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In focus

Why active trumps passive in emerging market equities

June 2020

Investors have been debating the benefits of active versus passive management for many years. In certain asset classes, such as large cap US equities, the argument appears to have been won emphatically by passive managers. Passive now accounts for an estimated 55% of assets under management in large cap US equities, up from 35% just 7 years ago. In emerging markets (EM), however, the debate continues.

Since the MSCI Emerging Markets Index was first launched at the end of the 1980s, much has changed. In this paper we review the evolution of emerging equity markets, analyse why the cost of beta has decreased, and explain why we believe it still pays for investors to take an active approach in EM equities.

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We examine the evidence and build a more accurate picture of the costs and benefits of an active versus a passive approach to EM equities investing. We show that, although the all-in cost of EM index tracking has fallen dramatically, and can be below 20bps annually, the case for an active manager remains compelling.

The longstanding, conventional wisdom is that although active management does add value, fees offset any benefit to the end investor. This is based on the premise that, however inefficient a market, the average active investor by definition cannot outperform the index (even before fees) since the index performance is the average of all returns.

On the surface, this argument against active management seems compelling, but we need to take into account market structure. Most of the academic literature exploring active management has focused on the US (and, to a much lesser extent other large developed markets). However, the structure of the US equity market, its participants, regulatory framework and scrutiny are

Figure 1: Relative performance of emerging versus developed equities

Past performance is not a guide to future performance and may not be repeated.
Source: FactSet, Schroders, MSCI, 31 December 2019. MSCI Emerging Markets vs. MSCI World (USD, Gross).

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not replicated across EM. Most strikingly, the amount of change in the structure of EM indices means that the trading, and hence the cost of a passive indexed approach, is much higher than it is for developed markets. These differences present exploitable opportunities for active managers.

In EM, the proponents of active management argue that their greater inefficiencies can be successfully exploited by well-resourced, skilled managers. The proponents of passive management counter that the benefits of any additional inefficiencies are at the very least offset by the costs of extracting them, including the search costs involved in finding good active managers.

How emerging equity markets have evolved

Global investors began to invest in EM equities as a separate allocation during the late 1980s and the asset class was popularised during the 1990s. Over the last 30 years, EM equities have provided positive long-term risk-adjusted excess returns and enhanced portfolio diversification. However, as figure 1 shows, a large degree of patience and a long investment horizon have been required; there have been long periods when EM equities have underperformed developed market (DM) equities.

In addition to the volatile performance ride, the opportunity set for an EM equities investor has changed dramatically over the last 30 years, as developing countries have opened their markets to foreign investors and enhanced their operational and regulatory regimes.

Figure 2 shows how the MSCI Emerging Markets Index has changed over the last 30 years. The biggest change is China, which has gone from zero to 36%, whilst Latin America's weight has shrunk by over 20%.

The biggest change over the coming years is likely to come from the increased inclusion of China's mainland-listed equities (A shares). By the end of 2019, China accounted for around a third of the MSCI Emerging Markets Index, predominantly offshore equities, with A shares included in the index at 20% of their free float. Should China relax its foreign ownership rules and A shares be fully included at 100% of their free float, China's weight in the index would rise to over 50%.

EM benchmark indices have tended to lag the changes in the opportunity set due to the process by which a country enters an EM index. This typically involves consultations with investors and extended implementation periods. With the potential for further evolution in the future, active investors' ability to anticipate benchmark changes and invest outside the index remains valuable.

