ABS GLOBAL INVESTMENTS

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White Paper

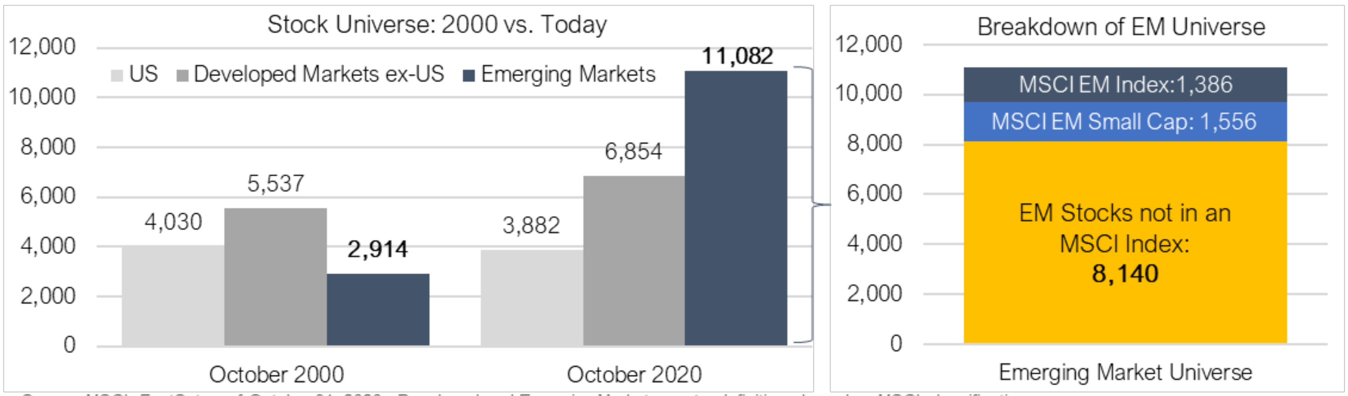
THE LOCAL ADVANTAGE:

ACCESSING ALPHA IN EMERGING MARKETS

Opportunities in Emerging Markets

Over the past 20 years, emerging market stocks have become a common feature of most asset allocation plans. While these markets can be subject to higher risk, they offer access to countries with accelerating growth that bring potentially higher investment returns. This beta component is well understood and accessed via a variety of products ranging from index-based ETFs to diversified emerging markets funds. However, there is another compelling opportunity available in emerging markets – alpha. The primary building blocks for alpha generation are volatility and dispersion across a large, diverse universe of securities. These factors are readily available in the emerging market stock universe, which is comprised of companies based in 26 countries across 5 continents operating under very different local economic and regulatory circumstances. In addition, unlike the US and other developed markets which have seen their active universe of stocks stagnate, the number of investable stocks in emerging markets has increased nearly fourfold over the past 20 years. In short, emerging markets offer active investors with abundant raw materials to generate alpha.

