Perspectives

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Emerging Markets: Why Your Active Manager May Be Underperforming

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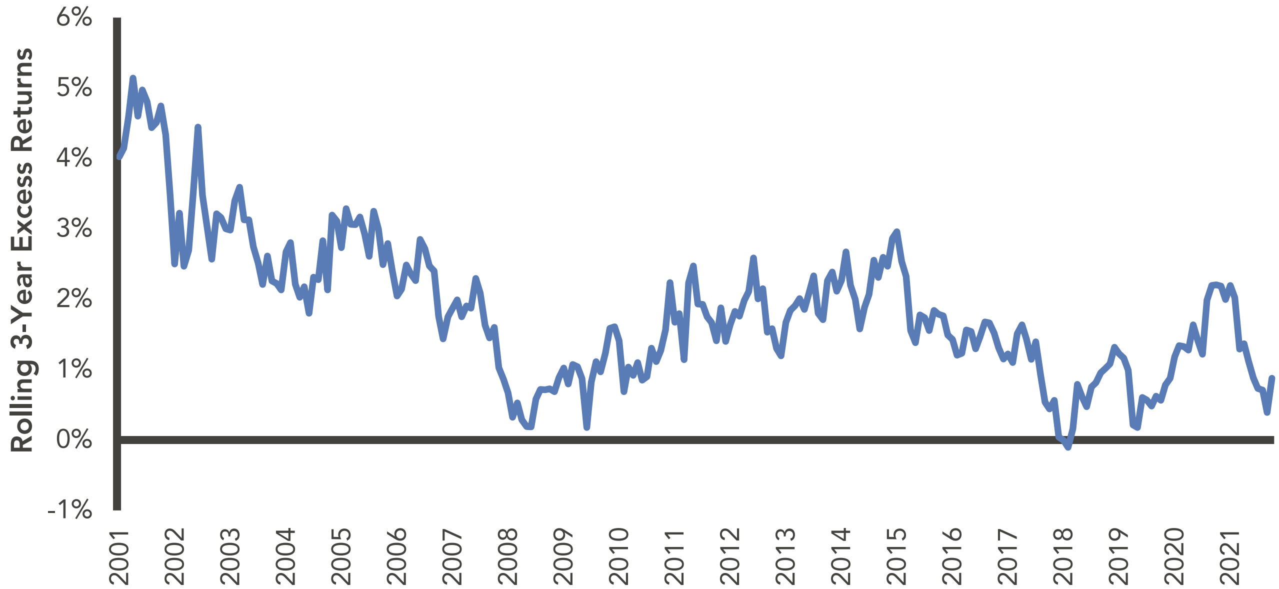
2022 has been a challenging year for investors as both bonds and equities have produced substantial losses. This unusual environment is the product of a kaleidoscope of macro headwinds that have unfolded throughout the year. Against this backdrop, active emerging markets equity managers have generally failed to protect to the downside, with the average manager underperforming the index year to date through September. The underperformance of the Quality factor helps explain why.

EM ACTIVE MANAGER PERFORMANCE

Emerging market equities are generally considered an inefficient asset class given less liquidity, less readily available information, and less analyst coverage compared to the more efficient U.S. large-cap universe. Theoretically, this inefficiency results in a greater opportunity for active managers to generate alpha given that stock mispricings are more likely. This has proved true over time. Exhibit 1 on the next page looks at rolling three-year excess returns for the median active emerging markets manager. While there are cycles to the performance, over the last 20-plus years the median manager has beat the benchmark by an average of 1.9%. Historically, an active allocation to the asset class has been an attractive long-term option for investors.