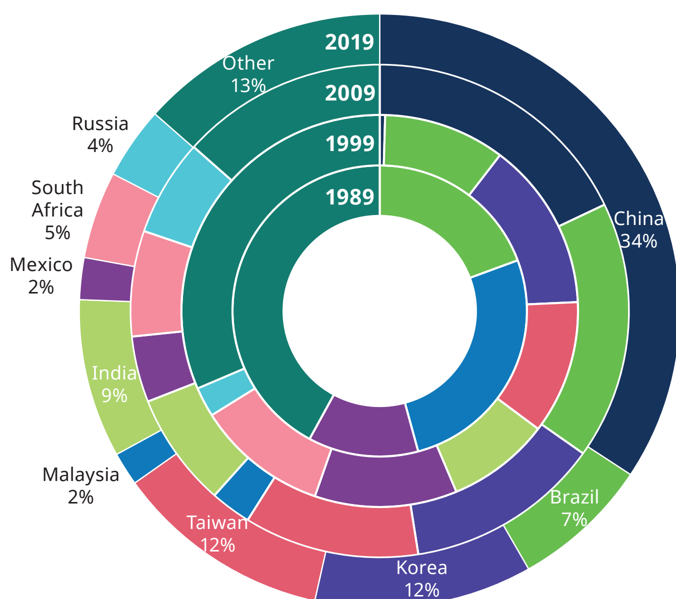
Why the cost of beta in emerging markets has decreased

Passive investing in EM equities began in earnest with the May 1994 launch of the Vanguard Emerging Markets Stock Index Fund. The first dedicated EM equities ETF, the BLDRS Emerging Markets 50 ADR Index Fund appeared in November 2002, and was followed in April 2003 by the iShares MSCI Emerging Markets ETF. By the end of 2019, in the US alone, there were more than 50 global emerging market ETFs, with over $200 billion assets under management (AUM), issued by more than 30 providers.[1]

EM equities ETF costs vary, but in general benefit from economies of scale. The larger the ETF, the higher the average daily volume (ADV) tends to be. Higher ADVs usually mean tighter bid/offer spreads as there are more secondary market transactions. Many EM equities ETFs also reduce their ongoing total expense ratios (TERs) and their tracking errors through securities lending programmes. The proceeds help to offset lower management fees, and some fraction of them may also be shared with the ETF itself. Costs have fallen over time as ETF providers have pursued market share and their AUM have increased. A survey of the US-listed EM equities ETFs shows an average annual TER of 0.5%, but with a wide range from 0.11% to 0.95%.

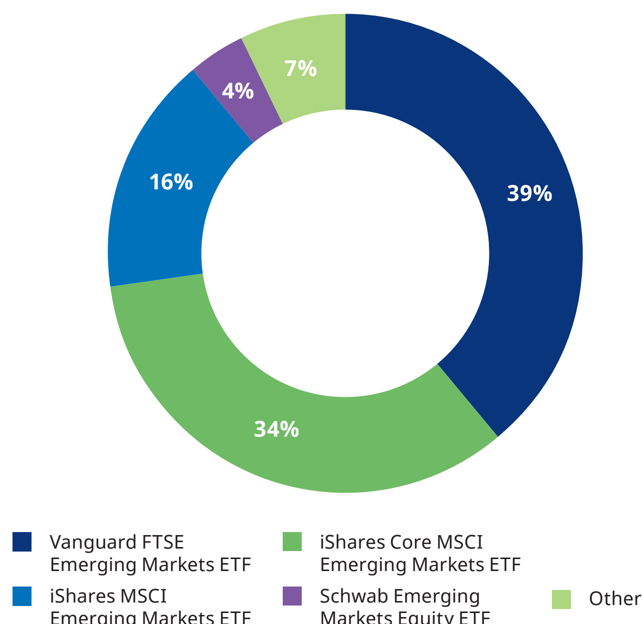
The benefits to scale are reflected in the market concentration of EM ETFs. As figure 3 shows, together the three largest EM ETFs account for nearly 90% of the sector's AUM.

Figure 2: The MSCI Emerging Markets Index over the last 30 years



Source: MSCI, FactSet, 31 December 2019. MSCI Emerging Markets Index Weights 1989-2019.

Figure 3: EM Equities ETF concentration



Source: BofA ML, 8 November 2019.

[1]Excludes EM small cap ETFs and single EM Country ETFs.

