

Improving the Performance of an Emerging Market Equity Portfolio

How combining two indices can lead to significant outperformance and higher income

Over the last 15 years, emerging market equities have experienced strong inflows and interest from investors. From 1999 through 2014, the MSCI Emerging Markets Index (the most popular emerging markets equity benchmark) provided annualized returns of 7.04%, compared to just 4.24% for the S&P 500 Index (the most popular US benchmark). At the same time, these higher returns came with greater annual volatility of more than 23% for the MSCI EM, compared to approximately 15% for the S&P 500.

In this research note, we examined if there was a way to improve the overall risk and return characteristics of the EM space for investors, while providing higher dividend yields. As discussed below, we believe that there is an attractive solution worth a look by anyone interested in investing in emerging market equities: a combination of the MSCI EM Index with the Indxx SuperDividend® Emerging Markets Index (ISDEMT).

Figure 1: Calendar Year Returns, 2000-2014



As shown in Figure 1, the emerging market equity space has strongly outperformed US markets over the last 15 years. However, in 2012 and 2013, the MSCI EM underperformed the S&P 500. As a result, emerging market equities are trading at a nearly 40% discount to developed markets, a level not seen since 2003 (the starting point for the last emerging markets rally). When combined with expected growth rates of more than 5%, emerging markets are expected to significantly outpace their developed market counterparts (with projected growth of just around 2%) in the medium-to-long term. However, with their historically higher volatility, is there a way to improve the risk/return tradeoff and make the space more palatable to investors? We believe that there is.

A Combined Portfolio with Better Potential

Unlike developed market firms, with mature markets and excess cash on their books, emerging market companies operate in developing, high-growth markets. This means that initiating or raising a dividend payout is often directly linked to strong bottom-line growth for the corporation, which makes dividend investing similar to growth investing in emerging markets. Based on these attributes, we wanted to see if combining an EM dividend index with the MSCI EM would not only boost performance, but also protect investors from volatility. For our exercise, we created a hypothetical portfolio with a 50% allocation to the MSCI EM Index and a 50% allocation to our Indxx SuperDividend® Emerging Markets Index (ISDEMT). ISDEMT is 50-stock portfolio that provides exposure to the 50 highest yielding EM corporations that have passed stringent size, liquidity and dividend consistency criteria.

