Why Country Allocation Matters in Emerging Markets

Identifying inefficiencies and building a framework to take advantage of emerging market opportunities

Emerging market (EM) countries exhibit great diversity and fragmentation, leading to a high dispersion in returns. We found conventional theories and tools created for developed market investing and predicated on the assumption that markets are efficient often do not work in the face of localized markets that exhibit more idiosyncratic characteristics. Therefore, we believe a disciplined, systematic, multi-factor approach to country allocation can help identify market inefficiencies and contribute substantially to outperformance over a full market cycle.

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Why Country Matters

Country selection currently explains a quarter of returns

Country selection remains a significant source of alpha generation in global portfolios even though economic integration and globalization have reshaped the global economy over the past 20 years. On average, from March 31, 2004 to March 31, 2021, country selection explained approximately 30% of returns for the MSCI Emerging Markets Index (Figure 1).[1]

With signs of globalization peaking, and as economic and social forces give rise to protectionism, we believe idiosyncratic country factors will likely become even more important in explaining returns. The decoupling of markets can ultimately lead to the regionalization of economies, causing individual country returns to become increasingly uncorrelated with each other. We expect these evolving dynamics to present greater opportunities to outperform though country selection, particularly through countries that are more isolated from these trends.

Figure 1: Proportion of returns explained by country, sector and company effects within MSCI Emerging Markets Index[2]
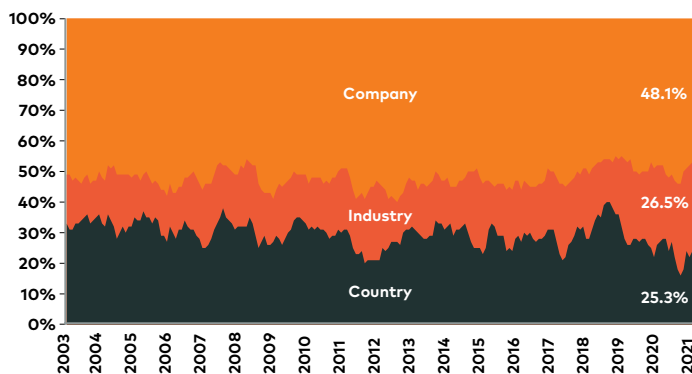

What Causes Mispricing in Emerging Markets

Capital Controls

We recognize that multiple factors can contribute to the pricing of global markets, including, but not limited to, monetary and fiscal policy, current account balance (surplus/deficit), political environment, capital flows and economic growth. However, an often overlooked consideration that contributes to the mispricing of markets is the prevalence of higher capital controls in developing countries. Despite a longer-term trend towards capital account liberalization, particularly amongst

advanced economies (Figure 2), the majority of emerging market countries still rely on regulatory and capital control restrictions that can create a structural bias towards their home market.

Figure 2: Percentage of country group with relatively open capital accounts[3]
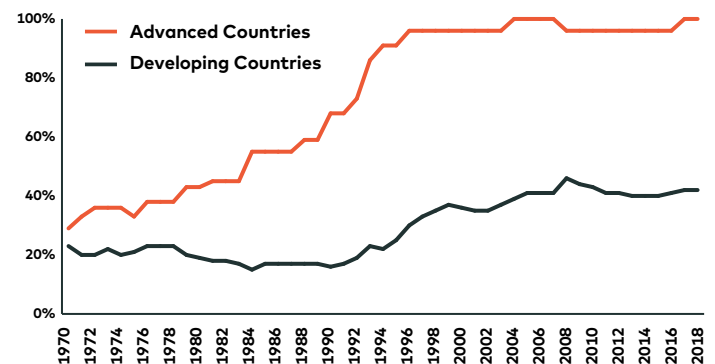
For instance, in India, pension funds are prohibited from investing offshore. Despite a tenfold increase in assets under management (AUM) for equities in India from Rs 1.1 trillion in 2009 to Rs 11.3 trillion in 2021[4], most of these assets remain captive within the country, leading India's stock market to trade at a premium relative to the MSCI Emerging Markets Index. Similarly, China's asset management industry has experienced a ninefold increase in total AUM from RMB 2.0 trillion in 2018 to RMB 18.0 trillion in 2020.[5] Given that offshore transactions in China are limited to US$50,000 per citizen per annum, the vast majority of this AUM is restrained domestically, leaving investors with limited alternative investment opportunities aside from their home market. These controls partially explain the historical price disparity between China's onshore (A-share) and offshore (H-share) equity markets, with the A-shares of dual-listed companies on average trading at an approximate 22% premium relative to their corresponding H-shares.[6] Another example is in South Africa where domestic funds are permitted to invest up to 30% offshore as long as they commit to investing an additional 10% in continental Africa (outside of South Africa). We believe that these structural restrictions create inefficient stock markets which can lead to sustained periods of over or undervaluation and mispricing. This can in turn create potential opportunities for global investors that have the skill to identify underpriced markets using relative valuation, growth and risk attributes.

