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The Case for Active Management in Emerging Markets

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The underperformance of active emerging markets managers compared to the MSCI Emerging Markets Index[1] (the "MSCI Index" or the "Index") in 2016 raised the perennial question of whether passive is better than active. The uncharacteristic outperformance of heavyweight cyclical stocks has been a headwind for most of the truly active portfolio managers. Indexed or quasi-indexed approaches tend to be "self-fulfilling prophesies" when money floods into them, but run the risk of reflecting the emerging markets' past, not their future. This is a potentially critical mistake for a dynamic asset class like emerging markets.

We believe an active approach to investing in emerging markets offers a number of substantial advantages over purely passive investing:

- Its perspective is always forward-looking, while any index (for example, the MSCI Emerging Markets Index) typically focuses on companies that have done well in the past.
- It allows portfolio managers to invest in potentially the most attractive opportunities in emerging markets while avoiding inefficient and cyclical ones. Investing in an index tracking vehicle is inherently restrictive.
- Its investment universe can include stocks of all capitalization sizes, while a market cap-weighted index will be dominated by large-cap names that tend to be driven by global events.
- Its built-in flexibility gives portfolio managers the ability to access companies and markets that are otherwise excluded from the index due to strict liquidity rules.
- Over the past 20 calendar years, the Index's performance has averaged a ranking in the 53rd percentile, underperforming the 25th percentile active funds by a yearly net average of 4.73%.

As investors evaluate their emerging markets exposure as part of a comprehensive asset allocation mix, the question they should be asking themselves is: Am I efficiently accessing the best opportunities in emerging markets? By "efficiently," we mean at an acceptable long-term cost and with acceptable risk-adjusted returns. And by "best opportunities," we mean fundamentally sound business models that are both aligned with the structural tailwinds of emerging markets economies and less correlated with the rest of the world.

While we've long supported both active and index-based passive management styles as a firm through VanEck Funds and VanEck Vectors ETFs, respectively, our research concludes that the active route is one of the best ways to invest in the *broad* emerging markets.

Issues with the Index

The rationale for the active approach starts with the basic yardstick for measuring the performance of emerging markets equities: the MSCI Emerging Markets Index, the most widely used benchmark for the asset class as a whole.

Doesn't fully represent the asset class. Simply put, the MSCI Index doesn't sufficiently represent the universe of opportunity in emerging markets. It's dominated by large companies, many of which are state owned and in cyclical sectors such as energy and materials, or in low-growth sectors such as utilities and telecommunications. Many of these companies became large due not to their superior competence, but rather due to being systemically favored by their own governments through cheap capital, access to raw materials, and preferential treatment. Furthermore, the MSCI Index is restricted by liquidity requirements and it underrepresents companies that either trade less or are in the smaller market capitalization range and emerging sectors, where structural growth is currently strongest.

Looking backward, not forward. Market cap-weighted indices tracking emerging markets tend to be backward-looking, influenced by the movement of companies that have succeeded in the past, without regard for future growth potential or risks. While these can

[1]All references to the MSCI Emerging Markets Index are to its version denominated in U.S. dollars.

be appropriate in mature and diverse economies with indices that tend to be balanced and stable (for example the U.S. and the S&P 500® Index), they may not be appropriate for emerging markets. Because emerging markets are diverse and evolving at a much faster pace, passive investment vehicles tend to be at a structural disadvantage compared to active managers who have the flexibility to rapidly shift exposures to sectors and countries with the best risk-adjusted growth potential.

To illustrate how emerging markets equities have evolved, let's examine the top ten holdings of the MSCI Emerging Markets Index in December 1997 (as the Asian currency crisis mounted and before Russia's 1998 debt default), August 2008 (prior to the global financial crisis), and more recently May 2016 (Figure 1).

