Emerging thoughts

Investing in emerging markets: Myths, opportunities and misconceptions

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Key points

- Emerging markets (EM) form a wide and diverse investment universe. They play an extremely important part in the global economy but remain relatively under-represented in financial markets.
- Investing in EM requires understanding certain biases. For example, China represents 34% of the EM equity universe but only 2.5% of the hard currency debt index, while 54% of the EM hard currency debt index is now in investment grade territory.
- Correctly analysing the macroeconomic and political risks in emerging markets is an important part of the investment process. But bottom-up selectivity matters.
- Responsible investing – taking into account environmental, social and governance issues – still has a long way to go in emerging markets. Yet there is an interesting opportunity for active investors engaged in dialogue with corporates and governments alike.

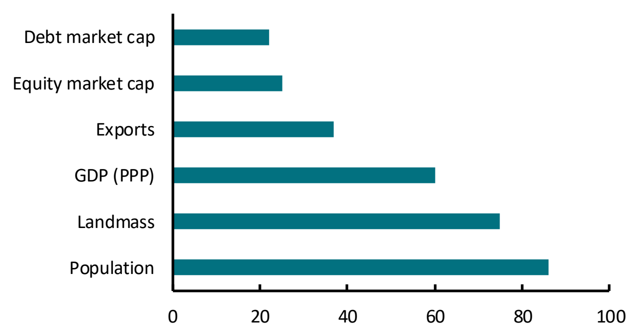
Why are emerging markets important?

Emerging markets (EM) encompass a significant part of the world. In simple terms, any country that does not fit into the definition of "advanced" or "developed market" economies (DM) can fall into the EM category. At present, the International Monetary Fund (IMF) classifies 155 countries as emerging and developing economies and 39 countries as advanced economies.

And yet there is no fixed definition of an emerging market per se. Coined by World Bank economist Antoine van Agtmael at an investment conference in 1981, the expression was used to replace what used to be referred to as "the third world" – which was certainly not an encouraging description for potential investors.

In order to classify the world in these EM/DM buckets, the IMF uses criteria such as per capita income level, export diversification and the degree of integration into the global financial system. These criteria can evolve over time. Significant changes can warrant a reclassification from EM to DM, as has been the case with some Eastern European countries that have recently joined the euro area.

Exhibit 1: Emerging markets in the global context



Source: IMF, Bureau of International Settlements (BIS), MSCI and AXA IM Macro Research, as of 2019

But this still leaves a wide EM universe with huge variation of features and inevitably the 'average' becomes meaningless.

The EM universe has evolved greatly over the past 20 years, increasingly growing into a powerful world economic engine. Emerging markets encompass 60% of world GDP (in purchasing parity terms), 37% of world exports, 86% of the total population and 75% of world's land mass (Exhibit 1). However, while their financial markets are quickly growing, they are still under-represented in the broader economy. Emerging markets make up less than 22% of global outstanding bonds[1] and 25% of world equity capitalisation[2].

Investing in emerging markets: History, investor perception and performance realities

Emerging markets arguably took off as an investable asset class in the last two decades (Exhibit 2). But the roots of investing in EM can be seen to date back to the early 17th century – the Dutch East India Company, founded in 1602, was probably the world's first formally-listed corporation to issue shares and bonds to the general public. It could also be viewed as the first modern multinational to be active across developing markets.