Figure 1: Number of Stocks with Market Capitalizations over $100 Million

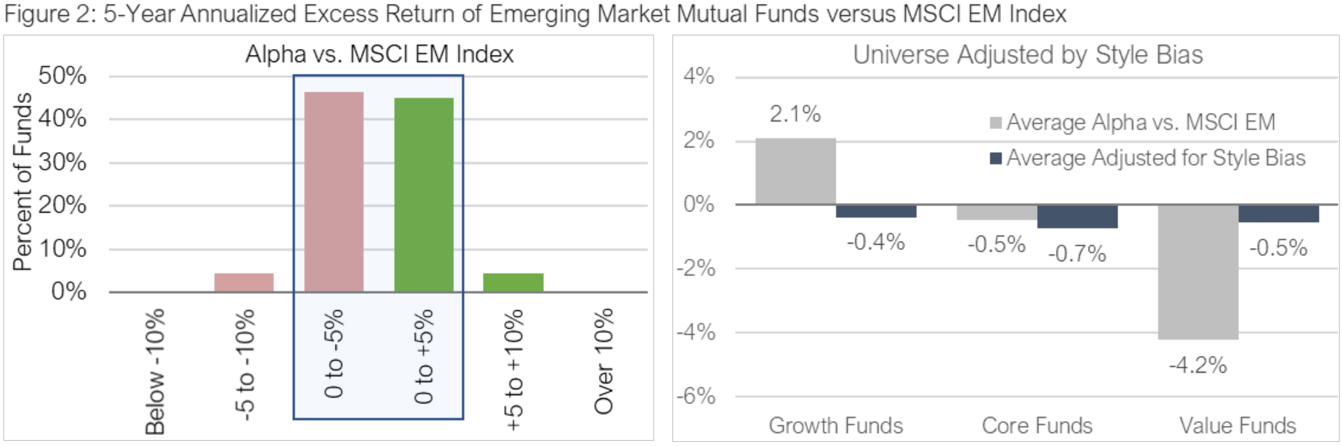


Source: MSCI, FactSet as of October 31, 2020. Developed and Emerging Market country definitions based on MSCI classifications.

Actively Seeking Alpha

This alpha potential in emerging markets creates a favorable environment for active management, which is evident in how investors approach these markets. Actively managed funds still have over 60% of the market share relative to passive strategies in emerging markets[1], compared to less than half in the US[2]. However, despite the diverse alpha opportunity, most active managers combine the 26 emerging market countries into a single investment mandate. While this may be an effective way for investor to access beta exposure to these markets, it offers significant challenges for managers seeking to deliver excess returns via stock selection (i.e., alpha). This is a result of the large universe, which makes it virtually impossible for any single investment strategy to effectively cover in detail. Therefore, the investment community has broken down the universe into smaller, more digestible pieces based primarily on size (large and small cap) and style (growth and value). This "style box" approach provides some advantages for managers to focus on a smaller universe of stocks but as you can see below, results in style factors driving the vast majority of excess returns as opposed to stock selection.

Figure 2: 5-Year Annualized Excess Return of Emerging Market Mutual Funds versus MSCI EM Index



Source: Bloomberg screen of US mutual funds classified as Emerging Market Stock with AUM of at least $250M and 5-year track records as of Sept 30, 2020

[1] Rencap estimate based on EPFR database of funds.

[2] Investment Company Institute, Morningstar Direct, and Strategic Insight Simfund.

As shown on the first chart in Figure 2, over 90% of global emerging market managers delivered returns within +/-5% of the MSCI EM Index. The second chart highlights the impact of style biases on relative performance, where relative performance was highly dependent on growth and value factors as opposed to stock selection. Our experience shows that this outcome is not reflective of the opportunity set. Asset managers simply cannot cover the entire emerging market universe in-depth and are forced to focus on a narrower subset of companies, either by applying a quantitative screen or adhering to a specific style or market cap bucket. In addition, large assets under management can limit the ability for managers to fully access the vast universe of emerging market companies. Larger funds are less willing to spend scarce resources identifying smaller cap, non-index opportunities that may have limited contribution to portfolio results. And with compensation based primarily on a manager's level of assets under management, incentives are aligned for managers to accumulate assets instead of prioritizing the delivery of outperformance.

An alternative to the traditional investment approach in emerging markets is to utilize a collection of local managers based in the regions or countries in which they invest. This local approach embraces tracking error relative to the headline market indices in the pursuit of alpha by expanding the coverage universe beyond the index to identify emerging companies and trends that are less covered and may become the market leaders in the future.

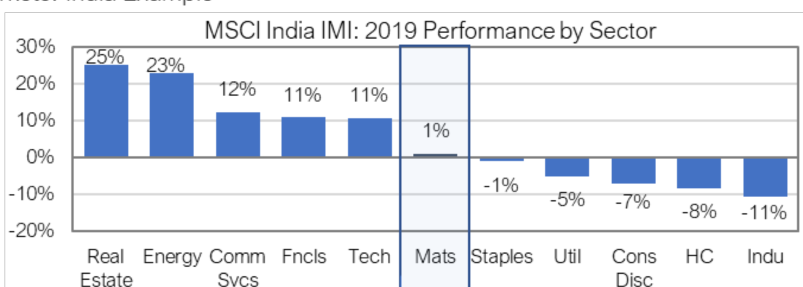
Boots on the Ground: The Local Manager Advantage