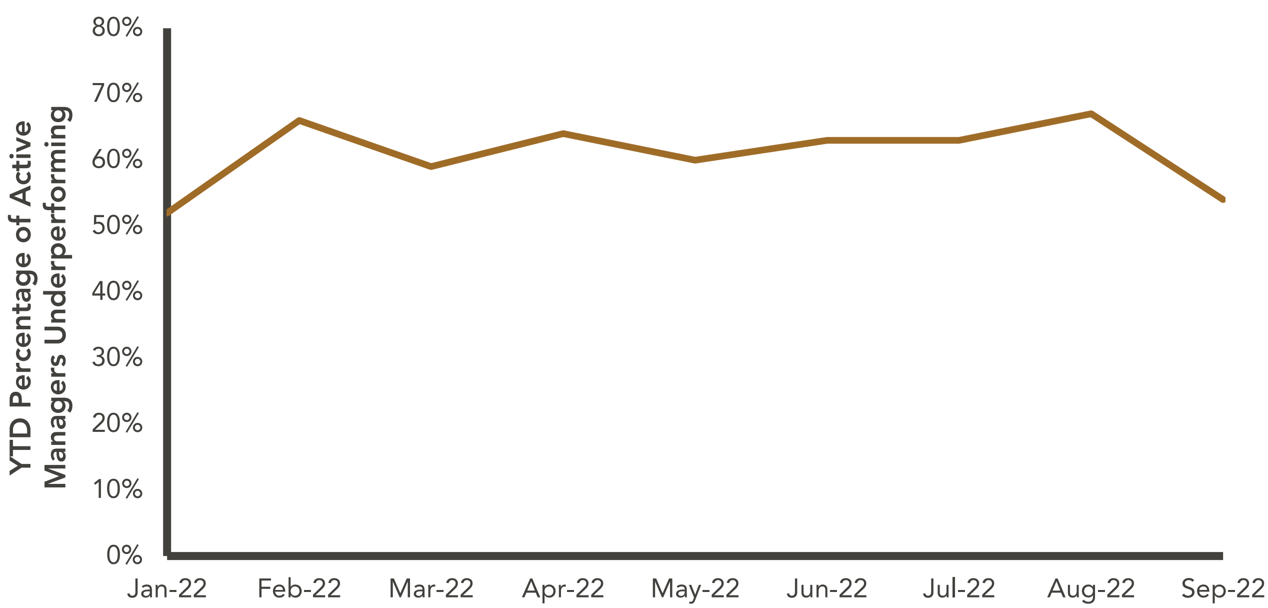
Exhibit 1: On a rolling 3-year basis, the median EM equity manager has outperformed the benchmark for almost all of the last 20-plus years



Source: eVestment EM All-Cap Equity as of September 30, 2022

In 2022, however, active managers have struggled in the emerging markets space, with more than half of managers trailing the benchmark through the first three quarters of the year. The eVestment Global Emerging All-Cap Equity universe contains roughly 300 different EM equity products. Through the second quarter, 63% of that universe had underperformed the index. That number hit a year-to-date high of 67% in August, with the benchmark ranking in the 33rd percentile. Active managers did see improved performance in September, with the index dropping to the 46th percentile. In September, the Quality factor rebounded and outperformed the broader EM index by 3.2%.

Exhibit 2: Over half of EM active managers have underperformed the benchmark this year



Source: eVestment as of September 30, 2022

There are several potential reasons why active managers have struggled in 2022. The Russian invasion of Ukraine in February caught most market participants off guard and resulted in substantial losses. China's underperformance relative to the broader index has also served as a headwind for many investors. China is the largest exposure in the MSCI EM Index at 31% and has been challenging for managers to navigate this year given the country's Zero-COVID Policy, property sector struggles, and negative investor sentiment amid geopolitical tensions. And lastly, the factor environment has dramatically shifted this year, with both Growth and Quality underperforming the broad benchmark. This newsletter further explores the impact that the underperformance of Quality has had on active manager returns this year.

QUALITY

Quality can be subjective, measured both qualitatively and quantitatively. Among other factors, *qualitatively*, asset managers often focus on:

Management team	Business model	Competitive positioning

Quantitative metrics include:

