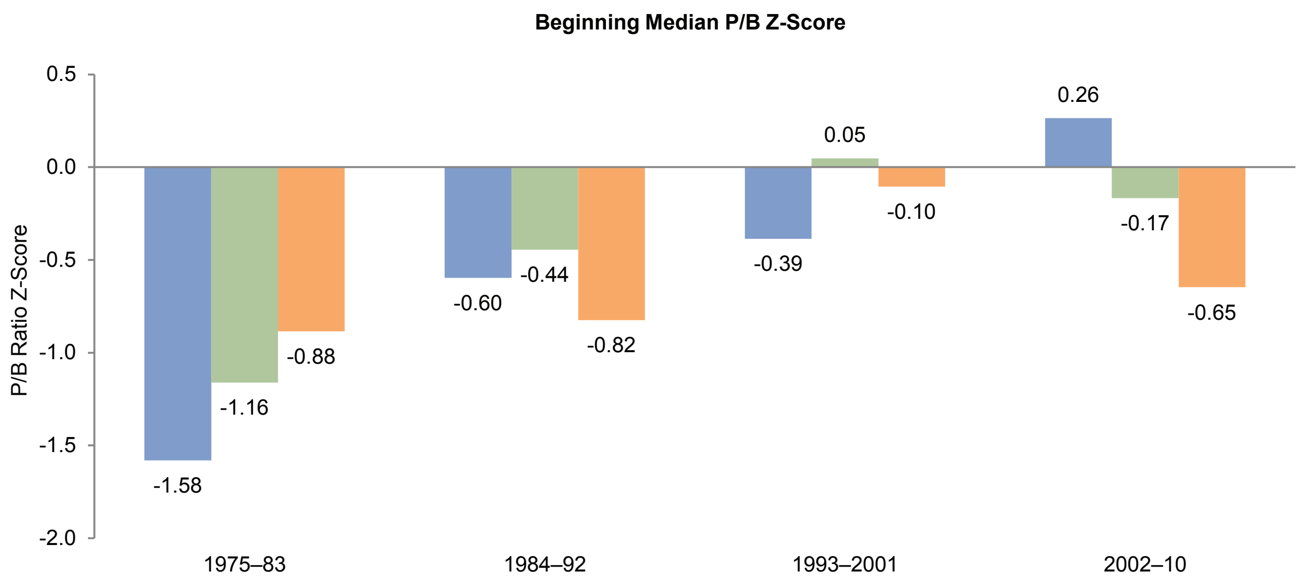
First Quarter 1980 – Fourth Quarter 2020



Sources: Oxford Economics and Thomson Reuters Datastream.
Note: Fourth quarter 2013 and onward are forecasts.

Figure 4. Real Equity Market Returns and P/B Z-Scores for Low-, Medium-, and High-Growth Countries
1975–2010 • Local Currency





Sources: Economist Intelligence Unit, MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: For the 1975–83 and 1984–92 periods, countries in the sample include: Australia, Canada, France, Germany, Japan, Norway, Sweden, the United Kingdom, and the United States. For the 1993–2001 and 2002–10 periods, countries in the sample include those previously mentioned and the following: Brazil, Chile, China, Colombia, Malaysia, Mexico, the Philippines, South Korea, and Thailand. Equity market returns reflect total returns of MSCI country indexes in local currency adjusted for inflation. Total returns for MSCI developed markets indexes are net of dividend taxes. UK inflation data are represented by the UK RPI until 2003 and the UK CPI from 2004 to the present. Z-score represents the number of standard deviations above or below the historical average valuation.

EM Currency Risk

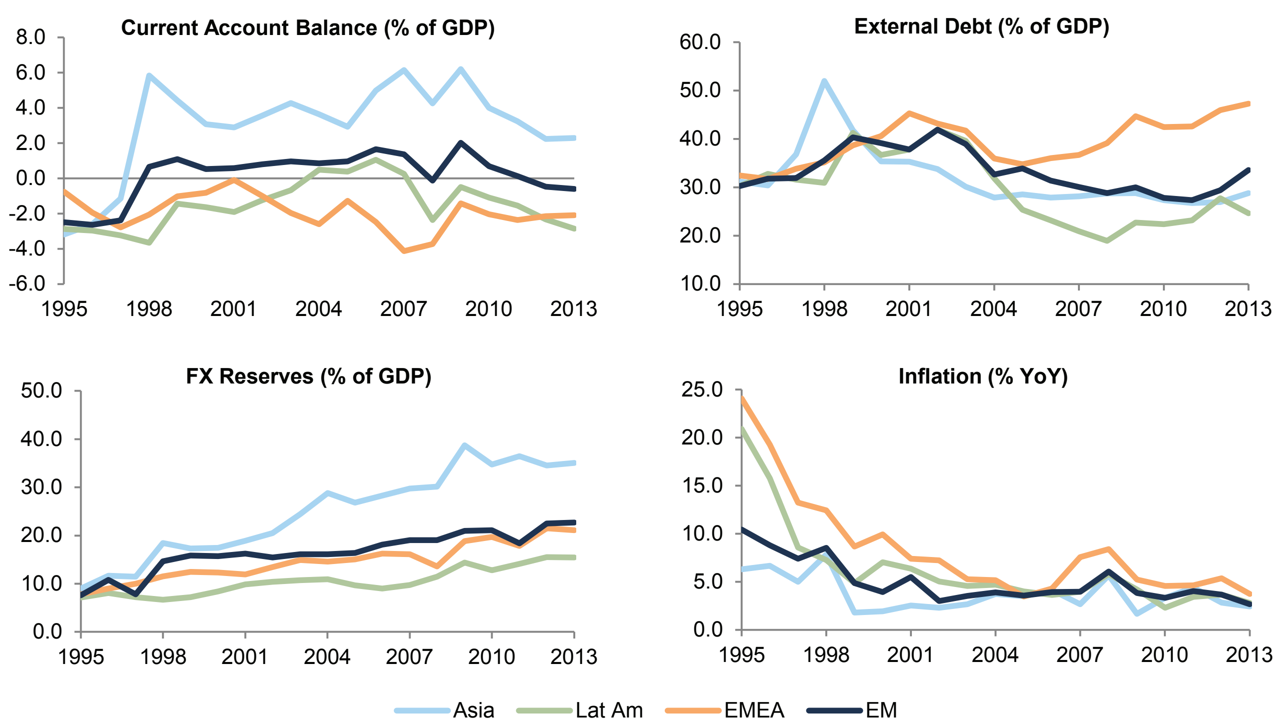
With the launch of "QE2" in 2010 marking the start of EM underperformance, it seems ironic that the unwinding of QE has caused further turmoil and underperformance. Yet speculation over the prospect of Fed tapering and rising U.S. interest rates last summer saw the outbreak of stress in EM currency and fixed income markets. While the U.S. dollar strengthened against most currencies, EM economies with large current account deficits, such as Brazil, India, Indonesia, South Africa, and Turkey, saw their currencies weaken sharply and stock markets wobble. These so-called Fragile Five remain most at risk from a reversal of the fund flows that QE had driven toward higher-yielding EM economies.

With the Fed now actually reducing its bond purchases, EM currencies have again captured the headlines in early 2014.

Despite increasing volatility and declines in some currencies, we believe that a full-fledged currency crisis in the emerging world can be avoided.[1] EM fundamentals are much stronger today than in the 1990s in terms of reliance on foreign-denominated debt, the size of current account deficits, the size of foreign currency reserves, and the absence of currency pegs (Figure 5). Further, the Fed's pledge to not hike rates for some time has given policymakers and markets in these countries time to adjust.

[1] Please see our September 2013 Market Commentary *Are We Heading for an Emerging Markets Currency Crisis?*

Figure 5. Emerging Markets Macro Indicators by Region
1995–2013



Sources: Oxford Economics and Thomson Reuters Datastream.
Notes: The current account balance data are the average of countries in the respective regions while the external debt, FX reserve, and inflation data are the median of countries in the respective regions. Figures for 2013 are forecasts from Oxford Economics.

While a currency crisis may be avoided, the adjustments needed to stabilize currencies and narrow current account deficits cannot. Combinations of rising interest rates, slowing economic growth, and lower real exchange rates will be needed among many emerging countries, and the Fragile Five especially—a process that is underway, but not yet complete. Corporations in emerging countries that have borrowed heavily in US$ terms may face the largest adjustments.

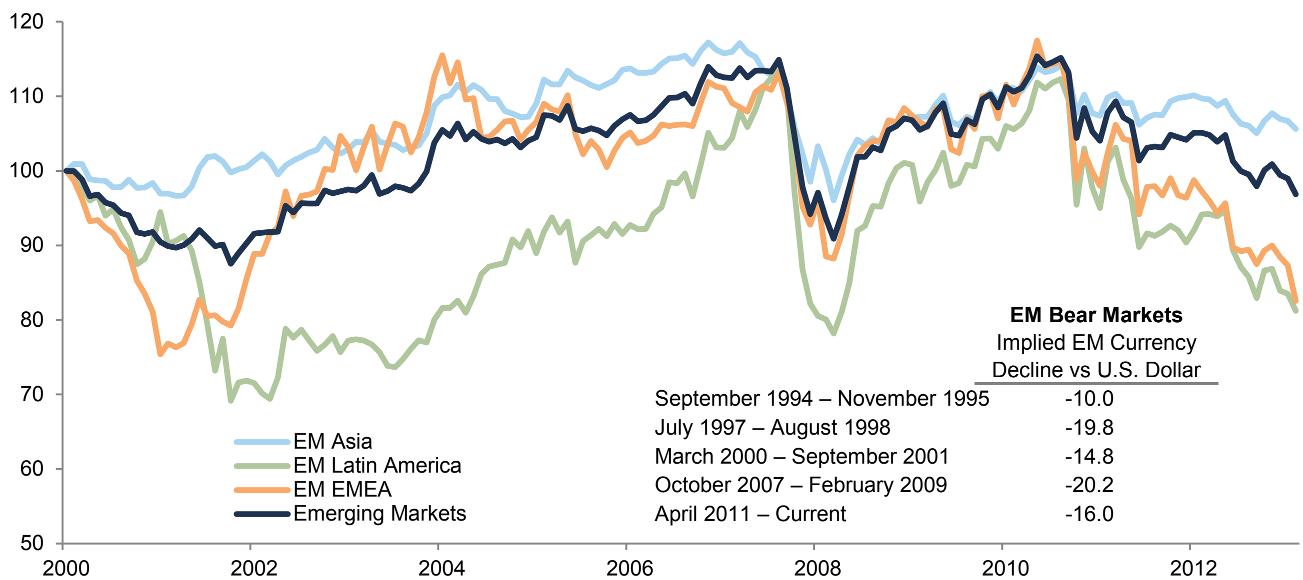
How much more downside could investors see in EM currencies? In 2013, currency weakness subtracted 6 ppts from MSCI EM equity returns for US$ investors and 16 ppts since peaking in 2011. Previous down markets saw EM currencies detract between 10 ppts and 40 ppts from returns (Figure 6).[2] Thus, EM currencies seemingly have scope to fall more, although we do not expect as dramatic a decline as over 1997–2002. This view is also borne out by currency valuations. On the metrics we track, the median EM currency is only fairly valued (Figure 7), although this encompasses a wide range of individual valuations, with some of the hardest-hit currencies starting to appear cheap. Still, we do not view EM currencies overall as undervalued or particularly depressed.

