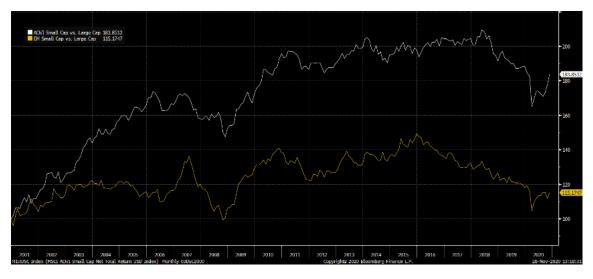
## DRIEHAUS EMERGING MARKETS SMALL CAP EQUITY STRATEGY

# Beyond China – Growing Opportunities Within Emerging Markets Small Cap

Over the last four years, emerging market (EM) small caps have struggled relative to large caps, in-line with a trend that has also materialized on a global basis. As shown below, the MSCI All Country World Index has been led by large caps since 2018, while EM small caps topped

out relative to large caps in 2016 (Exhibit 1). Notwithstanding recent performance trends, small caps in both EM and globally have outperformed large caps over the past twenty years, despite undergoing cyclical fluctuations.

Exhibit 1. Small Cap Relative Performance Against Large Cap



Source: Bloomberg

After enduring their longest stretch of underperformance on record, we believe one can argue that EM small caps are increasingly well positioned to return to a period of outperformance.

First, the starting point for an investment in EM small caps is favorable relative to its history. As shown in the following two tables, the MSCI EM Small Cap Index trades at a 12.8x forward price/

earnings multiple, a discount to all major asset classes, including the broad emerging markets index. At the same time, EM small caps register stronger estimated earnings growth than any asset class, making for an appealing combination amid the improving macro backdrop, which we describe below (Exhibits 2 and 3).