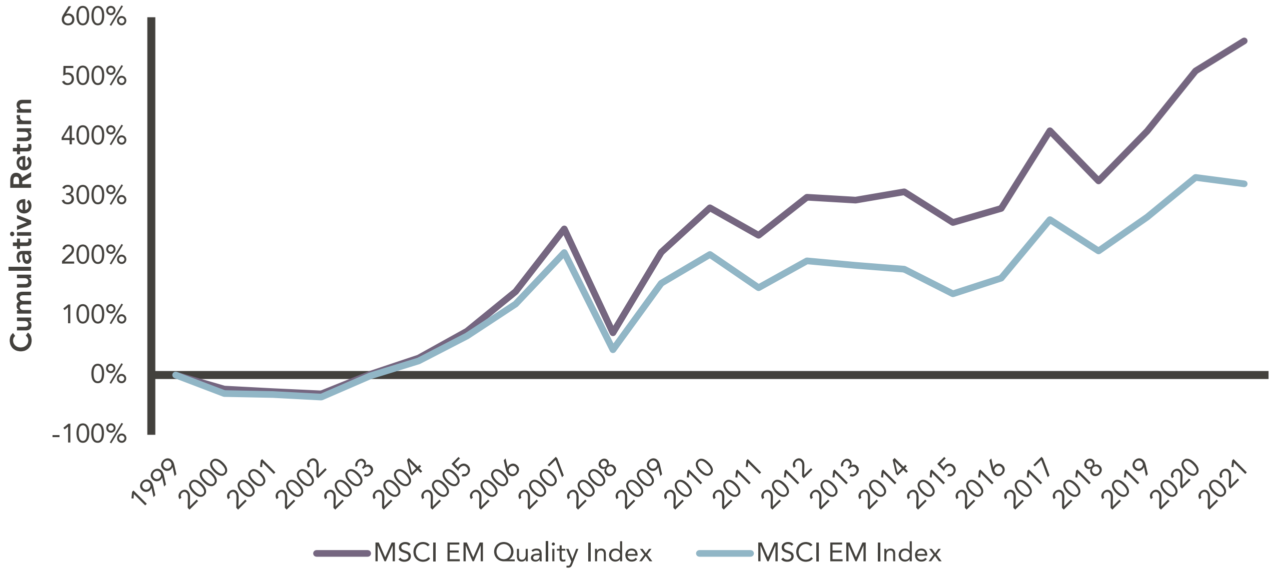
Balance sheet strength	Profitability	Stability
via accrual ratios, debt-to-equity, and other leverage ratios	via profit margins, return on equity, and return on invested capital	across earnings, cash flows, and sales

Typically, an investment manager that explicitly incorporates the Quality factor into its investment process will use some combination of qualitative and quantitative measures. Groups will emphasize various traits or metrics based on what matches their investment philosophy. At a high level, higher-quality companies are expected to provide more consistent and stronger returns over time with less sensitivity to changes in the economic environment. It is especially common for active managers to focus on quality companies within the volatile emerging market universe.

Quality Performance

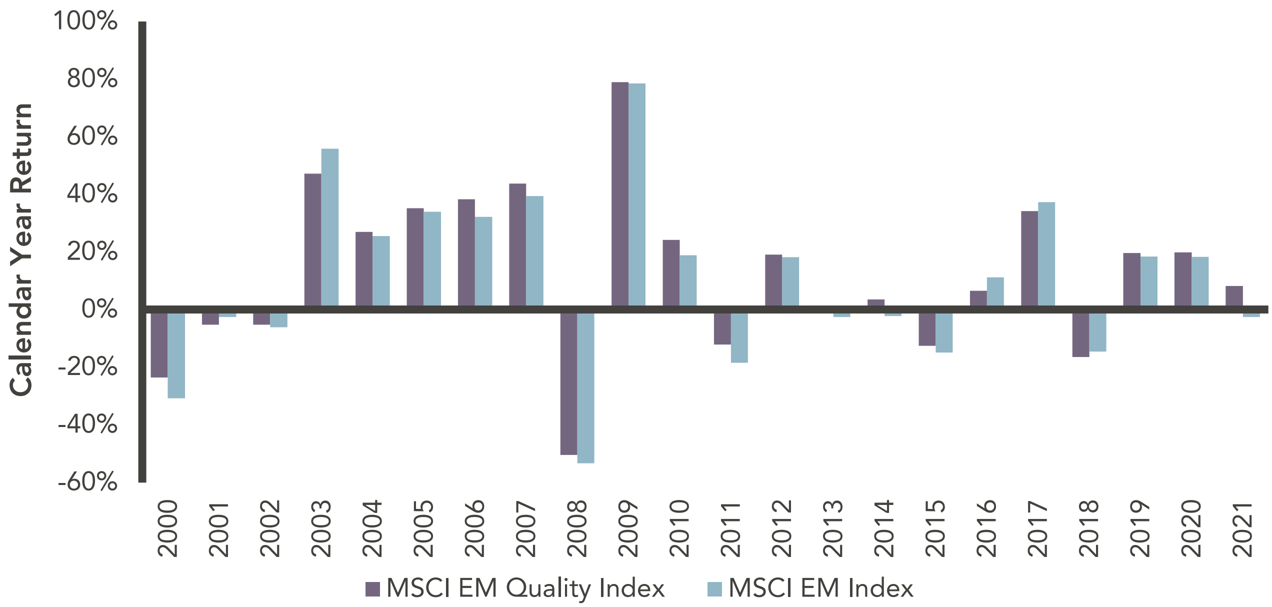
Since 1999, the MSCI EM Quality Index has outperformed the broader MSCI EM Index by a cumulative 240%, as seen in Exhibit 3 on the following page. Some of the factor's historical outperformance is attributable to its ability to protect capital during market downturns. Companies with strong balance sheets, higher profit margins, and more stable cash flows are typically better equipped to weather market downturns. Since 2000, there have been 10 calendar years where the MSCI EM Index has produced negative returns *(Exhibit 4, also next page)*. The Quality Index outperformed in eight of those 10 years, including the dot-com crash in 2000 and the Global Financial Crisis in 2008, with an average excess return of 4.6%. Since 2000, the MSCI EM Quality Index has captured 96% of the upside in the MSCI EM Index and only 90% of the downside.

