Lazard
Perspectives

Five Reasons to Own More Emerging Markets Equities

Every sell-off tells a story about an asset class—a story about what investors believe the assets are and what they are capable of becoming, for better or worse. As COVID-19 spread around the world and global growth prospects dimmed, many investors sold emerging markets equities. We believe this sell-off told the story of an asset class driven by the energy and materials sectors and populated by countries and businesses that are recipients of trickle-down demand from strong global growth, rather than drivers of that growth—the businesses that support the developed world, rather than strong markets in their own right.

Not every story is accurate, however, and we believe this view is not a true reflection of emerging markets today. We strongly believe that emerging markets remain a powerful investment in 2021—so much so that we think investors ought to be considering how best to increase their allocations, rather than selling their holdings. Here are five reasons why:

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1. **Composition**: Emerging markets are much less dependent on energy and materials than they once were, while entrepreneurial information technology and internet-related businesses are ascendant.
2. **Innovation**: Emerging markets have leapfrogged the developed world in several key technologies, while spending on research and development in China, in particular, rivals that of the US.
3. **Driving Force of Global Growth**: Emerging markets account for almost 60% of global growth, a proportion due to rise given their relatively young populations and ongoing urbanization.
4. **Recovery Potential**: History suggests the current rebound has more room to run.
5. **Underestimated Value**: Emerging markets equities are trading near historical discounts, and we believe the data suggest that investors are under-allocated to the asset class.

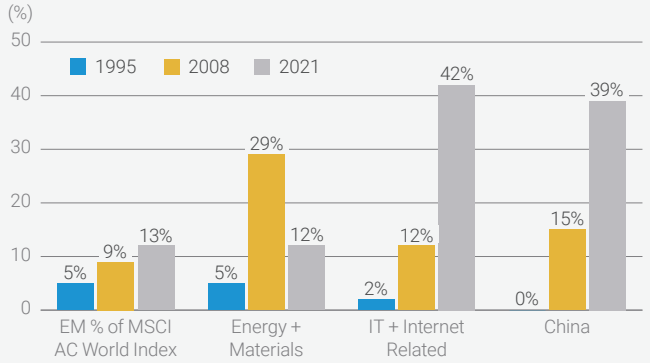
In general, we find that investor perception has not caught up with the changes in emerging markets over the past decade. Investors in the United States are heavily invested in US equities, a good trade for the last 10 years. However, we believe US investors who exclude non-US equities, specifically emerging markets equities, may be limiting their investment options and possibly minimizing their total portfolio outperformance. As the world comes to grips with a crisis, investors tend to broaden their holdings beyond "safe-haven" assets and countries. We expect the crisis brought on by the coronavirus pandemic will be no different, and when investors begin to shift capital into more asset classes, we believe emerging markets equities are primed to be a key beneficiary.

1. The Changing Composition of the EM Equity Market

Historically, the MSCI Emerging Markets (EM) Index has been heavily skewed towards Europe, the Middle East, and Africa (EMEA), as well as Latin America. Although Asia grew to represent 40% of the EM Index in 2000—even without China as an investable option (Exhibit 1)—EMEA and Latin America represented nearly 50% of the index by the time the global financial crisis hit in 2008. Meanwhile, the energy and materials sectors shot up to nearly 30% as the commodity supercycle propelled companies in many exporting nations during the early 2000s.

The changes since then have been quite dramatic. Today, Asia dominates the index, accounting for nearly 80% of some 1,400 emerging markets securities (Exhibit 2). China alone represents 40% of the market capitalization, followed by Taiwan at 14%, Korea at 13%, and India at 9%. By contrast, EMEA and Latin America representation has declined to approximately 20%. From a sector perspective, information technology (IT) and internet-related securities have quadrupled from their 2008 weight to more than 40%, while energy and materials companies have dropped to 12%; the next-largest sector, financials, represents less than 20% of the index (Exhibit 3).