The iShares Core MSCI Emerging Markets ETF ('IEMG'), which launched in October 2012 and has grown to be the second largest ETF in the space with $62 billion AUM as at 31 December 2019, is a very low cost passive option. It tracks the broader MSCI Emerging Markets IMI, which captures large, mid and small cap representation across 26 EM countries[2]. Like most EM equities ETFs it mimics index performance by physically sampling the constituents. IEMG has kept its TER consistently below 20bps since launch and for the last three years it has been just 14bps. Its tracking error has also been consistently low. In contrast, its older sister ETF, the iShares MSCI Emerging Markets ETF ('EEM'), which launched in 2003, is more expensive, with a TER of 70bps at the end of September 2019. Although the EEM tracks the standard MSCI Emerging Markets Index, due to its high cost, assets have flowed to the much cheaper IEMG.

The old arguments against ETFs, particularly in EM equities, were that they are not that cheap, and that they don't really track; so why not pay a bit more for active and the potential of some alpha. However, the cost of beta has fallen dramatically. Given the low cost of accessing EM beta, active managers in EM have to make a compelling case for an active approach.

The case for active management in emerging market equities

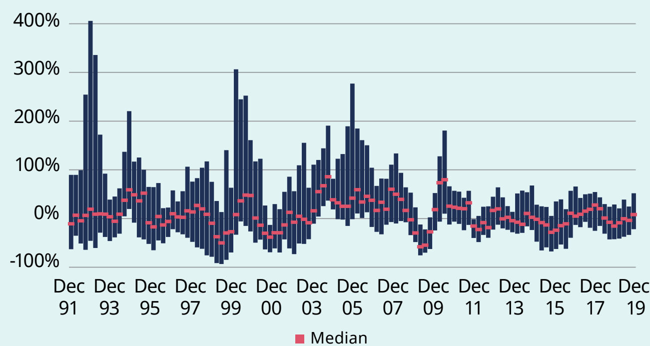
As shown in figures 4 and 5, in the last 20 years, the diversity within EM has consistently led to high cross-sectional return dispersion, both at the country and at the security level. This potentially creates opportunities for active managers to add value through country allocation and stock selection.

The first consideration is whether there are systematic reasons behind the wide dispersion in returns. If this is the case, then rather than observing an alpha opportunity for active management, these may be factor betas that can be captured by simple quantitative strategies.

Figures 6 and 7 show the performance of the two most common factor investing strategies in EM, value and size, using the corresponding MSCI Factor indices as proxies. Over a 30 year period, value has outperformed by 4.4% annualised in US dollars, while low size has outperformed by just 0.5% annualised in US dollars. However, the relative performance has not been consistent. In each case, there have been long periods when the specific risk factor underperformed the broad EM index. It's also important to note that each of these strategies encompasses much higher annualised turnover (34.3% and 37.7%) than simply holding the broad EM index (9.4%), and this turnover would substantially erode the factor returns achieved by investors, in the case of the low size factor index to close to zero. Additionally, the one EM value ETF, launched in December 2018, has a TER of 0.4%, making the cost of the factor beta relatively high.

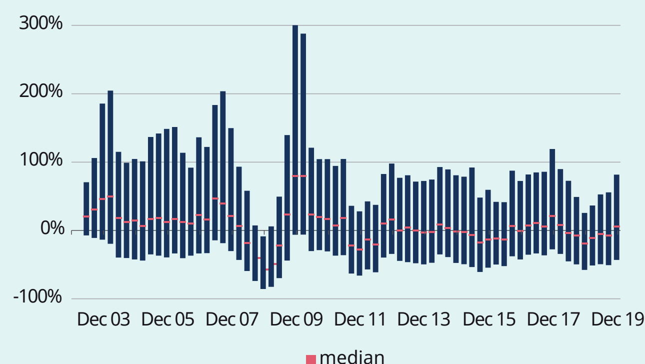
Outside the standard risk premia, another frequently mentioned explanatory factor behind the wide dispersion of returns is the lower governance standards in EM. In particular, the large part played by state-owned enterprises[3] (SOEs) and by family-controlled business groups.