Exhibit 3: Over the long term, Quality has meaningfully outperformed the broader benchmark in the EM space



Source: eVestment as of December 31, 2021

Exhibit 4: The MSCI EM Quality Index has outperformed in eight of the broader EM Index's 10 down years



Source: eVestment as of December 31, 2021

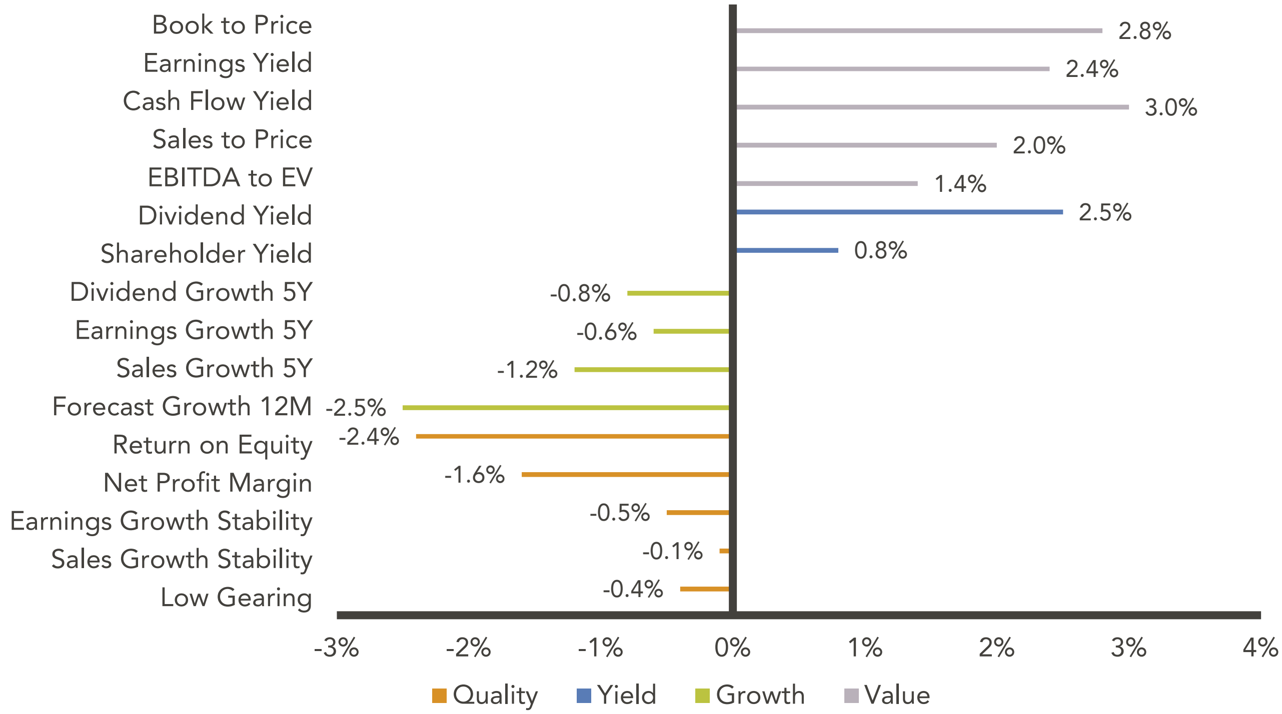
WHY HAS QUALITY NOT PROTECTED TO THE DOWNSIDE?

Growth

Quality's connection to growth has served as a headwind this year. Every down market is the result of a particular set of market conditions, and 2022 is no exception. The post-COVID inflationary environment, resulting from supply chain bottlenecks and recovery stimulus packages, was further exacerbated by

Russia's invasion of Ukraine, resulting in skyrocketing prices globally. In reaction, developed central banks around the world raised interest rates for the first time in years. During periods of high inflation and consequently higher interest rates, growth stocks tend to underperform their more value-oriented peers, given the impact of higher rates on discounted cash flow models. With rates up sharply so far this year, both Growth and Quality characteristics have suffered while Value characteristics have done relatively well.

