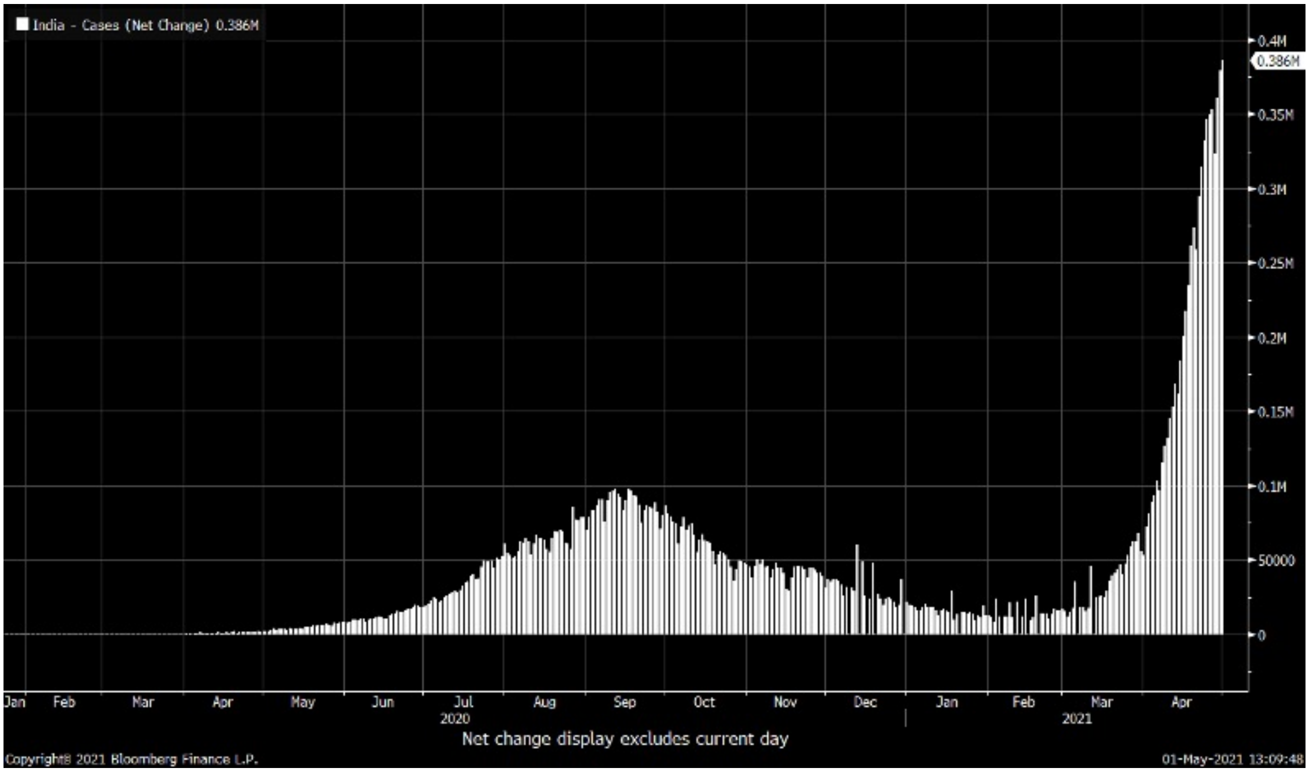
Driehaus Emerging Markets Small Cap Equity Strategy Summary

