Lazard Insights

Mind the Gap: The Risks of Going Passive in EM

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Summary

- Passive funds continue to gain market share, but investor preferences for passive over active vary greatly by asset class.
- Unlike other asset classes, the global flight to passive has been more restrained in emerging markets, where growth in assets has been split between active and passive and the case for passive is less clear cut.
- Passive investments in emerging markets have several hidden risks, including unwanted biases and volatility, while active managers can find good opportunities outside of an index and offer downside protection.

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A Global Shift to Passive?

Global assets under management have more than doubled over the past 15 years, but that growth has not been evenly distributed. Asset growth in active strategies, which aim to outperform a benchmark, has lagged asset growth in passive strategies, which aim to replicate the returns of their benchmarks through indexation.

In 2003, passive strategies, which include most exchange-traded funds (ETFs) and index mutual funds, only represented 12% of global assets under management. That figure reached 22% by 2015.[1] Passive flows have now outpaced active flows for over two years, a trend that appears to be a structural shift (Exhibit 1). We believe this growth is largely driven by the low cost of passive products. The fee for an S&P 500 Index fund can be as little as 4 basis points (bps), compared to the 100 bps some investors pay for an actively managed US equity strategy. Another reason for the broad shift to passive is performance. In a low volatility, beta-driven market, many active managers have found it difficult to outperform their benchmarks after fees. The growth in passive assets has also benefited from an increase in ETF usage over the last five years among global multi-asset managers who look to add alpha, or excess returns, through asset allocation rather than through stock selection.

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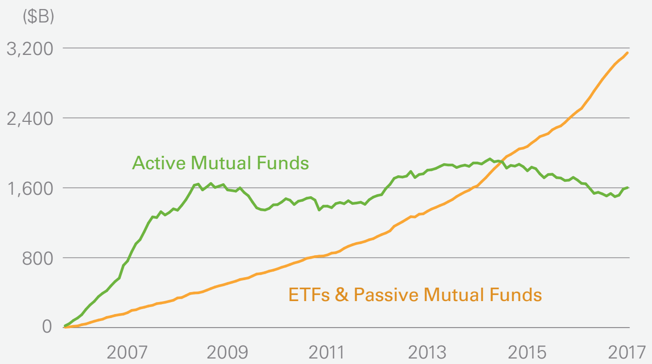
Exhibit 1
Passive Flows Have Outpaced Active Flows

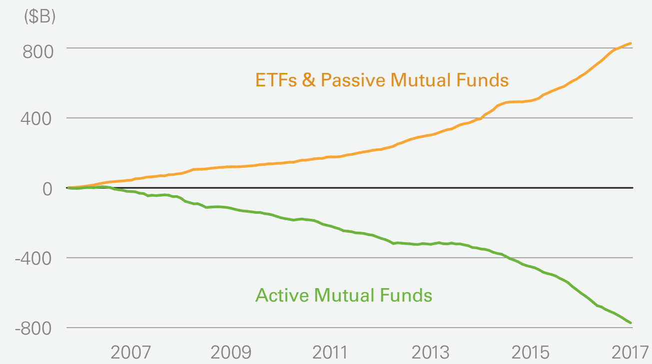
Global Active and Passive Inflows



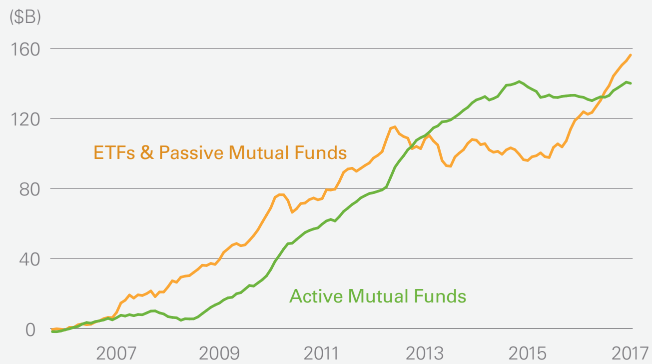
As of 30 September 2017
Source: Morningstar, Strategic Insight Simfund

Exhibit 2
US and EM Flows Tell a Different Story

US Large Cap Flows



Emerging Markets Flows



As of 29 September 2017
US Large Cap flows are represented by the monthly net new flows of the Morningstar US Large Value, Blend & Growth Category. Emerging markets mutual funds and ETFs flows are represented by the monthly net new flows of the Morningstar Diversified Emerging Markets Category.
Source: Morningstar, Strategic Insight Simfund

The shift to passive has been most pronounced in US large cap equities. From 2013 to 2015, US institutional investors' allocations to active US equities declined from 62% to 41%.[2] Actively managed US equity funds have seen $800 billion in outflows over the last ten years, while large-cap passive strategies have seen $800 billion of inflows (Exhibit 2, top). However, the story is quite different in emerging markets. Both active and passive emerging markets strategies have seen significant inflows (Exhibit 2, bottom). We believe the difference in these patterns reflects the divergence in asset class performance. Over the past three years, about 75% of all US large cap equity managers have underperformed the S&P 500 Index.[3] Most active emerging markets managers outperformed their index in the same time period, a point we will discuss later in this paper.

