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DRIEHAUS EMERGING MARKETS SMALL CAP EQUITY STRATEGY

The Evolving Opportunity Set within EM Small Caps

The small cap segment of emerging markets (EM) has provided a source of differentiated returns, featuring exposures that complement a core EM allocation in a manner that has been alpha generative and helped investors sidestep some of the volatility associated with geopolitical and regulatory developments within the asset class. This month's commentary revisits the case for an allocation to EM small cap.

At the forefront of the investment case for EM small cap is a compelling return stream. Over the last 20 years, EM small caps have generated 200 basis points of excess returns per year over EM large caps (Exhibit 1). This has been accompanied by lower volatility, as small caps have carried a standard deviation of 16.6% vs. large caps at 19.5%.

Exhibit 1: MSCI EM Small Cap vs. MSCI EM Large Cap

Source: Bloomberg

During periods of recent turbulence in emerging markets, underscored by 2021's regulatory crackdown in China and Russia's invasion of Ukraine in 2022, EM small caps have more than held their own, generating a positive return of 19% in 2021, well in excess of large caps' drawdown of -4%, while generating 500 basis points of relative outperformance year-to-date in 2022.

Within a world characterized by high cross-asset correlations, EM small cap has served as a relatively less correlated asset over time, exhibiting an average correlation of 0.6 versus the MSCI All-Country World Index since 2010 (Exhibit 2). The strong relative performance of the small cap segment of EM during 2021 was accompanied by a sharp decline in the correlation to 0.2 in the middle part of the year.

Exhibit 2: Correlation between MSCI EM Small Cap Index and MSCI All-Country World Index

Source: Bloomberg

Amid a rapidly changing global economy, featuring numerous geopolitical, regulatory, and thematic shifts, one of the Driehaus emerging markets team's messages to investors is that EM is not a static asset class. In other words, one must be open-minded about where to find growth, willing to incorporate macro analysis into allocation and stock specific investment decisions, and not overly dogmatic about sector preferences.

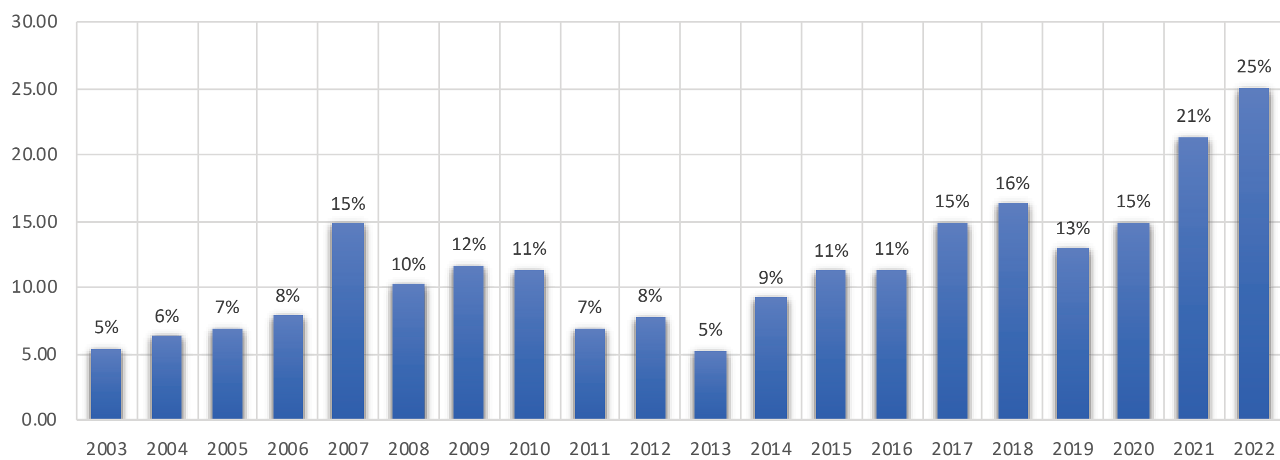
With that in mind, it is important to note some of the meaningful shifts in country allocations over time with the MSCI EM Small Cap Index.

India's weighting in the index has become prominent over the years, after having reached a low of 5% in 2013, as the country was among the "fragile five" economies that suffered under twin fiscal and current account deficits during the taper tantrum. Following the election of Narendra Modi in 2014, the Indian economy has grown rapidly, while a rising share of domestic household savings has been allocated to equities, propelling India to a 25% weighting in the index today (Exhibit 3).