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[1] Based on rolling 12 month average returns.
[2] Source: Internal Research, AGF Investments Inc./Highstreet Asset Management Inc., as of March 31, 2021.
[3] Source: Chinn-Ito Index, as of July 19, 2021.
[4] Association of Mutual Funds in India, figures referenced as of March 31, 2009 and June 30, 2021.
[5] KPMG Celebrating 20 years of asset management in China, June 2018. China Banking Association, January 26, 2021.
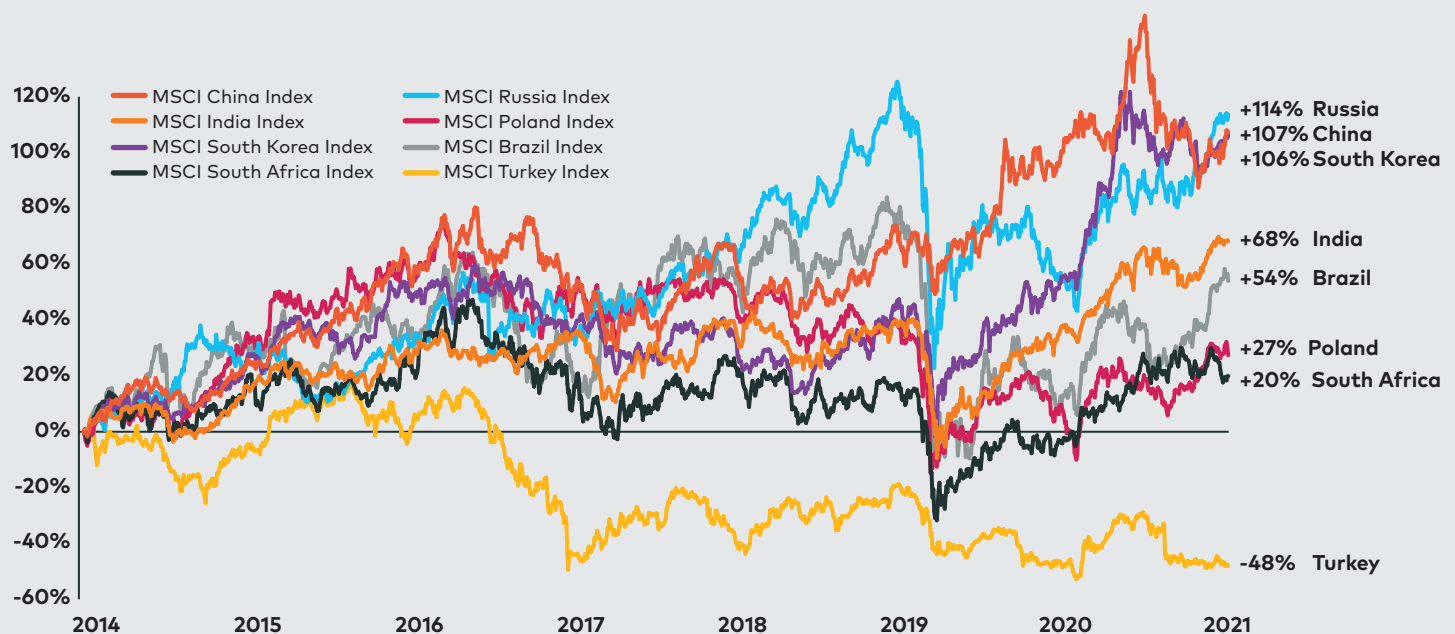[6] HSBC research report, as of October 14, 2020.