Exhibit 1
MSCI EM Index Composition: Now and Then

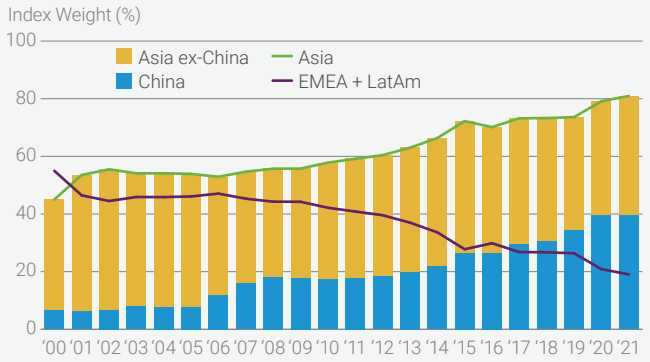


As of 28 April 1995, 31 Oct 2008, 28 Feb 2021

Note: "Internet-related" is the sum of the media and entertainment industry (communication services sector) and the internet and direct marketing retail industry (consumer discretionary sector).

Source: FactSet, MSCI

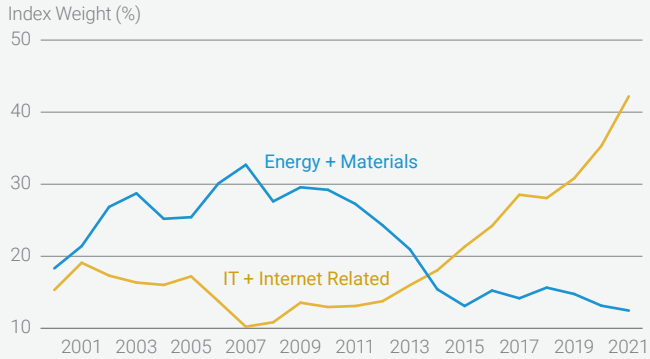
Exhibit 2
MSCI EM Index: Growth of Asia Driven by Emergence of China



Date range: 31 December 2000 to 28 February 2021

Source: FactSet, MSCI

Exhibit 3
MSCI EM Index: Growing Emphasis on IT and Internet-Related Companies

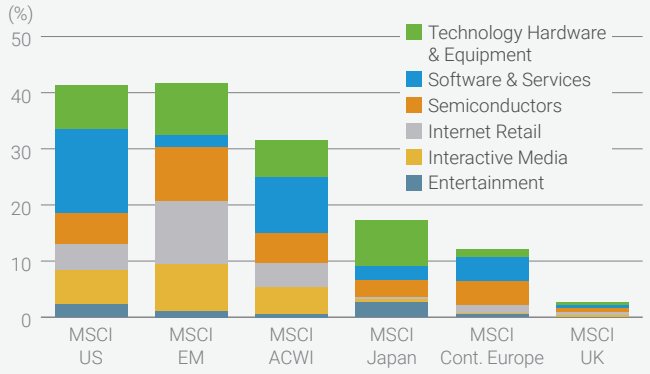


Date range: 31 December 2000 to 28 February 2021

Source: FactSet, MSCI

As a result of these changes, the emerging markets now offer investors greater exposure to IT and internet-related securities than do the developed markets: The MSCI EM Index has more than double the exposure of MSCI Japan, triple that of MSCI Europe ex-UK, and almost 20 times that of the MSCI UK (Exhibit 4). In fact, the IT and internet-related exposure in the EM Index is similar to that of the US, but at lower valuations. Many investors may not fully appreciate that EM equities can offer the opportunity to invest in the leading businesses of today, and more importantly tomorrow, at near historic discounts. (See reason 5 for more.)

Exhibit 4
IT and Internet-Related Exposure by Region



As of 28 February 2021

Note: "Internet-related" is the sum of the media and entertainment industry (communication services sector) and the internet and direct marketing retail industry (consumer discretionary sector).