Figure 4: Emerging Market country returns dispersion



Past performance is not a guide to future performance and may not be repeated. Source: Schroders, MSCI, based on rolling gross 1yr country returns (USD). Range and Median of MSCI Emerging Markets country returns

Figure 5: Emerging Market stock returns dispersion



Past performance is not a guide to future performance and may not be repeated. Source: Schroders, MSCI, based on rolling gross 1yr stock level returns (USD). MSCI Emerging Markets dispersion of stock returns 95-5 percentile ranges.

Figure 6: MSCI Emerging Markets equal weighted vs. MSCI Emerging markets

Past performance is not a guide to future performance and may not be repeated.
Source: Schroders, MSCI (gross USD) 31 December 2019.

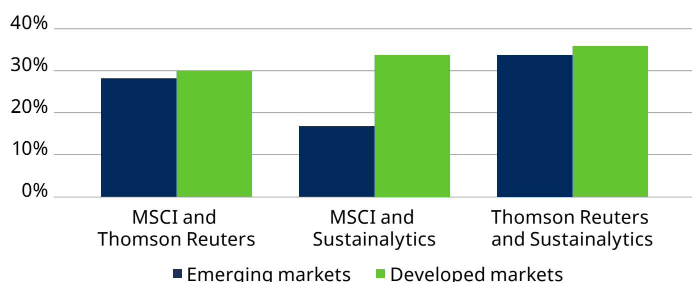
Figure 7: MSCI Emerging Markets Value vs. MSCI Emerging Markets

Past performance is not a guide to future performance and may not be repeated.
Source: Schroders, MSCI (gross USD) 31 December 2019.

[2] As of 31 December 2019. With 2,995 constituents, the index covers approximately 99% of the free float-adjusted market capitalisation in each country. It aims to be country and sector neutral compared to the large/mid cap MSCI EM Index.

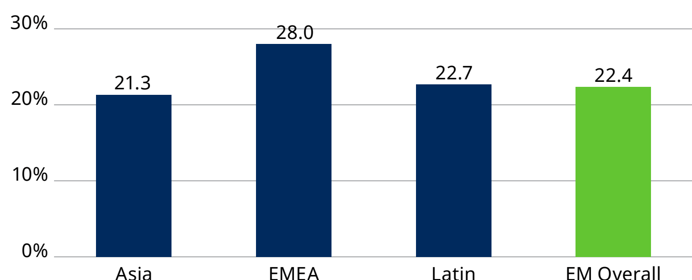
[3] State-owned enterprises are business enterprises in which the government or state exercises significant control either through full, majority or significant minority ownership.

Figure 8: ESG ratings vary across providers



Source: MSCI, Thompson Reuters, Sustainalytics. Probability of ESG scores being in the same quintile – developed and emerging markets.

Figure 9: State-Owned Enterprises are a feature of many emerging market countries



Source: Schroders, FactSet, 31 December 2019. SOE % within regional indices

Figure 10: Relative performance of SOEs in emerging markets

Past performance is not a guide to future performance and may not be repeated.
Source: Schroders, MSCI, USD Gross returns, 31 December 2019. SOEs vs. non-SOE performance.

A simple line of reasoning states that EM companies suffer from low governance standards and a straightforward 'weeding out' of the worst offenders can lead to sustained outperformance. This argument holds some attraction. Companies with poor governance tend to put minority shareholders fairly low down their list of priorities, leading to share price underperformance.

The problem lies in identifying these poor governance companies in a systematic, mechanical way. The problem with screens is that they are backward looking, dependent on the quality and consistency of data, and ignore the value of engagement. An even more basic problem, as figure 8 shows, is that there is little consistency among the scores supplied by the major third party ESG ratings providers. This inconsistency applies to both emerging and developed markets, but is slightly worse in EM. The probability of EM companies being given a similar ESG score is at best around 30%.