APRIL 2021

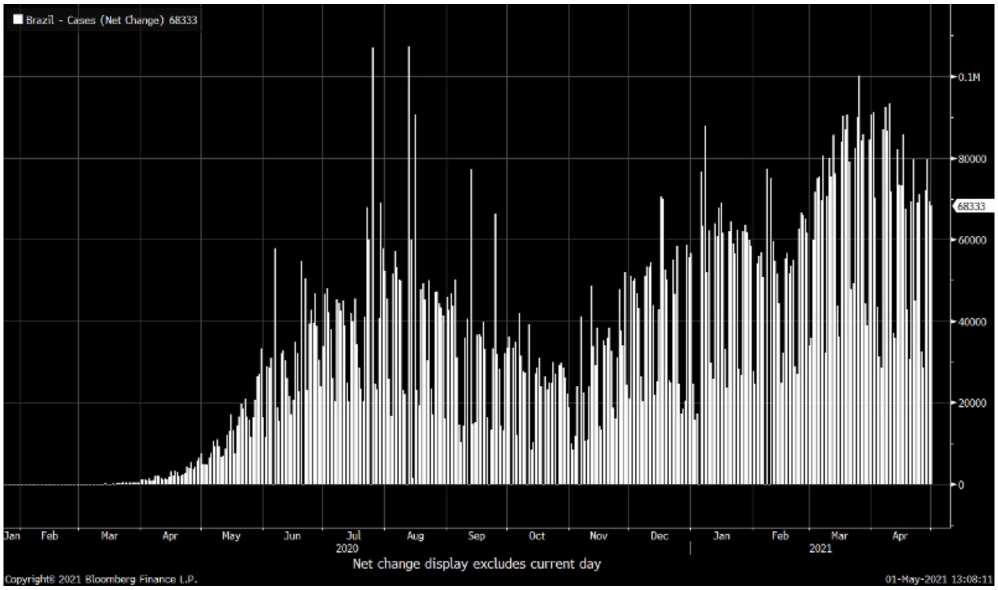
The first part of 2021 has brought about a wave of "US exceptionalism" with respect to economic growth rates, supported by an enormous fiscal stimulus, along with rapid progress in COVID-19 vaccination efforts. This stands in contrast to the story of much of 2020, where emerging market (EM) countries, particularly in North Asia, largely exhibited a swift response to the virus, enabling EM to grow faster than the rest of the world. Recent waves of COVID-19 cases have spiraled in India and Brazil, while EM lags behind developed countries with respect to the pace of vaccinations (Exhibits 1-4).

Exhibit 1. New COVID-19 Cases – India



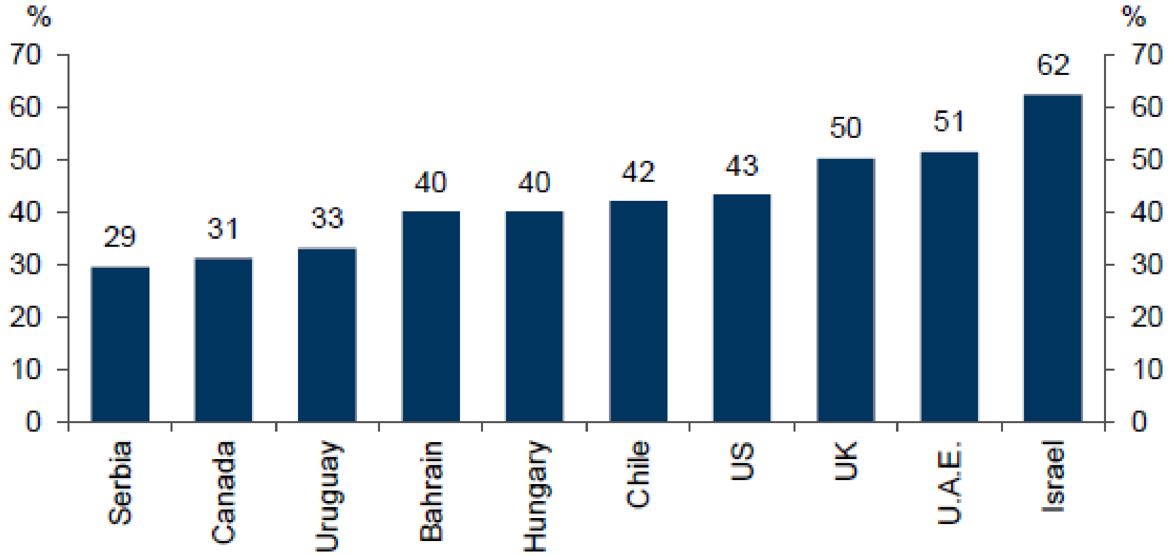
Source: Bloomberg Finance L.P.