The Driehaus emerging markets team views India as one of the best structural growth stories in the world, featuring attractive themes such as the growth of manufacturing, the strength of the consumer, and the shift in the information technology sector away from the traditional outsourcing model toward higher margin verticals such as digital transformation and software.

As a result of the strong growth in the economy, the outperformance of the equity market over time, and the deep pool of listed small cap names, we view the high allocation to India in the index as a positive factor for investors in EM small cap.

Exhibit 3: India Weighting in MSCI EM Small Cap Index

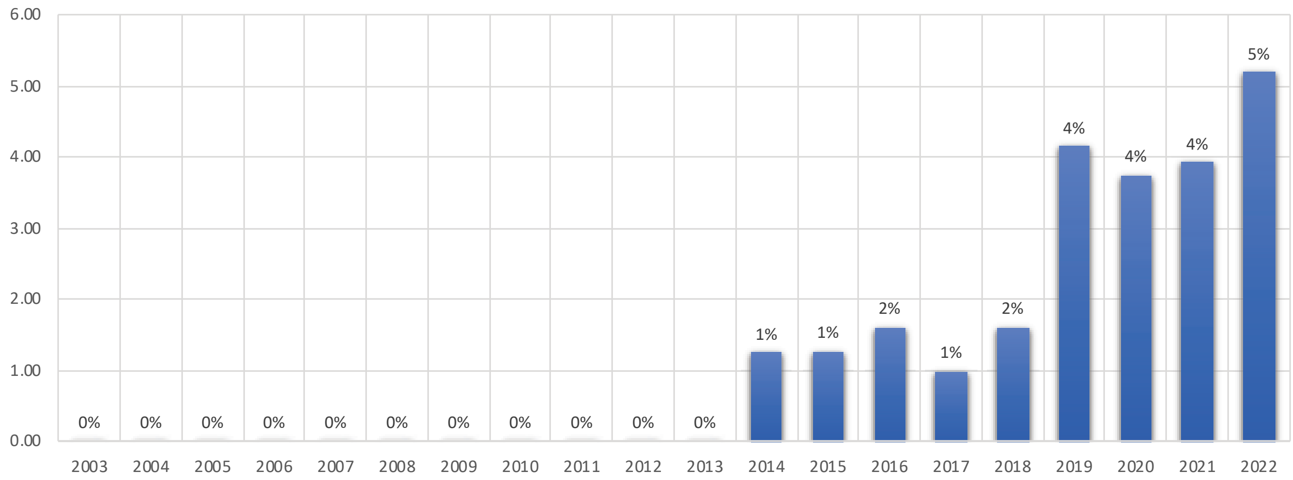


Source: MSCI

While we have been investing in the Middle East for over 15 years, the markets of Qatar, the United Arab Emirates, and Saudi Arabia were previously defined as frontier markets by MSCI until 2014, after which point the allocation within the index has risen from 1% to 5% (Exhibit 4). These economies are US dollar-linked and have historically been perceived by many investors as having little to offer outside of exposure to oil and natural gas. We believe this is an errant assumption and expect to see an expanding opportunity set in this region in the years ahead.

Specifically, Saudi Arabia is amid a period of significant social and economic transformation, as part of its Vision 2030 agenda. This is accompanied by the expectation that a material number of the holdings of the country's sovereign wealth fund will list in the public equity market in the coming years. One of the Strategy's top performing companies year-to-date is a recently listed pharmacy operator in Saudi Arabia, which demonstrates best-in-class return on invested capital and is maintaining consistent store growth and same store sales growth, providing visibility and durability in an otherwise challenging global macroeconomic backdrop.