Concerns over currency weakness remain a headwind for EM assets in the near term and will continue to drive performance dispersion across markets based on currency fundamentals. Notably, Asian currencies have held up well, with most of the weakness concentrated

[2] For the full period 1997–2002, EM currencies detracted 40 ppts from returns.

Figure 6. Implied Currency Movements in MSCI EM Index versus the U.S. Dollar

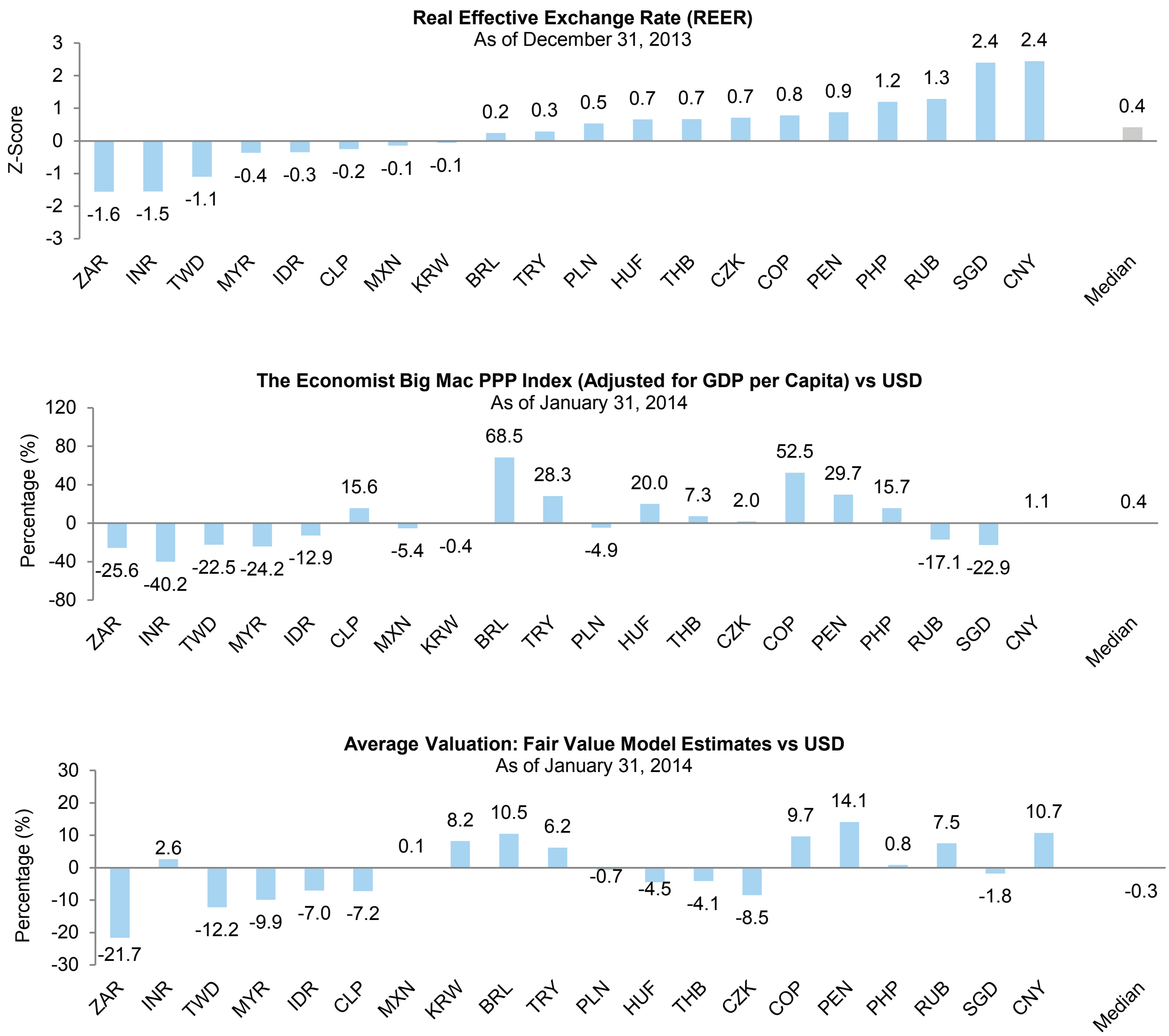
January 1, 2001 – January 31, 2014 • Rebased to 100 on December 31, 2000



EM Bear Markets	Implied EM Currency Decline vs U.S. Dollar
September 1994 – November 1995	-10.0
July 1997 – August 1998	-19.8
March 2000 – September 2001	-14.8
October 2007 – February 2009	-20.2
April 2011 – Current	-16.0

Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Figure 7. Emerging Markets Currency Valuations



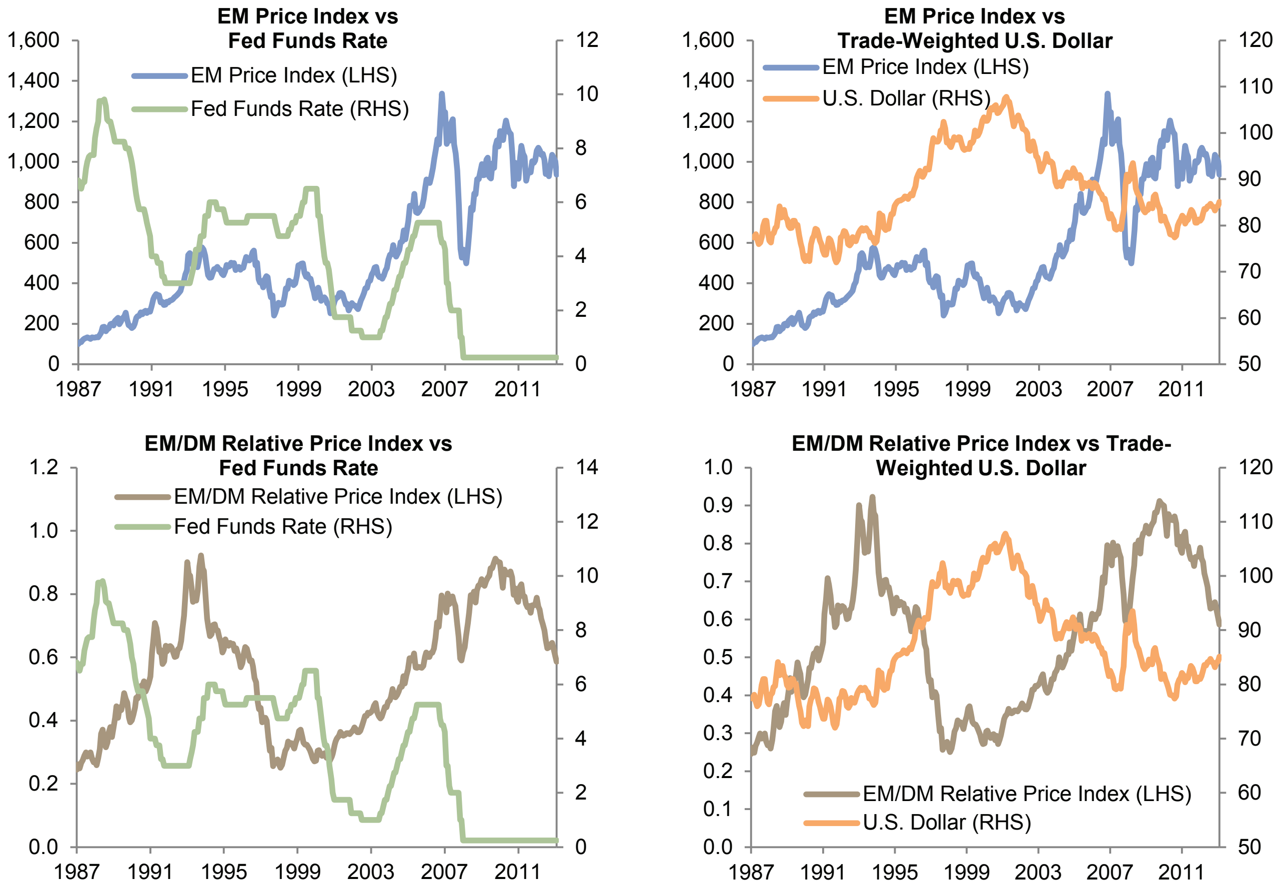
Sources: Bank of International Settlement (BIS), BofA Merrill Lynch, *The Economist*, and Goldman, Sachs & Co.
Notes: Real effective exchange rate (REER) is the trade-weighted basket of a country's currency relative to other currencies, adjusted for relative inflation levels. REER Z-scores are calculated based on BIS data for the post-1994 period. Z-score represents the number of standard deviations above or below the historical average valuation. Purchasing power parity (PPP)–implied exchange rates are based on relative price levels between countries, with the assumption that a basket of identical goods should cost the same across countries. For EM currencies, we adjust these PPP estimates by GDP-per-capita to reflect different consumption levels across countries. Fair value model estimates are derived from econometric models that take into account several variables such as PPP, interest rate differentials, fund flows, etc., to produce an equilibrium exchange rate. Fair value model estimate for each currency reflects a simple average of BofA Merrill Lynch and Goldman Sachs data. These fair value estimates differ from currency forecasts, as it is not always assumed that currencies revert to fair value over the forecast horizon.
3402 (mod)

in Latin American and EMEA currencies. Periods of rising U.S. rates and US$ strength do not always pose a problem for emerging markets, but US$ strength has tended to be the greater challenge (Figure 8). At a minimum, it is too soon to expect rising currencies to boost returns for unhedged foreign investors, in contrast to the tailwind undervalued currencies provided for EM assets a decade ago.