Market Fragmentation

Emerging market (EM) countries, generally defined as those that are on the path to becoming an advanced or developed market country, are often regarded as a homogeneous asset class by investors. While it is true that certain countries such as China and South Korea constitute a significant portion of the MSCI Emerging Market Index at approximately 38% and 13%[7], respectively, we believe the view of EM as a homogeneous,

single asset class is misguided. We believe idiosyncratic characteristics of each country, including demographics, economics and governance, all support the case for why EM countries should be viewed on an individual basis. This is visually evident in Figure 3, which shows the high dispersion of returns across various EM countries over a 5-year time horizon.

[7] Bloomberg, as of June 30, 2021.

Figure 3: 5-year performance of select EM countries[8]

MSCI China Index
MSCI India Index
MSCI South Korea Index
MSCI South Africa Index
MSCI Russia Index
MSCI Poland Index
MSCI Brazil Index
MSCI Turkey Index

+114% Russia
+107% China
+106% South Korea
+68% India
+54% Brazil
+27% Poland
+20% South Africa
-48% Turkey

[8] Source: Bloomberg, as of January 31, 2021. Returns presented in CAD.

One explanation for this high dispersion is the desynchronization of business cycles across emerging markets, which leads to divergences in economic agendas and monetary policies. For example, in 2018, Turkey was faced with a currency and debt crisis, characterized by a significant decline in the Turkish lira, high inflation and rising borrowing costs and loan defaults, which resulted in a 41% decline in Turkey's stock market.[9] During the same year, China was in the midst of an escalating trade war with the U.S. as it strived to bolster economic growth through domestic policy support. In 2020, South Korea, Taiwan and China were among the best performing countries across the emerging and developed markets during the COVID-19 pandemic, as they responded swiftly to control the initial outbreak and began their economic recoveries.

Another cause of broad divergences are macro-political risks, particularly in light of the increasing frequency and intensity of political/economic crises across emerging markets since the 2008-2009 Global Financial Crisis. As an illustration, in 2016, Brazil's overall GDP contracted by 3.6% after eight consecutive quarters of economic contraction. Despite its lackluster economy, Brazil was one of the best performing stock markets in 2016 owing to the impeachment of former president Dilma Rousseff over her violation of budgetary laws and subsequent corruption charges. As a result, Brazil's stock market surged 67% that year leading to a significant decoupling from the rest of emerging markets.

[9] Bloomberg, returns references in US$, as of June 30, 2021.

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The aforementioned examples help demonstrate the wide-ranging diversity and fragmentation across EM, which culminate in divergent returns. It is our experience that conventional theories and tools created for developed market investing and predicated on the assumption that markets are efficient often do not work in the face of localized markets that exhibit more idiosyncratic characteristics. Therefore, we believe a disciplined approach to evaluating these considerations and pursuing country selection can help turn these differences into attractive risk-adjusted investment opportunities.

Local stock market not representative of local economy

Identifying which countries will outperform is more difficult than some investors believe. A common misconception is that a country's GDP growth, which captures a host of economic information, is the most important indicator of a country's stock market performance. However, historical data has shown that economic (GDP) growth explains only a relatively small proportion of actual performance in emerging markets (R^2=0.24) indicating a limited relationship between the two (Figure 4). The data for developed markets shows an even weaker relationship with a significance of R^2=0.01.