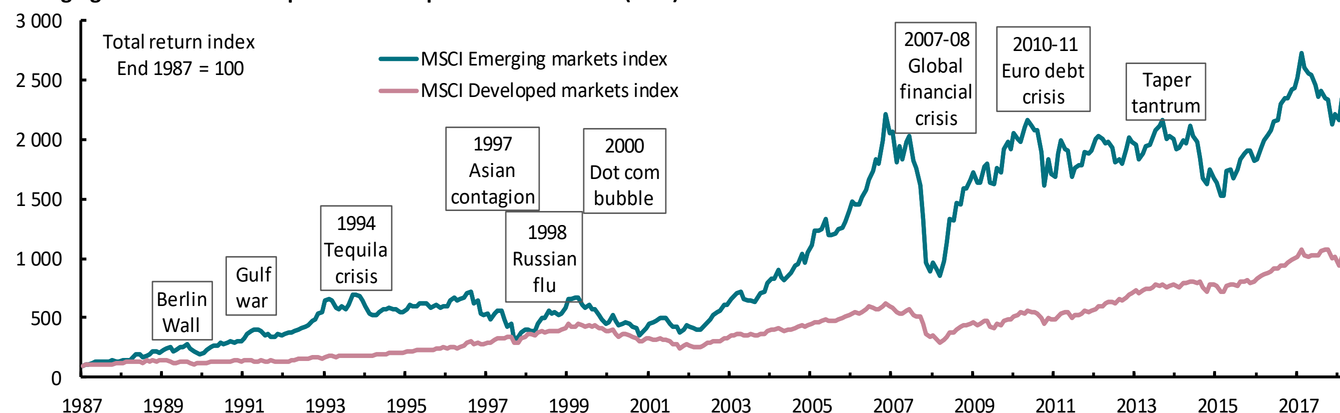
But it wasn't until 1986 that the first global **emerging markets equity** fund was launched by Capital Group together with the International Finance Corporation (IFC), the World Bank's investment arm. It was a closed-end fund managing $50m. Market indices appeared only in 1992, when Baring launched the BEMI EM index, which was subsequently bought by FTSE in 2001. However, the MSCI index became the standard benchmark for global EM funds – and on the last trading day of 2017, it celebrated 30 years since inception[3].

The birth of the EM **external sovereign debt market** dates closer to the early 19th century. The end of French rule over Spain brought the independence of countries across Latin America, which then looked for financing abroad. The 1825 financial crisis was the first of more than 300 sovereign external debt restructuring episodes in the 200-year history of the external sovereign debt asset class[4].

By 1929, more than 350 sovereign bonds of over 50 countries were actively traded in London and New York. After the Second World War and through the post-war Bretton Woods Agreement period until the 1970s, bank lending became the preferred financing tool for sovereigns – therefore, the debt market shrank. Only 20 countries issued foreign-currency bonds between 1950-1990. The lending boom eventually translated in large-scale defaults, and Latin America endured a long debt crisis during the 1980s.

The Brady Plan[5] in the early 1990s translated into sovereign bond issuance and marked the emergence of an active sovereign hard-currency bond market for developing countries. J.P. Morgan's original Emerging Markets Bond Index (EMBI) was introduced in 1992 – covering 10 countries, mostly Brady bonds. Now, it covers 73 sovereign issuers.

Exhibit 2: EM asset classes historical performance.



Source: Datastream, AXA IM Macro Research, as of 31/12/19

While external debt was the only source of sovereign borrowing in the 1980s and 1990s, **local currency debt** issuance has picked up sharply in recent decades. This is by far the largest part of the EM debt universe, accounting for 80% of the overall EM debt market, according to BIS data as of June 2019.

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[1] BIS, as of second quarter 2019

[2] MSCI, as of November 2019.

[3] For a historical 30-year perspective of the EM equity asset class, please refer to: Topa-Serry, I. and Ghotgalkar, V., 'You're fully developed when you hit 30', AXA IM Research, 7 February 2018.

[4] For a 200-year historical perspective of the external sovereign bond history, see Meyer, J., Reinhart, C. and Trebesch, C., 'Sovereign Bonds since Waterloo', Harvard Kennedy School faculty research paper, February 2019.

[5] The Brady Plan, articulated by the US Treasury Secretary Nicholas Brady in March 1989, offered debt holders the option to exchange their loans for either par bonds (equal principal, at fixed/below market interest rate) or discount bonds (up to 50% haircut of the principal, at market interest rate). In 1994, Brady bond trading accounted for more than 60% of EM debt trading at $1.7tn. By 2006, most Brady bonds were either exchanged or bought back by the debtor nations.