# Exhibit 2. Valuation Matrices for Countries and Sectors: Forward P/E

Region	MKT	15Y AVG	SDEV	xSD	ENE	MAT	IND	INF	FIN	RES	CDS	CST	HCA	TEL	UTE
US	22.5x	15.3x	2.5x	2.9x	30.2x	20.6x	22.6x	27.3x	13.0x	46.7x	37.1x	20.5x	17.2x	24.1x	20.2x
Europe	16.5x	12.8x	2.0x	1.9x	13.0x	16.1x	21.5x	25.0x	10.1x	16.4x	21.1x	18.5x	17.2x	13.9x	16.3x
lapan	17.5x	15.0x	3.5x	0.7x	8.7x	19.2x	22.1x	21.8x	8.2x	14.7x	19.1x	22.5x	27.7x	14.0x	8.5x
M	14.6x	11.3x	1.4x	2.3x	11.4x	11.2x	12.7x	16.3x	8.3x	6.0x	27.8x	22.1x	31.7x	22.4x	9.9x
EM Asia	15.4x	12.0x	1.8x	2.3x	13.0x	14.7x	11.8x	16.2x	7.7x	5.8x	28.2x	23.6x	33.4x	24.2x	9.7x
CEEMEA	10.9x	9.4x	1.6x	1.0x	8.8x	9.1x	11.0x		9.7x	7.4x	20.9x	19.3x	11.1x	16.4x	10.4x
LatAm	13.5x	12.0x	1.7x	0.9x	18.1x	8.9x	29.7x	43.4x	11.0x	11.4x	48.4x	19.0x	33.2x	11.8x	10.3x
China	15.5x	11.7x	2.8x	1.3x	8.6x	10.3x	9.5x	26.9x	5.9x	5.2x	33.4x	25.1x	40.7x	24.7x	9.2x
9. Korea	11.8x	9.7x	1.2x	1.7x	21.1x	16.0x	11.3x	11.5x	5.3x		9.4x	15.7x		24.9x	7.8x
Taiwan	17.0x	14.1x	3.0x	0.9x	27.2x	16.7x	20.4x	18.1x	10.4x	8.9x	21.9x	19.7x		27.0x	
ndia	22.1x	16.5x	2.5x	2.2x	16.8x	20.3x	23.8x	22.8x	22.0x	26.3x	31.0x	39.3x	24.4x	31.1x	7.5x
ndonesia	15.9x	13.7x	1.9x	1.1x	8.1x	21.6x			16.2x		13.3x	17.0x	23.6x	11.9x	19.6x
Malaysia	15.3x	14.9x	1.3x	0.3x	29.8x	23.5x	17.4x		10.2x		13.9x	31.3x	14.7x	23.0x	12.9x
Thailand	16.4x	12.4x	2.3x	1.7x	12.3x	13.5x	77.9x		9.3x	13.7x	68.3x	17.8x	32.1x	18.3x	15.7x
Philippines	17.4x	16.0x	2.4x	0.6x			21.0x		10.4x	20.8x	133.1x	21.5x		11.1x	14.0x
Pakistan	6.4x	8.1x	1.9x	-0.9x	4.7x				7.5x		100/100				-
S. Africa	10.9x	12.5x	2.1x	-0.8x	4.7x	6.2x	11.0x		9.3x	6.4x	20.7x	17.6x	10.1x	10.3x	
Russia	8.0x	6.6x	2.3x	0.6x	7.6x	7.6x			6.2x		-	19.6x		25.4x	4.9x
Saudi Arabia	19.9x	13.8x	2.4x	2.6x	30.8x	35.1x			14.6x	23.0x	20.6x	24.3x		19.6x	0.0x
Datar	13.7x	12.5x	1.30	1.0x	20.1x		23.4x		12.8x	20.00		20.00		14.3x	12.6x
IAE	10.6x	10.9x	2.0x	-0.2x	40.11				10.8x	7.0x				16.0x	-
Kuwait	19.8x	12.3x	2.1x	3.5x						7,000				10.00	
Poland	10.3x	11.8x	1.6x	-0.9x	6.1x	7.7x			8.6x		79.1x	32.5x		19.6x	4.6x
Hungary	9.9x	9.6x	1.6x	0.1x	6.9x				9.9x		19110		12.3x	19.00	
Czech R.	12.0x	12.7x	2.4x	-0.3x	9.44				11.2x				12.00		12.1x
Turkey	6.0x	8.7x	1.7x	-1.5x	11.7x	8.1x	7.41		3.3x		13.8x	18.1x		7.2x	18.10
Oreece	11.9x	11.8x	5.3x	0.0x	11.11	4.14					12.6x	100.100		13.3x	
Egypt	7.2x	9.9x	2.4x	-1.1x			6.2x		7.4x		18.95	6.1x		19.90	
Brazil	13.0x	10.8x	1.9x	1.1x	0.0x	6.7x	41.5x	10.3x	11.4x	26.2x	52.5x	19.6x	33.2x	14.3x	9.0x
Mexico	13.7x	15.0x	2.4x	-0.6x	0.00	17.4x	17.3x	19.45	8.3x	8.8x	U.S. U.A.	19.2x	00.21	10.9x	10.7x
Chile	16.3x	15.8x	1.9x	0.3x	28.8x	41.2x	11.00		11.2x	15.1x	20.7x	13.5x		22.0x	13.4x
Colombia	12.1x	13.7x	2.9x	-0.5x	10.4x	41.64			12.8x	14.10	20.17	THE SEC		ALC: YO	12.5x
Peru	14.9x	12.3x	2.2x	1.2x	10.44	22.3x			11.5x						12.00
Argentina	NM	9.7x	90.6x	1.20	13.3x	22.00		64.2x	11.44						
Australia	18.6x	14.3x	2.0x	2.1x	19.0x	12.2x	49.5x	71.3x	14.7x	17.2x	26.3x	24.2x	37.4x	32.7x	23.7x
Hong Kong	16.2x	15.3x	1.7x	0.5x	10.00	1624	49.0X	18.1x	19.4x	10.4x	36.8x	11.5x	U1.4E	19.3x	17.5x
ingapore	14.0x	13.4x	1.5x	0.4x			32.4x	15.6x	11.1x	16.7x	17.2x	14.6x		13.6x	27.UK
	15.4x	15.7x	4.1x	-0.1x			06.41	10.6X	14.1X	10.7%	11.21	P4.5X		10.00	
Vietnam EM Value	15.4x 9.8x	15.7X 9.4x	4.1x	-0.1x	_										
EM Growth	9.8x 22.9x	9.4x 14.2x	2.8x	0.2x											
EM Small Cap	12.8x	11.5x	1.4x	0.9x											