China Risk

Concerns over China continue to drive broader sentiment on emerging markets. Slowing Chinese growth and spiking interbank rates last June roiled markets, and rising rates and disappointing PMI figures also contributed to January's sell-off in EM assets. While a hard landing in China has global implications, it could also trigger a wider EM crisis and send fund flows back toward developed markets.

Figure 8. Impact of Fed Tightening and the U.S. Dollar on Emerging Markets Equities
December 31, 1987 – January 31, 2014



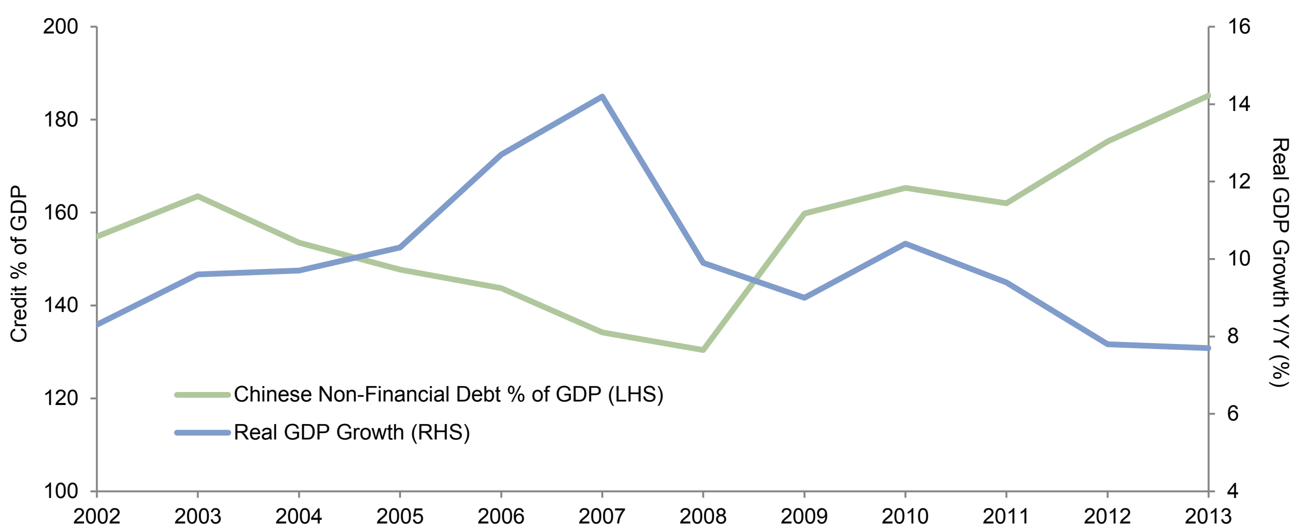
Sources: J.P. Morgan Securities, Inc., MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Emerging markets price index represented by the MSCI Emerging Markets Index in US$ terms. Developed markets price index represented by the MSCI World Index in US$ terms.

Rising debt levels are the key source of concern. China's investment-driven growth model of the past decade, especially the stimulus over 2009, has resulted in an accumulation of misallocated capital and potential bad debts in the financial system. A comprehensive audit released in January further highlighted the risks, with local government debts nearly tripling since the end of 2008.

Chinese authorities are well aware of the situation and are trying to achieve a gradual deleveraging of the system by reining in credit growth and rebalancing the economy away from investment and more toward consumption. This is the essence of the reform agenda announced last November, which seeks to help level the playing field between the private sector and state-owned enterprises (SOEs). Fiscal reform is also slated to rein in local governments whose overinvestment alongside local SOEs has driven up debt levels, while at the same time the central government will increase social spending to help boost consumption over time.

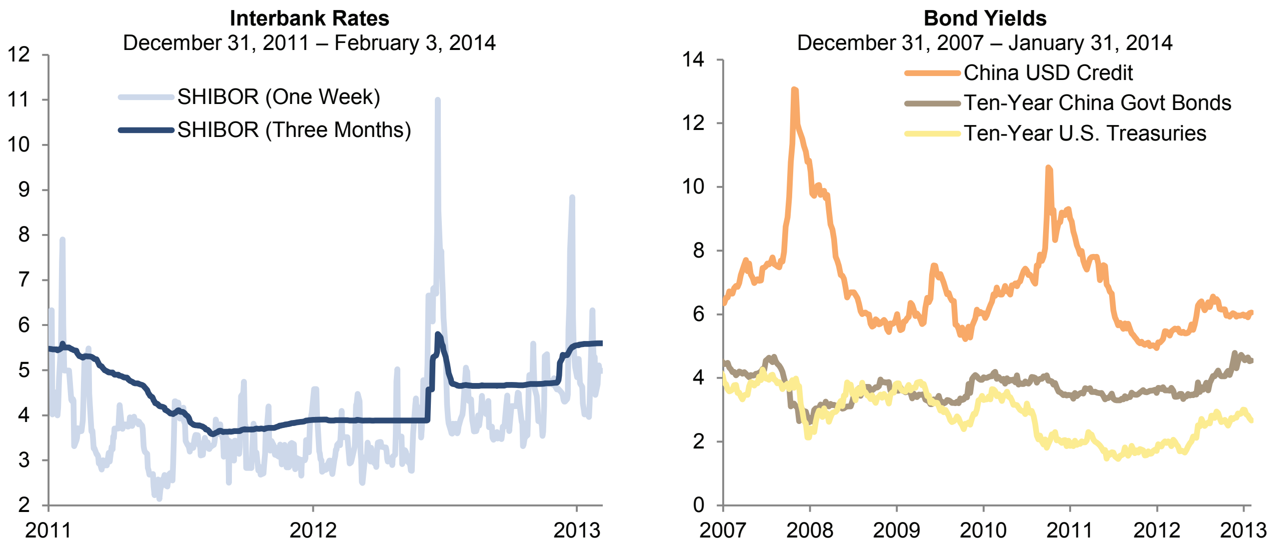
The authorities have continued to tighten credit following the modest relaxation last summer, with the People's Bank of China allowing interbank rates to rise, while bond yields in China have risen to five-year highs (Figures 9–10). At a reported 7.7%, Chinese growth in 2013 was similar to 2012 (but below consensus expectations of 8%+). The recent tightening and clampdown on "shadow banking" will likely weigh on growth over 2014, although consensus forecasts are for a gradual slowing toward 7.5%. Such a modest slowing in growth alone would not be sufficient to trigger a financial crisis in China, but the economy remains vulnerable to a sharper slowdown stemming from a too-abrupt tightening of domestic credit. This is especially the case if domestic investors move away from

Figure 9. China Credit as a % of GDP vs Year-Over-Year Real GDP Growth
2002–13



Sources: BofA Merrill Lynch, CEIC, and NBS.
Notes: Non-financial debt data include estimates of central government debt, local government debt, non-financial corporate debt, and household debt. Estimates of off–balance sheet shadow banking debt not included. Debt data for 2013 are through June 30.

Figure 10. China Interest Rates



Sources: J.P. Morgan Securities, People's Bank of China, and Thomson Reuters Datastream.
Notes: China USD credit is represented by the J.P. Morgan Asia Credit Index (JACI). Interbank rates data are daily while bond yields data are weekly.

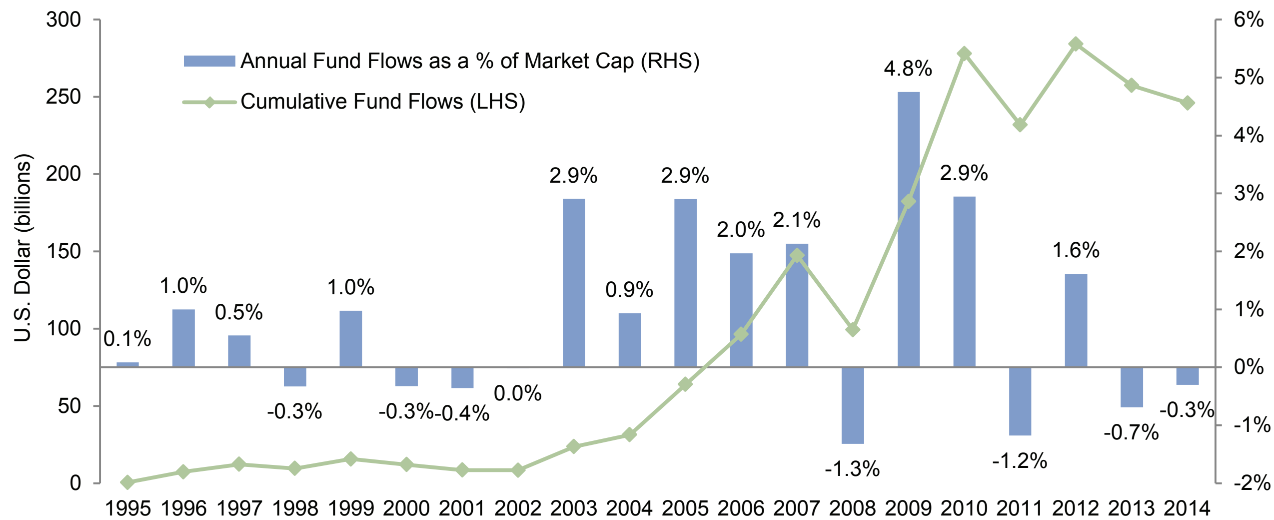
high-yielding shadow banking "wealth management products" amid rising defaults, a situation not dissimilar from U.S. subprime debt in 2007. At the same time, Fed tapering is unlikely to strongly impact China's financial system, given the closed capital account and current account surplus. However, both domestic and global tightening may weigh on growth more than the consensus expects.

The key point is that China must now deleverage by allowing credit to grow slower than GDP, which should keep investment demand weaker than much of the past decade. This will be a headwind for those sectors that benefited the most from China's infrastructure build out (i.e., materials, energy, and industrials), while uncertainty over Chinese financial sector risks will prevent a re-rating of Chinese financial stocks and other investment plays. A bold plan to deal with China's financial sector risks is needed and lifting this uncertainty will be a key market catalyst. Conversely, rising stress in China has the potential to send markets sharply lower, which may occur this year.