The J.P. Morgan Global Bond index (GBI-EM Global Diversified) was launched in 2005 – it has a market capitalisation of around $1.4tn, larger than the US high yield bond index. Yet this index represents a small part of the overall local currency universe, as much of this debt is not yet accessible to foreign investors. For example, Chinese debt - which is the third largest debt market in the world[6]. As these markets open up to foreign investors, investment opportunities could potentially be exploited.

The **emerging markets hard currency corporate bond** market has experienced strong growth since the early 2000s, accelerating significantly after the global financial crisis, and presently outsizing the US high yield corporate bond market with a market capitalisation above $2tn. But the EM local currency corporate bond market has grown even faster, approaching a market value of close to $8tn – albeit mostly inaccessible to foreign investors given taxation, liquidity and currency risk.

Exhibit 3: EM historical performance perspective

1987-2019	EM (USD)	EM (local)	DM	EMBI	UST
Total returns	2471%	142302%	1102%		524%
1987-2002	321%	21372%	163%		239%
2002-2019	511%	563%	357%	289%	84%
CAGR	10.7%	25.5%	8.1%		5.9%
1987-2002	10.0%	43.0%	6.7%		8.5%
2002-2019	11.2%	11.8%	9.4%	8.3%	3.7%
Volatility	22.4%	21.1%	14.5%		4.4%
1987-2002	24.0%	25.2%	14.8%		4.4%
2002-2019	20.9%	16.0%	14.3%	8.3%	4.3%
Max drawdown	-65.1%	-57.8%	-57.5%	-38.9%	-7.3%
1987-2002	-56.0%	-45.1%	-48.8%	-38.9%	-7.0%
2002-2019	-65.1%	-57.8%	-57.5%	-29.8%	-7.3%
Return / risk	0.48	1.20	0.56		1.33
1987-2002	0.42	1.71	0.45		1.91
2002-2019	0.54	0.74	0.66	1.00	0.85
Sharpe ratio	0.21		0.15		0.00
1987-2002	0.07		-0.12		0.00
2002-2019	0.36		0.40	0.56	0.00

1993-2019	EM (USD)	EM (local)	DM	EMBI	UST
Total returns	298%	984%	610%	791%	244%
1993-2002	-35%	63%	55%	129%	87%
2002-2019	511%	563%	357%	289%	84%
CAGR	4.4%	7.7%	6.3%	7.1%	3.9%
1993-2002	-2.8%	3.3%	3.0%	5.7%	4.3%
2002-2019	11.2%	11.8%	9.4%	8.3%	3.7%
Volatility	22.3%	18.7%	14.5%	12.6%	4.4%
1993-2002	24.7%	22.9%	14.9%	18.3%	4.4%
2002-2019	20.9%	16.0%	8.3%	8.3%	4.3%
Max drawdown	-65.1%	-57.8%	-57.5%	-38.9%	-7.3%
1993-2002	-56.0%	-45.1%	-48.8%	-38.9%	-7.0%
2002-2019	-65.1%	-57.8%	-57.5%	-29.8%	-7.3%
Return / risk	0.20	0.41	0.44	0.56	0.90
1993-2002	-0.11	0.15	0.20	0.31	0.97
2002-2019	0.54	0.74	1.13	1.00	0.85
Sharpe ratio	0.02		0.16	0.25	
1993-2002	-0.29		-0.09	0.08	
2002-2019	0.36		0.69	0.56	

Source: Datastream, AXA IM Macro Research, as of 31/12/19

Emerging markets have, however, been more prone to crises. Some were spurred by external shocks such as the dotcom crash, the global financial crisis and subsequent European sovereign debt crisis. Others were ignited domestically – the most violent following revolutions and regime changes such as in Russia in 1998, the 1994 Mexican Tequila Crisis, the 1997 East-Asian crisis, or Argentina's economic crisis in 2001 and 2002.

