Active management and emerging markets equity
The RBC Emerging Markets Equity team
Together they work

Introduction

One important consideration investors have with regard to Emerging Markets (EM) investing is whether to employ active or passive management. In this paper we take a closer look at some of the fundamental challenges particular to EM and how active management helps overcome them.

Consider that since investment managers make up the market, they cannot in aggregate beat the market. The active industry, it is argued, will underperform a market index because of the aggregate excess fees it charges. In our view, such arguments miss the point. What is important is not so much what active managers do in aggregate, but the conditions under which it makes sense to pursue active management and why active management is even more important in EM.

There are several fundamental reasons why experienced investors should consider an actively managed portfolio when choosing an allocation to EM equities.

Active managers can outperform in EM

- During the last fifteen years active managers in EM have generated a rolling 5-year excess return over the MSCI Emerging Markets Index of more than 200 bps. An excess return is maintained even after paying management fees.1
- Outperformance over the MSCI Emerging Markets Index and passive funds may be obtained with less risk and volatility.
- The top tercile of active money managers have exhibited consistency in generating excess returns – outperforming benchmark and peers approximately 70% of the time over the past three years (see Exhibit 4).
- Truly active fund managers, defined as those with an active share above 70%, have a better chance to outperform over time.

Going active makes sense if markets are inefficient

- The EM universe is very large and there are a large number of stocks with little or no coverage at all. For example, there are three times more stocks listed collectively in Brazil, Russia, India and China (BRIC) than there are in the U.S., yet there are three times fewer analysts covering these stocks.
- As a result of lower research coverage, the accuracy in forecasting earnings and returns is much lower than in developed markets (DM) which increases opportunities for fundamental analysis to exploit market inefficiencies.

Portfolio needs to be selective in EM

- Focus on quality is very important in EM as there are many companies with poor corporate governance.
- Approximately 30% of the benchmark for EM equities is comprised of large state owned enterprises (SOEs) whose profits may be used for social purposes at the detriment of profitability and equity performance. These companies have underperformed private companies and the MSCI Emerging Markets Index by approximately 80% and 30%, respectively2.
- Investors buying exchange traded funds (ETFs) will inevitably invest in these private companies.

Benchmark is a poor reflection of EM universe opportunities

- There are almost 10,000 companies listed in EM and only 836 stocks in the MSCI Emerging Markets Index, of which 674 are mega or large caps.
- EM small caps and frontier market stocks are considered inefficient and are generally excluded from passive strategies.
- The MSCI Emerging Markets Index is biased towards large state owned companies.

Active investments in EM are ESG compatible

- The analysis of environmental, social and governance (ESG) is particularly important in EM. This is because while there is a lack of comprehensive research coverage in EM in general, there is a dearth of ESG related analysis in particular. This makes the bottom up analysis of money managers in this area increasingly important.
- Excluding or favoring securities on the basis of ESG criteria involves deviating from the benchmark, which leads to higher tracking error and may work as a defeating argument for passive investments.

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1Based on average annual management fee of 88 bps for active EM managers. Source: Fee Survey 2014, Mercer
2Active managers rely on analytical research, forecasts, and their own judgment and experience in making investment decisions on what securities to buy, hold and sell. UBS, February 2015.
( Truly ) Active managers outperform in emerging markets

As Exhibit 1 illustrates, evidence suggests that active managers in EM have outperformed over time and based on our analysis, they have done so with less risk and volatility.

The median EM active managers have generated, on average, a rolling 5-year excess return of more than 200 basis points (bps) versus the MSCI Emerging Markets Index in U.S. dollars over the past 15 years ending September 2014. Assuming an average management fee of 88 bps, these returns are also maintained net of fees. These returns boast superior risk characteristics compared to the performance generated by their passive counterparts. In fact, the universe of EM active managers analysed (based on the Mercer Database of EM active managers) reveal a better risk/return ratio, as demonstrated by their higher Sharpe ratio, and also lower overall volatility than passive strategies. As Exhibit 2 illustrates, the average Sharpe ratio for active EM active managers is higher than the iShares EM ETF, one of the largest EM passive strategies.

