EM vs. DM – The Unhappy Decade. Why it's set to change

Emerging Market Underperformance vs. Developed Markets

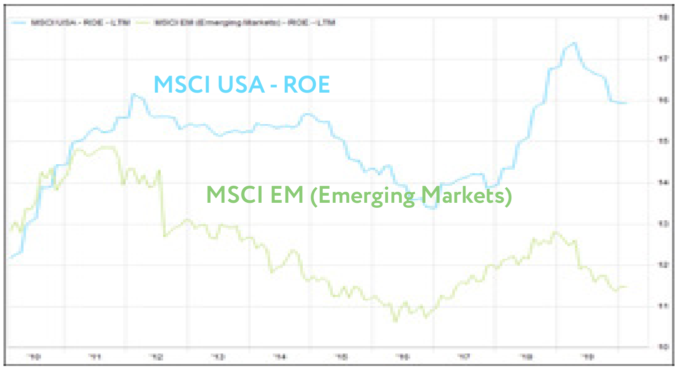
The underperformance of emerging market (EM) equities over the past ten years has been frustrating for allocators but in our view has had very clear causes. While a number of things have gone into this relative underperformance, we see the three largest factors as having been company-level profitability trends, the impact of the US dollar, and the volatility of local economic cycles and what that has meant for local interest rates.

We see the potential for many of these realities to change positively, albeit some with less clarity, and view active management, and the Driehaus investment philosophy employed by the Driehaus Emerging Markets strategies, as being well-suited to potentially outperform in this environment.

Main Causes of Underperformance

The roughly decade-long underperformance of EM versus developed markets (DM), primarily relative to companies in the US, has been mostly explained by deviations in profitability at the company level. This is most plainly evident in what has happened to return on equity (ROE) in the two respective areas over the past decade. In Chart 1, the deviation in profitability trends is clear and we think this is the single-biggest factor explaining the differences in stock price performance.

Chart 1: EM ROE Trend vs. US ROE Trend



Source: FactSet Research Systems LLC

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Richard Thies is the lead portfolio manager of the Driehaus Emerging Markets Opportunities strategy and a portfolio manager for the Driehaus Emerging Markets Growth and Driehaus Emerging Markets Small Cap Equity strategies. Additionally, Mr. Thies leads the Driehaus Emerging Markets Team's coverage of the financials sector and has primary responsibility for macroeconomic analysis. His macroeconomic analysis, idea generation, security analysis, portfolio construction, and risk management responsibilities are leveraged across the three strategies managed by the Driehaus Emerging Markets Team.

Mr. Thies has spent his entire career focused on emerging markets. Prior to joining Driehaus Capital Management in 2011, he worked as an international economist covering emerging markets at The Northern Trust. In advance of his time at The Northern Trust, Mr. Thies worked in microfinance banking in sub-Saharan Africa with both the International Finance Corporation of the World Bank Group and Opportunity International. Mr. Thies received his Bachelor of Arts in international studies from Emory University in 2005 and his Master of Arts degree focused in international political economy from the University of Chicago in 2007.

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This can be seen at the deviation of earnings-revisions trends as well, illustrated in Chart 2.

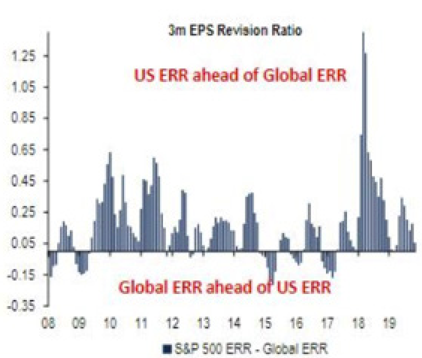
On one hand, companies in the US have improved efficiency, realized material effective tax rate declines, seen large declines in debt servicing costs and have increased leverage on the whole, resulting in an aggregate improvement in ROE. In contrast, emerging market corporates have experienced the opposite. Speaking broadly, business models were set up for higher economic growth, with more operating leverage required, higher capex spending and little improvement in debt servicing requirements throughout this period. While there are countless exceptions to this, and these exceptions are the types of companies we have and will continue to focus on, the emerging market corporate sector has had a ten-year period to transition to the new reality of lower economic growth and many of the large corporates who lead the index have done a poor job making that transition while others have performed better. As we will elucidate further, we think there's an argument to be made that we are now in the later stages of this transition toward improved profitability.