Despite the many crises that have shaken EM financial markets and the currency depreciation – even devaluations – that those crises triggered, the risks taken by long-term investors have been compensated to some extent by returns. In the fixed income space, the Harvard research paper 'Sovereign bonds since Waterloo'[4] shows that real ex-post returns averaged 7% annually in US dollar terms, an excess return of around four percentage points over the US government bond yield. The same margin is apparent considering the EMBI index returns since the inception of the J.P. Morgan benchmark in 1993 (Exhibit 3).

In the equity space, the MSCI EM index has returned 10.7% per annum in US dollar terms since its inception in 1987. Looking at index performances may be misleading, as emerging markets are a particular fertile place for active investors given big index biases – and there is still scarce coverage of the investment universe.

Beware of big biases

Investing in emerging markets is nevertheless not as easy as it seems. Understanding the investment universe and their biases takes on greater importance in the EM space perhaps than elsewhere. This creates opportunities for active managers. Areas to consider include:

Country biases. When considering financial market indices, investors must be aware of biases. To begin with, a country may be considered developed by the likes of the IMF or the World Bank and yet be considered emerging for investment standards, or vice versa. For example, South Korea and Taiwan are classified as developed economies by the IMF but are still components of the MSCI Emerging Markets index. Slovakia is part of hard currency debt indices (such as the J.P. Morgan EMBI Global), while being considered a developed market since its entry into the Eurozone.

Furthermore, the equity and debt investment universes have very little overlap. There were 26 countries represented in the MSCI Emerging Markets equity universe at the end of 2019. In the debt universe, there were 73 countries represented in the JP Morgan EMBI Global (EMBI G) hard currency sovereign debt index and 18 countries in the JP Morgan GBI-EM local currency sovereign debt index. Take China for instance – it represents 34% of the MSCI EM Index but is just 2.5% of the hard currency sovereign debt market EMBI GD index, and still not represented in the local currency

[6] Yao, A. and Shen, S., 'Five reasons to consider China as a standalone asset allocation', AXA IM Research, 8 October 2019

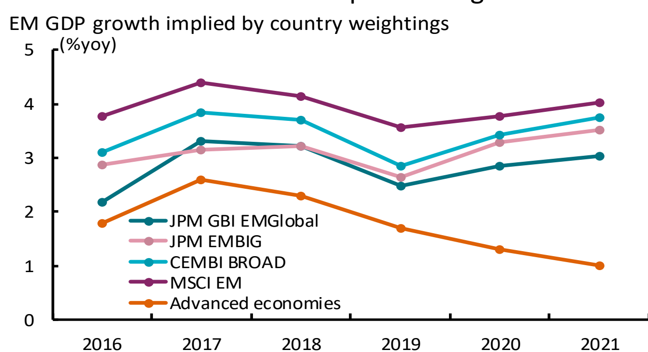
one. The EM sovereign debt market, particularly for local currency bonds, still has a long way to go until being properly represented within benchmark indices. While progress is being made, the current structure often leads to crowded positions in some markets.

Regional biases. Latin America is an important component of the debt market, accounting for almost a third of both hard and local currency sovereign debt indices, while it is still a fraction of the equity EM MSCI universe at 11%. Asian equities have now taken a major share in the EM space – particularly with Chinese equities' share rising – and now make up 74% of the universe. South Africa and Egypt are the only African countries represented in the equity universe (5% and 0.13% respectively), while Africa represents 12% of the EMBI G (17 countries which account for between 0.1% to 2.5% of the overall index each) and 9% of the GBI-EM (South Africa only).

"Quality" biases and sensitivities. As market access increases and index providers include other constituents, benchmarks shape up in various ways. It is important to understanding these features to identify the type of risk to which investors are exposed.

Take for example the hard currency sovereign index EMBI Global Diversified (EMBI GD). Back in 2008, 68% of the index was classified as high yield, but presently 54% of the index is in investment grade territory, partly due to the addition of several Gulf countries. It now encompasses 73 countries, but its sensitivity to oil price volatility has increased as a result.