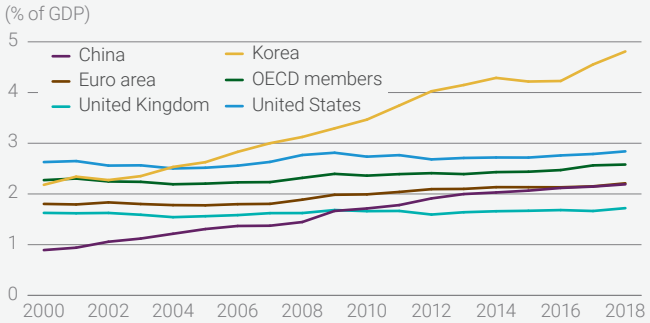
Source: FactSet, MSCI

2. Culture of Innovation: The Next Tech Ecosystem?

Traditionally, emerging markets relied on developed nations for most of their advanced technology. Although in some key areas this is still the case, emerging nations have been investing steadily to increase their own capabilities, primarily to spur the next phase in their economic growth. Indeed, emerging countries have leapfrogged the developed world to become leaders in next-generation telephony, 5G, and mobile payments.

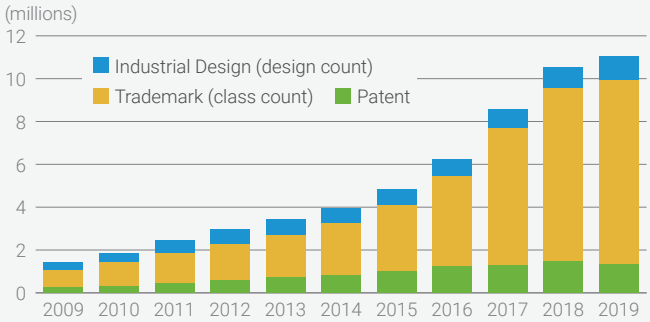
In 2018, the US led research and development (R&D) spending[1] with $552 billion on a purchasing power parity basis,[2] but China followed closely with $526 billion, and together, the two accounted for half of the global total. That marks a big leap for China since 2000, when R&D expenditure totaled only $44 billion, or approximately 12% of US spending. While it is difficult for smaller nations to match the US and China in dollar amounts, many, such as Korea, show greater R&D intensity, or total R&D expenditure as a percentage of GDP (Exhibit 5).

Exhibit 5
R&D Expenditure



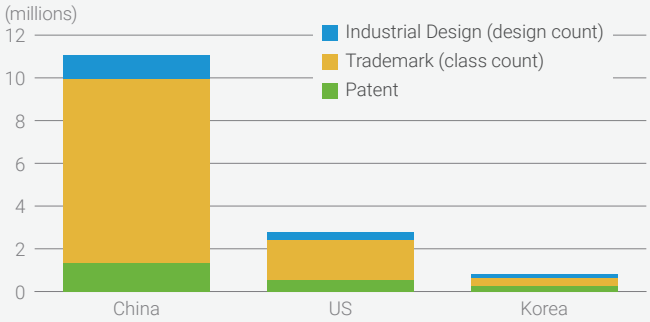
As of 31 December 2018
Source: UNESCO Institute for Statistics

China Intellectual Property Filings (Resident and Abroad, Including Regional)



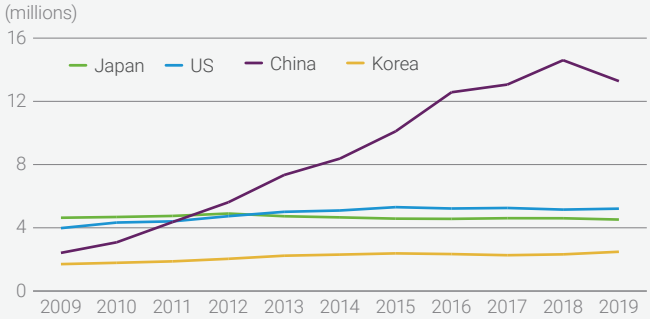
As of 31 December 2019
Source: World Intellectual Property Organization (WIPO)