A second important factor in emerging markets' relative weakness during this period has been the impact of the US dollar. There is a first order impact whereby dollar returns for emerging market investors have been depressed by the strength of the dollar reflexively. Since the start of 2010, the JP Morgan EM FX index is down just over 40% (Chart 3).

The related impacts of dollar strength are several, however. First, EM corporates still have a larger share of export revenue than DM peers and are adversely impacted by dollar strength insofar as it reduces the price of dollar-based commoditized products, generally. Secondly, generally weak local currencies impact the ability of EM central banks to set monetary policy accommodative enough for the state of the weak local economies given they need real interest rates to protect the FX from weakening too much. Finally, EM corporates typically have US dollar denominated debt and when the US dollar rises, so too does leveraging and servicing costs.

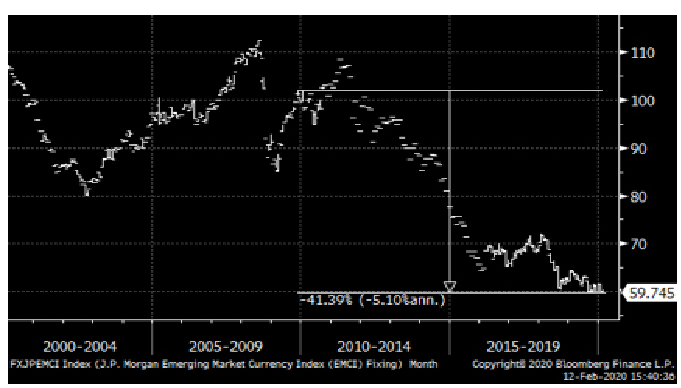
Thirdly, emerging market economies and companies suffered from the years of above potential economic growth. For many years, ending around 2011, many countries in EM were growing significantly faster than potential growth rates should have allowed. That left a long hangover for policymakers in terms of having high inflation which monetary policy needed to correct, large external deficits that made domestic economies more fragile, and interest rates that needed to remain high to bring growth down. This seems like a long-time ago to still be feeling these effects, but Brazil paid for its years of excess with a many-years long recession and we only last year started to see the country emerge from the painful period. As discussed earlier, businesses were frequently set up with this higher growth in mind as well and adjusting to the new reality has taken time. This last area is one where we see a definitively more positive outlook and believe the best environment for EM equities to be lower than potential, but improving GDP growth, which is the current situation.

Chart 2: EM EPS Revisions have Consistently Disappointed Relative to the US the Past Ten Years



Source: Bank of America Merrill Lynch

Chart 3: EM FX has Cost Investors Over 40% Relative to Dollar Returns Over the Past Ten Years



Source: Bloomberg

Catalysts for Change

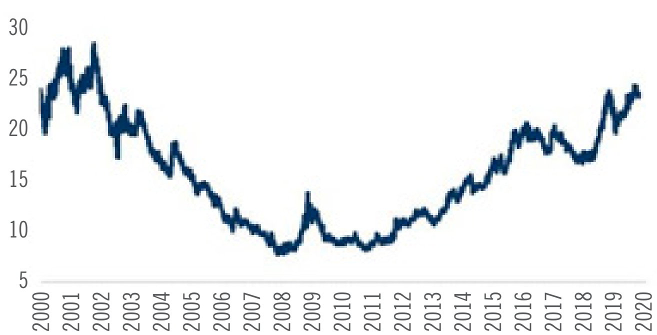
The recent decade of underperformance for EM growth stocks relative to US growth stocks is not unprecedented and reverses a similar period of outperformance seen between 2000-2008 (Chart 4).