Exhibit 2. New COVID-19 Cases – Brazil



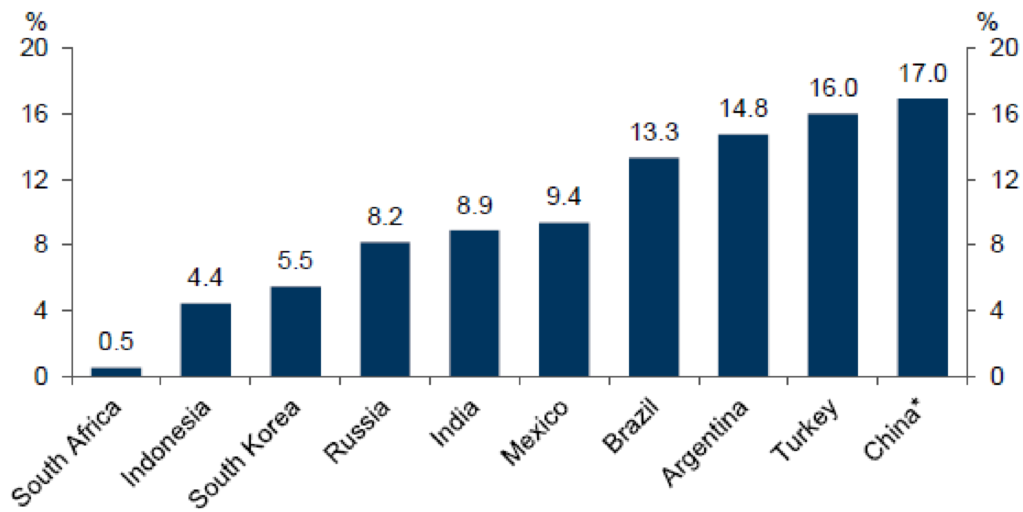
Source: Bloomberg Finance L.P.

Exhibit 3. Percent of Population Receiving First COVID-19 Vaccine Dose – Top 10 Countries*



Source: Goldman Sachs. *Excludes datapoints not distinguishing between 1st and 2nd dose.

Exhibit 4. Percent of Population Receiving First COVID-19 Vaccine Dose – Emerging Markets



Source: Goldman Sachs. *China refers to total doses administered as a percent of the population.

While these factors have contributed to EM's underperformance relative to global equity markets since mid-February, it is important to place the short-term relative underperformance in context, and in that regard, we note the following points.

First, in absolute terms, the MSCI Emerging Markets Small Cap Index has recently staged an important breakout after effectively spending thirteen years in a wide trading range (Exhibit 5). Coinciding with this breakout, EM small caps broke their ten-year downtrend relative to the MSCI All-Country World Small Cap Index (Exhibit 6).

Exhibit 5. MSCI Emerging Markets Small Cap Index Performance from May 2001-May 2021

Source: Bloomberg Finance L.P.

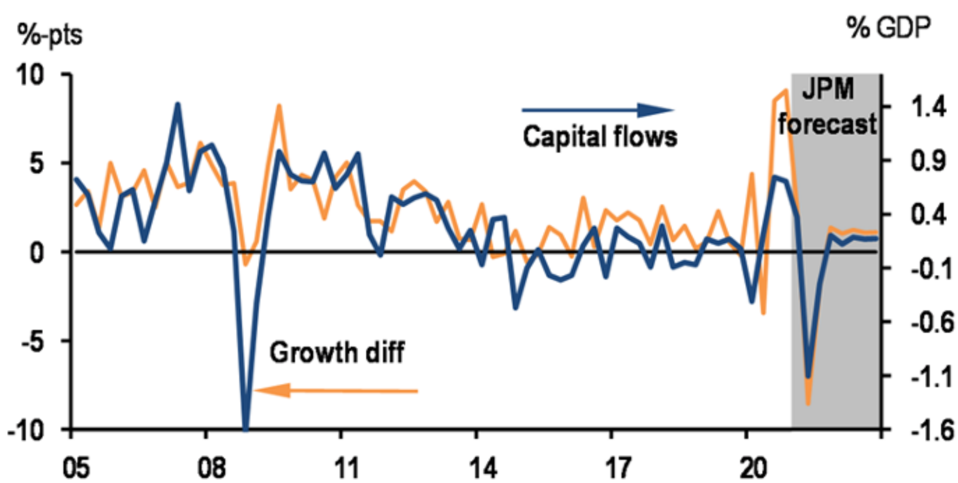
Exhibit 6. MSCI Emerging Markets Small Cap Index Relative Performance to MSCI All-Country World Small Cap Index Performance from May 2001 – May 2021

Source: Bloomberg Finance L.P.

Second, EM equity valuations look increasingly attractive relative to their developed market counterparts. As Bank of America recently noted, the combined market cap of Apple, Microsoft, Amazon, Google, and Facebook, at $8.2 trillion, is now equivalent to all emerging markets, despite EM's population of six billion people.