Investor Sentiment

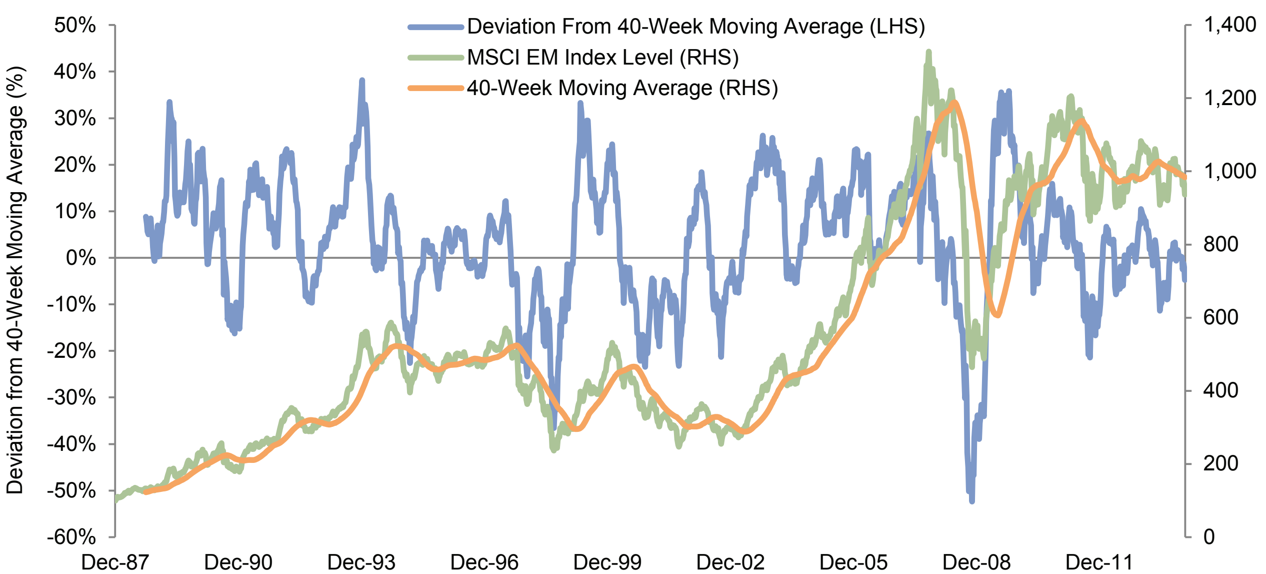
Given the above, investor sentiment clearly has room to deteriorate further. Mutual fund outflows have yet to reverse the net inflows from 2012 for both EM equities and debt, and have not reached levels that suggest a washout (Figure 11). The same goes for momentum—we have not yet seen the type of panic selling that pushes EM equities into very oversold territory (25%+ below their 200-day moving average) from which a rebound is more likely than not (Figure 12). In short, should macro concerns continue to escalate, EM equities have plenty of scope to get worse before they get better.

Figure 11. Net Annual and Cumulative Inflows into Emerging Markets Funds
1995–2014



Sources: EPFR Global and Morgan Stanley Research.
Notes: Fund flows cover all dedicated emerging markets equity funds. Data for 2014 are through January 31.
1865m (mod)

Figure 12. MSCI Emerging Markets Deviation from 40-Week Moving Average
December 31, 1987 – January 31, 2014 • U.S. Dollar



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

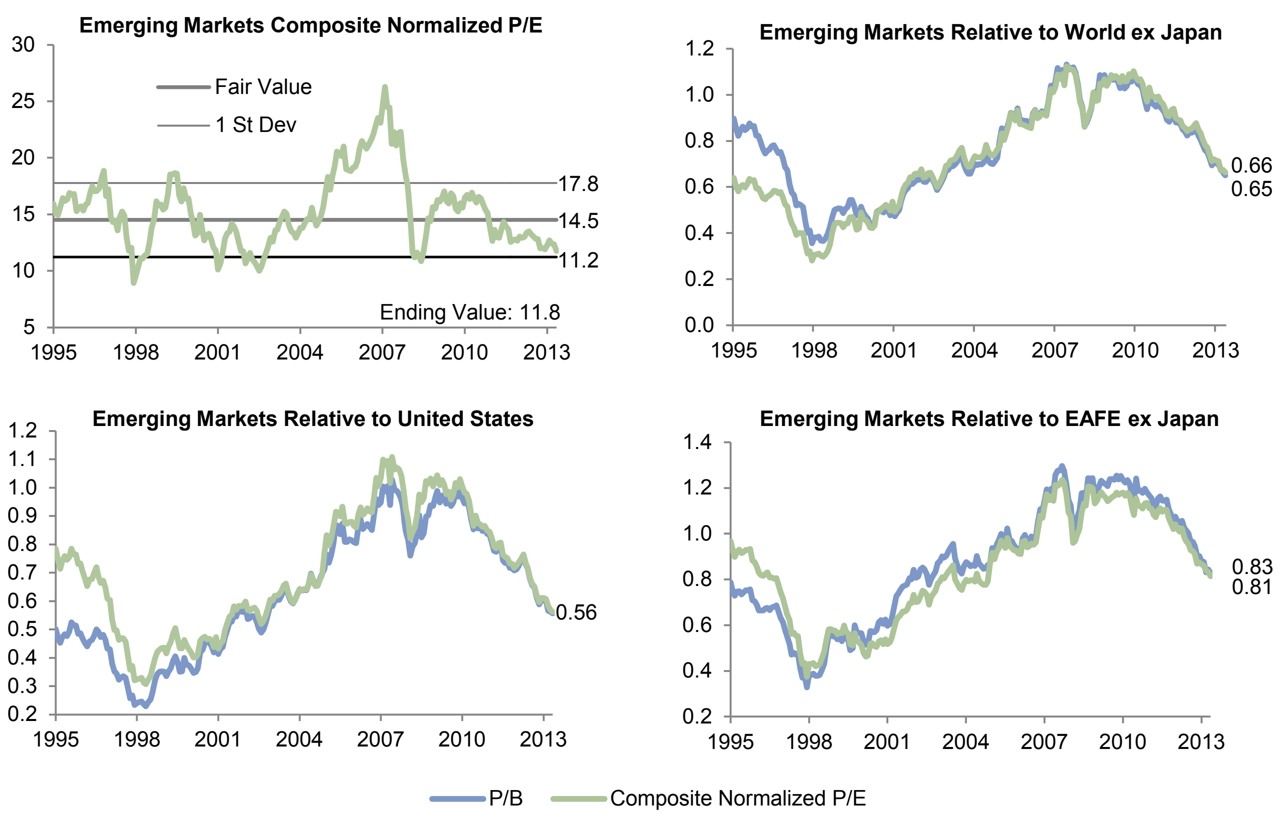
How Much Is Already in the Price?

If these risks are reasons to be cautious about EM equities in the near term, they are also increasingly reflected in the price, as three years of underperformance have left EM equities trading on low valuations. At the end of January, EM equities traded at a normalized price-earnings (P/E) multiple of 11.8, moving into our undervalued range during the month's decline. At the same time, relative valuations for EM equities versus DM equities seem even more compelling, trading at a 35% discount to DM equities as a whole, down from a 10% premium in late 2011. EM equities appear significantly cheaper versus U.S. equities, with a 45% discount, compared to only a 19% discount to non-U.S. equities (Figure 13). These discounts are wide compared to our assumed "fair value" discount of 10% for EM equities.[3]

[3] Based on ratio of our fair value P/E ratios of 16 for DM equities and 14.5 for EM equities.

Figure 13. Emerging Markets Valuations

September 30, 1995 – January 31, 2014



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied

Notes: The composite normalized price-earnings (P/E) ratio is calculated by dividing the inflation-adjusted index price by the simple average of three normalized earnings metrics: ten-year average real earnings (i.e., Shiller earnings), trend-line earnings, and return on equity–adjusted earnings. All data are monthly. CPI-U, CPI-G7, and emerging markets inflation data are as of December 31, 2013.

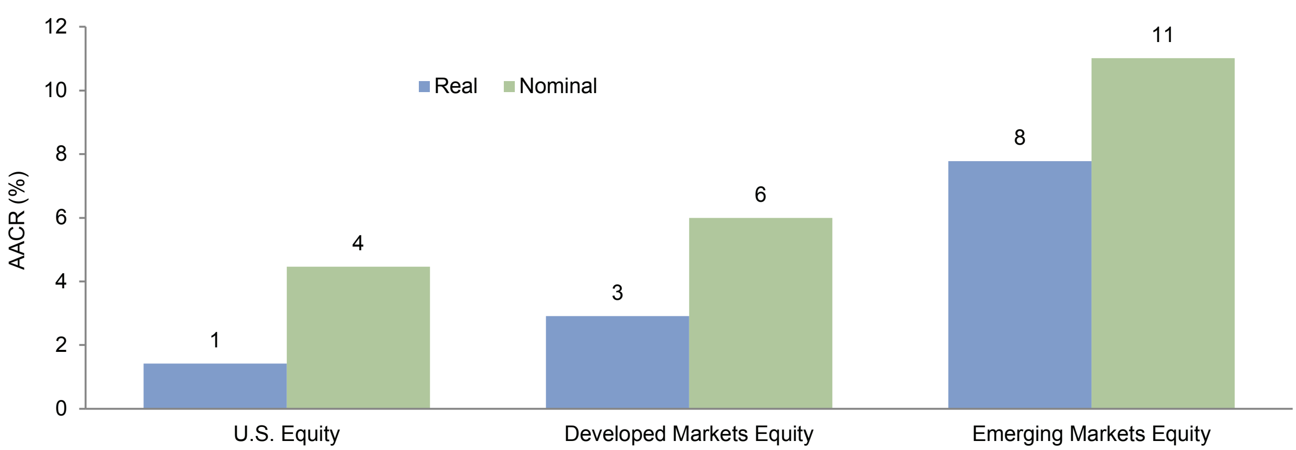
Over the long term, the discount embedded in EM equities should normalize, allowing investors to reap a sizable risk premium over developed markets. We currently estimate the risk premium to be roughly 6 ppts versus U.S. equities and 5 ppts versus DM equities annualized over the next ten years[4] (Figure 14).

However, we raise two important considerations. First, the cheapness in emerging markets is by no means uniform. Index valuations are well below average due to low valuations for the heavily weighted energy, financial, and materials sectors, while the rest of the EM universe appears fairly valued (Figure 15). Indeed, "defensive" sectors such as consumer staples and utilities appear expensive—especially the former, which until just recently traded at record levels. Still, nearly every EM sector today appears cheaper relative to its own history than does its DM counterpart, with the exception of health care, consumer staples and utilities.

Given their approximate 50% weight in the index, the outlook for the energy, financial, and materials sectors is key to EM index performance. These sectors (as well as industrials) are among those that outperformed over the previous cycle and are most vulnerable to a hard landing in China. These sectors also tend to be dominated by large SOEs, which face a host of governance issues that have resulted in poor management and disdain from foreign investors.

[4] Based on our Return to Normal return projection framework, which assumes valuations revert over a ten-year period given assumptions about earnings growth, dividend payout ratios, and inflation. This is not a forecast, but rather a reflection of what the return impact would be if mean reversion of valuations took place over ten years.