Going forward, several catalysts can potentially trigger a shift in this trend including: 1) ongoing capital efficiency measures and increased focus on ROE within developing economies 2) increased local and global allocations to emerging market equities and fixed income 3) improved fiscal and current account management by policy makers in developing countries 4) a cyclical tapering of the current US dollar bull cycle 5) the continued urbanization and the coincident evolution of the technology industry within China.

The push against globalization has been steadily evolving since the global financial crisis and the recent China-US trade dispute has amplified a pre-existing trend. Recognizing that the mercantilist ways of the past are less relevant today, emerging market companies have steadily abandoned heavy capex/export-oriented initiatives in favor of asset-light strategies. Capex/GDP in Asia ex-Japan peaked around 40% in 2015 and sits near 35% today* while continuing to steadily improve (Charts 5 and 6).

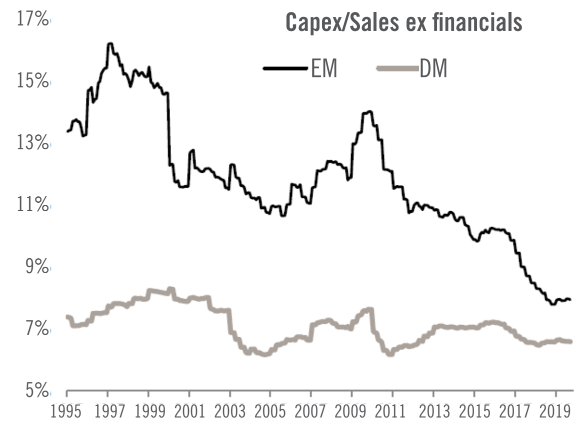
Similarly, Russia represents an example of a country historically maligned for poor capital management and governance where behavior has quietly shifted beneath the surface: the projected market dividend yield has roughly doubled in five years and Morgan Stanley projects dividend yield of ~8% this year (Chart 7).

Chart 4: MSCI US Growth/MSCI EM Growth



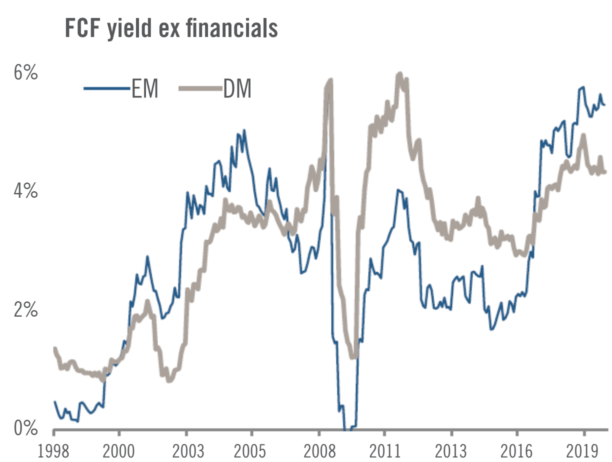
*Source: Bank of America Merrill Lynch

Chart 5: Capex intensity continues to fall



Source: Refinitiv, Credit Suisse research

Chart 6: Free cash flow has improved materially



Source: Refinitiv, Credit Suisse research

Chart 7: Improved shareholder alignment with record high dividend yield

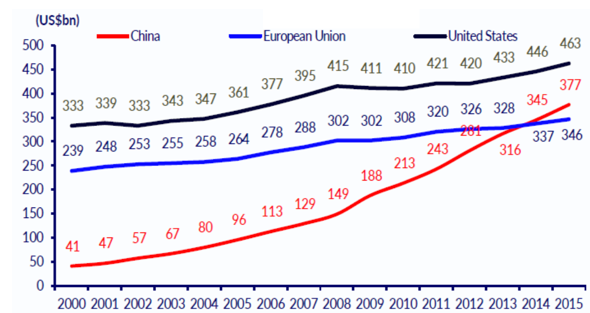
Source: Elkon and Morgan Stanley Research

This trend should continue over the ensuing decade – along with a gradually increasing focus on environmental, social and governance (ESG) – and enable EM companies to continue closing the returns gap between themselves and developed nations. Redefining sustainable margin and free cash flow (FCF) objectives should enable EM to reverse some of the massive valuation differential which has materialized in the past decade between US and EM assets, with the Shiller PE for US equities currently hovering around 29x versus 11x for global EM equities.