Exhibit 4: EM asset classes exposure to growth



Source: Datastream and AXA IM Macro Research, as of end 2019

Meanwhile in the equity space, the MSCI EM Index started out as essentially a commodity investment, with the oil, gas and mining industries accounting for around a third of the index. Today, technology is a major influence. Information technology is now the second biggest sector in the index, at 16%, after the financial sector at 24%. The technology sector has also moved away from being centred on semiconductor manufacturing to focus on software and services. These changes have shifted the ultimate revenue source for the asset class towards more domestic exposure, with large names in the internet, financial and consumer space based in emerging markets.

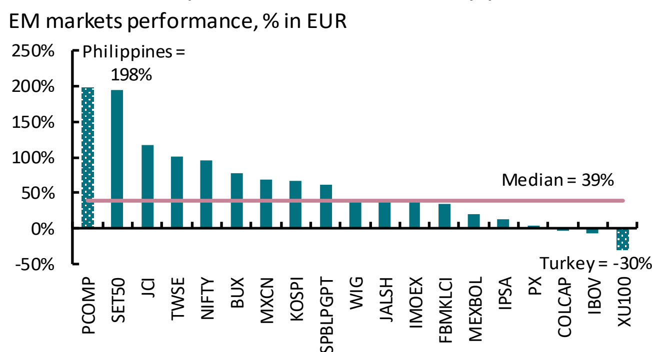
Exposure to growth. Even so, EM assets will offer investors broader exposure to areas of potential growth. EM indices that cover multiple countries provide diverse opportunities for growth. Furthermore, the relative growth resilience of emerging markets' economies could be an interesting investment argument given the GDP growth of advanced economies is expected to slow in the years ahead (Exhibit 4).

Selectivity matters

For foreign investors, assessing the correct macroeconomic framework of each emerging country before investing has massive performance consequences. This translates most often into the currency performance vis-à-vis our investment currency. This can be a generator of good performance, or a drag on returns, though stock selection then magnifies the top-down assessment.

To illustrate[7], we consider the country indices performance of emerging markets over the 10 years to 2019. We can observe a massive outperformance of the Philippines, up 198% in euro terms, with Turkey the laggard – losing 30% of its value in euros over the same period, against a median performance of EM country indices of 39%. Of that, 16% is due to peso appreciation and 67% to the fall in the Turkish lira (Exhibit 5).

Exhibit 5: EM equities: historical country performance

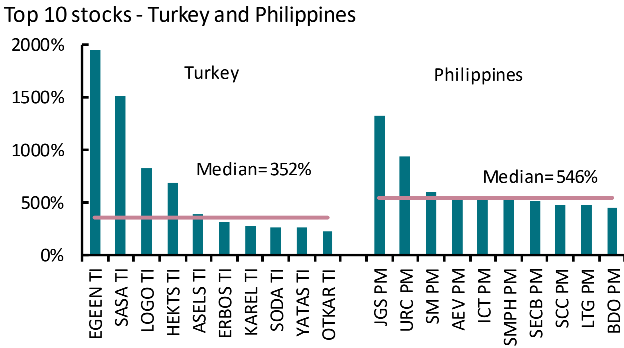


Source: Bloomberg and AXA IM Macro Research, as of 31/12/19

A good top-down approach may guide investors towards the best performing countries, while helping to avoid the worst. Still, stock picking within an emerging country can have a massive impact on a portfolio's performance. In this example, we found that investing in the top 10 performing stocks in Turkey during the past 10 years would have offered a median return in euros of 352%. This is significantly better than the EM markets' median performance, indicating that active stock picking can bring substantial outperformance to EM equity portfolios (Exhibit 6).

[7] One of the shortcomings of such a simplistic exercise consists in the survivorship bias, which can distort performance figures significantly by making the results seem better than they actually are, as the worst performing stocks systematically leave the indices.