Passive Investing in Emerging Markets

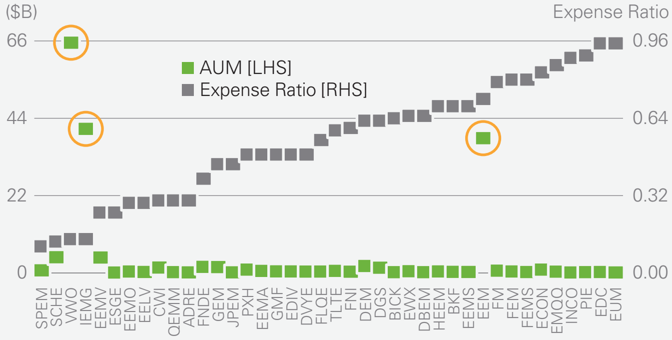
Today, three US-listed emerging markets equity ETFs command more than 80% of the total assets in this space: Vanguard FTSE Emerging Markets ETF (VWO), iShares MSCI Emerging Markets ETF (EEM), and iShares Core MSCI Emerging Markets ETF (IEMG). We believe it is no coincidence that the two funds receiving the lion's share of emerging markets ETF inflows also have the lowest fees (Exhibit 3). VWO and IEMG only charge 14 bps and have seen a combined $42 billion of inflows in three years. On the other hand, EEM, which was the first emerging markets ETF to launch, has seen $2 billion in outflows over the last three years, likely because of its higher fee of 75 bps.

Fees aside, an important difference between these ETFs is their benchmarks. VWO now tracks the FTSE All Cap China A Inclusion Index, which excludes Korea, while EEM and IEMG track the MSCI Emerging Markets Index and MSCI Emerging Markets Investable Market Index, respectively, which both include Korea. VWO also owns China A-shares, while the other two ETFs do not.

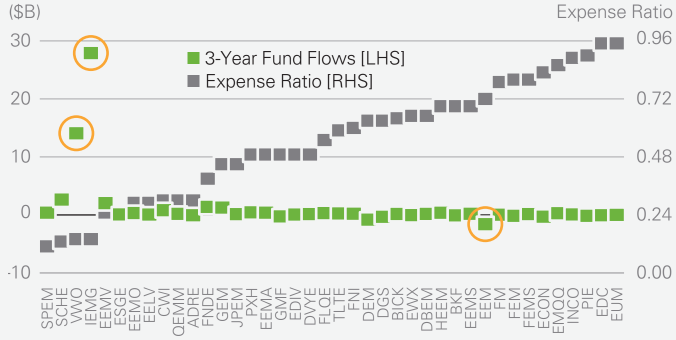
China A-shares are on track to be included in MSCI indices in May of 2018, read more.

Exhibit 3

Two of the Largest EM ETFs Only Charge 14 Basis Points...



...And Have Seen the Most Inflows



As of 21 November 2017

EM ETFs over $100M

Source: Bloomberg

These differences may seem minor but they are important because they can affect performance. Year to date through 30 November 2017, VWO has returned 23%, while EEM and IEMG have both gained 30%.[4] This dispersion in performance reflects the differences in their referenced benchmarks (Exhibit 4). VWO's lack of exposure to Korea, and by default Samsung, which was up more than 58% in US dollar terms during this period, caused it to underperform EEM and IEMG.