Select developing countries have also succeeded in cultivating more domestically driven investment markets, helping to mitigate some of the historic reliance on more fickle developed market asset flows. Brazil (Chart 8) has experienced a step-change in long-term bond yield expectations and subsequently seen individuals flock into equities. India has introduced policies to foster greater individual/institutional participation in local equities and these efforts have seen domestic equity AUM rise for six straight years with domestic institutional investors now representing 14.5% of the market. Domestic fund investments in India have outpaced overseas peers by 260% and AUM of domestic mutual funds has grown by ~19% annually while the systematic investment plan (SIP) business has grown 28% annually since 2016. Finally, China has made well publicized strides in modernizing and formalizing the local equity market with trading turnover on the A-Share market up nearly three-fold since 2017 and institutions now controlling more than 20% of daily turnover. The ongoing domestication and formalization of equity markets should enable certain developing nations to create a more sustainable and viable investment culture.

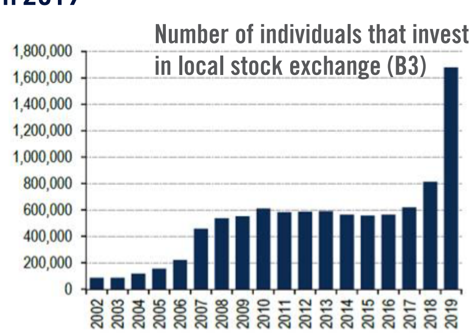
Technology continues to be the strategic focus and unsurprisingly has been the crux of the trade dispute between China and the USA as the former has ascended to represent the primary threat to American dominance in the sector. As illustrated in Charts 9 and 10, China is ramping its research and development and has been an early mover in 5G deployment. It continues to evolve a countrywide ecosystem incorporating smart cities, e-payments, advanced logistics, self-driving vehicles and automation. With the urbanization rate in China trending towards 75% by 2030 (from 60% today), the synthesis of technology and development will continue to manifest and promises to expand the number of investable innovative opportunities quickly. Such disruption and advancement promise fertile grounds for active stock pickers as a far more vibrant and modern economy emerges relative to the opportunity set of the prior decade.

Chart 9: Research & development spending



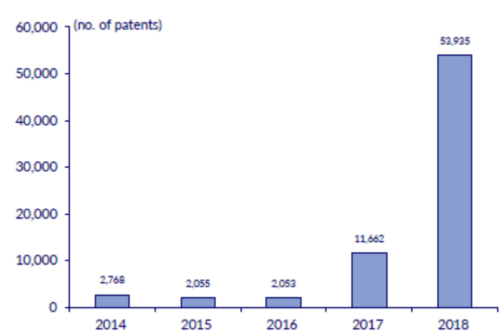
Source: CLSA, US National Science Foundation

Chart 8: Individuals investing the stock exchange surged in 2019



Source: B3

Chart 10: 5G patents



Source: iPlytics, CLSA

While the dollar is not significantly overvalued in our view, it is on the more expensive side of its history on a real basis. These real levels of exchange rates are not effective trading tools but they do provide valuation context on a longer-term basis. The dollar's value suggests more room for disappointment than any other major trading peer and while we can think of several potential catalysts for that, it is difficult to time exactly. In theory, the ever-increasing treasury issuance, the Fed keeping real rates artificially low to subsume that issuance and increasing policy risk premium associated to the US should all weigh on the currency. To date, that has not happened and its resilience has come from better relative economic performance in the US which we believe will change going forward, higher relative real interest rates to other DM FX, and the lack of a credible alternative. We would not call for a collapse in the dollar, but do not view another rally like we've seen the past ten years as likely given the starting point of valuation and the fact that the US has bought relative economic strength with fiscal expansion in recent years, a trend that has limits.