By the same token, the volatility of top quartile EM managers’ portfolio returns is lower than those of the iShare EM ETF (Exhibit 3). Furthermore, research shows a remarkable degree of consistency in the excess return generated by the top EM portfolio managers. The key attributes necessary to outperform are a high active share - basically the portfolio needs to differ from the benchmark - and a strong and replicable investment process. The lack of one or the other may lead to underperformance or the “mortality” of the manager in the long run. Those EM active managers with a strong investment process which gives them confidence to implement “active bets” seem to perform with a very high degree of consistency suggesting that a strong investment framework pays off in inefficient markets.
The analysis can be further seen by identifying the top tercile of best EM managers in terms of performance over 1-, 3-, 5- and 10-years. Exhibits 4 and 5 show the long-term sustainability of their performance relative to their peers (Exhibit 4) and relative to the MSCI Emerging Markets Index (Exhibit 5). The data points for this analysis have been taken on a quarterly basis.

The evidence suggests that some managers in EM can consistently take advantage of market inefficiencies. In order to do so, managers need a strong professional culture, sustainable investment process and comprehensive risk management. The higher the quality of these factors and a manager’s superior ability to employ this skill set, the greater the chance the portfolio will outperform.

Investors must make a crucial qualitative judgment on manager quality. The importance of thorough manager due diligence by advisors and investors can’t be overstated in the effort to find active managers who can be expected to outperform the benchmark over time. In this context, it is important to have a bias toward active managers who are skilled at making diversified stock picks and proficient in building portfolios that don’t just mirror a benchmark. Truly active portfolios have a better chance of outperforming benchmarks over time, which is quite an intuitive statement, as in order to outperform, a portfolio must have differences from its benchmark, whether in terms of position sizes or the stocks themselves.

The concept of “active share” quantifies this intuition as the percentage of a portfolio that is different than its benchmark. The active share measure was developed by Martijn Cremers and Antti Petajisto of the Yale School of Management, and it determines the fraction of a portfolio that is invested differently from its benchmark. The calculation sums the absolute values of the difference between each stock holding and each benchmark holding and divides by two to give an active share value of between zero (portfolio is the same as the benchmark) and 100 (portfolio is completely different from the benchmark).

Portfolios showing an active share of below 60% are deemed to be too similar to the benchmark index and receive the ominous tag of “closet tracker,” charging active fees for little more than passive management. To be considered active, more than 60% of the portfolio’s weights must be different from the benchmark (Exhibit 6). Importantly, research shows that portfolios with the highest active share have enjoyed market-beating returns, net of fees, over time. While having an active share above 60% does not guarantee outperformance, any outperformance appears to be highly unlikely without it.
Emerging markets are inefficient

It is important for one to recognise that a high degree of variation exists across asset classes and EM equity is still a relatively inefficient asset class where price information is released slowly and reliable data is scarce. As such, this provides opportunities for experienced and skilled managers to add value through stock picking. For that reason, while indexing may provide higher average returns in some of the most efficient markets, this is not the case when it comes to more specialised asset classes and strategies such as EM. For example, the EM universe is very large and there are a high proportion of stocks with little or no research coverage at all. In fact, as Exhibit 7 illustrates, there are three times more stocks listed in the BRIC countries than there is in the U.S., yet there are three times fewer analysts covering these stocks.

In addition, and perhaps a reflection of the low level of coverage, the accuracy in forecasting EM earnings is lower than in DMs (Exhibit 8). As a result, this opens opportunities for fundamental analysis to exploit market inefficiencies.

Stock selection is crucial when investing in emerging markets

Many, if not most, passive indexes are market-cap weighted, meaning that the investor is more exposed to the movement of a few large companies than he or she may think. In addition to this large-cap bias, these indexes tend to overweight certain markets and thus have a large market bias. On the other hand, active portfolios can be selective and this is crucial in EM. The universe is huge and includes poorly run companies that have weak corporate governance, particularly SOEs (Exhibit 9).

For example, SOEs make up approximately 30% of the MSCI Emerging Markets Index (Exhibit 10). Because of their weight in the index and their high liquidity, passive strategies are inevitably biased towards these large SOEs whose profits are often used for social purposes at the detriment of minority investors and as a result, have performed very poorly. If an investor buys an ETF, that investor is effectively investing in these companies.