The Hidden Risks of Passive Investing

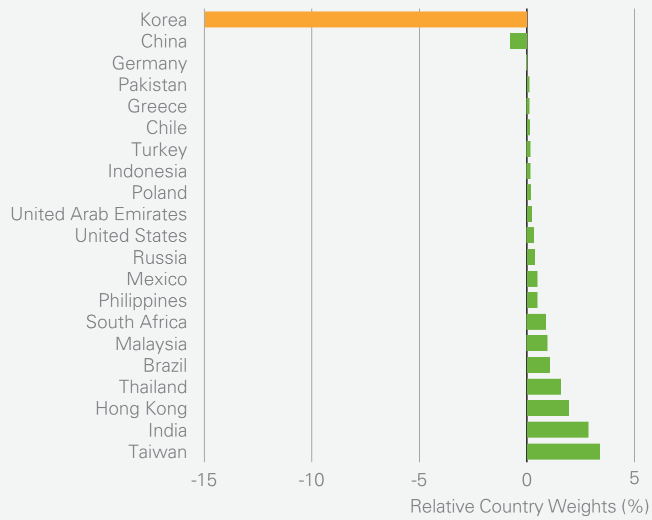
As flows suggest, investors may realize that passive funds are not always the best instruments to access the emerging markets opportunity set. Passive funds, such as ETFs, are useful for tactical investors looking to take advantage of a short-term assessment of a certain region or sector but, in our view, are not an adequate strategic investment for those looking to establish a long-term emerging markets allocation.

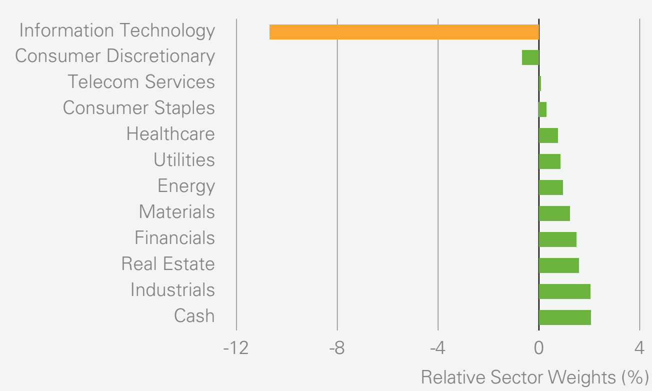
We believe there are several drawbacks of investing in passive emerging markets strategies. For one, passive investing can introduce unwanted biases for investors. Passive funds track popular emerging markets benchmarks and by extension are limited to a narrow subset of emerging markets companies. These benchmarks are typically market capitalization weighted, which means they often have large-cap bias and sector and country concentration. Consider this: more than 50% of the MSCI Emerging Markets Index is composed of financial and technology companies; more than 50% is made up of three Asian economies, China, Korea, and Taiwan; and the top five stocks account for about 20% of the index. In other words, since the biggest companies have the largest weights in the index, ETF performance is heavily dependent on those companies' performance, whether positive or negative. Concentration is even more pronounced in passive

Exhibit 4

Seemingly Similar Funds Can Provide Very Different Exposures

Vanguard FTSE EM ETF vs. iShares MSCI EM ETF

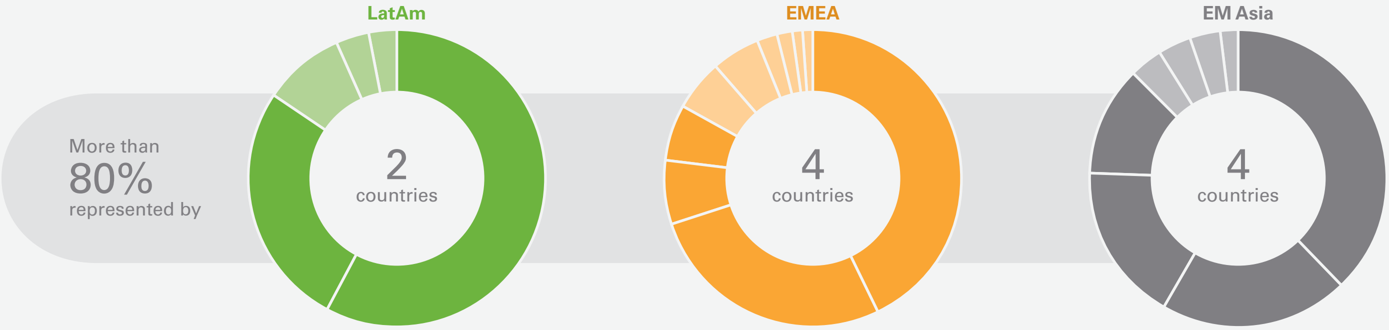




As of 30 September 2017

Source: Morningstar

Exhibit 5
The MSCI Emerging Markets Index Is Heavily Concentrated in Certain Regions



As of 31 December 2016
Data are based on MSCI regional indices.
Countries – LatAm: Mexico, Brazil; EMEA: South Africa, Turkey, Russia, Poland; EM Asia: China, Korea, Taiwan, India.
Sectors – LatAm: financials, consumer staples, materials; EMEA: financials, energy, consumer discretionary, EM Asia: information technology, financials, consumer discretionary.
Source: MSCI

Exhibit 6
EM ETF Holdings Have Less Analyst Coverage

Analyst Coverage	iShares MSCI Emerging Markets (EEM)	iShares Core S&P 500 (IVV)
Number of Companies	855	505
Stocks with No Coverage	50	0
5 or Less	107	8
10 or Less	191	29
Average Analysts per Stock	18	22

As of 30 September 2017
Source: Morningstar

regional emerging markets funds. For example, 80% of the MSCI Emerging Markets Latin America Index is concentrated in just two countries, Mexico and Brazil (Exhibit 5).