Source: J.P. Morgan

Second, during a period which saw broad EM equities register rangebound absolute performance and relative underperformance compared to global equities, it is no surprise that the flows that did come into emerging markets tended to favor passive vehicles. Over the past five years, EM equity funds have garnered only \$60 billion of net inflows, mostly during the bull market of 2017, which has subsequently seen half of the accumulated inflows reverse (Exhibit 4). According to JP Morgan, EM as an asset class is under-owned by global investors, with EM assets under management (AUM) only 7% of total global AUM, below its historical average of 9%.

# Exhibit 3. Earnings Outlook: Regions and Countries Matrix

Region	2019	2020	2021	2020	2021	1W	4W	3M	1W	4W	3M
US	141.1	132.6	159.6	(6.0)	20.4	1.5	3.3	6.8	0.4	0.9	2.9
Europe	7.4	6.7	9.1	(9.6)	36.4	0.4	1.9	1.3	(0.0)	0.5	0.2
Japan	0.58	0.44	0.62	(23.4)	40.6	0.5	1.6	(5.2)	(0.2)	1.0	(0.7)
EM	70.6	63.1	83.2	(10.6)	31.9	0.8	2.7	3.8	0.3	2.6	3.1
EM Asia	34.3	35.1	43.6	2.2	24.4	1.0	3.2	4.6	0.6	3.0	3.8
CEEMEA	22.4	15.1	20.5	(32.7)	35.9	(0.3)	0.7	(2.8)	(1.2)	(0.1)	(3.0)
LatAm	159.1	64.3	163.4	(59.6)	154.3	1.5	(0.3)	4.3	0.5	4.4	3.3
China	0.78	0.76	0.91	(2.7)	19.9	1.1	1.9	1.9	0.8	1.6	1.9
S. Korea	0.03	0.04	0.06	23.2	41.1	1.3	6.7	11.0	0.7	6.0	8.3
Talwan	0.82	0.97	1.11	18.2	14.3	0.6	4.8	9.7	0.6	5.1	9.2
India	0.80	0.71	1.01	(11.4)	41.9	1.6	1.4	4.4	0.4	0.9	2.1
Indonesia	0.03	0.02	0.03	(24.9)	26.0	2.7	10.2	5.4	2.7	8.2	4.4
Malaysia	7.36	6.95	7.60	(5.6)	9.4	(0.3)	2.1	17.2	(0.3)	2.8	1.8
Thailand	1.04	0.59	0.82	(43.4)	39.9	0.8	(0.5)	(9.4)	0.5	0.7	(3.2)
Philippines	1.46	0.97	1.33	(33.5)	36.7	(0.4)	(0.7)	(14.5)	(0.5)	(2.5)	(9.2)
Pakistan	0.31	0.31	0.32	(0.0)	2.7	1.5	3.9	10.9	1.6	3.6	7.8
S. Africa	5.8	6.3	8.2	8.3	30.1	4.2	6.2	16.5	3.9	6.0	10.5
Russia	120.3	49.9	73.9	(58.5)	48.1	0.5	2.6	(5.7)	(1.9)	(1.0)	(5.8)
Saudi Arabia	27.0	21.1	28.3	(21.9)	34.2	0.0	(2.0)	(3.0)	0.5	0.0	6.2
Oatar	52.4	48.8	56.5	(6.9)	15.6	1.6	0.4	2.8	1.3	2.1	4.4
UAE	8.9	6.3	7.5	(29.3)	19.1	1.2	2.2	(7.9)	0.2	(1.1)	(3.8)
