ANALYSIS

Passive emerging markets: A wasted allocation?

The MSCI Emerging Market index's annualised return has been 1.4% higher than the MSCI World since inception

Jamie Gordon | 20 May 2024

Fund selectors may have gone cold on passive emerging markets (EM) after a decade of flat earnings, recent US dollar strength and China mayhem, however, this does not change the fact broad EM has trounced global and developed market equities since the turn of the century.

According to FTSE Russell data, the FTSE Emerging TR index gained 355.2% between 31 December 1999 and 10 April this year versus 329.2% and 303.1% for its developed and all-world TR indices, respectively.

This trend is even more pronounced with the younger MSCI Emerging Markets index, which has booked impressive 418.9% returns since 31 January 2001, as at 29 March, versus 379% and 360.2% for its world and ACWI indices.

In fact, not only was the MSCI EM's 7.6% annualised return between 2001 and 2023 an entire 1.4% a year ahead of the MSCI World, but it was just 0.2% shy of the MSCI USA's annualised return over the period.

All this is to say buy-and-hold investors – and risk-conscious managers – are not wasting their time by tracking an EM benchmark over a very long-term horizon. Although, this is not the whole story.

A fraught entry point

The first question an investor might ask is 'why buy EM when I can get better returns with US exposure?' and the answer would be the same as buying a world exposure – passing up some potential returns to reduce geographic concentration – except EM has also outstripped global equities.

However, it is undeniable that aside from pockets of cyclical uplift, EMs have faced a 'lost decade'. After leaving developed markets in their wake in the 2000s, EM equities have been stymied by a strong US dollar eroding their dollar-denominated earnings-per-share (EPS).

Last year also saw the MSCI EM lag with 9.9% gains versus 26.3% for MSCI USA, however, these numbers too deserve caveats.

Sammy Suzuki, head of emerging market equities at Alliance Bernstein, noted the MSCI EM ex-China index returned 20.1% last year, whereas the S&P 500 minus the 'magnificent seven' would have risen just 8%.

Admittedly, these omissions are a convenient sleight of hand for the EM allocation case, but they are meaningful considerations for those expecting a current change in either Chinese or US large cap equities going forward.

"With EM being so under-owned, if there is a derating in US equities, there could be a diversification back into EM," Stefan Wiederkehr, co-founder and managing director at IMP AG, said.

"For the moment, an investor will not go off and find the diamond in the rough if it is right in front of them in the form of the 'magnificent seven'."

Suzuki argued this 'diamond in the rough' appeal may return and described EMs as an "unrecognised opportunity", with 12-month EPS growth estimates being revised upwards by 5% for EMs in Q4 last year – versus 1.3% for the S&P 500 – while companies growing earnings by at least 10% a year comprise more than half of the MSCI EM index.

However, this is not to say investors should get comfortable with the idea of smooth sailing ahead. Instead, it might be wise to brace for a dose of geopolitical headwinds, Wiederkehr warned, with tensions in the Middle East creating uncertainty around accessing trade routes.

The prospect of a second Donald Trump presidency is also accompanied by an inevitable re-escalation of 'tariff wars', with promises of 60% tariffs on Chinese imports and a 10% universal import tariff.

Active alternatives

Despite an impressive track record over the past quarter of a century, the constantly changing make-up of benchmarks, idiosyncratic and currency risks prompt investors to routinely pass up a passive approach to EMs in favour of active managers and selective, tactical allocations.

Yvan Roduit, head of investment advisory at Raiffeisen Switzerland, told *ETF Stream* his firm adjusts the size of its EM position according to prevailing risk sentiment, but the current approach is comprised of the Goldman Sachs Emerging Markets Equity fund, which has "been doing a bad job for the past two to three years".

Having outperformed MSCI EM for almost two decades, the $2.7bn fund has been punished by its China overweight, returning 344.4% since January 2001, with an eye-watering gross expense ratio of 1.12%.

Roduit added his team is now "considering active ETFs" such as the JPM Global Emerging Markets Research Enhanced Index Equity (ESG) UCITS ETF (JREM), which leverages its parent company's "huge research capabilities through a low-cost product".

Explaining Raiffeisen's broad-based active approach to EM, Roduit concluded: "The heterogeneities between EMs brings diversification – their differing sectors and economic growth stories complement each other."

In contrast, Wiederkehr also believes it pays to take an opportunistic and tactical approach.

"EMs are almost too volatile to play it long-term, one has to take more of a short-term approach, be more cyclical with it and play it that way," he said.

"At the moment, our exposure is quite low, it has not been this low in quite some time."

Offering support to this view, none of the top 10 constituents of the FTSE Emerging index have remained in place over the past two decades.

Also, while China may now be a dominant force within MSCI EM today, its weight was less than half of that of South Korea in 2004.

Instead, Wiederkehr's team predominantly addresses EM through tactical sector allocations such as the KraneShares CSI China Internet ETF (KWEB), with the Chinese technology sector now trading at around half its valuation in 2020 – when it traded at a premium to US tech.

“We are still holding those positions but we have reduced them drastically. If we were to increase our exposure to EM again, we would look to KWEB and for more broad-based exposure. We like JREM,” Wiederkehr concluded.

Adopting a similar approach, Will Bartleet, CIO at Pacific Asset Management, said his firm entered a position in the HSBC Hang Seng Tech UCITS ETF (HSTC) in January.

“It is a really interesting allocation – clearly extremely volatile – but everybody loved those companies prior to 2020 as they grew rapidly. They are still amazing companies and have a huge amount of growth to come from AI and they are finally incredibly cheap,” he said.

Overall, passive EM is far from a wasted allocation but it may not suit the needs of all investors. Given enough time, it has the potential to outdo its developed market peers, but higher volatility, cyclicality, potentially long periods of sideways returns and the occasional ‘black swan’ event mean fund selectors tend to prefer to remain nimble within the space.

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