Exhibit 6: Scope for stock selectivity within EM equities

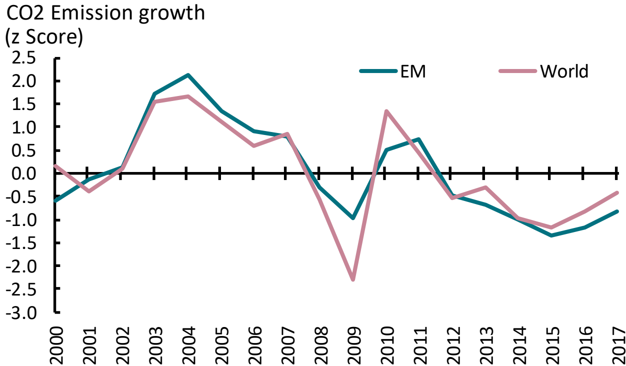


Source: Datastream and AXA IM Macro Research, as of 31/12/2019

ESG in emerging markets

Many investors may be tempted to think that applying an environmental, social and governance (ESG) lens to emerging markets investments may be next to impossible, excessively reducing the investment universe and the potential for return. Heavily polluting coal mines and steel producing factories, workers suffering from poor conditions, and corruption at state and corporate levels characterised the image in many investors' minds of a "typical" emerging market some two or three decades ago. Things have changed since.

Exhibit 7: EM carbon emissions improve



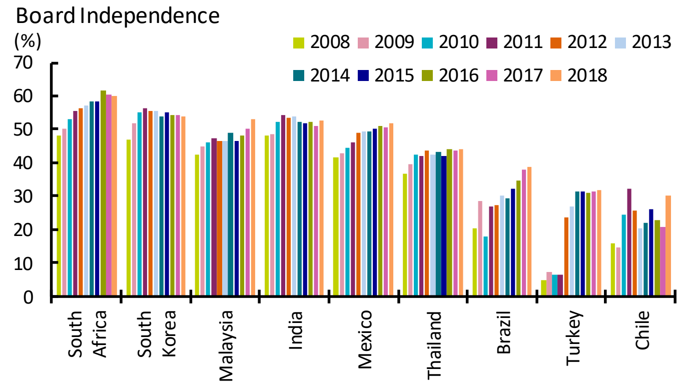
Source: British Petroleum 2018 Annual Report and AXA IM Research

Increased environmental awareness is driving change. Awareness of pollution and climate change has increased, and many countries are taking action. For example, China unveiled an ambitious five-year plan in 2016 to improve ecological and environmental protection. At a corporate level, the rise of globalisation after the entry of China in the World Trade Organization in 2001 has brought EM companies in the global value chain. On the whole, they have started to improve product standards and obtain certified systems needed in order to be a recognized global partner (Exhibit 7).

Social data gaps. In 2011, the United Nations drafted a human rights framework of how international businesses are expected to respect and protect fundamental freedoms and human rights. Arguably still too little data is available on the social aspect of ESG investment globally, while environmental engagement has recently gained importance. But it is fair to say that in many developing countries, big corporates - often state-owned enterprises - are important regional economic actors which can take on board a series of social spending.

Governance is slowly improving. Emerging markets companies often show concentrated ownership and state-owned companies are often monopolies in various industries (Exhibit 8).

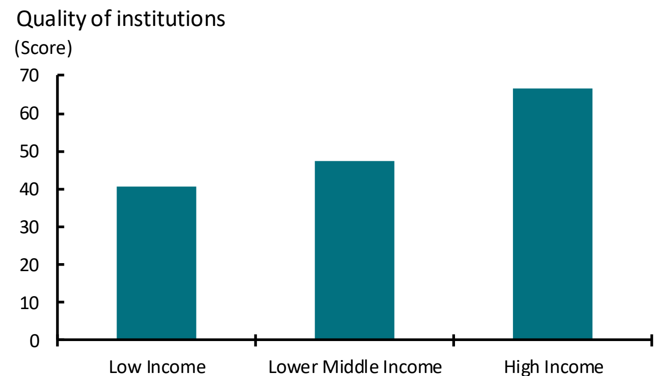
Exhibit 8: Companies' board independence improves