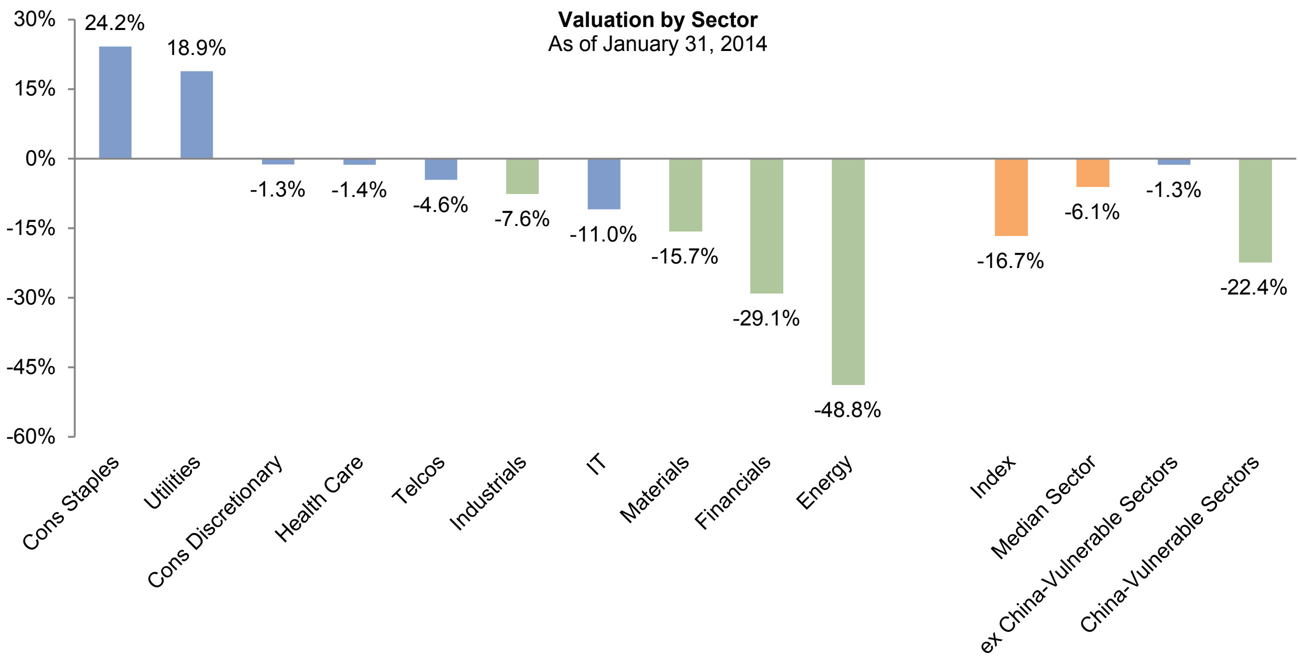
Figure 14. Ten-Year Real and Nominal Return Scenarios: "Return to Normal"
As of January 31, 2014

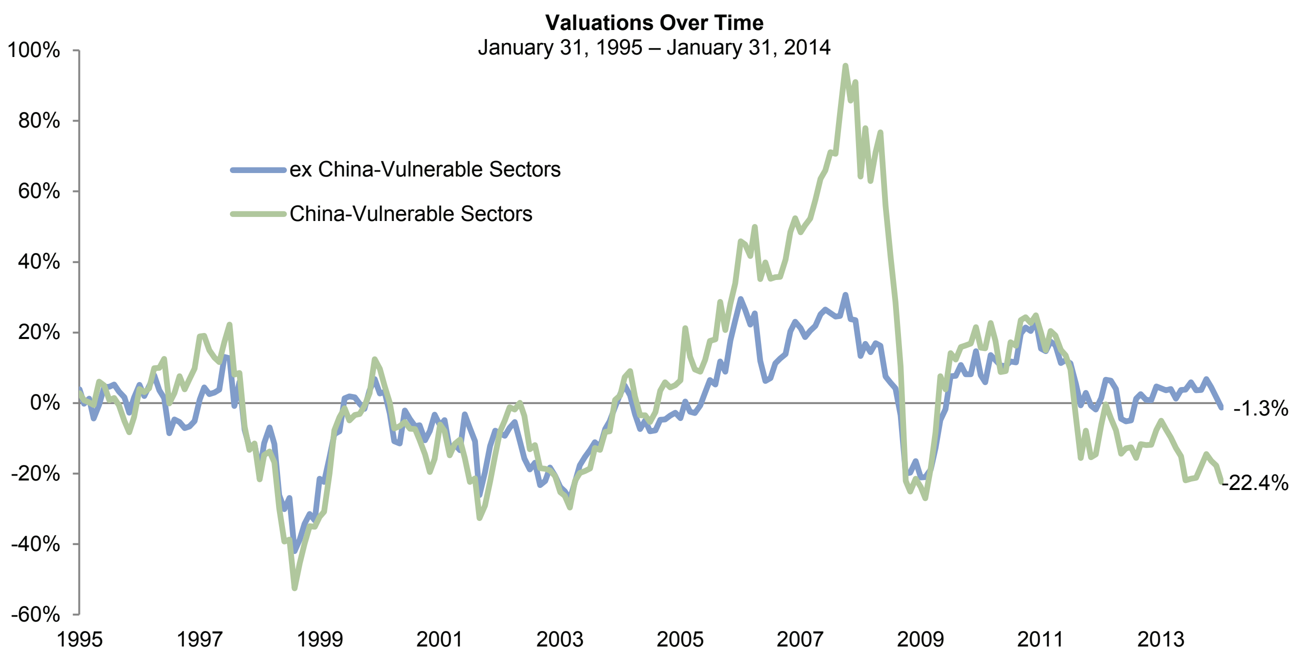


Assumptions: Inflation: 3%; Real EPS Growth: 2% for U.S. and Developed Markets, 3% for Emerging Markets

Sources: Barclays, Cambridge Associates LLC, Global Financial Data, Inc., MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Figure 15. Emerging Markets Sector Valuations
Percent Deviation from Median ROE-Adjusted P/E





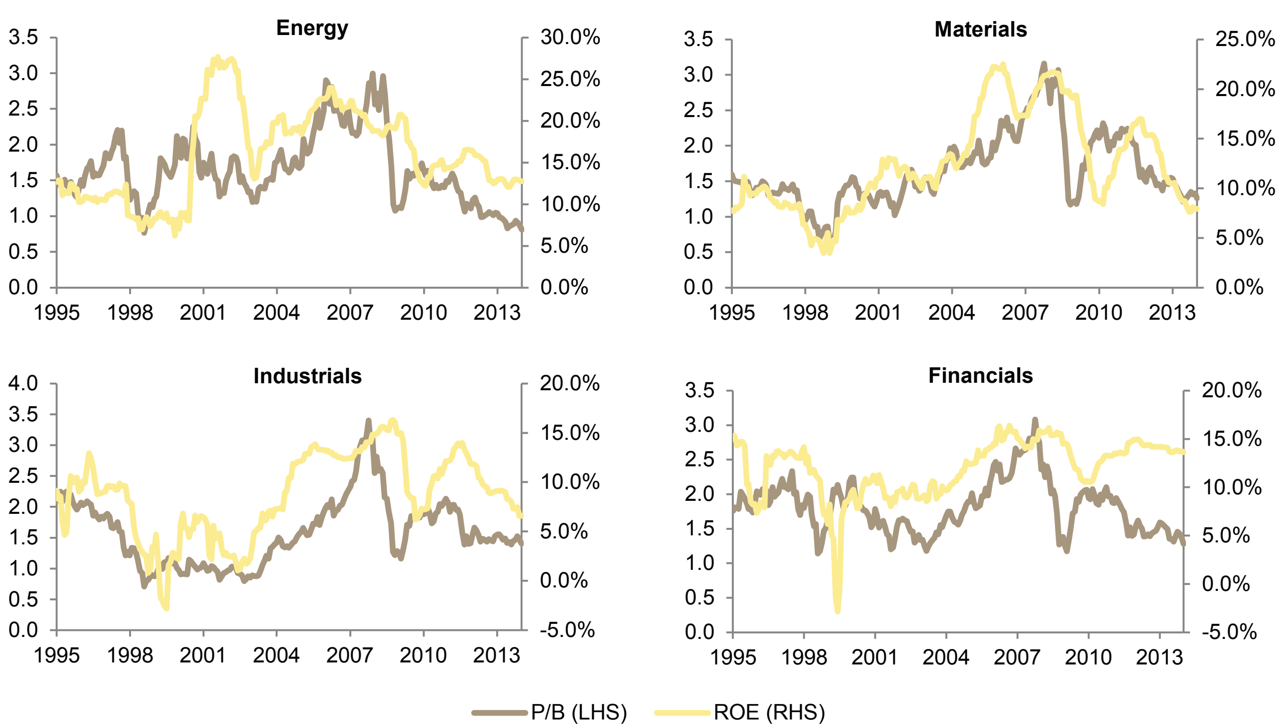
Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: China-vulnerable sectors include energy, financials, industrials, and materials. IT valuations based on post-2001 median to fully adjust for tech-bubble valuations. Chinese financials account for 30% of emerging markets financials.

Still, the low valuations for these sectors reflect falling return on equity (ROE), which for every sector save financials has reverted back to pre-boom (1995–2002) average levels (Figure 16). While financial ROE has not reverted, trough valuations (largely due to Chinese bank valuations) imply a substantial decline has been priced in. Thus, it could be argued that these four sectors have adjusted for the new reality of lower commodity prices and slower EM growth. However, a re-rating of these sectors seems unlikely absent rising profitability, which may require a sharp rise in commodity prices and EM credit growth, neither of which seems likely in the near term.

A second consideration is that EM valuations have room to head lower before turning around. January's normalized P/E of 11.8 remains above trough levels seen at previous market bottoms, such as 2001, early 2003, and 2008, when normalized P/E ratios fell below 11x. We estimate EM equities would need to fall at least 7% from end-of-January levels to reach near-trough valuations, though a 25% decline is needed for 1998-type valuations of 9. Relative valuations, while more compelling, are also above the deep discounts seen in 2001–02 that marked the bottom of the previous cycle. Thus, relative valuations could widen further amid investors pushing DM valuations higher, especially versus non-U.S. markets.

The widening of EM relative valuations also mirrors the decline in ROE since 2011, especially relative to U.S. ROE. The convergence

Figure 16. Return on Equity vs Price-to-Book for China-Vulnerable Sectors
January 31, 1995 – January 31, 2014



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied of EM and DM ROE, which allowed EM valuations to re-rate to premium levels over developed markets, was a key driver of the previous EM bull market. Lagging EM profitability will continue to hold back EM equities, especially if DM ROE remains steady or improves (Figure 17).