Exhibit 5: Within EM, Value factors outperformed year to date through 3Q22, while both Quality and Growth factors struggled



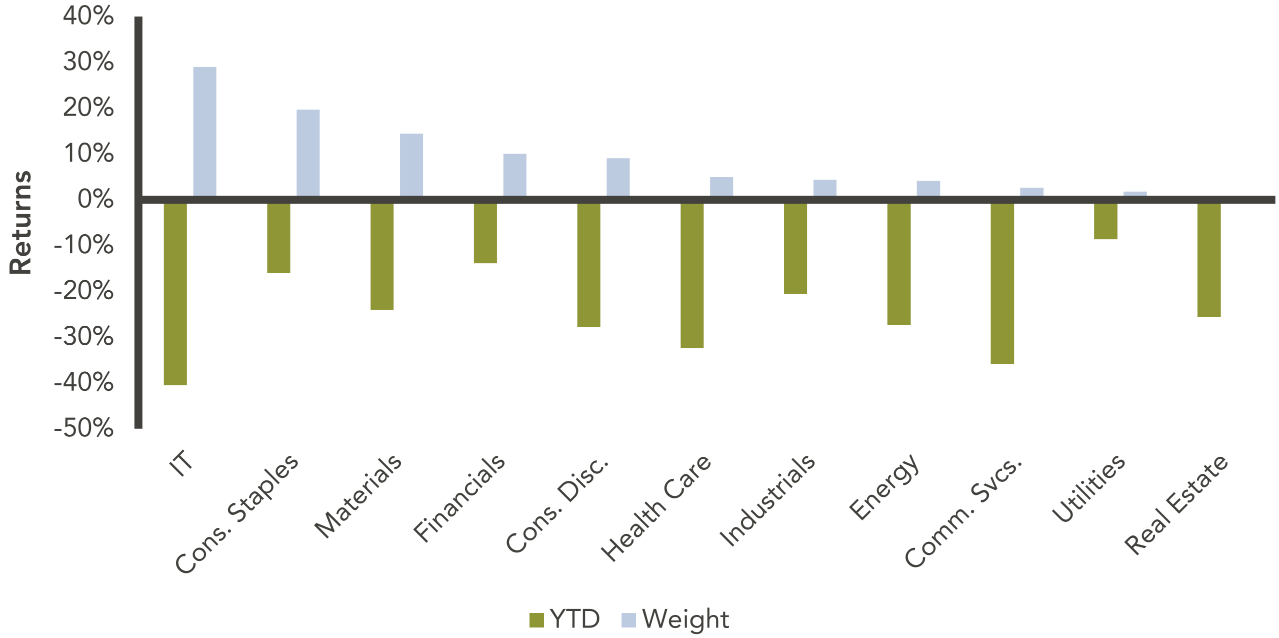
Source: StyleAnalytics as of September 30, 2022, style factor performance, return relative to emerging markets region, country, and sector adjusted

Sectors

Similarly, Quality's sector exposures have also served as a headwind. While the growth-oriented Information Technology (IT) sector is the largest weighting across indices, it comprises more of the MSCI EM Quality Index (29%) and the MSCI EM Growth Index (23%) then the broad MSCI EM Index (13%). Information Technology has been the worst performing sector this year, down 40% through September.[1] Sectors like Energy, which has benefited from a surge in oil and other commodity prices, and Utilities have outperformed, though both are smaller components of the Quality benchmark.

[1]MSCI EM Index Technology sector as of September 30, 2022

Exhibit 6: The MSCI EM Quality Index has the highest weighting to IT — the worst performing sector on a year-to-date basis through 3Q22



Source: Bloomberg, MSCI as of September 30, 2022

LOOKING FORWARD

While the median EM active manager has added value over the long term, this is not the first cycle of underperformance. In 2018, active managers struggled in the face of slowing economic momentum, rising U.S. interest rates, and the China vs. U.S. tariff war. Active managers struggled again in early 2020 when COVID-19 shook the globe and financial markets. In both instances, active manager performance eventually rebounded.

This year the world has been caught off guard by the Russia-Ukraine conflict, 40-year high inflation, sharp interest rate hikes, threats to economic growth, and geopolitical tensions. Many of these issues are interrelated, exacerbating the impact on financial markets. Though bottoms-up active emerging markets managers have struggled against this macro-driven market, with dynamics like Quality underperformance particularly challenging, the long-term opportunity set remains. Emerging markets are a more inefficient asset class that should benefit active managers over the long term.

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