The Case for Active Management

EMs provide a better opportunity set for active management compared to other asset classes. Past performance supports this. Wilshire Associates analyzed how active managers performed against passive benchmarks for various time periods ending in December 2018. They found that 69% and 91% of active managers outperformed the MSCI Emerging Markets Index on a five- and ten-year basis, respectively, before fees. This is much better than the track record of developed market active managers. We believe that there are several reasons that the opportunity to generate alpha is greater in emerging markets.

First, we think that EMs are generally less efficient than developed markets. There are several possible explanations. Retail investors, who are generally less sophisticated, account for a higher percentage of market volume in EMs relative to developed markets. Additionally, local institutional investors are often constrained by mandates that require them to own a certain percentage of local assets regardless of the fundamental outlook, which can lead to unjustified valuations. While we do see this changing, with greater institutionalization of local markets, the transition is generally in the early days. We have also anecdotally noticed that in markets where local institutional buying has increased, we have found the types of companies we focus on to be increasingly favored, likely for similar reasons we prefer the companies.

Next, emerging market active managers also benefit from the composition of industry benchmarks. State-owned enterprises and conglomerates account for a meaningful percentage of the MSCI Emerging Markets Index. These companies are often inefficient, generate below-industry returns, and have poor capital allocation track records. They may also not have robust reporting standards which makes information hard to come by. Conversely, there is no shortage of innovative business models and very strong companies that can take advantage of idiosyncratic on-the-ground factors and weak competition. We think stock-picking is more relevant given the quality disparity in emerging markets.

Chart 11: Universe Statistics / Universe Index: MSCI Emerging Markets Index ($ Net)

Periods Ending 12/31/2018	1 Year	3 Years	5 Years	10 Years
Number of Products	140	134	123	71
Index Ranking (Percentile)	**44**	**43**	**69**	**91**
Average Excess Return	-0.99	-0.70	0.68	1.87
Median Excess Return	-0.85	-0.48	0.59	1.79
Average Information Ratio	-0.19	-0.09	0.15	0.35
Median Information Ratio	-0.22	-0.10	0.12	0.33

Source: Wilshire Compass

Finally, macroeconomics plays a more significant role in driving emerging market returns than in developed markets. Many emerging market countries are heavily reliant on global liquidity to fund their balance of payments. Poor fiscal and monetary policy implementation can result in rapid portfolio outflows that depreciate local currencies and raise the cost of capital. Demographics also vary widely across countries within the index. All the above factors increase the volatility of emerging market asset prices and the dispersion of returns. This results in a more robust opportunity for skillful active managers to deliver positive excess returns.

Driehaus Emerging Markets Equities

We believe Driehaus Capital Management is well-placed to generate excess returns in EMs because of our team's long history focusing on EMs and our time-tested investment process.

The portfolio managers of the Driehaus Emerging Markets team collectively have 37 years of emerging markets-related portfolio management experience at Driehaus. Aside from a deep familiarity with local markets, the portfolio managers have a strong understanding of what drives emerging market returns and risk as well as a track record navigating the volatility that is inherent to the asset class.

The Driehaus process has been consistently applied and the foundation of the strategy is employed to search for and own companies with positive earnings growth revisions. We believe this is a distinguishing factor relative to other EMs strategies because it enables us to cast a wide net. More specifically, we break down opportunities into four growth buckets: consistent growth, dynamic growth, cyclical growth, and recovery growth. This enables us to apply an appropriate lens to different opportunities and participate in diverse return streams rather than only seeking out companies based on one specific factor (e.g. quality or valuation).

Our team has deep domain expertise in EMs as a result of our long history investing in the developing world. We have a well-defined process that is consistently applied and has generated excess returns over time and market cycles. We believe these factors will continue to enable us to generate positive excess returns for our clients. This is an area upon which we focus and that has added value to our bottom-up selection process.

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