Figure 4: Higher GDP growth in emerging markets did not translate into higher returns[10]

Real GDP Growth Versus Real Equity Returns EM (2000 -2020)
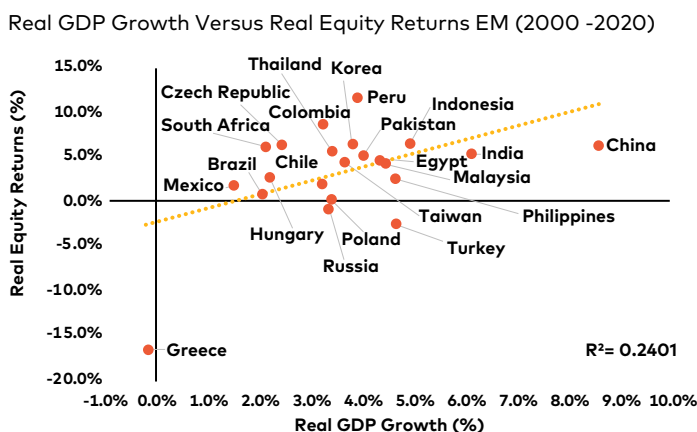
One potential reason for this limited relationship is that local stock markets may not be representative of the local economy. For example, a significant portion of Korea's stock market is comprised of global multinational firms that operate worldwide. The largest constituents within the MSCI Korea Index include some of the world's largest consumer electronics companies and automotive

manufacturers– all global firms with significant foreign operations. Yet, global profits of such companies are not necessarily related to prosperity at home, a fact that might explain why a country's economic growth has a low correlation to its stock market returns.

Another potential reason for the divergence between a country's stock market returns and GDP growth is how much of the constituent companies' revenue is derived domestically based on a company's country of domicile. While companies in countries such as Brazil, Indonesia and Thailand generate a majority portion of their revenue domestically, those in many other EM countries generate a significant portion (and in some cases a majority) of their revenue internationally (Figure 5). Therefore, the economic growth of a country of domicile is not always indicative of a country's potential stock market return.

Figure 5: Domestic revenue exposure based on country of domicile[11]
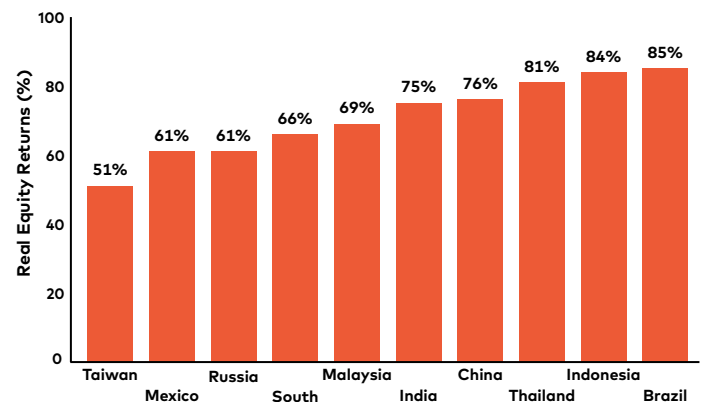
State-Owned Enterprises

Another driver of market inefficiency and fragmentation in emerging markets is the prevalence of state-owned enterprises (SOEs), one of the largest distinctions between developed and EM equities. In contrast with developed market companies, which are widely held with a dispersed investor base, the majority of EM companies are SOEs, in which local and state government agencies hold significant ownership control (generally greater than 20%).

As of September 2020, SOEs represented approximately 25-30% of the MSCI Emerging Markets Index.[12] Based on data as of December 31, 2018, the proportion of state ownership in China, the largest country constituent in the index, is 43%, and reaches as high as 95% and 94%, respectively, in the United Arab Emirates and Qatar.[13]

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[10] Source: Internal Research, AGF Investments Inc./Highstreet Asset Management Inc., as of December 31, 2020
[11] Source: Internal Research, AGF Investments Inc./Highstreet Asset Management Inc., as of March 31, 2021.
[12] Copley Fund Research, September 9, 2020.
[13] Callan, MSCI, December 31, 2018.

Some of the world's largest and most well-known companies are fully or partially state-owned, including a large telecommunications equipment company in China and the world's largest oil and gas company by market capitalization.[14]

The misalignment between government interests and those of minority shareholders amongst SOEs have historically led to greater inefficiencies, evidenced by the underperformance of SOEs relative to non-SOEs as well as their lower returns on assets (Figures 6-7). Given these inefficiencies lead to wide divergences both within and across countries, we believe a combination of an appropriate country selection approach along with fundamental research, including consideration of corporate governance and other qualitative factors, can generate attractive investment opportunities.