Figure 1. Top ten holdings of the MSCI Emerging Markets Index – then and now

Top ten as of 12/31/1997	Top ten as of 8/29/2008	Top ten as of 5/30/2016
Centrais Electricas Brasileiras S.A.	Gazprom	Samsung Electronics Co., Ltd.
Telecomunicacoes Brasileiras S.A.	China Mobile Limited	Taiwan Semiconductor Manufacturing Co., Ltd.
Telefonos de Mexico SAB de C.V.	Petroleo Brasileiro S.A.	Tencent Holdings Ltd.
Oil company LUKOIL PJSC	Samsung Electronics Co., Ltd.	China Mobile Limited
Unified Energy System of Russia	Vale S.A.	Naspers Limited
YPF S.A.	America Movil SAB de CV	China Construction Bank Corporation
Petroleo Brasileiro S.A.	Taiwan Semiconductor Manufacturing Co., Ltd.	Alibaba Group Holding Ltd.
Tenaga Nasional Bhd	Teva Pharmaceutical Industries Limited	Industrial and Commercial Bank of China Limited
Wal-Mart de Mexico SAB de CV	Oil company LUKOIL PJSC	Hon Hai Precision Industry Co., Ltd.
Genting Malaysia Bhd.	Sasol Limited	Infosys Limited

Source: FactSet.

In 1997, transportation and utility companies from Latin America and Russia dominated the top ten. Some of the countries represented in the list (e.g., Argentina) have since been recategorized with a frontier market status and some of the companies have been delisted.

By the turn of the century, many emerging nations had progressed into a new phase of financial reform, technological advancement, and massive infrastructure building, which, naturally, changed the Index's composition. By 2008, the top ten list included companies such as China Mobile, Petrobras, Samsung, Vale, and Taiwan Semiconductor.

Since the financial crisis in 2008, the top drivers of economic growth have shifted from infrastructure development that favored fixed-asset companies to domestic consumption, which favors consumer electronics manufacturers, Internet and Internet-related tech companies, and banks, among others. The top ten list changed accordingly.

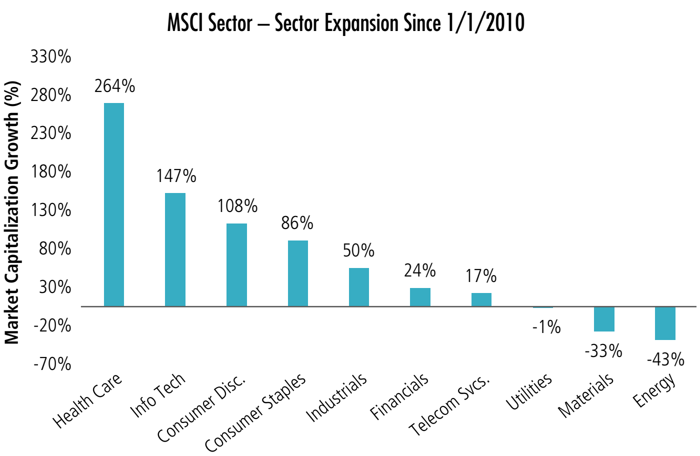
As the evolution of emerging markets continues, we wonder how the benchmark will look in the next five years. We believe that the emerging markets of today will be different from tomorrow. We are already seeing significant change in industry and sector compositions. Will China dominate the index five years from today or will Brazil breakthrough the middle income trap? Will South Korea and Taiwan graduate to developed status? Which small cap will become the next Tencent? These are some of the questions to consider as we look forward in emerging markets.

Sectors dispersion. Having the ability to implement a forward-looking perspective can help investors avoid sectors that are shrinking. 2010 marked another inflection point in the evolution of emerging markets, as dynamics shifted considerably following the global financial crisis of 2008. After the economic stimulus from monetary and fiscal easing slowed globally, emerging economies had to look for other ways to maintain their robust economic growth.