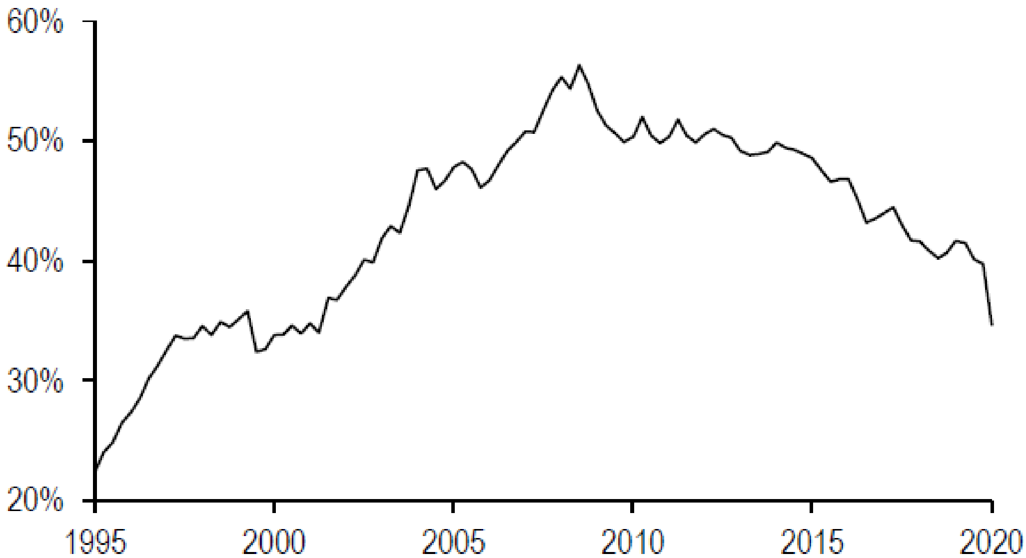
Third, questions linger about the sustainability and ramifications of the US fiscal stimulus. While the growth differential between developed and emerging markets suggests the potential for developed economies to attract capital flows, recent data point to a widening disparity in the growth of US deficits and the willingness of foreign investors to fund these deficits (Exhibits 7-8). Historical relationships suggest the potential for a meaningful depreciation of the US dollar, resulting from widening fiscal and current account deficits (Exhibit 9).