Figure 6: Cumulative Returns of SOEs vs. Non SOEs in the MSCI Emerging Markets Index[15]
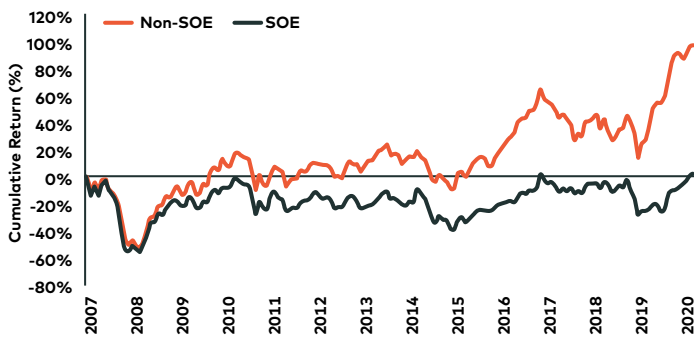
Figure 7: Return on Assets of SOEs vs. Non SOEs in the MSCI Emerging Markets Index[15]
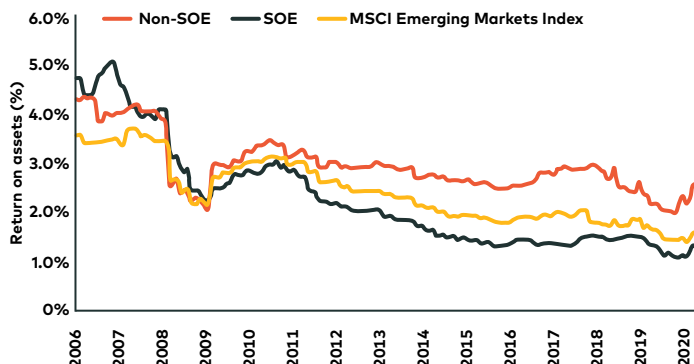
Drivers of EM Performance

Currency

An important distinction between emerging and developed markets is the role that currencies play. Throughout history, exchange rates in emerging economies have experienced higher volatility than exchange rates in developed countries, particularly during periods of regional or global economic turmoil. Relative to developed markets, EM economies have also been more vulnerable to external shocks, often leading their currencies into crisis as exemplified by the Asian currency crisis in 1997 and more recently in Argentina.

While the drivers of these factors are difficult to disentangle, we believe the impact of currency fluctuations on a country's current account, in particular, deficits, is often overlooked. Given that developing countries typically borrow in the form of foreign debt (denominated in either U.S. dollars or euros), a stronger local currency helps to lower the burden of the approximately US$11 trillion in external debt outstanding across emerging and developing markets.[16] In addition, the country benefits from lower costs of imports on goods and services, which in turn lowers domestic inflation and affords central banks greater flexibility.

One of the most prominent examples of such dynamics at play occurred during the Taper Tantrum of 2013, when many developing economies, such as Brazil, India and South Africa, had become reliant on foreign capital and accumulated large deficits. When the U.S. Federal Reserve announced in 2013 that it would end its quantitative-easing policy, the resulting 'taper tantrum' hit many of these emerging countries' financial markets and economies the hardest as local currencies devalued sharply in response.

The result of these dynamics is evidenced by the positive relationship between stock market performance and local currency performance in many EM countries. By contrast, developed markets often exhibit a negative correlation (Figure 8). We believe that understanding these underlying dynamics in emerging markets allows us to better determine a country's ability to outperform.

Figure 8: EM relative performance is positively correlated with local currencies[17]
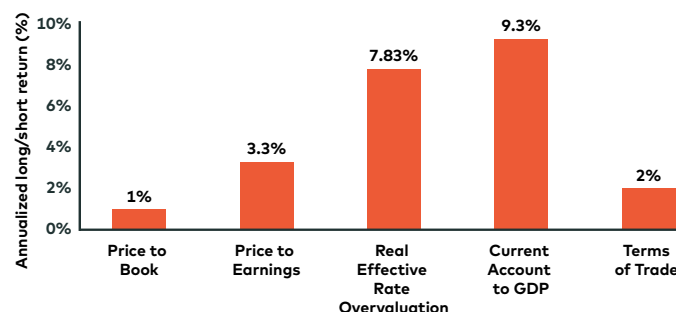

Valuation, Momentum and Risk

We have found that over a longer time period, paying attention to a combination of valuation, growth/ momentum and risk characteristics can help identify country's stock markets that could outperform.