For many governments, a focus on domestic growth and self-reliance was the answer. Hence, the shift to service-led economies driven by consumption from those led by fixed-asset infrastructure companies. As a result, policymakers and investors turned their attention to the emerging markets consumer, favoring sectors and industries influenced by consumption and services. These sectors have not only outperformed in the past few years, but have also expanded quite nicely, especially when compared to some cyclical sectors that have shrunk considerably in the same period (Figure 2).

Unfortunately for passive investors, struggling commodity-based companies continued to represent a large portion of the MSCI Index, while booming health care and consumer companies represented a much smaller portion.

Figure 2. Consumption-oriented sectors have outperformed in the last few years



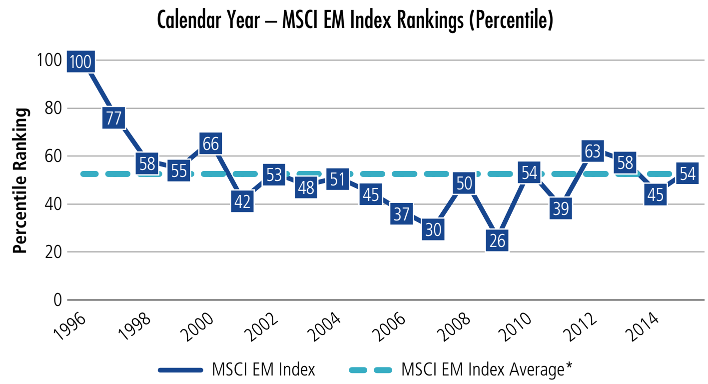
Source: MSCI.

The Proof is in Performance

Given the issues associated with the MSCI benchmark index that we've highlighted, it's not surprising to see that, over time, passive investment in emerging markets has struggled to keep up with active managers.

We compared the performance of the benchmark to that of the Morningstar Diversified Emerging Markets universe of actively managed mutual funds in the 20 years through 2015 (Figure 3). The benchmark's average annual return ranked in the 53rd percentile – meaning that more than half of active emerging markets managers outperformed the passive strategy. The Index never made it into the first quartile of the universe during the period; its highest ranking was in the 26th percentile in 2009.

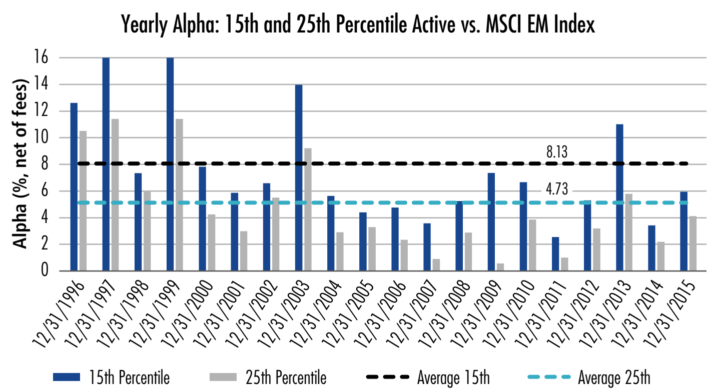
Figure 3. Active managers have outperformed the Index annually for 20 years



*The simple average of all observations.
Source: Morningstar. Past performance does not guarantee future results.

A deeper look at returns reveals that the difference in performance between active funds and the Index is even more striking. Actively managed funds at the end of the Morningstar universe's top performance quartile – i.e., in the 25th percentile – outperformed the benchmark by an average of 4.73 percentage points on a net basis annually over the last 20 years. This number, referred to as excess return or alpha, nearly doubled to 8.13 points for active funds in the 15th percentile (Figure 4).