Exhibit 7. EM-DM Growth Differential and Capital Flows



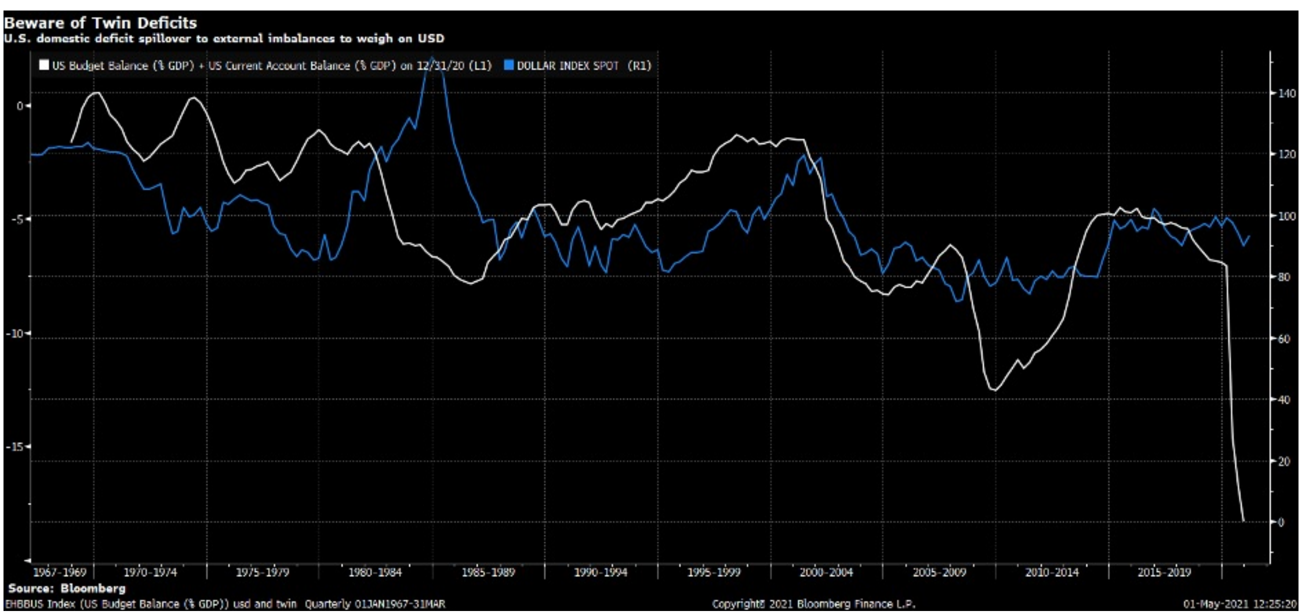
Source: J.P. Morgan

Exhibit 8. Foreign Share of Marketable Treasury Debt Outstanding



Source: Federal Reserve

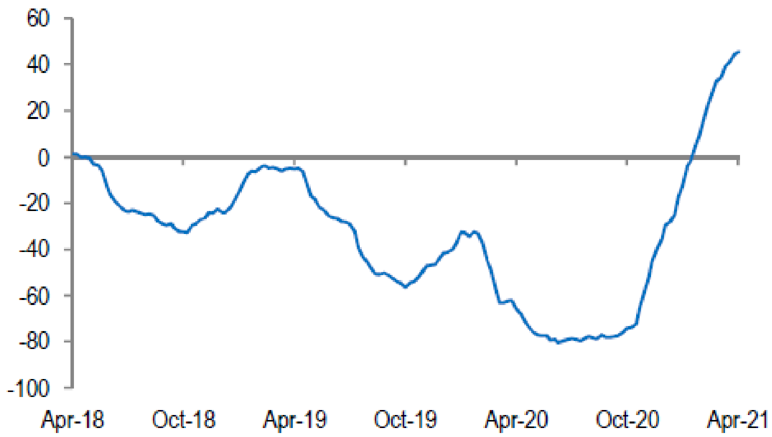
Exhibit 9. US Twin Deficits and US Dollar Index



Source: Bloomberg Finance L.P.

Taking these three points together, it is perhaps unsurprising that investors have increased their allocations to emerging markets, with inflows occurring over 30 consecutive weeks, a record duration, and amounting to $77 billion year-to-date (Exhibit 10).

Exhibit 10. Monthly Cumulative EM Equity Flows (Billions of Dollars)



Source: EPFR Global

While COVID-19 case trends and the relatively slow pace of vaccinations in EM have contributed to recent underperformance of EM equities, we continue to observe an expanding opportunity set in EM equity markets, and are encouraged by the resilience of flows into the asset class, as investors continue to close their longstanding underweight to EM.

Performance Review

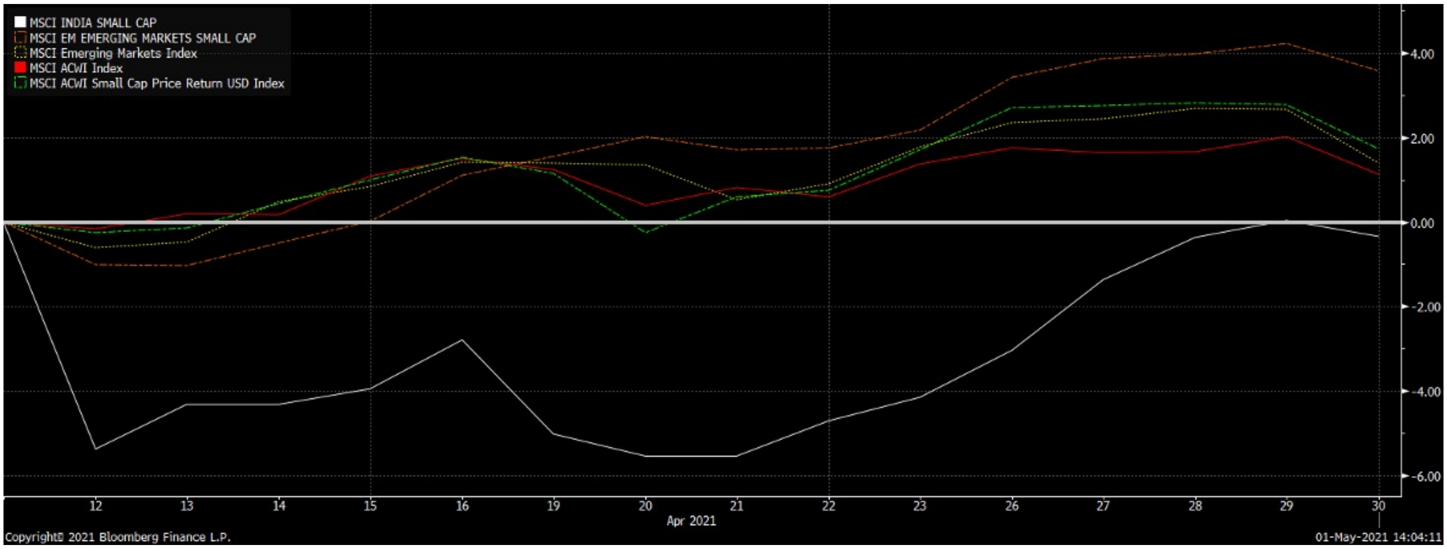
At the sector level, the most significant contributors to returns were information technology and consumer discretionary. Utilities and real estate detracted the most value. At the country level, Brazil and China contributed most to performance for the month, while India and Australia were notable detractors from performance.