2019 Intellectual Property Filings (Resident and Abroad, Including Regional)



As of 31 December 2019
Source: World Intellectual Property Organization (WIPO)

Patent Filings (Resident and Abroad)



As of 31 December 2019
Source: World Intellectual Property Organization (WIPO)

Asia has also strengthened its position as the region with the greatest activity in intellectual property: Patent, trademark, and industrial design application filings from the region represented approximately 70% of the global total in 2018, up from roughly half in 2008. China drove most of the increase, with 1.5 million patent applications—46% of the total worldwide. By comparison, North America and Europe together accounted for only 30%. Looking at the number of patent applications per unit of GDP, Korea again stood out with the most, followed by China, Japan, Germany, and Switzerland.

In recent years, emerging markets consumers have embraced the internet and adopted smartphones in overwhelming numbers, from the 2G standard, which is fast enough for texting, to 3G-enabled graphics and 4G-enabled smartphone video. Now 5G promises to accelerate communication among interconnected devices, and China is leading the world in adopting 5G technology. The country plans to spend more than $420 billion on 5G technology—double what it spent on 4G and just under the planned spending by the US, Korea, and Japan combined (Exhibit 6). Between 2020 and 2025, roughly 90% of Chinese operators' capital expenditure in mobile technology is expected to be in 5G networks. By 2025, China's mobile internet user base is projected to reach nearly 1.2 billion, and of the estimated 1.8 billion 5G connections globally, China is expected to account for more than 800 million.[3]

The rise of emerging markets in technology has had an unfortunate consequence: political fallout. In the US, the former Trump administration, in particular, had been uncomfortable with the prospect of next-generation technology coming from China and had sought to impede its development. One possible result of the political tensions may be that the emerging world will develop a separate tech ecosystem, with less reliance on developed nations.

This would pose both a challenge and an opportunity for investors: Traditional holdings in US technology stocks would have limited exposure to this new ecosystem, but on the other hand, the new terrain would be ripe for active stock pickers in the emerging markets universe.

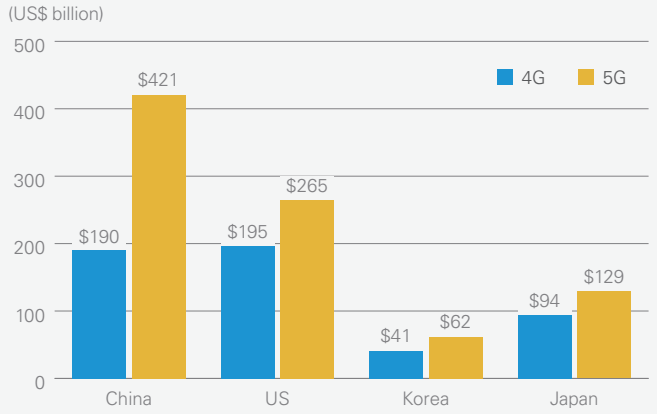
3. Better Growth Prospects

More than a decade ago, emerging markets overtook the developed world in economic growth, and today they contribute nearly 60% of global GDP (Exhibit 7). China alone accounts for nearly one-fifth of global growth, up from just 2% in 1980, while India's share has more than doubled to almost 10% over the same period. It is likely that emerging markets will represent an even larger percentage of global growth as urbanization—the shift in populations from rural to urban centers—continues and as informal sectors transition into the formal economy. With nearly 85% of the world's population, emerging markets have younger populations than the developed economies have. Many young people are moving into the middle class and increasingly shaping global consumption patterns, a key driver of growth.