Exhibit 4: Middle East Weighting in MSCI EM Small Cap Index



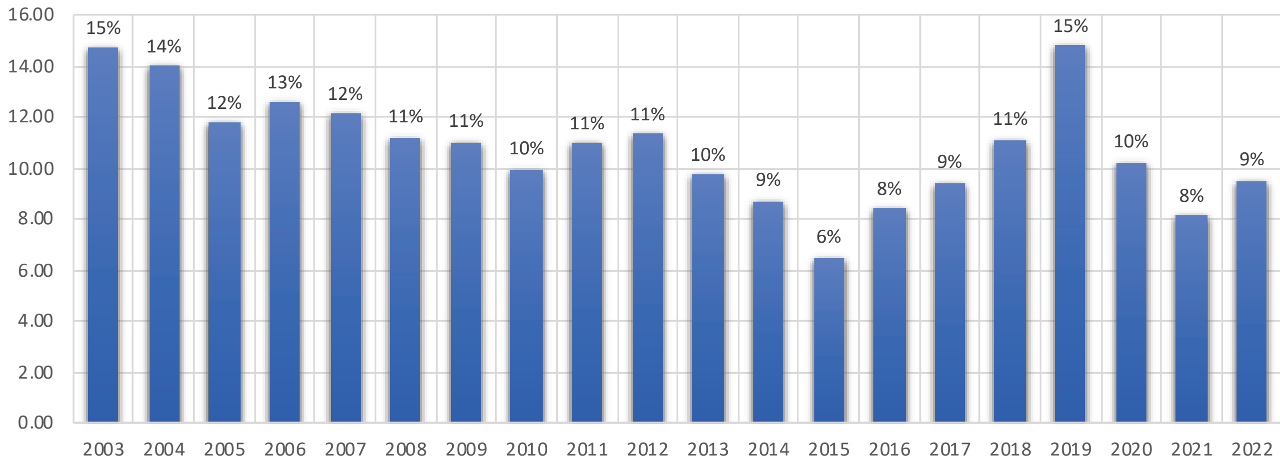
Source: MSCI

Counter to India and the Middle East, the weighting in Latin America has come down within the MSCI EM Small Cap Index over the years. This commodity-centric region faced headwinds from weak global growth post the global financial crisis, and Brazil endured a painful recession alongside corruption and government mismanagement in the middle part of the 2010s, contributing to the regional weighting reaching a low of 6% in 2015 (Exhibit 5).

These days, there is increasing cause for optimism, particularly in the small cap space, where resource companies are benefiting from improving fundamentals in energy and agriculture, while domestic consumer brands are flourishing, and newer themes related to e-commerce and environmental protection are gaining traction.

Mexico maintains select opportunities in themes such as nearshoring, and both Brazil and Mexico have exhibited currency strength throughout 2022, during a period in which the broad US dollar index has appreciated sharply, putting added pressure on the total return potential for most emerging markets. We expect Latin America to be a beneficiary of a changing landscape for EM investors.

Exhibit 5: Latin America Weighting in MSCI EM Small Cap Index



Source: MSCI

As areas like the Middle East and India have witnessed an increasing allocation in the index in recent years, China's weighting has come down considerably from its peak of 21% in 2015, to around 7% today (Exhibit 6). At face value, given the deteriorating investor sentiment toward China, marked by recent turbulence resulting from the regulatory campaign undertaken by policymakers, the rising stress in the property market, and the depressed growth resulting from the zero COVID strategy, one might perceive such a low weighting in the country as another factor that works in favor of EM small cap, especially when considering this vis-à-vis the 31% China weighting in the all-cap MSCI Emerging Markets Index.

On this point, we take a bit more of a nuanced view. We concede that investing in China has been a losing endeavor for many allocators in emerging markets over the last decade, as nominal GDP averaged 9% per year, while MSCI China returned 0% and the Shanghai Composite returned 3% per year. We further concede that the developments mentioned above, which have occurred over the last two years, give legitimate reason for macro and geopolitical concern.