Emerging markets have been, and are likely to continue to be, a volatile equity asset class. In fact, over the last ten years the MSCI Emerging Markets Index has been roughly 25% more volatile than the MSCI World Index.[5] While emerging markets passive funds are subject to similar levels of volatility as is the index, skilled active managers have the ability to dampen this volatility by optimizing weights within their portfolios and avoiding those stocks, regions, or countries that they deem too risky.

In addition, we believe state owned enterprises (SOEs) can pose another issue for passive emerging markets investors. SOEs are companies that have governments as large controlling shareholders and they now represent about 25% of the MSCI Emerging Markets Index. Many of the large utilities, energy, financial, and telecom services companies in emerging markets are SOEs. In addition, about half of all companies in China and Russia and about a third of Brazil's MSCI Emerging Markets-listed stocks are SOEs. This can be an issue as business decisions for these companies can be influenced by political and social ambitions of a country's government and are often run as investments of the state and do not exist to serve shareholders.

The Active Advantage

Downside protection is a key advantage for active managers and essential to wealth preservation and long-term capital growth. For example, a passive fund that declines by 50% over time would need to subsequently increase by 100% to break even. On the other hand, if an active fund is able to protect capital and declines by 40% during that same time period, it would only need to gain 66.7% to break even. One of the key drawbacks of passive funds is that they are subject to the full downside of an index. Skilled active managers, on the other hand, can construct their portfolios to protect against extreme or prolonged market declines.

Perhaps the most attractive feature of active investing in emerging markets stems from the asset class's inefficiency. Emerging markets are still a relatively under-researched asset class and most companies in that universe have less sell-side analyst coverage than those in the United States and other developed markets (Exhibit 6). This opens the door for active stock pickers to sift through those stocks that may or may not be attractive. In addition, active managers have the ability to find stocks that are not included in an index. Today, the MSCI Emerging Markets Index holds around 850 stocks, but the current investable emerging markets universe consists of over 2,500 companies, providing a wider opportunity set for active managers to find so-called "diamonds in the rough."

Exhibit 7
EM Active Managers Prove Their Worth

	Returns					
	YTD	1 Year	3 Years	5 Years	7 Years	10 Years
5th Percentile	37.76	29.87	8.32	7.87	5.21	5.67
25th Percentile	31.03	23.72	6.73	6.08	4.09	2.69
Median	28.60	22.46	5.13	4.70	3.23	1.91
75th Percentile	27.78	22.07	4.90	3.99	2.54	1.32
95th Percentile	24.22	19.52	3.90	3.79	1.91	0.69
MSCI EM Index	19.00	12.43	0.22	1.42	0.71	-0.38

As of 30 September 2017
Results displayed in US dollar terms, net of fees. The data represent 53 observations from eVestment's Global Emerging Markets Large Cap Equity universe.
Source: eVestment

Finally, all of these inefficiencies in emerging markets have been reflected in the performance of actively managed strategies. Over the long term, the majority of emerging markets active managers have outperformed the MSCI Emerging Markets Index, net of fees (Exhibit 7). Even in this year's beta-driven market, most active managers in emerging markets have outpaced the index.

Conclusion

Around the globe, flows to passive funds have continued to outpace flows to actively managed strategies. In emerging markets, however, flows seem to reflect investors' recognition that active managers add value over time. While passive strategies can serve a purpose, we believe investing in an actively managed strategy is the most effective way to exploit the emerging markets opportunity set. Active managers can find good companies outside of the index and, equally as important, they can underweight, overweight, or have no exposures at all to a certain region, sector, or stock. This is crucial to developing unique insights that can generate outperformance and to protecting client assets if indices suffer significant draw-downs—protection that is not available in a passive strategy.

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Notes

1 As of December 2016. Source: BCG Global Asset Management, Greenwich Associates

2 As of 31 December 2015. Source: Greenwich Associates US Institutional Investor Studies

3 As of 30 September 2017. Source: Morningstar

4 As of 30 November 2017. Source: Bloomberg

5 As of 30 November 2017. Source: MSCI

Important Information

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