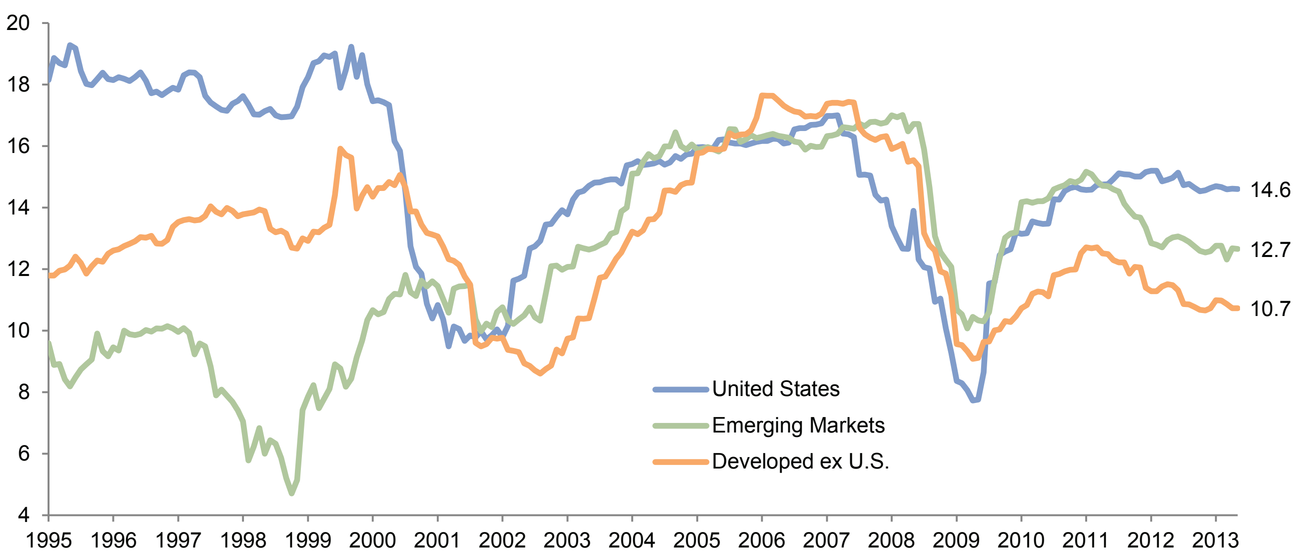
The main takeaway is that while EM equity valuations are low, they are not yet deeply depressed, especially given that most EM sectors are not particularly cheap, unlike previous market bottoms. To some extent, today's valuations make sense, as we have not yet had a true EM crisis or a global recession, which is usually the source of rock-bottom valuations. If anything, EM equities (and particularly China-vulnerable sectors) appear stuck in a netherworld of low valuations, but still weakening fundamentals.

How to Think About EM Equity Allocations

Given the rough seas ahead, investors should clarify expectations for the near, intermediate, and long term.

In the near term, markets are driven by momentum and sentiment, both of which have turned decidedly negative and imply further weakness for EM equities. Downside from today's levels of between 10% and 30% would be within historical norms and reflective of the asset class's typical volatility. Yet it is also possible that the events that trigger such a drawdown in EM equities could also lead to similar losses for DM equities, allowing EM equities to outperform on the downside. Such was the case in 2001 and 2002. U.S. equities are particularly at risk from a disappointing economic recovery. At the same time, should current negativity be misplaced (if the global

Figure 17. Return on Equity for Emerging Markets and Developed Markets
September 30, 1995 – January 31, 2014



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Developed ex U.S. represents the MSCI EAFE ex Japan Index.

economy accelerates and China avoids a crisis), EM equities could snap back sharply. Another outcome could be a combination of a sharp panic sell-off immediately followed by an equally powerful rally and EM outperformance. Anything is possible in the short term, which is why investors must remain calm and not overreact.

The intermediate term will largely be dictated by relative trends in profitability, which will need to stabilize and improve in EM's favor. While buying EM equities at their crisis lows in 1998 was a profitable move, allowing investors to capture a sharp rebound in 1999, sustained EM outperformance had to wait until 2003 as the global economy and EM profits began to recover.

While the near term is *always* uncertain, the long term is easier to grapple with. Valuations make a clear and compelling case for eventual EM outperformance versus developed markets, and especially U.S. equities. But to reap eventual valuation reversion, investors must be able to tolerate further volatility.

Bottom line: Lower your expectations for EM equities in the near term, prepare for potentially sharp drawdowns, understand how much downside risk is acceptable, and adjust exposures accordingly. However, do not decrease exposure after markets tumble and valuations become depressed. Long-term investors should maintain modest overweights and be willing to rebalance or increase exposure on any meaningful decline.

Implementation: Putting It All Together

Today we think a more nuanced approach to EM allocations is needed, as the past decade saw a broad-based boom across nearly all emerging economies and sectors (see "Practitioners' Perspectives on Implementation" on the following page for two views on EM implementation strategies today). Going forward, we expect increasing EM divergence—if the previous EM cycle was driven by the integration of China into the global economy and the resultant commodity boom, China's economic rebalancing will create a different dynamic and smaller themes across emerging markets.

In thinking about how to adjust EM allocations for the current environment, we found it helpful to group various implementation options and themes. The following list provides a range of reasonable implementation options, depending on investors' outlooks.

- **Defensive EM.** Strategies such as EM minimum volatility and quality-biased products, managers that consider country risk as part of their investment process, and open-mandate EM equity/EM debt blend funds have the ability to lower downside risk, but sacrifice upside. EM long/short hedge funds[5] would also be included here. However, investors should be aware that quality and minimum volatility strategies in particular have outperformed and are relatively expensive today, suggesting they may be less defensive going forward.

[5] While long/short hedge fund strategies should be expected to dampen risk relative to that of emerging markets broadly, they should not be expected to reduce risk as much as long/short managers operating in developed markets given both the higher volatility of emerging markets and the relatively limited ability to hedge out equity risk.

- **EM Recovery.** Aside from pure passive implementation, value managers would benefit most from an EM recovery and rotation from safety.
- **DM Recovery.** Managers positioned in EM stocks that would benefit from a recovery in DM demand and lower commodity prices. This would largely favor Asian equities at the expense of Latin America.
- **Domestic Demand/Consumer Theme.**
  - Benchmark-agnostic managers that invest in domestic demand–driven stocks across various segments including DM-listed companies, frontier markets/smaller EM countries, and EM small-caps.
  - Private equity investments in frontier/smaller EM countries that focus on opportunities underrepresented in increasingly expensive public markets.
- **China Opening Theme.** Opening of the domestic A-share market provides differentiated China exposure. We prefer active management given the top-heavy market. This is a long-term theme as A-share products have liquidity restrictions and a limited (but growing) universe of institutional-quality managers. Private equity opportunities in Chinese consumer and restructuring themes are also of long-term interest.
- **EM Crisis.**
  - Macro hedge fund managers and strategies that would benefit from stress in EM financial markets such as a Chinese hard landing. Such managers would help to offset increased cyclical exposure via value tilts to EM equities.
  - EM-focused private equity managers that will be disciplined in investing over any potential economic downturn to reap the benefit of the eventual recovery.
  - Distressed credit funds given the potential for various "special situations" across emerging markets and especially Asia as corporates will be forced to refinance amid a rising rate and slower growth environment.

Two Practitioners' Perspectives on Implementation

Investors that adopted a strategic overweight to emerging markets over the past ten years have been handsomely rewarded, at least in terms of equity market beta. EM equities outperformed DM equities by nearly 500 bps annualized in local currency terms. In the more recent past, this position has proved more uncomfortable; to make good decisions from here, investors need to be absolutely clear what they are trying to achieve and the beliefs underpinning the strategy.

For me there are two plausible rationales for a strategic overweight to emerging stock markets: to benefit from increased domestic wealth, income, and consumption in emerging countries or to earn a premium for accepting the additional risks (volatility, transparency, etc.). I am sympathetic to both, but no investment idea is so good that what you pay for it doesn't matter—a belief that drives the way I build EM portfolios today.

Taking the "domestic consumption" rationale first, I believe this is really a sector or stock selection strategy rather than a geographic theme. Once you explore the sources of revenue for individual stocks in a manager's portfolio, it becomes clear that exposure to the EM consumer may appear in stocks listed in any part of the world. It tends to feature strongly among large "branded" consumer goods companies, wherever listed. If I felt this was an attractive strategy today I would question each equity manager in my portfolios, asking for their estimate of geographic revenue breakdown across the stocks they own. Their answers would illuminate how much fundamental research they've done and would enable me to ensure an EM consumer bias holistically across the portfolio.

The fact, however, is that I am not doing this today. Whether applied to developed or emerging stocks, the EM consumer theme has been fashionable and is dearly priced. As Figure 15 illustrates, the consumer staples sector is by far the most expensive area within emerging markets. However, DM consumer staples underperformed in 2013 and their valuations no longer stand out, either on a relative basis or against their own history. Faced with this situation, investors looking to benefit from the "EM Consumer" might do better to look in developed markets for managers who place an emphasis on benefiting from EM consumption, even if this means moving underweight a geographic EM target based on domicile/listing.

My second rationale—earning an emerging stock market risk premium—looks more promising. A risk premium is only another way of describing a valuation discount, and as this paper makes clear, emerging stock markets on average are trading at a valuation discount to both their own history and to developed markets. The valuation case applies to index exposure, not necessarily to every EM active strategy, particularly the consumer-oriented growth or high-quality approaches. For EM exposure today, I search out active strategies that have a sensible business quality screen but whose primary characteristic is valuation sensitivity. Index exposure is a respectable second alternative where manager availability is lacking. Alternatively, I am quite content to gain a significant portion of EM exposure via Asia ex Japan mandates. These allow a wider choice of managers, are highly correlated to global emerging markets, and reduce any unintended sensitivity to natural resources prices, which I may have deliberate exposure to elsewhere. Since I am more concerned about deflation than inflation today, I don't want to double up on resource exposure.

But even with the ideal manager structure, timing is still important. While EM stocks look relatively cheap, it seems increasingly likely that we are entering a classic EM liquidity crisis—not as bad as 1997–98, because few EM currencies are now pegged, but nevertheless enough to take markets some way below today's level during 2014. EM equities are cheap enough to support a small overweight position relative to developed markets, but I am holding off for now on adding to positions. Emerging markets may be setting themselves up for significant longer-term outperformance, but in the shorter term things look likely to get worse before they get better.