4. Attractive Recovery Potential

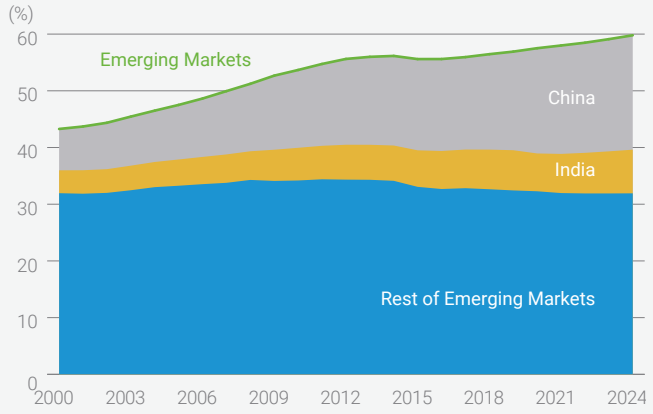
Historically, market pullbacks have been an attractive entry point for investors in emerging markets equities. In the past 30 years, emerging markets have seen 12 bear markets, defined as declines of more than 20%, with an average peak-to-trough drop of 37% (Exhibit 8). The average one-year price return after the trough (excluding this year) is 45%. While the greater than 70% rebound for the MSCI EM Index from the 23 March 2020 low through 28 February 2021 is above the average, the expected earnings growth rebound has the potential to support the emerging markets recovery.

Exhibit 6
5G Capex – Driven by China



As of 23 February 2020
Source: Morgan Stanley Research Estimates

Exhibit 7
EM Share of Global GDP



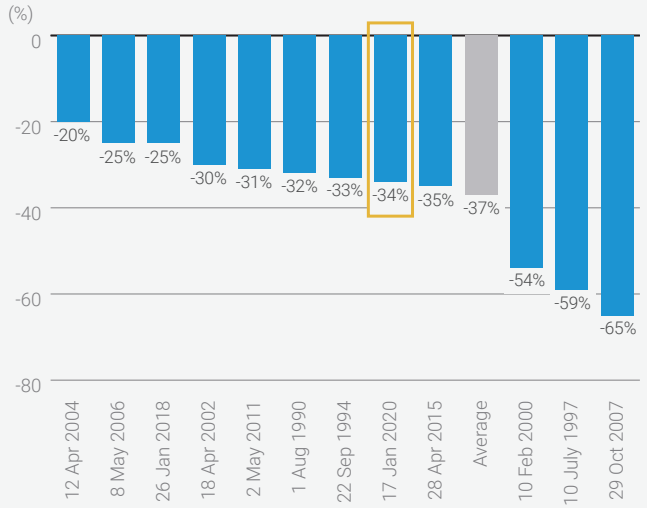
As of 13 October 2020
Source: Haver Analytics, IMF

We are currently seeing some divergence in the pace of economic recovery among emerging markets. In general, the larger Asian economies are recovering faster than expected from the shock brought on by the COVID-19 pandemic. Economic indicators in Taiwan and Korea have already rebounded sharply, and Chinese leaders have set a 2021 growth target of more than 6%. These countries' experience in dealing with pandemics in the past may be helping them bounce back more quickly. Across other regions, the results are mixed: most countries saw their first COVID-19 cases more recently and are still battling the spread of the virus.