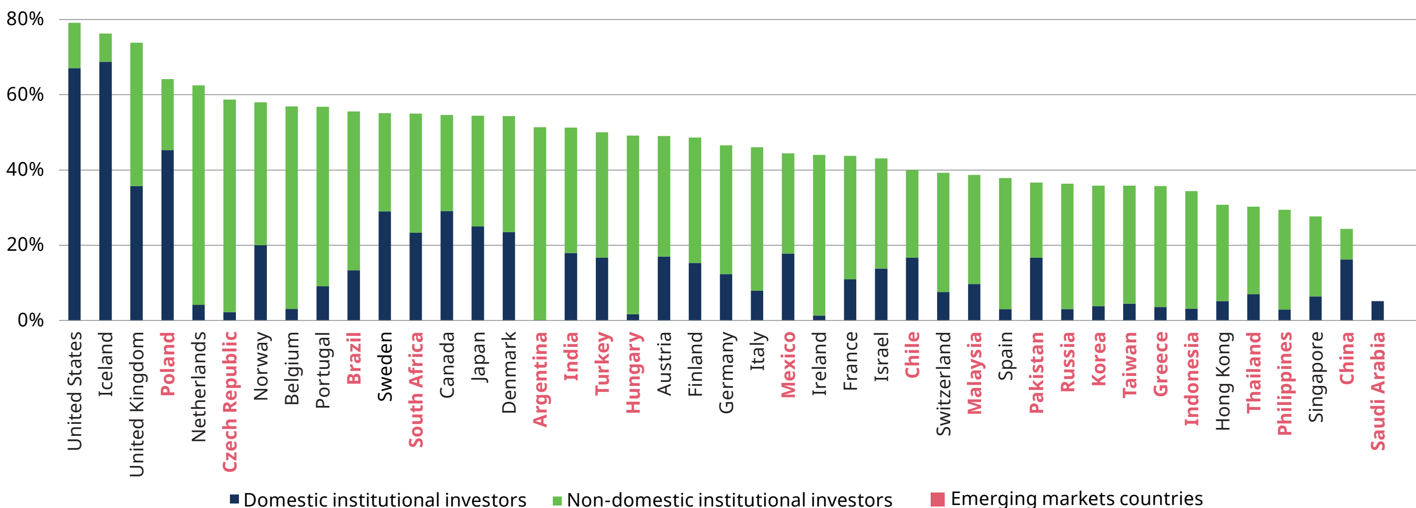
One of the factors behind poor corporate governance standards is that ownership structures in EM vary widely and controlling shareholders' interests are not always aligned with those of minority shareholders. The most prominent example of this feature is SOEs. SOEs are widespread in EM, accounting for 22.4% of the MSCI Emerging Markets Index, compared with 0.4% in the developed world, as measured by the MSCI World Index, as at 31 December 2019.

Of course, this would not be an argument for truly active management if all one had to do was systematically screen out all SOEs. This could be achieved by creating an SOE index to follow. However, as figure 10 shows, it's not that simple. The relative performance of SOEs is not consistent. From December 2000 until November 2013 SOEs as a group outperformed. Since then, however, SOEs have underperformed. An active manager can benefit from anticipating periods when a state's interests will be aligned with the interests of minority shareholders, and when the two will diverge.

The systematic factors that we have discussed are not consistent predictors of performance across time, and are also either not economic and/or not straightforward to replicate mechanically. That leaves room for fundamental active managers to add value in EM above the available market index return. Before we move on to examine their performance track records, let's return to the market structure argument for why emerging stock markets can be fertile ground for active managers.