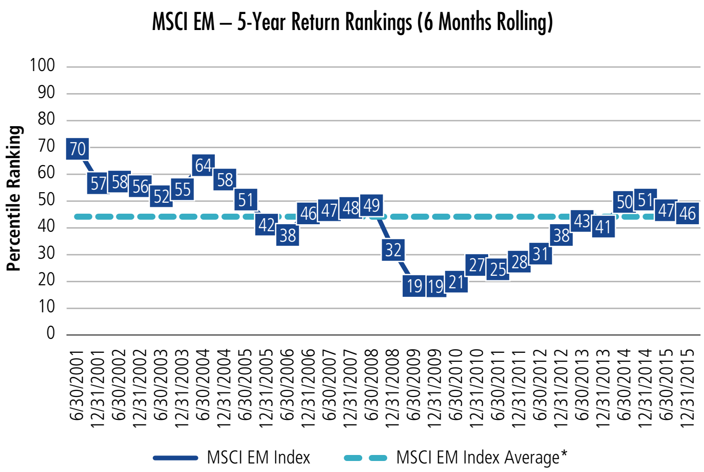
Figure 4. Top-performing active funds have dramatically outperformed the Index



Source: Morningstar. Past performance does not guarantee future results.

Results are similar when viewed on a five-year quarterly rolling basis, where the benchmark's ranking averaged in the 48th percentile (Figure 5). The benchmark did best following the financial crisis, with its five-year return breaking into the top quartile for a few quarters in 2009 and 2010. Shortly thereafter, though, it moved upward to revert to its average as markets began to normalize.

Figure 5. Passive performed average on a five-year quarterly rolling basis...

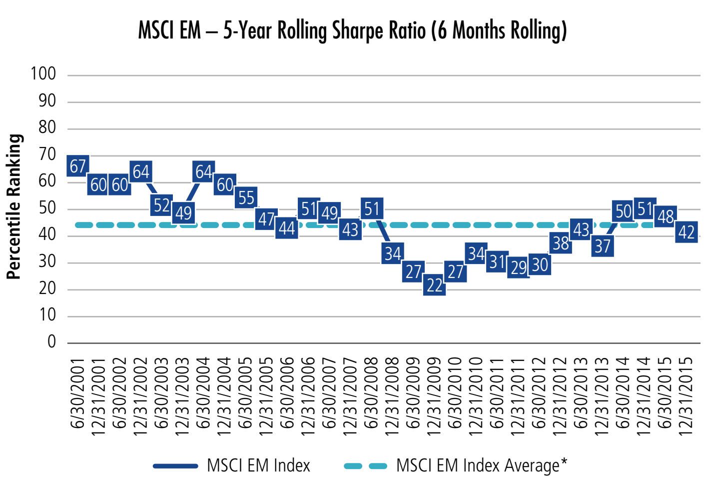


*The simple average of all observations.
Source: Morningstar. Past performance does not guarantee future results.

Even on a risk-adjusted basis, measured by calculating the five-year rolling Sharpe Ratio[2] for the benchmark and the active management universe (Figure 6), the benchmark continued to underperform, generating an average ranking in the 44th percentile.

The benchmark's best days on a risk-adjusted basis were also during the financial crisis. By then, the impressive run of commodity and technology companies in the 2000s helped push the Index's five-year performance ranking beyond its long-term average, but soon began to revert back toward its mean following the financial crisis.

Figure 6. ...and when returns were adjusted for risk



*The simple average of all observations.
Source: Morningstar. Past performance does not guarantee future results.

The Liquidity Concern

Despite the significant expansion of emerging markets equities over the past 20 years, trading liquidity remains a factor requiring caution for active and passive investors alike.

Given the large size of passive funds, investing in companies that trade in smaller quantities, and/or infrequently, can be challenging. Passive funds can deprive investors of exposure to stocks that may prove not only potentially rewarding, but also less vulnerable to the unpredictability of global flows in and out of passive exchange-traded funds.

For smaller active funds, this represents a good investment opportunity with a potential bonus: less volatility and lower valuations given the liquidity premium that's typically priced into such companies. An active fund with the ability to invest in small- to mid-size companies can be nimbler and more flexible in finding potentially high-growth businesses. It also can provide investors with access to rising companies before they become liquid enough for inclusion in large active and passive funds.