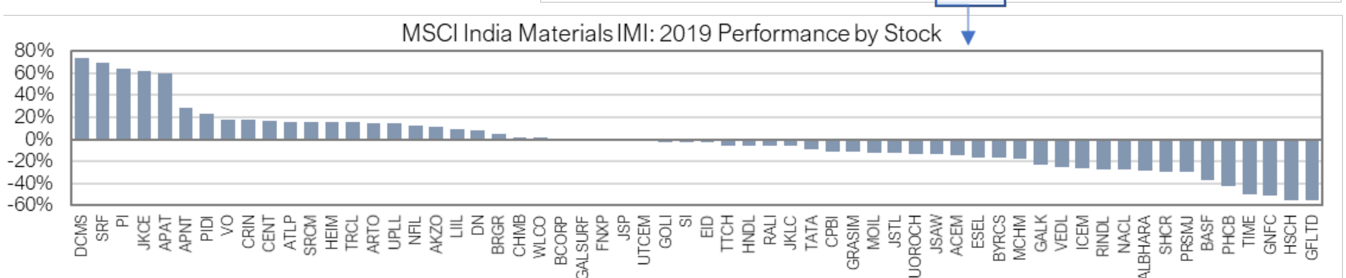
If a manager based in Hong Kong offered a strategy to invest in US and European stocks, most US-based investors would be quite skeptical and likely choose a fund based in the US or Europe instead. However, the reverse is typically not true, as US and European-based managers dominate the emerging market fund universe. While many have small teams of analysts based in a few key locations, most decision makers sit far away from the local markets. In addition, the global pandemic imposed strict travel restrictions that has kept managers from assessing the local environment, leading to a further disconnect between the ultimate decision makers and the companies in which they invest.

We believe local managers focused on a specific country or region offer a compelling alternative for investors looking to unlock the diverse alpha opportunities. In addition to providing their onsite perspective, local specialists typically cover a broader array of stocks within countries and tend to be less benchmark sensitive. This focused approach allows managers to take advantage of the high level of sector and stock diversity within many emerging market countries. An example of the alpha opportunity set within a particular country is displayed in Figure 3, which shows the level of performance dispersion in a single country from both a sector and stock perspective. This provides ample alpha opportunities for local managers.

Figure 3: Diversity and Dispersion Within Local Markets: India Example

India Market Summary	
Weight in MSCI EM Index (10/31/20)	8.3%
Total Stocks >$100M Market Cap	795
Stocks in MSCI India Index	86
Stocks in MSCI India Small Cap	209
Stocks not in MSCI India IMI Index	500
MSCI India IMI Index 2019 Return	+5.3%