Academic researchers distinguish between 'informed' investors, who understand asset valuations, trade on information and set prices, and 'uninformed' investors for whom asset valuation is not a part of their buying and selling decisions. A higher share of informed investors in a market makes that market more efficient and reduces the opportunities for active investors. We can distinguish between the two

Figure 11: A global comparison of institutional investor ownership



Source: Schroders, De La Cruz, A., A. Medina and Y. Tang (2019) 'Owners of the World's Listed Companies' OECD Capital Market Series, Paris. Domestic and non-domestic institutional ownership, end-2017. Aggregate holdings of institutional investors as share of free float market capitalisation*.

*Free float market capitalisation is estimated as being comprised of Institutional Investors plus Other Free-float.

classes of investors by using the percentage participation share of institutional investors in the equity market as a proxy for informed investors. As figure 11 shows, the share of informed (institutional) investors, both international and domestic, is on average lower in emerging equity markets than it is in the US, and in some instances, such as China, very much lower.

It's not therefore just the amount of change in EM indices that makes them a more favourable environment for active managers than the more stable DM. The higher share of retail participants in EM stock markets should be positive for fund managers with active investment processes.

Of course, the existence of opportunities for active managers to outperform does not mean that they do so. As a final step, we looked at the historical evidence for active management in EM equities.

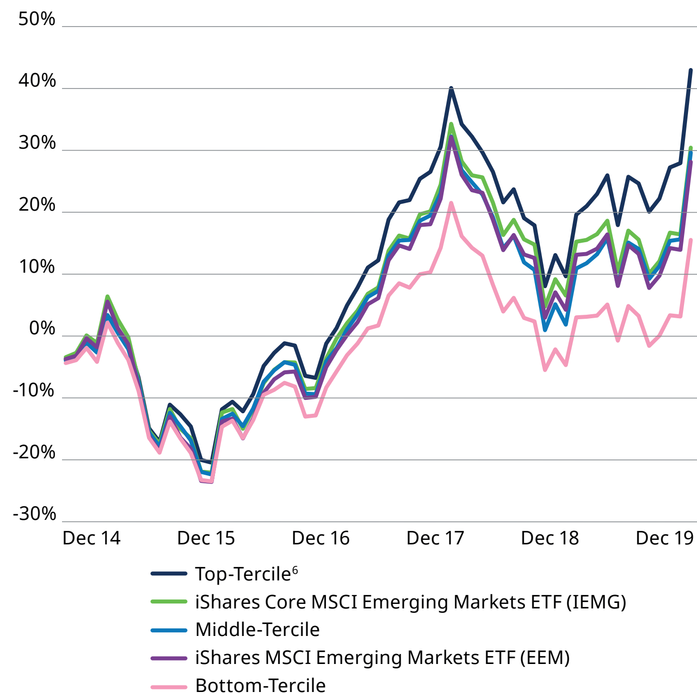
Using a sample of 222 actively managed US, UK and European based global EM equities funds with a combined $350 billion AUM[5], we compared the after cost performance of their US dollar institutional share class against the after cost performance of the two popular ETFs, the longstanding iShares MSCI Emerging Markets ETF (EEM) and the newer and cheaper iShares Core MSCI Emerging Markets ETF (IEMG).

As Figure 12 shows, over the most recent five year period, a large number of active managers outperformed the passive products that most investors can access, net of institutional fees. Indeed, we can reframe the challenge of selecting the right fund away from trying to pick the top performing fund to avoiding the worst performing funds – potentially a much more achievable task for investors who are able to conduct due diligence on managers.

Figure 13 shows that this is not just a function of the last five years. Although short-term relative performance is volatile, on a one-year trailing basis, on average, a passive ETF ranks in the bottom half of the universe of active funds.