Kuwait	42.0	24.6	33.7	(41.6)	37.2	(4.1)	(2.3)	(21.1)	0.6	(1.2)	(6.3)
Poland	23.3	20.5	23.6	(12.4)	15.4	(11.7)	(17.1)	(19.3)	(12.2)	(15.6)	(16.1)
Hungary	0.70	0.38	0.58	(45.1)	51.3	(1.2)	(3.6)	(7.9)	0.3	(2.1)	(7.7)
Czech R.	0.77	0.63	0.64	(18.7)	2.1	1.6	1.2	2.3	3.4	2.6	2.4
Turkey	26.306	17.452	29.381	(33.7)	68.3	(4.2)	(10.7)	(0.2)	(2.5)	(8.1)	(2.4)
Greece	0.180	0.228	0.288	26.4	26.2	(2.1)	(3.1)	(1.3)	(2.2)	(2.2)	(4.1)
Egypt	18.9	18.4	22.1	(2.3)	20.1	(0.1)	0.9	0.9	(0.1)	1.7	(1.7)
Brazil	116.1	43.4	130.4	(62.6)	200.5	5.7	0.9	12.5	0.7	5.6	6.2
Mexico	298.0	161.5	295.1	(45.8)	82.7	(4.6)	1.0	18.8	(0.2)	3.3	0.3
Chile	83.0	43.8	68.6	(47.2)	56.6	0.2	(5.8)	(14.0)	0.1	(2.8)	(6.9)
Colombia	56.6	25.3	42.1	(55.2)	65.9	(1.5)	(3.9)	(16.2)	0.5	1.6	(4.6)
Peru	98.1	29.5	89.9	(69.9)	205.1	(3.1)	1.9	(50.0)	0.2	2.9	(2.8)
Argentina	134.6	(73.9)	22.6	NM	NM	NM	NM	NM	48.5	(2.8)	(27.5)
Australia	49.9	43.1	48.7	(13.6)	12.8	1.4	2.1	7.3	0.8	0.3	3.5
Hong Kong	141.8	87.5	115.0	(38.3)	31.5	(0.6)	(1.1)	(10.1)	(0.2)	(0.5)	(5.6)
Singapore	100.9	57.3	77.7	(43.3)	35.7	0.8	0.2	(6.6)	1.3	1.1	0.5
Vietnam	42.6	41.5	52.5	(2.6)	26.4	0.0	2.8	3.6	0.4	4.2	3.1
EM Value	18.4	14.5	18.9	(21.4)	30.7	0.8	2.4	3.4	0.3	2.1	2.5
EM Growth	10.1	10.7	14.3	5.6	34.0	0.9	3.0	8.3	0.2	3.3	6.5
EM Small Cap	45.3	54.9	86.1	21.2	56.8	(0.6)	(0.0)	(4.6)	0.0	2.0	2.3

Source: J.P. Morgan

To put some numbers behind the narrowness of EM performance over the period, four stocks, which represented 11% of the MSCI Emerging Markets Index at year-end 2015, have generated 40% of the subsequent index returns. This dynamic has only intensified over time, as shown by year-to-date performance in the asset class, where the same four stocks, representing 18% of the index at the end of 2019, have accounted for 78% of the index return in 2020. The MSCI EM Small Cap Index today has a cumulative market capitalization of \$792 billion, similar to that of Facebook, and lower than five individual companies. Simply put, the case for EM small cap is a broadening out of performance trends, which would cause some of these disparities to reverse.