Positioning and Outlook

As spiraling COVID-19 case counts in India and Brazil continue to consume the news headlines, we will focus our comments on these markets.

India's second wave of COVID-19 started on February 11, and counter to the first wave, authorities have eschewed a national lockdown. A lack of adequate healthcare infrastructure and shortages of oxygen have contributed to a dramatic number of cases and deaths, with sad scenes documented on international news networks. Despite the severity of India's second wave, the equity market has thus far proven resilient. Indian small caps peaked on April 9, a full two months after the case count started rising, and subsequently sold off by around 6% from the peak, before recouping the majority of the losses, while only modestly underperforming various equity indices (Exhibit 11).

Exhibit 11. India Small Cap Performance Since Equity Market Peak



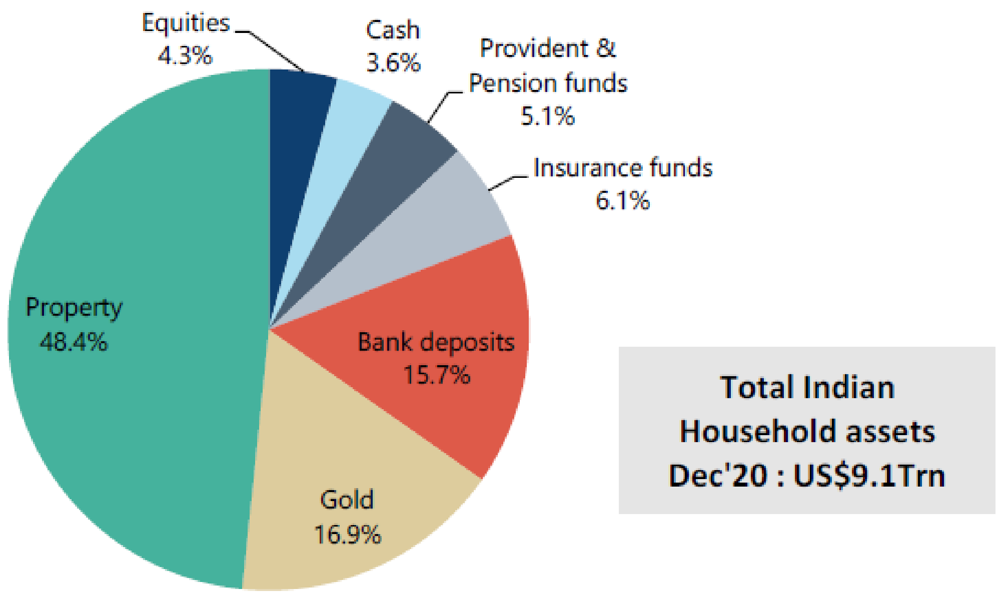
Source: Bloomberg Finance L.P.

Market observers have struggled to reconcile this performance with the horrific scenes on the ground, and there is some hope that new cases will peak in the next 2-3 weeks, while the pace of vaccination may improve as the country has opened up vaccinations to 18- to 45-year-olds. Scope for further volatility remains, particularly as we continue to get real-time updates from companies during earnings season, and outlooks are inevitable to become less visible as a result of the recent COVID-19 wave.