On the other hand, by choosing active management, an investor can select managers who can avoid these stocks. In addition, investment prospects have rarely been more differentiated between the various EM; several countries in EM are implementing a number of political or social reforms and will likely perform better in the long term once those reforms are in place and prove to work (call out box, page 6). Alternatively, passive strategies don’t differentiate; country allocation is not an option and any investor in these vehicles could end up missing significant opportunities.
A benchmark is a poor reflection of the vast emerging markets opportunity set

The MSCI Emerging Markets Index is a poor reflection of the opportunities offered by the EM universe (Exhibit 11). For example, Emerging Markets Small Cap companies, Frontier Market companies and Developed Market companies that generate the majority of their revenue from Emerging Markets are excluded from passive strategies, whereas active managers can choose to allocate to these promising areas.

Exhibit 9: Large representation of SOEs in the MSCI Emerging Markets Index

Exhibit 10: MSCI Emerging Markets Index government owned company weightings

Exhibit 11: Number of stocks in Emerging Markets Universe

Unprecedented EM Reforms

<table>
<thead>
<tr>
<th>Country</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>Aggressive plans for privatisation and reducing corruption</td>
</tr>
<tr>
<td>India</td>
<td>Widespread reforms to unlock bottlenecks</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Government will focus on Energy and Infrastructure</td>
</tr>
<tr>
<td>Philippines</td>
<td>Targeting Infrastructure</td>
</tr>
<tr>
<td>Korea</td>
<td>Pursuing Chaebol reform</td>
</tr>
<tr>
<td>Taiwan</td>
<td>Finalising services pact with China</td>
</tr>
<tr>
<td>Mexico</td>
<td>Reforms at full speed: Labour, Fiscal and Energy</td>
</tr>
<tr>
<td>South Africa</td>
<td>Incremental positive adjustments</td>
</tr>
<tr>
<td>Brazil</td>
<td>Economic management to improve</td>
</tr>
<tr>
<td>Chile</td>
<td>Better, more accessible education</td>
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Active investments in emerging markets are compatible with the adoption of ESG criteria

The integration of ESG criteria in passive management can only be found in a small number of passive strategies that benchmark against ESG indices. Conventional benchmarks do not take ESG into account, and as such, most passive strategies exclude favouring securities based on ESG criteria in order to replicate an index’s performance.

Furthermore, there is a lack of comprehensive research coverage in EM in general, and a dearth of ESG related analysis in particular, which makes the bottom-up analysis of active portfolio managers in this area increasingly important. Given the higher levels of both risk and return in EM, investors who make an effort to understand the impact of ESG on a company’s earnings have a better chance of reducing risk and increasing returns. Because information is scarcer in EM, managers see ESG criteria as a way to make superior investment decisions.

ESG criteria can help identify long-term industry leaders and potentially reduce investment risk by providing insight into companies’ operations. As the strength of companies’ competitive positions and management of ESG risks and opportunities become more important, the inclusion of these factors into an investment process becomes crucial. A study from Goldman Sachs (GS Sustain, Growing Pains, May 7, 2012) shows that EM companies with stronger ESG have delivered higher cash returns on average than their sector peers. In addition, the same study shows compelling evidence that high return companies tend to maintain those returns for longer where accompanied by stronger ESG management quality. Exhibit 12 depicts companies with first quartile ESG scores tend to deliver higher cash return on capital invested (CROCI) and sustain above sector average CROCI for one year (10%) longer than average.

Not only does this evidence suggest that investing across ESG lines in EM may create favourable returns, but also suggest that investors following a strategy that adopts ESG analysis as part of the investment decision process will help them to meet investment goals.

Conclusion

We believe there is a strong case for active management in EM, as demonstrated by the continuous outperformance of EM active strategies over the MSCI Emerging Markets Index. As long as EM is an ineffective market with little analytical coverage, inaccurate earnings and return forecasts, investors can benefit from active management’s abilities to glean valuable investment recommendations. As the benchmark is not reflective of this asset class’ universe, active managers are able to select well-researched companies that are privately held and follow ESG criteria. Active managers providing insightful market advice, a superior skill set and new viewpoints, may help with successful investing in the EM equities.
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