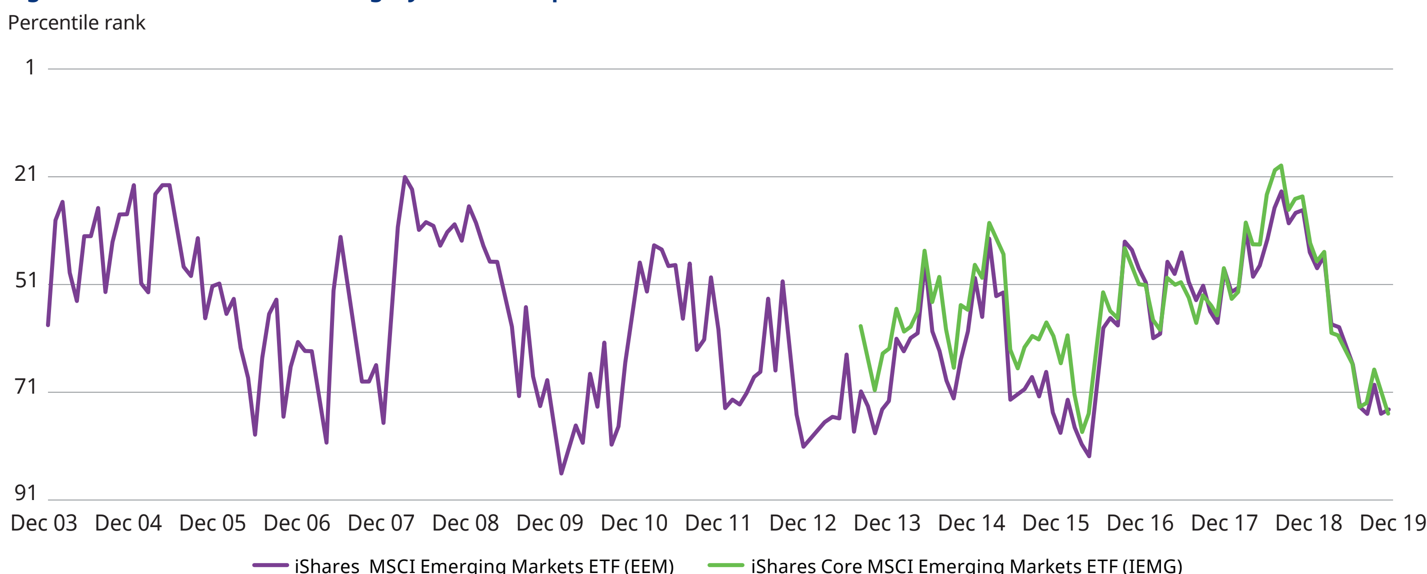
However, it's not always plain sailing right from the start. Figure 14 shows that you need to hold a fund for more than a year, and preferably up to three years, before it starts to outperform reliably. (The exception to this was the global financial crisis when active managers underperformed, and took a long time to recover.) An investor needs to have conviction that a manager's investment process can deliver alpha, and confidence that the manager is sticking to that process. Here we show only the MSCI EM ETF, as the shorter history of the MSCI EM IMI ETF means there's only four years of trailing three-year returns. However, the picture is similar.

Figure 12: Over the last 5 years a large number of active EM managers outperformed a passive alternative



Past performance is not a guide to future performance and may not be repeated.
Source: Copley Fund Research, December 2019. Fund universe of 222 actively managed US, UK and European based global emerging market equity funds. Institutional share class net of fees. 5-year cumulative returns.

Figure 13: iShares EM ETFs trailing 1 year returns percentile ranks



Past performance is not a guide to future performance and may not be repeated.
Source: Copley Fund Research, 31 December 2019. Fund universe of 222 actively managed US, UK and European based global emerging market equity funds. USD institutional share class net of fees. ETF percentile rank within active fund universe.

[5]Fund data is sourced from Copley Fund Research, which provides independent research on equity fund positioning and performance, focusing on Global, Global Emerging Markets and Asia Ex-Japan actively managed equity funds.
[6]Terciles split the universe into thirds and are used here rather than quartiles as the ETFs have historically tended to track near the middle Tercile.