Figure 2: Performance Analysis: 50/50 Allocation vs. the MSCI EM Index

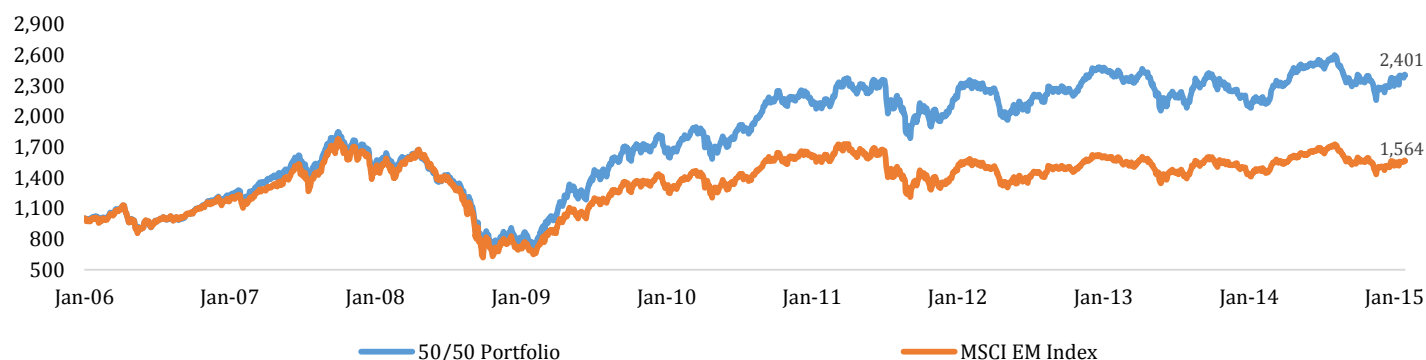


Table 1: Risk/Return Analysis: 50/50 Allocation vs. the MSCI EM Index

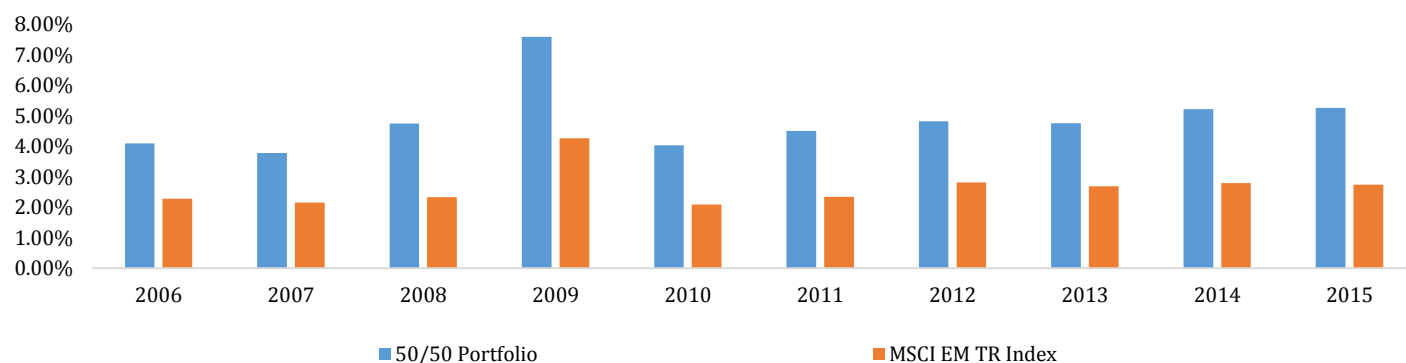
Year	Returns		Volatility		Risk-adjusted Returns	
	50/50 Portfolio	MSCI EM	50/50 Portfolio	MSCI EM	50/50 Portfolio	MSCI EM
2006*	20.22%	18.87%	16.84%	17.45%	1.20	1.08
2007	43.36%	39.42%	20.35%	20.52%	2.13	1.92
2008	-50.64%	-53.33%	36.99%	40.82%	-1.37	-1.31
2009	103.33%	78.51%	29.32%	26.54%	3.52	2.96
2010	29.08%	18.88%	17.71%	18.11%	1.64	1.04
2011	-10.19%	-18.42%	19.87%	22.31%	-0.51	-0.83
2012	20.49%	18.22%	14.15%	14.65%	1.45	1.24
2013	-6.46%	-2.60%	13.28%	13.43%	-0.49	-0.19
2014	0.85%	-2.19%	11.88%	11.30%	0.07	-0.19
2015*	5.35%	3.71%	5.72%	4.88%	0.94	0.76
Cumulative Annualized (Jan 2006 - Feb 2015)	10.12%	5.05%	21.18%	21.87%	0.48	0.23

*From Jan 2006 ** Through Feb 2015

As can be seen in Figure 2 and Table 1, a 50/50 allocation to ISDEMT and the MSCI EM offered significantly improved risk and return characteristics over the MSCI EM alone. Cumulative annualized returns from this combined portfolio nearly doubled, to 10.12%, compared to 5.05% for just the MSCI EM. More importantly, this superior return performance was achieved at a lower volatility than the MSCI EM Index alone (21.18% vs. 21.87%). As a result, risk-adjusted returns for the 50/50 portfolio were more than double (0.48) the 0.23 for the MSCI EM Index alone. In terms of overall performance, the 50/50 portfolio outperformed the MSCI EM in every calendar year except 2013. Also worth noting is in the 3 years following 2008, when risk aversion increased significantly, the outperformance of the 50/50 allocation over just the MSCI EM rose sharply. Finally, in the years marked by sharp bear markets such as 2008 and 2011, volatility for the 50/50 strategy remained notably lower than the MSCI EM.

Based on our analysis, it appears that a 50/50 portfolio for emerging markets provides a much better solution for investors than exposure to the MSCI EM index alone. In addition, this portfolio provides exposure to companies with stronger growth potential, along with significantly higher yields (discussed below).

Higher Dividend Yields

Figure 3: Trailing 12 Month Dividend Yields*

*As of January 31 each year

As shown in Figure 3, historical dividend yields for the 50/50 portfolio would have been consistently higher (in the range of 4%-5%) compared to the MSCI EM Index alone (in the range of 2%-3%). In addition, the methodology of ISDEMT has applied in-built mechanisms such as sector caps, country caps and equal-weighting, which reduces the typical biases associated with dividend investing. The index also looks at dividend consistency over time, to try to improve the quality of the portfolio and reduce turnover.

A final point to note is that the 50/50 portfolio would be better allocated towards true emerging market economies. As an example, the BRIC countries (Brazil, Russia, India and China) are the largest five country allocations for ISDEMT, and midcap companies comprise nearly 50% of the index. In contrast the MSCI EM Index allocates nearly 30% of its total weight to more developed countries such as South Korea and Taiwan, and a 70% allocation to large cap stocks (with a market capitalization greater than \$10 billion.) As a result, a 50/50 allocation should provide higher exposure to companies that are more focused on the emerging market space.

Conclusions

Based on current valuations and market performance, many investors are taking a new look at emerging market equities and considering an increase in their exposure. We believe that, rather than simply allocating their capital to the typical and most popular emerging market benchmark (the MSCI EM Index), they may want to consider a blended approach that allocates half their portfolio to the MSCI EM Index, and the other half towards the Indxx SuperDividend® Emerging Markets Index. This 50/50 combined portfolio shows significantly better historical performance and higher yields than the MSCI EM Index alone, as well as exposure to companies that may be better situated to take advantage of the expected growth trends in emerging market economies.

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