—Simon Hallett

The most often cited rationale for investing in emerging markets is a desire for exposure to the growing domestic consumption story—yet consumer stocks in these markets are by far the most expensive today.

Unlike macro guesswork, hopes for consumer growth, GDP growth, or views on the political backdrop—which should certainly be data points to consider—I weigh valuations and mean reversion most heavily in my investment process. Value-based investing is often tested in the short term, but successful long-term investors know the importance of patience and buying cheap assets in providing a margin of safety on the downside and outsized return potential on the upside.

Today, the consumer story is well known. EM consumer sectors trade at a significant premium to historical averages and more so relative to cyclical sectors in that market. Many of our clients increased portfolio exposure to the consumer story when valuations were attractive and have benefitted from this approach.

Some of the most well-regarded EM active managers in C|A client portfolios were positioned to benefit from a growing consumer base and remain positioned in these relatively expensive stocks.

Looking at a list of well-regarded EM managers in C|A's universe, the average allocation of their funds points to overweight positioning in the expensive sectors of the market (consumer discretionary, consumer staples, health care, and utilities), while the more cyclical and currently undervalued sectors save financials (energy, IT, and materials) are underweight. Finding alpha-generating managers is a difficult task, so investors should think carefully before exiting such funds despite any current biases in portfolios. Nonetheless, significant trimming of managers with overvalued portfolios is always a reasonable practice.

The tables on the next page provide a snapshot of manager average allocations compared to market indices.

Table 1. Allocations to Undervalued Sectors

	% of MSCI EM Index	% of EM Funds
Financials	27.0	24.1
IT	15.1	13.6
Energy	11.9	9.6
Materials	9.8	8.1
Total	**63.8**	**55.4**

Table 2. Allocations to Overvalued Sectors

	% of MSCI EM Index	% of EM Funds
Cons Disc	8.8	11.5
Cons Staples	8.8	11.0
Utilities	3.2	3.5
Health Care	1.6	3.2
Total	**22.4**	**29.2**

Investors should review EM allocations closely—look under the hood and assess manager biases—and consider these through a valuation framework. Some adjustments are likely warranted. In certain instances a simple tilt toward index exposure through a low-cost index fund may be enough to bring the allocation into a more reasonable valuation position. For those seeking a decidedly more value-oriented allocation, which I would argue is defensible today, some value-oriented active strategies are worth considering, but note that value exposure in emerging markets should be expected to increase volatility. Therefore, dedicated EM value mandates will require close monitoring and strict rebalancing to lock in profits when markets turn in favor of those undervalued cyclical sectors. Similarly, a strong will to add to these value strategies should markets test this positioning in the near term will be required to win over the medium- to long-term. Investors must assess their willingness to be contrarian and long-term oriented before taking on deep-value exposure in emerging markets.

A separate point to consider is that index exposure is cheap to implement, and valuations are attractive in absolute and relative terms. "Tapering" uncertainty is high today and active managers may prove advantageous in the near term; however, should emerging markets draw down further, cheap beta exposure will undoubtedly be a desirable trade, even for those with significant active exposure in this portfolio allocation.

For portfolios currently at target or slightly overweight to policy targets in emerging markets, and where further exposure may be desirable, a global or global ex U.S. manager with a proven record of buying direct EM exposure is a reasonable approach. The ability for this additional exposure to "swing" toward emerging markets could accent existing dedicated exposure while freeing investment committees and/or private clients from making the call to overweight to the region further.

A word on frontier markets is required. Unlike the disappointing EM returns this year, frontier markets have been a winner. Flows into Africa and other frontier markets have been significant. I continue to recommend active managers for this mandate, specifically those with an ability to toggle allocations between emerging and frontier markets. Anecdotally, we do see managers with an ability to trade in both markets now tilting to emerging markets as they report seeing more value there following the significant run-up in frontier markets. I believe emerging markets provide a valuation opportunity today that trumps frontier markets, despite comparable valuations in aggregate. When the more favorable liquidity and lower cost of trading in emerging markets is considered, the case becomes even clearer. For those with a truly long-term horizon, allocations to frontier markets still make sense, but they are less attractive versus emerging markets at this juncture.

—Francisco Aguirre

What Is Your Rationale?

In assessing these themes, investors also need to keep in mind their strategic rationale for EM equity allocations. There are two common reasons given to support strategic EM equity allocations. The first is to earn a risk premium over DM equities over the long run in exchange for higher risks. This idea has merit, particularly when equities are attractively priced, as they are today.

A second reason for EM allocations is to capture the "EM growth story" driven by rising domestic demand and consumption in emerging economies. While there is a long-term case to be made for the continued growth and importance of emerging markets in the global economy (even if growth is slowing), EM equities (and especially the current composition of the EM index) are not the only or most effective way to benefit from EM economic growth.

If focused on the EM risk premium rationale, allocations should include index exposures and value managers, which today seem cheap. Incorporating active managers could also involve using a barbell approach that balances defensive-quality and country risk–focused managers with high-conviction "satellite" value-oriented managers. Investors can then rebalance between the two tilts as market conditions dictate. However, keep in mind that value managers can be even more volatile than the broad market, so be prepared to rebalance more frequently.

For exposure to the "EM growth story," implementation should be much more holistic and diversified in nature.[6] Such allocations should look quite different from the benchmark, and include exposures to the domestic demand/consumption theme, with tilts to small- to mid-cap and frontier markets equities, as well as private equity exposures to better narrow the gap between equity markets and economic growth. Increased exposure to China (both public and private) may be needed given China's underrepresentation in the cap-weighted benchmarks.[7] However, such allocations cannot be valuation insensitive, and we suggest adjusting allocations and exposures to different themes to take valuations into account. For example, some consumer-related equities are expensive today, especially in China, while rising interest rates in emerging economies may also pose a headwind for consumer spending. Furthermore, EM small caps and frontier equities are expensive relative to large-cap EM equities, although they are fairly valued today in absolute terms. Thus, we would be more inclined to increase exposure on additional weakness, but are not overly concerned about price risk.

Active Versus Passive?

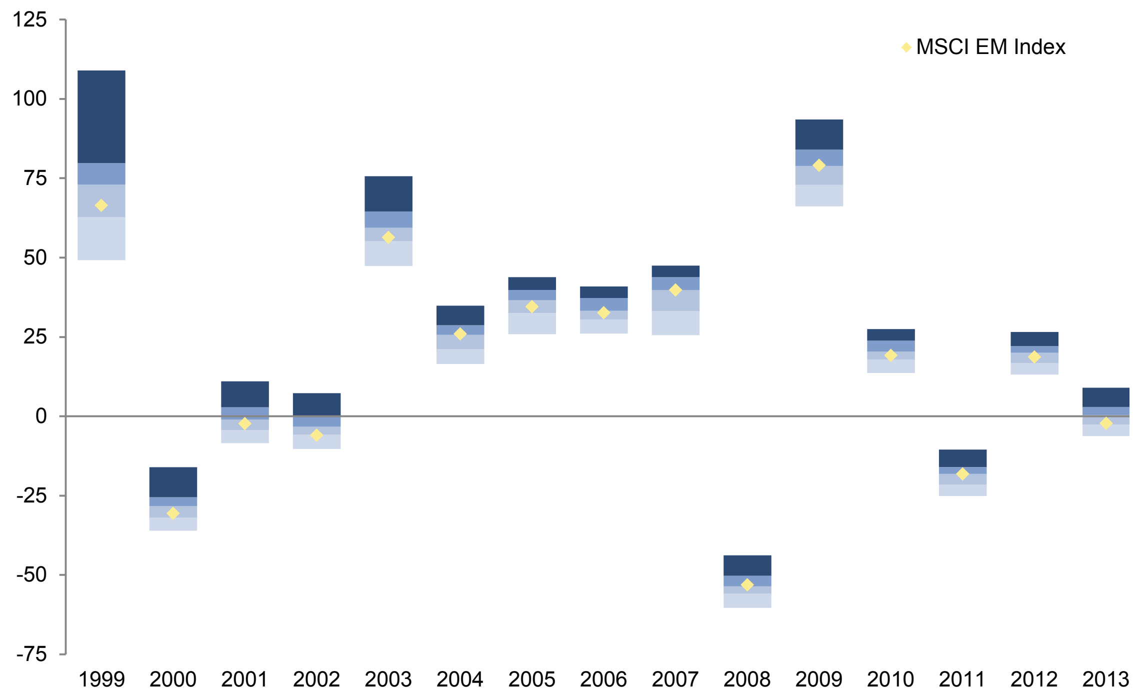
Many of these strategies require active management for implementation, which raises the question of whether this is a good time for active management in EM equities. In an environment that sees widespread divergence in performance across countries and sectors, active managers have more opportunity to outperform. Indeed, our data show that top-quartile managers have tended to outperform the index by a wider margin during years in which stock dispersion is wide.

However, we would be remiss to suggest that active management is simple. Just as dispersion helps good managers, it also offers less skilled managers the opportunity to underperform more severely, so manager selection is critical (Figures 18–19). Further, while top performers

[6] Please see our 2011 report *The Case for Diversified Emerging Markets Exposure*.

[7] Investors should be mindful of potential concentration given that China is already roughly 20% of the MSCI Emerging Markets Index. Including China A-shares would effectively double China's weight, bringing it more in line with the size of its economy.