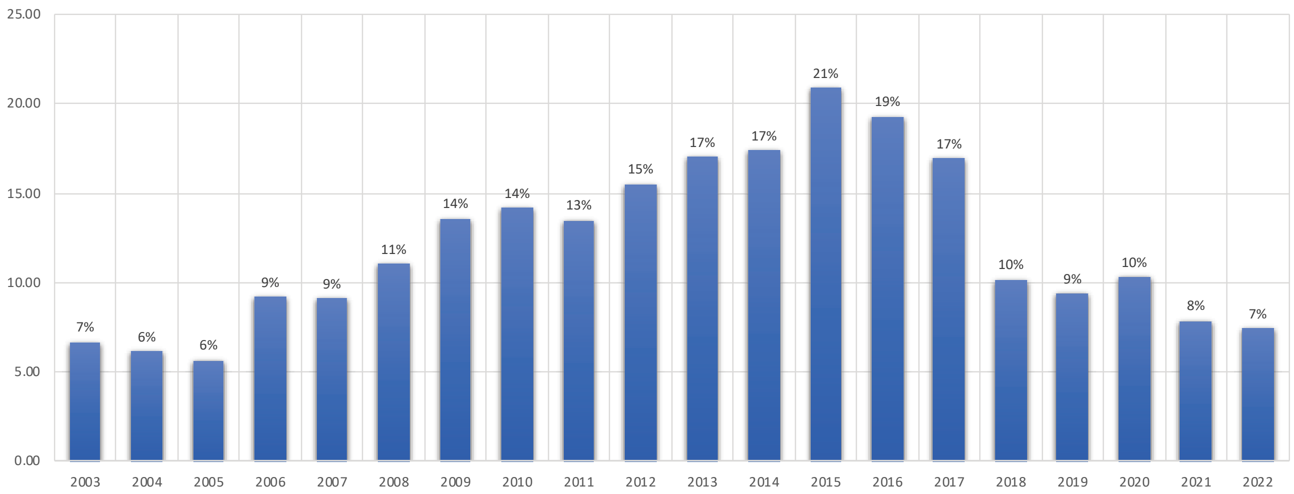
However, positioning in the right themes, sectors, and stocks at the appropriate point in the market cycle has proven to be highly profitable for investors over time, and we expect that this will continue to be the case when investing in China.

We currently see a strong case for investing in small caps in China, driven in part by policy support for small and mid-size enterprises (SME) in the economy and capital markets, which is occurring at the same time that many of the large cap market darlings of recent years have faced rising regulation.

Throughout the last year, the term "Little Giants" has become an increasing part of investors' vernacular in China, as this cohort of around 700 listed SMEs has received attention by the Chinese authorities, who have handpicked these companies to garner comprehensive policy support, including easier access to capital markets. The listed Little Giants average $1.1 billion in market cap, and consensus expectations are for these companies to grow their earnings at an average 35% compound annual growth rate over the next two years.

While macro and geopolitical concerns dominate much of the discussion about Chinese equity markets, we believe that many investors are missing out on one of the best micro stories in emerging markets, spanning such industries and themes as renewable energy, import substitution, the rise of domestic consumer brands, and innovation within the healthcare sector.

Exhibit 6: China Weighting in MSCI EM Small Cap Index



Source: MSCI

Lastly, at the core of the case for an allocation to EM small cap is the opportunity that exists for alpha generation from stock selection. With over 4,000 companies meeting our initial liquidity screen, the universe is enormous, and many of these companies are undercovered by sell side analysts and off the radar of larger investors, creating opportunities to capitalize on inefficiencies.

While many of the economies in EM continue to exhibit high growth rates, passive allocations to EM equities continue to maintain material exposure to less desirable companies, some of which are state-affiliated and lack alignment with the interests of minority shareholders. Fundamentally, EM small cap companies are often better equipped to tap into the growth of the domestic economies, and given their small size, it is common to see more rapid rates of earnings growth relative to the mature parts of the large cap index.

The Driehaus Emerging Markets Small Cap Equity Strategy has maintained active share in excess of 93% over the last five years, emblematic of the opportunity for stockpicking in this segment of the market.

In conclusion, EM small caps provide a differentiated and compelling return profile, which serves as an attractive complement to an existing EM allocation. This segment of the asset class brings exposure to high growth areas such as India, expanding opportunity sets in the Middle East and Latin America, and a shifting mix of growth within China. With the advantage of a deep universe, which is largely undercovered and underowned by institutional investors, the small cap segment of emerging markets is relatively less efficient, creating a standout opportunity for stock selection.

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ABOUT THE AUTHOR

Chad Cleaver, CFA, is the lead portfolio manager of the Driehaus Emerging Markets Small Cap Equity strategy and a portfolio manager for the Driehaus Emerging Markets Growth and Driehaus Emerging Markets Opportunities strategies. His idea generation, security selection, portfolio construction, and risk management responsibilities, and macro-level analysis, are leveraged across the three strategies managed by the Driehaus Emerging Markets Team.

Mr. Cleaver began his career with the Board of Governors of the Federal Reserve System and joined Driehaus Capital Management in 2004. He received his A.B. in economics from Wabash College in 2000 and his M.B.A. from the Kenan-Flagler Business School at the University of North Carolina at Chapel Hill in 2004. Mr. Cleaver is a CFA charterholder.