Taking a longer-term view, Indian equities remains significantly underinvested, and the large, growing domestic investor base continues to increase their allocations to equities. Systematic investment products (SIPs), where investors contribute a defined monthly amount, have become popular in India in recent years, and as of March, SIP assets under management stand at $58 billion, up 78% year-over-year.

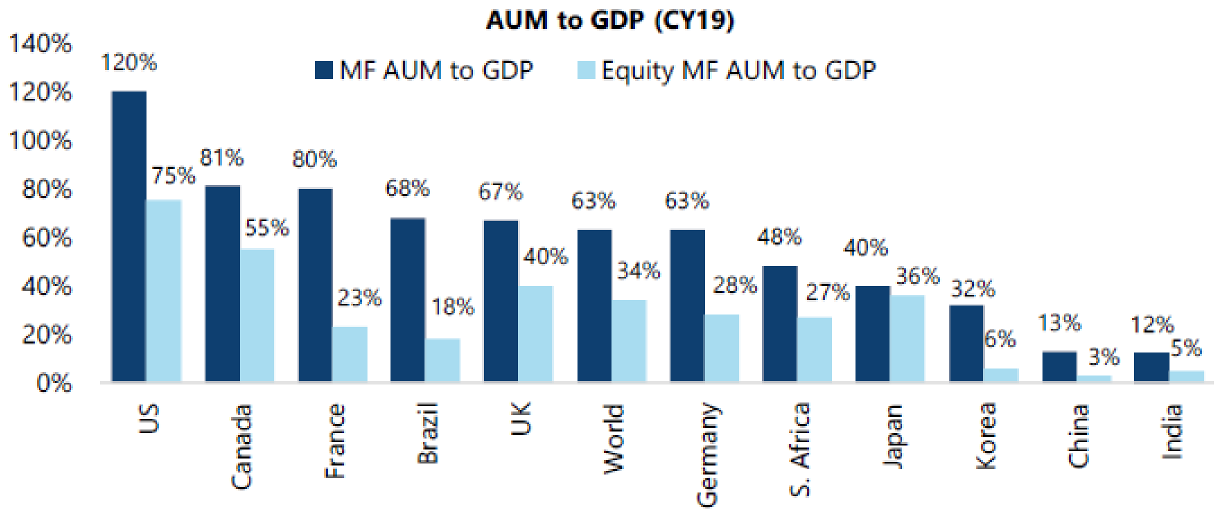
Putting this in context, Indian households own $9.1 trillion of assets, with only a 4% allocation to equities, while property and gold together represent 65% (Exhibit 12). The financialization, or shift from hard assets to financial assets, has a long way to run, in our view, as India's equity mutual fund assets stand at 5% of GDP, while in the US, the equivalent number is 75%, and globally this ratio stands at 34% (Exhibit 13). This is likely to be an important driver of flows and returns in the future, while dampening volatility during periods such as the current COVID-19 spike.

Exhibit 12. Breakdown of Indian Household Assets



Source: RBI, Jefferies estimates

Exhibit 13. Mutual Fund Assets Under Management/GDP Ratio

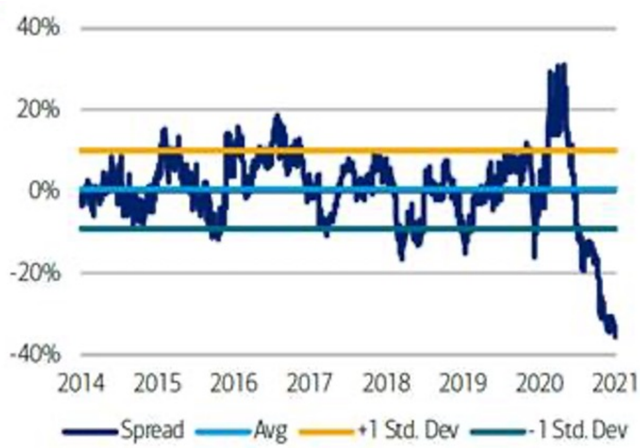


Source: AMFI, World Bank, Jefferies

Brazil has endured a number of macroeconomic and geopolitical concerns, which have weighed on the market alongside COVID-19. These include uncertainty surrounding the fiscal budget, resurfacing concerns about government interference in the energy and utilities sectors, and a potential return of former president Luiz Inácio Lula da Silva, who seeks a political comeback in the 2022 presidential election, after having been convicted for corruption and money laundering as part of the "Car Wash" saga in 2017.