Figure 18. Emerging Markets Equity Manager Calendar Year Returns by Quartiles
As of Fourth Quarter 2013



	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
5th Percentile	109.0	-16.0	11.0	7.3	75.6	34.8	43.9	40.9	47.5	-43.8	93.5	27.5	-10.5	26.6	9.0
25th Percentile	79.8	-25.5	2.9	0.1	64.5	28.7	39.8	37.3	43.9	-50.3	84.0	23.8	-16.1	22.1	2.9
Gross Median	73.1	-28.4	-1.1	-3.3	59.3	25.7	36.6	33.2	39.8	-53.6	78.8	20.4	-18.2	20.0	0.4
55th Percentile	71.6	-28.9	-1.6	-3.9	57.9	24.6	36.0	32.7	39.0	-54.1	77.9	20.0	-18.8	19.6	-0.5
75th Percentile	62.8	-32.0	-4.3	-5.8	55.1	21.1	32.5	30.5	33.1	-55.8	72.9	17.9	-21.6	16.8	-2.6
95th Percentile	49.2	-36.0	-8.5	-10.3	47.3	16.5	25.9	26.0	25.6	-60.4	66.1	13.6	-25.1	13.1	-6.2
MSCI EM Index	66.4	-30.6	-2.4	-6.0	56.3	26.0	34.5	32.6	39.8	-53.2	79.0	19.2	-18.2	18.6	-2.3
No. of Managers	*54*	*60*	*62*	*61*	*64*	*66*	*67*	*72*	*82*	*91*	*100*	*106*	*116*	*126*	*104*
Mean	73.3	-28.8	-0.7	-3.6	59.4	24.7	34.8	32.7	37.9	-53.7	77.4	19.7	-19.0	18.7	0.1
AUM-Weighted Mean	75.9	-31.3	-2.8	-5.6	58.7	25.8	35.3	32.3	38.2	-53.1	79.0	20.7	-17.9	19.8	-0.3
No. of Managers	*46*	*56*	*55*	*56*	*62*	*61*	*64*	*71*	*78*	*88*	*96*	*103*	*110*	*119*	*62*

Spread Between Percentiles and Index (Net)

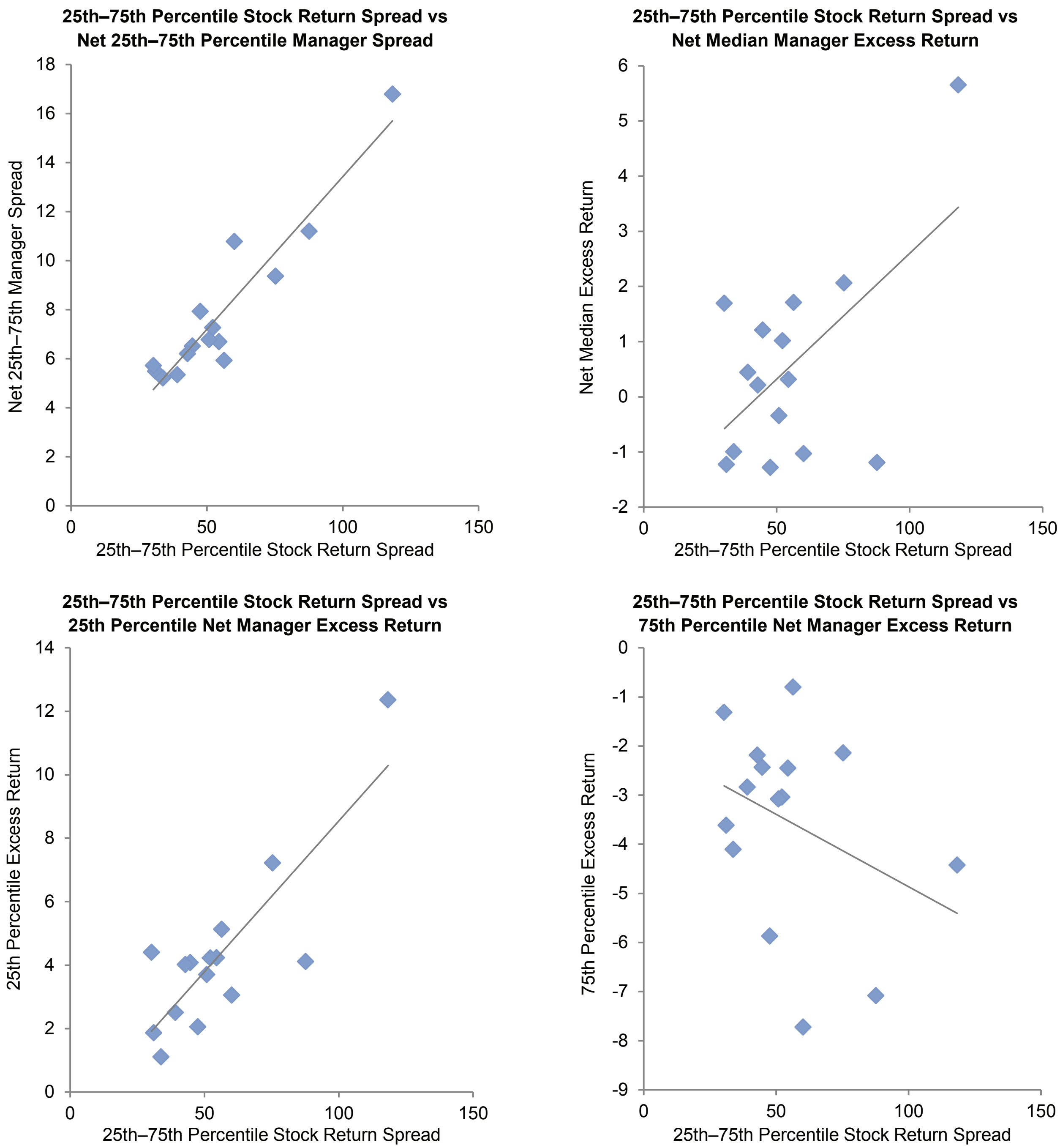
25th - MSCI EM	12.4	4.1	4.2	5.1	7.2	2.1	4.2	3.7	3.1	1.9	4.1	4.0	1.1	2.5	4.4
Median - MSCI EM	5.7	1.2	0.3	1.7	2.1	-1.3	1.0	-0.4	-1.0	-1.2	-1.2	0.2	-1.0	0.4	1.7
55th - MSCI EM	4.3	0.7	-0.3	1.1	0.6	-2.4	0.4	-0.9	-1.8	-1.7	-2.1	-0.2	-1.6	0.2	1.0
75th - MSCI EM	-4.4	-2.4	-2.4	-0.8	-2.1	-5.9	-3.0	-3.1	-7.7	-3.6	-7.1	-2.2	-4.1	-2.8	-1.3

Sources: Cambridge Associates LLC, MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Cambridge Associates LLC's (CA) manager universe statistics are derived from CA's proprietary Investment Manager Database. Performance is generally reported gross of investment management fees. Managers that do not report in U.S. dollars, exclude cash reserves from reported total returns, and have less than $50 million in product assets (for 1998 to the present) are excluded. Returns for inactive (discontinued) managers are included if performance is available for the entire period measured. Net figures were calculated using an annual fee of 1.00%.

Figure 19. Relationship Between Emerging Markets Stock Return Divergence and Manager Performance

1999–2013 • U.S. Dollar



Sources: Cambridge Associates LLC, FactSet Research Systems, MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

persistently outperform the index by increasing margins during years in which EM stock return dispersion is high, the managers in the top ranks rotate with some regularity. Analysis looking at the top quintile of EM managers in our database from 2004–08 finds that nearly 30% remained in the top quintile, while 43% went to the middle quintile. None fell to the bottom. Similarly, of the top quintile performers during 2009–13, other than the 30% that remained in the top quintile from the prior period, an equivalent amount came from the bottom quintile and the remainder from the second quintile. In short, dispersion is good for the best active managers, but the top-performing active managers also shift over time.

Hedge Currencies?

Should investors hedge EM currency exposures? While hedging EM currencies would help reduce volatility, it is unfortunately quite costly in terms of negative carry and transactions costs. The recent spike in volatility has also made options strategies too costly to implement. Given the 15%+ fall in EM currencies already, the benefit of hedging the potential remaining downside might be modest compared to the costs. In other words, it might be too late to hedge. Investors in EM equities must inherently accept currency risk (and can also benefit from any potential rebound in currencies going forward). Those particularly concerned about FX risk may want to simply reduce EM exposures or tilt portfolios toward Asian equities (including Hong Kong and Singapore), given the solid fundamentals of most Asian currencies. However, this will reduce, not eliminate, FX volatility.

Sizing Allocations

Given risk of further underperformance, as discussed above, investors should consider their exposure to emerging markets today when sizing positions.

While we are confident that emerging markets will outperform over the long term given today's valuations, such mean reversion may not be likely in the near term. Thus, we feel investors should seek to maintain allocations, or build only modest overweight positions today. We would seek to build more meaningful overweights on further weakness that brings EM equities to more depressed and oversold conditions.

EM equities currently account for roughly 10% of the MSCI All Country World Index, which reflects depressed EM valuations. Investors with allocations to EM equities within their traditional long-only equity allocations that are comparable to or smaller than their weight in global benchmarks should consider modest overweight positions of roughly 2 ppts to 4 ppts, preferably funding overweights from a reduction in U.S. equities.

For those with very large strategic allocations to emerging markets (e.g., 30% of public equity exposure, or perhaps 10%+ of the total portfolio), we would be more cautious. Such positions already reflect a meaningful overweight relative to indices. While emerging markets are relatively cheap, they are also more vulnerable and volatile than developed markets. We recommend investors with such large strategic EM allocations remain at these strategic weights at this juncture and shift to a more barbell approach discussed earlier, integrating defensive quality and country-risk focused managers with high-conviction "satellite" value-oriented managers.

Why not underweight EM allocations today? This would certainly be a reasonable course of action for investors with a short time horizon or low risk tolerance. However, as we have discussed, anything can happen in the short term, while in the longer term valuations are a reasonable guide to future performance and justify modest overweights today. For investors that cannot tolerate the potential downside, a reduction may be prudent, particularly for those with the ability to quickly adjust portfolios and the willingness to subsequently increase exposures should markets reach more depressed and oversold levels. Market timing is always easier said than done, and most investors are better served riding through the storm, as fast-moving markets may whipsaw investors that may find it very difficult to increase exposures amid stressed conditions in emerging markets.

Conclusion

EM equities have been under pressure and face risks on multiple fronts. After three years of underperformance relative to DM equities, these risks are also increasingly reflected in valuations. While EM equities should outperform DM equities as valuations ultimately mean revert, the timing of such reversion is uncertain (as is always the case) and investors need to lower their expectations for returns in the near term.

We believe that the burden of proof for ignoring valuations is high. Rewards from valuation mean reversion could be substantial. Investors should consider their ability to tolerate additional risk inherent in an overweight position in the context of the size of their strategic allocations. In general, we believe those with policy target allocations sized comparably to index market-cap weights should have small overweight positions. Those with very large strategic overweights should stand pat provided they have the ability to tolerate downside risk in the near term. All investors should keep in mind that the best time to overweight any equities is when they are at depressed valuations in oversold conditions. Should EM equities suffer further meaningful declines that take them back to the depressed absolute and relative valuations of the 2001–02 period, we would ramp up overweights more significantly. A crisis in China is the most likely trigger.

Finally, given that the approach to EM equity allocations should be consistent with the strategic rationale for investing, a review of implementation should be a priority, particularly since valuations and fundamentals have diverged across sectors and countries.

In sum, most investors should maintain modest overweights and invest for the long term, prepare for the worst, understand why they are in the asset class, and be willing to increase exposure on meaningful declines. ■