For instance, as a country risk factor, we found the current account-to-GDP ratio to historically be one of the strongest predictors of return in emerging markets. Based on a hypothetical EM portfolio strategy that purchased countries in the MSCI Emerging Markets Index with the highest current-account-surplus-to-GDP ratios and shorted countries with the highest current-account-deficit-to-GDP ratios, the portfolio would have outperformed by approximately 930 basis points per year since 2000 (rebalanced annually). Similarly, a hypothetical portfolio that took the same approach using real effective rate and price-to-earnings would have outperformed by approximately 780 basis points and 330 basis points, respectively (Figure 9).[18]

Figure 9: Predictors of return (long/short return with annual rebalancing)[18]

As another example, a hypothetical, long-only portfolio strategy that purchased countries with attractive valuation (measured by price-to-book), growth/ momentum (12-month price momentum) and risk (current-account-to-GDP) characteristics would have also significantly outperformed the benchmark over the longer term (Figure 10).[18]

Figure 10: Single factor cumulative return (long-only)[18]
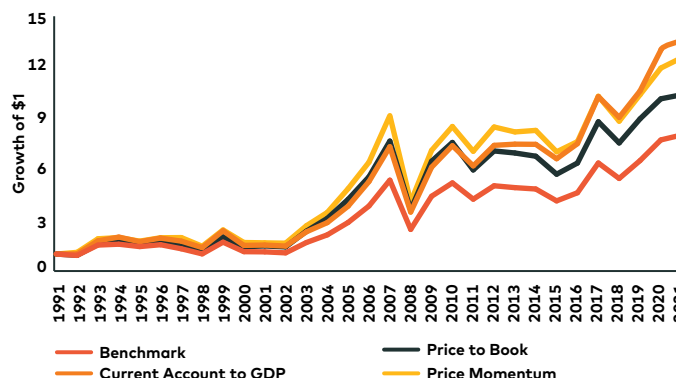
Investors can infer that a framework or methodology that includes these types of factors – valuation, growth/ momentum and risk characteristics – can generate additional alpha.

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Country Allocation: A Disciplined, Systematic Multi-Factor Approach

A framework best suited for emerging markets

In our view, country allocation should not be based solely on macroeconomic factors, but rather a systematic process of identifying attractive country stock markets. This works particularly well for the MSCI Emerging Markets universe, which contains a wide variety of heterogeneous markets and a higher dispersion of returns in comparison with developed market countries (Figure 11). In 2020, South Korea delivered the highest returns of +45.2% while Greece delivered the lowest returns of -26.7%. The wide spread in returns (71.9%) points to a significant opportunity for investors to generate excess returns by allocating optimally between the numerous markets in EM (27 stock markets in the MSCI Emerging Markets Index).

We believe a country allocation framework would not work as well in an investment universe with a more homogeneous group of countries, such as the MSCI World Index. In 2020, developed markets posted a smaller spread in returns (54.8%), ranging from a minimum of -10.4% to a maximum of 44.4% (Figure 11).

Given the wider dispersion of returns in emerging markets as compared to developed markets, there is a greater opportunity to add value through a country allocation, or more precisely, the reward for correctly identifying country relative performance can be greater.