Source: ISS Analytic and AXA IM Research; as of end 2018

Recently, corruption scandals have erupted forcefully and proved painful for politicians and companies alike, such as the *Lava Jato* – or Operation Car Wash – scandal which started in Brazil in 2014. This turned from a corporate-level bribery case into an anti-corruption project of unprecedented scale that took hold of the entire Latin American region. Now, corporate governance regulations are better implemented – governance codes as regulatory requirements for corporate good practice have been introduced in Brazil, India, South Africa, South Korea and Turkey over the past few years.

Exhibit 9: Quality of EM institutions lags



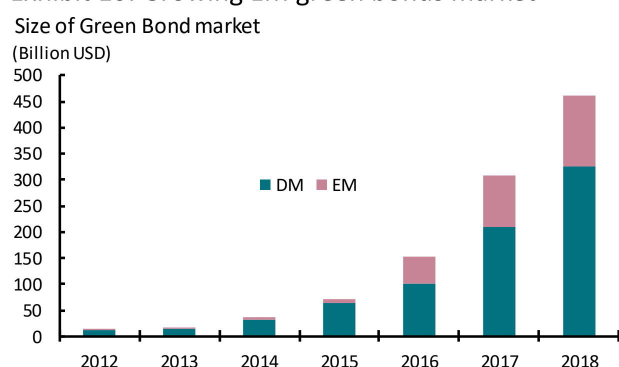
Source: World Economic Forum – Global Competitiveness Report and AXA IM Research, as of November 2019

Governments have an important role in infrastructure and public services. According to the World Economic Forum, EM countries are still facing issues regarding the quality of these institutions (Exhibit 9). Not only does this constitute a limit on the growth potential of a country, but it can also become a

cause of social unrest, as it has proved recently in Latin America and Lebanon[8].

Green bonds investment opportunity. Most green bond issuance has taken place in advanced economies, but the opportunity in emerging markets is growing. Both the public and private sectors are increasingly using this type of funding, helping them to invest in more environmentally respectful economic models. Since 2012, the date of the first emerging market issuance by South Africa, the share of EM in the green bond market has grown from less than 5% to 35% last year. Most of the outstanding debt comes from China, followed by India and Mexico (less than half of EM green bonds is in hard currency). We see growing investors' appetite for EM green bonds as shown in the recent issuance in Chile this year (Exhibit 10).

Exhibit 10: Growing EM green bonds market



Source: Bloomberg and AXA IM Research, December 2018

However, this does not mean that emerging markets can be viewed in general as ESG investments. Standards of best practice lack, and poor disclosure is a common reality. Annual reports often contain little information on ESG – and sometimes lack consistency. Corporates face the difficult task in meeting international standards while facing local challenges. Civil society in each country has variable awareness and interest in ESG, given their different stages of economic development, sophistication and personal aspirations. While all these issues may appear as limits to ESG investment in the EM universe, they constitute nevertheless a big opportunity for active investors who can better understand and eventually help companies to improve their ESG practices. Investors need to engage in a consistent dialogue, which in turn could translate into excess investment returns.

The future of emerging markets investing

Emerging markets will likely become an even wider investment universe as local financial markets open up to foreign investors. Correctly analysing the macroeconomic and political risks in emerging markets will remain an important part of any investment process in EM. Nevertheless, given the diversity of the universe, bottom-up selectivity remains particularly relevant. While ESG investment still has a long way to go in emerging markets, progress is coming along, undeniably creating an interesting opportunity for active investors engaged in consistent dialogue with corporates and governments alike.

[8] Topa-Serry, I., "Latam turmoil follows the region's structural decline", 29 November 2019 and "Lebanon in the eye of the storm", 6 December 2019, AXA IM Research

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