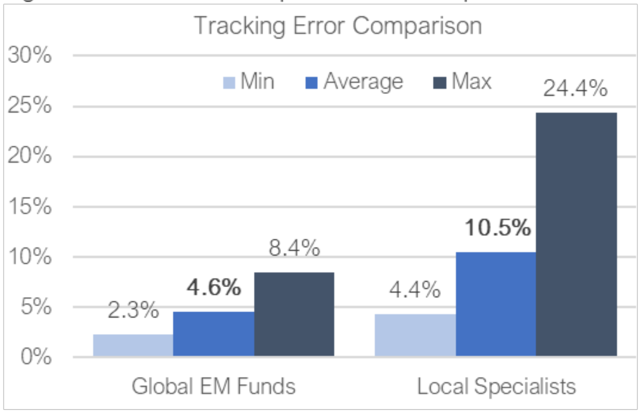


Source: MSCI, Bloomberg. Stocks not in MSCI based on minimum $100M market cap

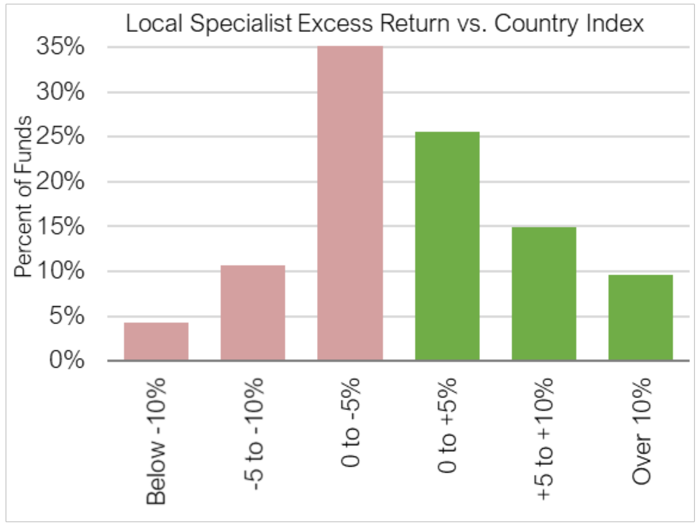
The opportunity for alpha does not always result in significant excess returns. However, our experience has shown that local managers are at least attempting to capture that excess alpha. Figure 4 compares the higher tracking error of local managers relative to global emerging market managers and wide performance divergence relative to the local index for country specialist managers in the five largest EM countries (China, Taiwan, Korea, India, and Brazil). Nearly

40% of this universe produced returns in excess of +/5% relative to their MSCI country index, compared to less than 10% of the global EM managers in Figure 2.

Figure 4: Active Risk Comparison – Local Specialists versus Global EM Funds



Data based on the 5-year period ending September 30, 2020. Local Specialist fund universe includes country-specific funds for the top 5 countries in the MSCI EM Index (China, Taiwan, Korea, India, and Brazil) in the ABSolute database with 5-year performance through September 30, 2020 (94 funds). Global EM Funds based on the universe presented in figure 2.



There are several reasons why local managers are ideal for capturing alpha in non-US markets. Common characteristics of the most successful managers include:

1. **Specialization** – Single strategy with all team members focused on a specific market
2. **Small and Nimble** – Smaller asset base allows for participation across the market cap spectrum
3. **Organizational Simplicity** – Portfolio manager(s) dedicated to the portfolio, not managing a large business
4. **Performance Oriented** – Compensation geared towards performance as opposed to asset gathering

The common thread that binds these attributes together is the alignment of incentives with investors. In many cases, local specialists tend to manage smaller pools of assets, have fees that are linked to performance outcomes, and most importantly, are comprised of portfolio managers as opposed to business managers.

The Execution Challenge

While local specialists offer significant alpha potential, they do present some challenges as well. First and foremost is the ability to source, diligence, structure, and monitor a large group of funds around the globe. Language barriers, local networks, and more recently, travel restrictions make it difficult to build an institutional quality local manager platform. Secondly, we note that the wide range of alpha outcomes experienced by local managers in Figure 4 is just as much a risk as it is an opportunity. Manager selection is critical when increasing active risk and requires ample resources qualitatively, quantitatively, and operationally to ensure funds are meeting expectations, keeping up with peers, and maintaining best practices. Lastly, the cost of implementation can be high, as ancillary costs such as travel, new data inputs, and operational structuring can be significant at smaller scale.

These challenges can be actively managed by an established partner with an extensive history of investing in local markets to build a portfolio that balances the risks with the rewards. The ideal partners should be able to provide cost-effective solutions by using their scale to negotiate and structure investments that may not be feasible for smaller allocators. Lastly and most importantly is the ability to uncover talented managers. This requires a dedicated team of analysts turning over as many stones as possible, preferably guided by a deep network of local contacts and a time-tested process for analyzing and monitoring investments.

Conclusion

We believe local managers are the most effective way for investors to benefit from the diverse alpha opportunities in emerging markets while maintaining exposure to the long-term growth in these regions. Some of the largest allocators in the world have already implemented this approach with success (i.e., The Government Pension Fund of Norway, aka Norges Bank), as have a handful of other niche investment firms. The size of the market is extensive, and the universe of managers is expanding, leaving plenty of runway for growth looking forward. Whether opportunistically targeting a specific market or building a broader portfolio, partnering with local specialists can provide institutional portfolios with alpha potential to help meet their return objectives.

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