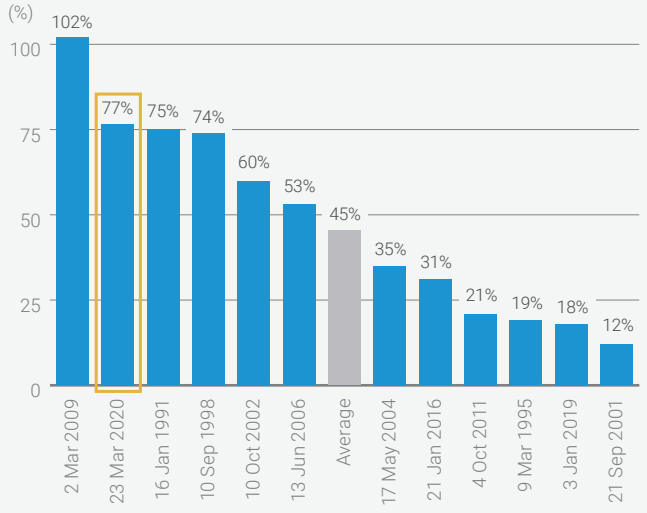
5. Undervalued and Under-Allocated

Despite all the positive changes in emerging markets, the valuation divergence between developed and emerging markets equity indices has actually widened since 2011 (Exhibit 9). The MSCI EM Index currently trades between a 20%-25% discount to the MSCI World Index and at almost a 30% discount to the S&P 500 Index (Exhibit 10). The divergence holds across sectors and styles. For example, the consumer discretionary sector of the MSCI EM trades at nearly a 25% discount to that of the S&P 500. Digging deeper into internet retailing, or e-commerce, emerging markets equities are 50% cheaper than their US peers.

Exhibit 8
Bear Markets in EM: Peak-to-Trough Declines



One-Year Price Return Post-Trough

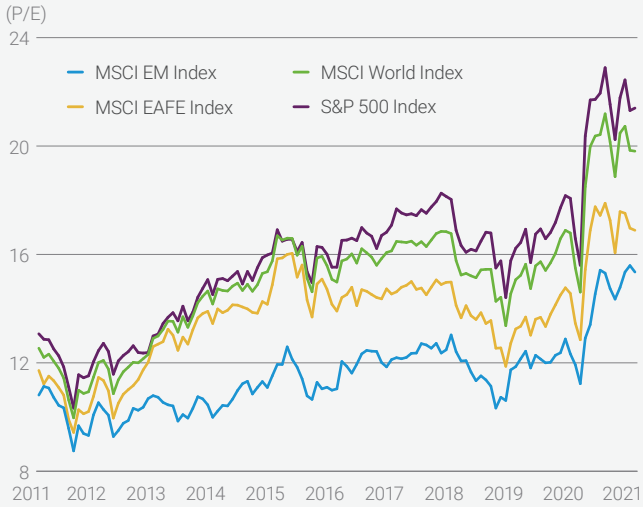


As of 28 February 2021

Note: Dates on x-axis represent the MSCI EM Index peak date (top chart) and trough date (bottom chart) of the corresponding bear market. Average one-year price return post-trough excludes 23 March 2020 trough date.

Source: FactSet, MSCI, UBS Global Research

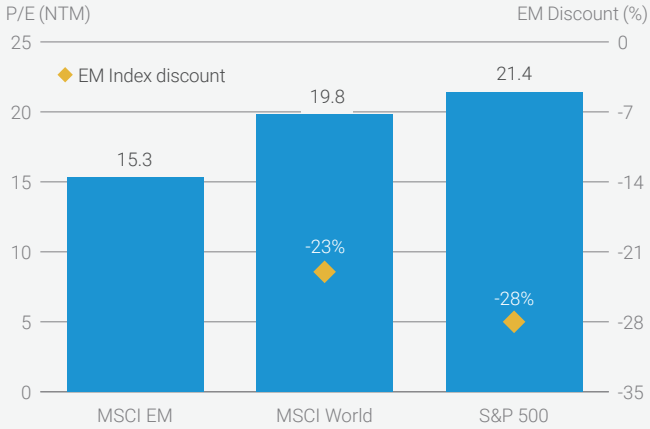
Exhibit 9
Price/Earnings Next Twelve Months (NTM)