Sbn Cumulative flows into EM funds

EM credit funds
(hard currency bond funds)

EM bond funds
(local currency bond funds)

EM bond funds
(local currency bond funds)

EM equity funds

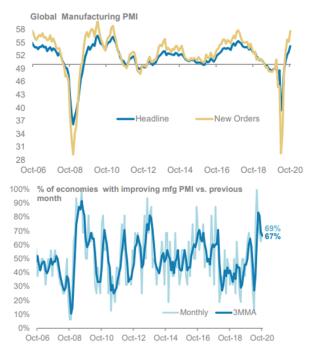
**Exhibit 4. Cumulative Flows Into EM Funds** 

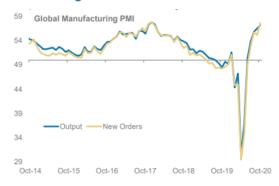
Source: EPFR, Goldman Sachs Global Investment Research

Third, the Driehaus Emerging Markets team sees an improving macro backdrop for EM equities. We consider a series of economic indicators that inform our view of broad macro trends as well as those of individual economies.

If we look at an aggregate of manufacturing PMIs, we see that we have recently reached a new cycle high of 54.2 in the October data (Exhibit 5). In fact, the aggregate headline measure is approaching previous cycle highs. Some 83% of the economies in observation set have headline PMI measures in expansionary territory; the picture is very similar if we look at the new orders component.

## **Exhibit 5. Global Manufacturing PMI**







Source: EPFR, Goldman Sachs Global Investment Research

The aggregate picture shows the recovery from the troughs of the pandemic induced recession (Exhibit 6).

If we look at the data on a more granular level, we see dispersion and can get a sense of relative strength across economies (Exhibit 7). We note particular strength in India (the largest move

off of the pandemic in our dataset below with the largest move in the last three months and one of the strongest PMI and new order levels), Brazil (similar story to India on the three month momentum and move off the trough with the highest manufacturing PMI in our data at 66.7), and South Africa (similar story to Brazil).

**Exhibit 6. Percentage of Countries With Manufacturing PMI Above Pre-pandemic Levels** 



Source: Markit, Haver Analytics, IMF, national sources, Morgan Stanley Research

**Exhibit 7. PMI and New Order Levels** 



Source: Morgan Stanley

The pandemic has introduced certain thematic trends related to the virus itself and the changes in consumption that resulted from the imposition of social distancing measures globally. Exports from Asian economies have been a beneficiary of these trends (a shift to durable goods from services in the consumption bucket), as we can see in the data shown below in data from Korea

(Exhibit 8). We see export volumes growing alongside an increasing dispersion between chips and the rest of the export categories.

Taiwan export data show a similar picture, as shown in exports by group and destination (Exhibit 9).

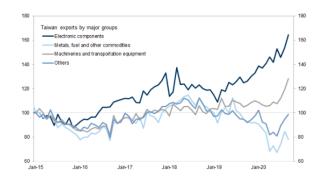
## **Exhibit 8: Korea Export Data**

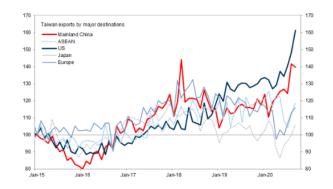




Source: Ministry of Trade Industry and Energy

## **Exhibit 9: Taiwan Export Data**



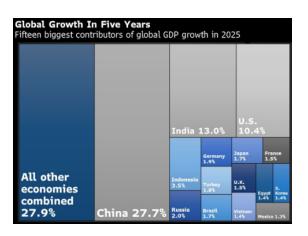


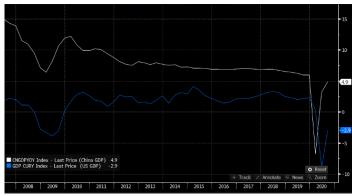
Source: Ministry of Finance, Haver Analytics, Goldman Sachs Global Investment Research

No consideration of EM economies would be complete without highlighting trends in data from China (Exhibit 10). In today's world, positive GDP numbers are exceedingly rare, leaving the

Chinese GDP particularly interesting. In the most recent policy 15-year vision, President Xi Jinping has targeted a doubling of GDP over the coming 15 years (implying 4.7% annual growth).