Figure 11: Casting a wider net can help identify opportunities[19]

Dispersion of country annual returns
(as of December 31, 2020)

● DM Countries ● EM Countries
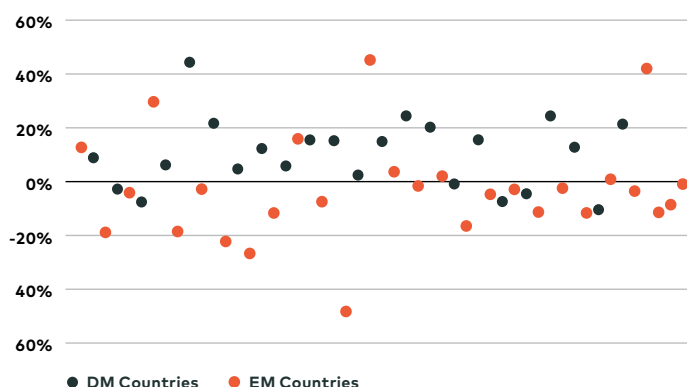
Our framework using valuation, growth/sentiment and risk

Given the broad diversity and complexities across emerging markets, we believe the one-size-fits-all approach that investors commonly take does not work well in EM. To successfully capture a second source of alpha (or relative outperformance) and the one-quarter of returns explained by country selection, an investor should consider using an empirically-verified process that ranks and identifies the best opportunities available.

We employ a disciplined, multi-factor country allocation framework that incorporates time-tested valuation, growth/momentum and risk measures. Our framework aggregates the characteristics of various markets, which are ranked based on the following factors:

- Valuation (e.g. price-to-earnings and price-to-book ratios);
- Growth/sentiment (estimate revisions, price momentum); and
- Risk (e.g. current account to GDP, real effective exchange rate).

Based on our experience, the factors described above explain a greater proportion of a stock market's performance than economic growth and have each been tested for their ability to add value for our investors.

We believe that over time, valuations should demonstrate reversion to the mean as one market will not be perpetually more expensive than another. Markets that have become cheap (e.g. as a result of overzealous selling) will likely normalize and gain in value and expensive markets will likely become cheaper over time. However, markets can remain cheap for significantly long periods of time (Figure 12) and by considering factors such as price momentum and earnings estimate revisions, one can avoid being caught in a value trap.

Figure 12: Valuation: A key indicator of a stock market's attractiveness[20]

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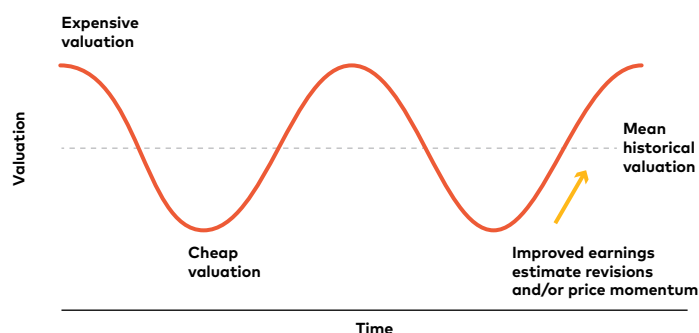
[19] Source: Bloomberg, as of December 31, 2018. Returns in USD.
[20] Source: AGF Investments Inc. for illustration purposes only.

Not a "black box"

The country allocation framework is not a "black box". It provides recommended weights for individual country stock markets and we evaluate the merits of the recommendations. We recognize that no approach is absolute, and therefore believe it is important to evaluate the recommendations of any approach in the context of the political and economic environment, which may not necessarily be captured via a systematic process. We also consider additional qualitative considerations, including valuation biases in certain countries such as India and China's A-share stock markets. Most importantly, the recommendations from the framework are considered within the context of a carefully constructed portfolio while taking into account individual holdings and their correlations with other holdings within the portfolio.

Conclusion

When it comes to emerging markets, we believe that country allocation can play a pivotal role in generating alpha. Through this paper, we have attempted to demonstrate that:

- Country selection explains a quarter of returns;
- GDP growth is a poor predictor of EM returns;
- Capital controls, market fragmentation and market structures drive inefficiencies;
- EM performance is positively correlated with local currencies; and
- EM performance is not homogeneous.

By using a multi-factor country allocation framework that incorporates time-tested valuation, growth/momentum and risk measures, investors can exploit a measurable inefficiency embedded in EM. We believe our disciplined country allocation framework provides a distinct, second source of alpha generation, separate from bottom-up stock selection, that can help deliver more consistent risk-adjusted returns for our clients.

For more information about emerging markets investing visit AGF.com