As of 28 February 2021

Source: FactSet, MSCI

Exhibit 10
EM at a Steep Discount to Developed Markets



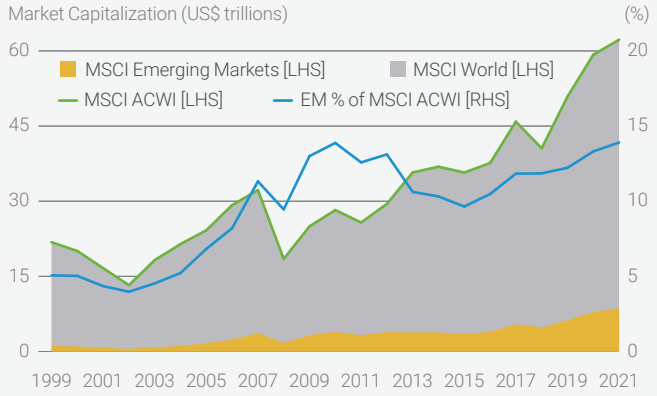
As of 28 February 2021

Source: FactSet, MSCI

In addition, investors are still under-allocated to EM equities. Emerging markets represent 13% of the total market capitalization in the MSCI All Country World Index (Exhibit 11). Yet, the median exposure by a global equity manager to EM equities has hovered between 2% and 6% (Exhibit 12); even managers with the most exposure (the top quartile) hold only around 10%. We would also argue that these weights do not reflect emerging markets' projected share of global growth, young consumers, and new technologies.

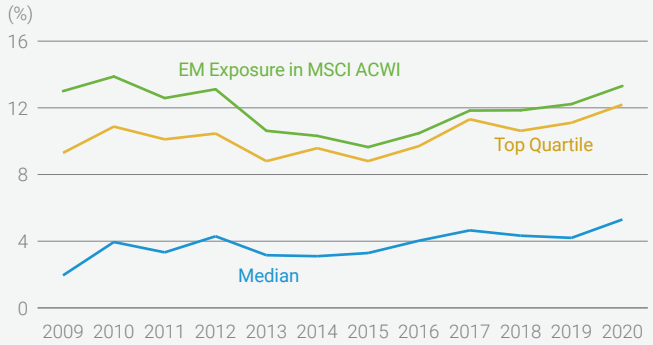
In our opinion, emerging markets valuations and allocations point to a disconnect between the market and underlying fundamentals. In our experience, such disconnects do not last forever. We expect investor exposure to eventually rise to levels that better represent the importance of these economies in the 21st century, and we think the current market pullback is a good opportunity for investors to get started.

Exhibit 11
EM Market Cap as % of Global Equities



As of 28 February 2021
Source: FactSet, MSCI

Exhibit 12
EM Exposure by Global Equity Manager vs. MSCI ACWI



As of 31 December 2020
Note: Percentile ranking is based on All Global Equity eVestment universe and includes approximately over 1,400 products.
Source: eVestment, MSCI

About the Team

The Lazard Developing Markets Equity team aims to generate strong relative returns over a full market cycle by investing in emerging markets companies with sustainable earnings growth at attractive valuations. The team seeks out emerging markets companies at the forefront of innovation and development, reflected in the companies' disruptive business models and above-average earnings growth, and focuses on those that remain unrecognized by the markets and cheaply valued. The portfolio management team consists of 7 investment professionals with more than 20 years of industry experience and 13 years at Lazard, on average. As part of their process, they leverage Lazard's global research platform and are fully supported by more than 300 investment professionals.

This content represents the views of the author(s), and its conclusions may vary from those held elsewhere within Lazard Asset Management. Lazard is committed to giving our investment professionals the autonomy to develop their own investment views, which are informed by a robust exchange of ideas throughout the firm.

Notes

1. Defined as gross domestic spending on R&D, or the total expenditure (current and capital) on R&D carried out by all resident companies, research institutes, university, and government laboratories, etc. in a country.
2. Source: OECD Science, Technology and R&D Statistics. Based on purchasing power parity measured in USD constant prices using 2010 as the base year.
3. GSMA The Mobile Economy: China 2020 Report.

Important Information