We note in this context that liquidity limitations were a major factor in MSCI's decision to exclude China's A Share market – the world's second-largest stock market – from the Index. China is home to some of the most innovative companies in the world with immense growth potential. Although many are listed on the Hong Kong Stock Exchange, which is easily accessible to non-Chinese investors, a large number of companies on local exchanges in Shenzhen and Shanghai are not accessible.

Small-Caps are Ignored by the Index

Many of the most rewarding opportunities are those of companies that started small and grew larger through effective management and favorable business conditions. There's no shortage of such inspiring companies in emerging markets.

In many cases, small-caps (or companies below $2 billion) embody the true spirit of emerging markets, as they tend to be influenced by local factors and less affected by global gyrations. When skillfully blended with larger emerging markets companies doing business globally, small-caps can enhance a portfolio's risk/return profile, given the lower expected correlations between local businesses and global ones.

[2]The Sharpe Ratio measures the excess return per unit of risk (as measured by standard deviation) in an investment asset or trading strategy.

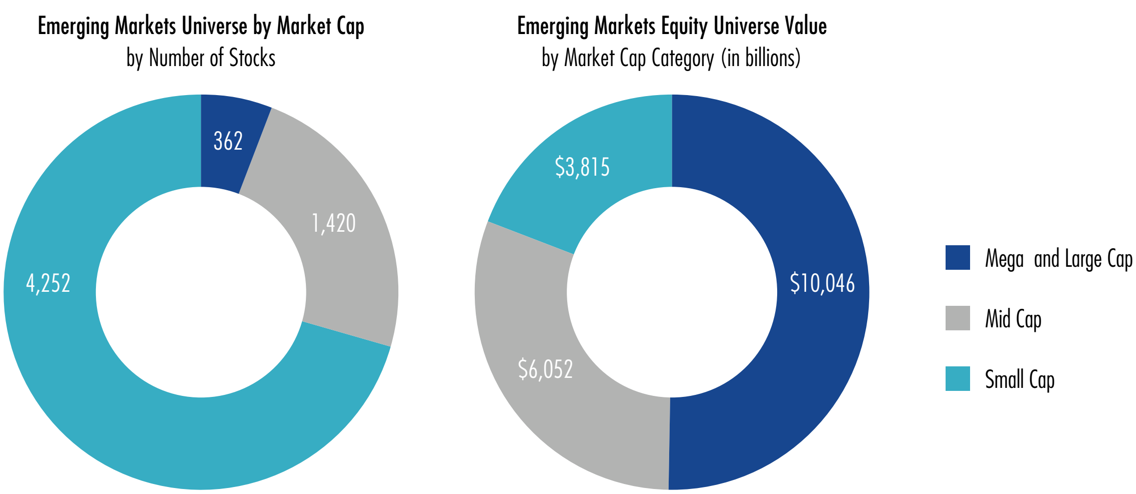
Nonetheless, small-cap companies and some mid-caps are also underrepresented in the traditional emerging markets indices (Figure 7). Small-caps constitute less than 3% of the Index, but more than 70% of the emerging and frontier markets universe.

Figure 7. Emerging and Frontier Markets Universe by Market Cap and Number of Stocks

The Bottom Line

It's hard to reconcile the concepts of "passive" and "emerging," as the essence of the former is thriving on the stability of the status quo, while the latter is a symbol of dynamism and upward progress. This thesis certainly holds true for emerging markets equities: Actively managed portfolios have significantly outperformed index-based passive vehicles over the course of the last 20 years on an absolute and risk-adjusted basis.

In sum, VanEck believes active management is the best approach to investing in broad emerging markets equities. We encourage investors to talk to their financial advisors about how an active strategy may be the right choice for the emerging markets portion of an overall portfolio.



Source: Bloomberg. Data as of 03/31/2015.

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