Against this backdrop, it is unsurprising that Brazilian equities have suffered a relative de-rating against broad EM equities that has reached extremes not seen over the last seven years (Exhibit 14).

Exhibit 14. Brazil Valuation Relative to EM

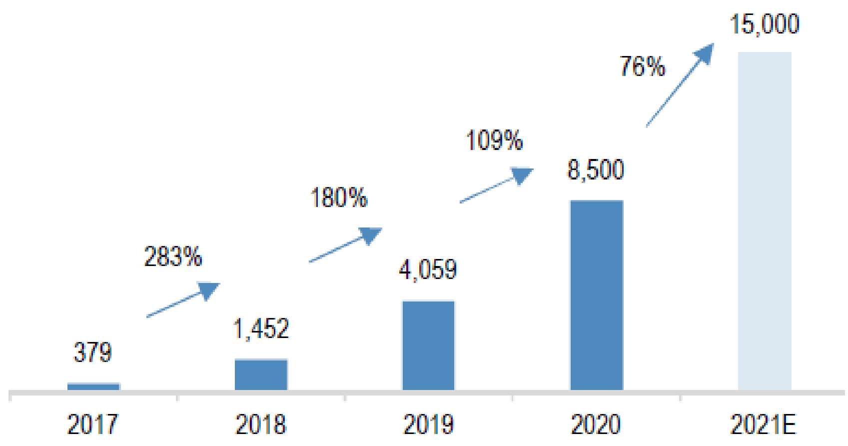


Source: Bank of America Global Research, Bloomberg

An underappreciated aspect of the Brazilian equity market, in our view, is the degree of transformation that has occurred in recent years, specifically related to digitalization, as well as the growing number of new IPOs, adding breadth and differentiation to a market that was previously dominated by state-affiliated companies and commodity producers.

One of our strongest performers in Brazil is a digital bank, which has rapidly acquired customers since its launch, and is estimated to reach a customer base of 15 million this year (Exhibit 15). This company is taking advantage of rising digital connectivity in the country, along with the fact that many of the incumbent banks charge excessively high fees for basic financial services. Through the rollout of a "super app," the company will provide a platform where users can buy products, book hotels and plane tickets, and order food, among other things, speeding up the monetization of this rapidly growing customer base.

Exhibit 15. Customer Growth at Leading Brazilian Digital Bank (Thousands of Accounts)



Source: Company data

The strategy also owns a position in a company that operates a cashback platform, connecting its 3.6 million users to over 800 partners, offering cashback and coupons to encourage purchases. The company earns commissions on transactions and leverages data analytics to optimize marketing efforts. The seller only pays for promotions where purchases are made, providing this company with a point of differentiation relative to competitors.

A third standout company in Brazil is the leading provider of Internet services to small and medium-sized enterprises (SMEs), which helps clients establish a digital presence, promote marketing campaigns and send promotions to customers, and operates an e-commerce platform that enables clients to create a virtual store and sell online. The company's focus on SMEs and its extremely high customer lifetime value to customer acquisition cost ratio differentiate it from peers in other regions.

We would be remiss if we did not mention the supportive conditions stemming from Brazil's status as a leading producer of iron ore and agricultural commodities, both of which are skyrocketing in price as the global economy recovers, logistical bottlenecks exacerbate supply and demand dislocations, and weather-related disruptions add upside amid tight market conditions. The combination of these factors is causing Brazil's terms of trade to rise to its highest level on record, dulling the pain from the recent US dollar strength and aforementioned macro and geopolitical developments (Exhibit 16).

Exhibit 16. Citi Brazil Terms of Trade Index

Source: Bloomberg Finance L.P.

Amid an expanding opportunity set, featuring unique and high growth businesses such as the ones described above, the cases of India and Brazil provide evidence of the transformation of emerging markets from a cyclical asset class with high beta to global economic conditions, to one that is more resilient to external shocks. This reinforces our optimism on emerging markets, which appears to be increasingly embraced by asset allocators.

Until next month,

Chad Cleaver, Lead Portfolio Manager
Driehaus Emerging Markets Small Cap Equity Strategy