OLD MUTUAL MULTI-MANAGERS

GENERATIONAL OPPORTUNITY OR PERSISTENT UNDERPERFORMER?

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DO GREAT THINGS EVERY DAY

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INTRODUCTION

The growing size and influence of Emerging Markets (EMs) make it an asset class that is increasingly hard to ignore. This vast shift happened slowly but steadily over the last 30 years. The result is EMs now have much larger influence on the global stage with far-reaching socio-economic implications for the rest of the world. And growth rates (particularly in Asia) suggest that this change of influence will continue.

HOW DO EMERGING MARKETS FIT INTO GLOBAL REGIONS?

This classification by MSCI shows how emerging countries fit into the global economy:

MSCI EMERGING MARKETS INDEX		
AMERICAS	**MIDDLE EAST AND AFRICA**	**ASIA**
Argentina	Czech Republic	China
Brazil	Egypt	India
Chile	Greece	Indonesia
Columbia	Hungary	Korea
Mexico	Poland	Malaysia
Peru	Qatar	Pakistan
	Russia	Philippines
	Saudi Arabia	Taiwan
	South Africa	Thailand
	Turkey	
	United Arab Emirates	

While this segmentation has obvious limits, it does offer a convenient starting point to understanding regional changes.

THE EMERGING MARKET FRUIT SALAD

An important distinction to be made at the outset, is that EMs are a heterogeneous group, that is, individual countries differ greatly from one another. This fact is key to reiterating how unique, nuanced and diversified EM countries are from each other. It naturally follows that the fundamental factors driving long-term returns will also differ substantially between countries.

EVOLUTION OF THE INDEX

The EM Index has structurally transformed, even over the last decade. The most obvious trend is a substantial increase in the weight of Asian shares (at the expense of other regions). China has gone from 17% of the index in 2010 to over 40% today, with this likely to increase as further inclusion of A-Shares is expected.

REPRESENTATION OF EMERGING MARKETS IN THE GLOBAL ECONOMY

At current growth rates, Chinese GDP (in USD) may overtake the US as soon as 2025. Yet, surprisingly, EMs still only represent around 12% of global equity market indices. A summary illustrates this:

	GLOBAL EMERGING MARKETS	GLOBAL DEVELOPED MARKETS
Global Population	85%	15%
Global Reserves (USD)	76%	24%
Global GDP (PPP adjusted)	59%	41%
Global GDP (USD)	45%	55%
Market Gap in MSCI ACWI Index	12%	88%

There is clearly a large discrepancy between market inclusion and GDP growth. There are many reasons for this such as companies remaining privately or government owned, and the free float factor (investable shares) which is low in EMs. The question is whether the inclusion of EMs in global indices can increase on the back of higher relative economic growth.

GDP IS DIFFERENT TO EQUITY MARKET PERFORMANCE

MSCI Barra research concluded that GDP growth doesn't necessarily translate into higher company earnings (one of the fundamental long-term drivers of market performance). This doesn't mean GDP growth has no relationship with equity markets, but rather that the links between GDP growth and corporate earnings are complex and need to be understood.

CORPORATE EARNINGS

One of the more prominent arguments explaining why high GDP growth doesn't necessarily translate into higher local earnings, is that multinationals (domiciled in developed markets) are capturing a large part of EM growth. A simple example is Apple phones sold in emerging markets. While demand is from a consumer in an emerging market, the profits and earnings accrue to a developed market company. These developed market companies generally come with a higher level of governance and reporting standards compared with their EM peers. This offers an attractive investment proposition: accessing higher emerging market growth from a company that is domiciled in a developed market, with lower risk.

The reality is however more complex as some multinationals are domiciled in emerging markets. EM companies are also capturing earnings from developed consumers. Samsung phones as an example are sold in developed countries.

To solve this, one must evolve the question into something more useful: which companies (EMs vs developed markets) are capturing relatively more of global growth? Said differently, if EM companies can improve their **relative** competitiveness versus developed markets, then EM equity markets will increasingly capture (and benefit from) EM growth.

ON AGGREGATE EMERGING MARKET CORPORATE COMPETIVENESS IS INCREASING

The broadest measure is the increase in EM companies' market weight in the global MSCI ACWI from 6% in 1995 to 12% today. A more anecdotal example is the number of Chinese companies included in the Fortune Global 500 (a list of the top 500 companies in the world) has risen to 124. The US has the second highest number of companies at 121. Even more astounding is that two decades ago, China only had 10 companies in the Fortune Global 500.

Looking at sector composition, EM technology companies have been the largest driver of increased competitiveness at the expense of commodity-based businesses.

WHY MIGHT THIS SHIFT BE HAPPENING?

Firstly, developed market tech is predominantly based in the US. The size of US tech companies makes the tech sector look large across developed markets but developed markets outside the US don't contribute nearly as much toward the technology sector weight. The European tech sector, for example, is small. Asian technology companies are more competitive than tech in developed markets outside of the US. Their success has driven inclusion in global benchmarks.

Secondly, EMs make up 85% of the world population. Rapid increase in per capita wealth, as Asia has experienced, creates a flywheel effect for local companies which are better-suited to satisfy local demand. Government support for local business, in India and even more so in China, protects companies from external competitors. This has seen many local businesses thrive.

Thirdly, Asia in particular has invested heavily in growing its technology capabilities for multiple decades. Asia's investment far exceeds every developed country except the US. These positive developments are highlighted by the World Economic Forum who asserted, "This is the Asian century," and one of the world's most prestigious consulting firms, McKinsey, which states, "In the decades ahead, Asian economies will go from participating in global trade and innovation flows to determining their shape and direction."

Further examples of innovation that are driving growth:

- Aggregate Research and Development (R&D) spend as a % of GDP has risen faster in Asian economies. Korea leads the world while China has doubled their R&D budget over the last two decades. US R&D investment is still the highest in nominal terms but has remained flat over the same period.
- Chinese patent filings are three times larger than the US; two decades ago they were half the size of the US.
- Chinese 5G capex spend is 58% higher than the US.
- Chinese Intellectual Property filings (which cover patents, trademarks and Industrial design protection) are a monumental 3.6 times larger than the US.

CONCLUSION

Emerging market corporate competitiveness is rising mostly on the back of Asian technology growth and the rise of the middle income consumer. Rising corporate competitiveness is powerful when you combine it with already higher GDP growth, population and consumer spending growth. It means emerging markets are capturing increasingly more value from their growing economies. This should see the weight of emerging markets continue to expand in global indices.

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