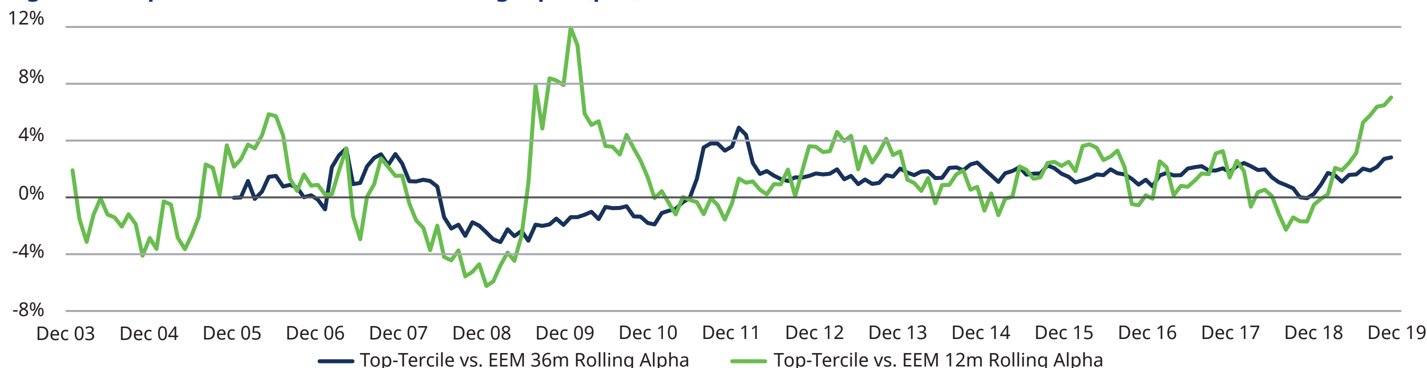
Finally, a word on retail investors. The performance discussion so far has centred on institutional investors who are able to choose from a global set of managers and to undertake due diligence on potential fund investments. For retail investors, the situation is slightly different but our broad conclusions remain valid.

Retail investors typically can only invest in funds that are available for sale in their home country, and pay higher fees. They do not have direct access to managers to conduct due diligence, but they do have indirect access if they go through an intermediary who undertakes manager research on their behalf.

As an example, a US retail investor choosing an active emerging markets fund at random would have outperformed a passive ETF alternative roughly half the time over the past five years. Over that period, the cheaper IEMG ETF ranks in the 47th percentile, and the more expensive EEM ETF ranks in the 55th percentile of that universe.

Clearly the higher fees paid by retail investors reduce active funds' net performance versus passive ETF alternatives. However, they do not propel the ETFs convincingly into the top half of performers. For a retail investor, the argument for selecting an active manager in EM equities remains valid.

Figure 14: Top-Tercile vs. MSCI EM ETF, Rolling Alpha (p.a.)



Past performance is not a guide to future performance and may not be repeated.
Source: Copley Fund Research, 31 December 2019. Fund universe of 222 actively managed US, UK and European based global emerging market equity funds. USD institutional share class net of fees.

Conclusion

The ease and cost of buying simple index exposure to EM equities has improved significantly over the last five years. EM index returns are now cheap and easily accessible. However, there are good arguments against simply buying the market return. Excluding the first decade of this century, EM returns relative to DM have not been compelling, but an alpha contribution can help close the gap. Simple passive factor approaches are expensive to implement in a dynamic universe, and have also offered inconsistent return patterns. Active managers have added value for institutional investors in EM, net of the higher fees they charge. Active managers are also able to adopt a forward-looking approach to ESG as part of their investment process, which is particularly important in EM given the lack of company disclosure and corporate ownership structures. There are many reasons why investors seek EM equities exposure and solid reasons why all investors should consider selecting an active manager. In particular, institutional investors with the resources and access to conduct due diligence on prospective managers, should find it worthwhile to do so.

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