## **Exhibit 10. China Economic Growth**



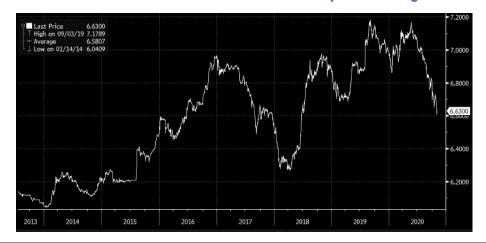


Source: Bloomberg

We also highlight recent trends in foreign exchange markets relative to the US dollar. The Chinese yuan serves a central role in reflecting economic realities and impacting EM investor returns. Recently, the yuan has appreciated

markedly amid strong fundamentals and a weak USD backdrop (Exhibit 11). The fundamental strength of the yuan is particularly relevant for EM investors as it is closely related to the performance of many peer currencies.

Exhibit 11. US Dollar / Chinese Renminbi Spot Exchange Rate



Source: Bloomberg

As shown in the following table from Bank of America, net US Treasury supply is set to meaningfully outstrip the Fed's current trajectory of bond purchases in the coming quarters (Exhibit 12). In an environment in which foreign official

flows into US Treasuries remain muted, this suggests the potential for additional monetary stimulus in order to contain bond yields, further reinforcing a weakening trend for the US dollar.

Exhibit 12. Net Treasury Supply and Fed Treasury Purchases

	Net Treasury Supply (\$bn)	Fed Treasury Purchases (\$bn)
3Q '20	504	233
4Q '20	625	237
1Q '21	597	240
2Q '21	618	240
3Q '21	572	240
4Q '21	584	240

Source: BofA Global Research, Federal Reserve

Looking to historical precedent to observe relative performance of asset classes during

periods of US dollar depreciation, we note the strong performance of EM equities (Exhibit 13).

**Exhibit 13. Asset Returns During Declining US Dollar Regimes** 

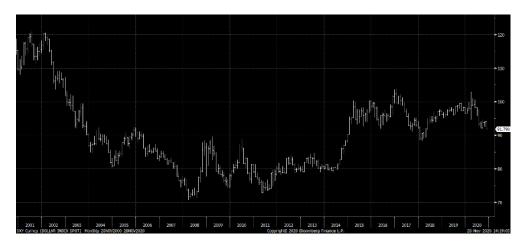


Source: BofA Global Investment Strategy, Bloomberg, Global Financial Data, Homer and Sylta "A History of Interest Rates." (2005)

Considering the potential topping pattern exhibited by the broad US dollar index, the improving macro data highlighted in the discussion above, and the relatively better job that emerging economies have done in combating

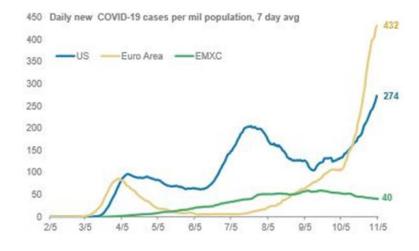
COVID-19 compared to the US and Europe, we see a growing likelihood that EM equities break their decade-long period of underperformance against developed markets (Exhibit 14, 15 and 16).

## **Exhibit 14. US Dollar Index**



Source: Bloomberg

## Exhibit 15. New COVID-19 cases



Source: Johns Hopkins University, WHO, CEIC, Haver Analytics, Morgan Stanley Research

Exhibit 16. MSCI Emerging Markets relative to MSCI World (Developed markets)



Source: Bloomberg

In an environment of improving macro and performance trends, alongside an attractive starting point, we believe that a broadening out of participation in emerging markets will support the relative attractiveness of the small cap segment of the asset class. We have already

begun to see a strong environment for stock selection over the last two years, and we continue to be excited about the large opportunity set of rapidly growing companies in this underinvested segment of EM equities.



## **ABOUT THE AUTHOR**

**Chad Cleaver,** 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.