The Evolving Emerging Markets Opportunity Set

While the emerging markets bull run of the 2000s was largely driven by rising commodity prices on the back of China's insatiable demand for raw materials, the past several years have been much different. Recent market leadership has shifted to more nimble, dynamic and innovative private companies in the consumer, technology, health care and other service sectors that have carved out unique competitive positions or adeptly captured the shifting growth opportunities in the emerging markets world. In effect, **we are seeing a transition in growth opportunities away from capital-intensive industries and increasingly toward service-oriented areas.**

As evidence of this evolving opportunity set within emerging markets, we point to the recent semiannual emerging markets index review conducted by MSCI that concluded with a decision to add Chinese ADRs (American Depository Receipts) to the MSCI Emerging Markets Index. This is the first time developed market-listed companies were included in the index, with additions primarily consisting of companies operating in the technology and consumer discretionary sectors. ADRs now represent more than 3% of the index. At a sector level, additions to the technology and consumer discretionary sectors came at the expense of the financial sector, while at a country level China saw the largest increase—rising more than 2 percentage points with a concentration in Internet companies—while most other countries were marginally reduced.

The companies recently added to the index epitomize the changing emerging markets opportunity set as all are privately owned, most have a heavy technological component to the business, and all are capturing compelling structural growth opportunities—be it private education, online gaming, e-commerce or the shift to online advertising. The performance of the stocks has also been phenomenal. Exhibit 1 shows the relative strength of an equally-weighted basket of these 14 stocks versus the MSCI Emerging Markets Index. As you can see, over the past five years these stocks have outperformed the index by an average of more than 37%, annualized, in US dollar terms. Despite the abundance of negative emerging market headlines, differentiated growth opportunities continue to exist within developing countries albeit in increasingly dispersed, or new, areas.

Exhibit 1: Historical relative performance of the recently added Chinese ADRs versus the MSCI EM Index

Source: Bloomberg

It is important to understand that emerging markets are not a singular intra-correlated asset class, and within the general categorization there are many nuances and divergences at the country, sector and company level. In fact, the headwinds faced by emerging markets in recent years have increased the level of return dispersion as there are clear winners and losers from prevailing broader trends. Business and economic growth models have consistently experienced transformations throughout history, and the current period of transition is no different. Intuitively, increased dispersion presents ample opportunities for active managers to add value within the asset class and consequently we believe that the inclusion of ADRs by MSCI simply reflects a reality that already exists within our investment portfolio.

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The implications of this shift in actual and perceived opportunity set for the Driehaus emerging markets strategies are multifold. First, this latest wave of stocks being recognized in the index is the type of company that tends to fit our investment philosophy by having some combination of innovative business model, strong competitive position, asset-light operating structure, private ownership, superior growth potential and alignment of interests for minority shareholders. We have previously owned most of the 14 stocks added to the index and we currently own several of them. This highlights our ability to find and buy compelling companies often long before they become widely recognized and rewarded by the market. Indices will continue to reflect the evolving economic reality of emerging markets with a lag, which provides opportunity to generate alpha in the present.

Second, as liquidity and exposure for these types of stocks improve, more and more of them become investable. Success and more widespread recognition are likely to encourage other privately held businesses to list in the future. If you look at the 14 companies added to the index, only four of them have been listed for more than five years, which shows the nascent nature of this trend. Early recognition of these opportunities will be a key component of the alpha potentially harnessed by active managers.

Finally, inclusion of these companies in the index enables us to increase exposure to high conviction areas without increasing risk on a commensurate level.

The evolution of the investable emerging market universe is in its early stages. We believe our nimble and unconstrained investment philosophy will enable us to fully exploit these dynamics to the advantage of our clients.

ABOUT THE AUTHORS

Howard Schwab, Lead Portfolio Manager, is responsible for the strategy's portfolio construction and buy/sell decisions. Additionally, he analyzes macro-level trends and associated market risks for the firm's emerging markets strategies. Mr. Schwab joined Driehaus Capital Management in 2001. He received his B.A. in economics from Denison University in 2001.

Trent DeBruin, CFA, Assistant Portfolio Manager, focuses on emerging market stocks within the consumer discretionary, consumer staples, financials and health care sectors. Mr. DeBruin joined Driehaus in 2007. He received his B.A. in finance from the University of Notre Dame and his MBA from the University of Chicago Booth School of Business. Mr. DeBruin is a CFA charterholder.

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