Does Style Still Matter in Emerging Markets?

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We recently conducted follow-up research to our 2010 study, *Does Style Matter in Emerging Markets?* and found that the style distinctions among investment managers that we originally identified have grown more pronounced, generating differentiated patterns of performance—patterns that, in some cases, are negatively correlated.[1] In our view, this differentiation presents an opportunity to blend style exposures, smooth portfolio volatility, achieve higher risk-adjusted returns, and determine asset class entry and exit points more precisely. Over the same period, the growth and maturation of the emerging markets small cap asset class has opened a new avenue of diversification opportunities.

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The Evolution of the Emerging Markets Equity Universe

The market cap of the MSCI Emerging Markets Index has expanded by more than 400% over the last nearly 14 years, outpacing all other broad indices, as the number of names in the index grew by roughly 350 names to approximately 1,200 (Exhibit 1). Similar to what happened in other major asset classes, the structural changes and resulting expansion of the number of investable companies and countries have broadened the opportunity set. This, in turn, prompted an elaboration of investment styles that paralleled the earlier pattern in developed world equity markets. In the United States, manager style distinctions have been measurable and comparable in the form of indices and style peer groups since at least the late 1980s. And international and emerging markets equity manager portfolios have evolved over the last 20 years, from top-down and bottom-up classifications to ones focused on growth, value, and core styles.

A Decade of Divergence

To determine the extent to which style has driven emerging markets returns, we categorized emerging markets equity managers by their professed style, portfolio holdings, and characteristics. In addition, we grouped managers by z-score,[2] a statistical measure of how far a given value lies from the mean of all values as measured in standard deviations. Working with a style-based regression to establish style-group purity, we divided the equity manager universe into five groups:

- Deep value seeks to build portfolios of stocks trading for less than their intrinsic worth—it aims to acquire inexpensive assets, in other words.
- Relative value weighs the tradeoff between valuation and some measure of quality (e.g., profitability, such as return on equity, return on assets, or return on invested capital)—it aims to acquire profitability inexpensively.
- Core aims to build a well-rounded portfolio for "all seasons" that sidesteps the style allocation decision with exposures to a blend of value and growth stocks.
- Growth at a reasonable price, or GARP, attempts to identify companies that are at once attractively valued and have the potential for sustainable earnings growth.
- Growth seeks companies whose earnings growth rate exceeds the market average.

In 2010 we set out to determine whether the five styles were discrete. A decade on, we wanted to learn if and how the styles evolved. Plotting the five style groups on a cap-weighted holdings-based matrix traces the ongoing emergence—and steady divergence—of emerging markets investment styles. In the early years of the emerging markets as a distinct asset class—MSCI launched its index in 1988—emerging markets styles didn't really exist. By the time of our initial study, the differences between growth and value and between those two styles and their blended counterparts had become clear. Today each of the five styles has staked out a distinct territory (Exhibit 2).

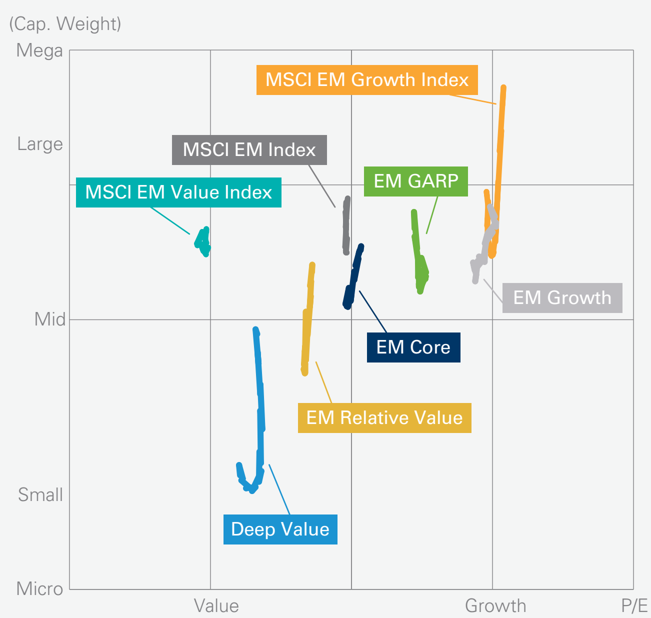
Exhibit 1
Emerging Boom: EM Market Cap Has Grown Almost Twice as Fast as US Market Cap

Market Cap of Key Equity Indices	30 June 2005 ($T)	30 June 2019 ($T)	% Increase (%)
MSCI Emerging Markets Index	1.3	5.5	425
MSCI Emerging Markets Growth Index	0.6	2.8	432
MSCI Emerging Markets Value Index	0.6	2.7	428
MSCI EM Small Cap Index	0.3	0.7	229
MSCI USA Index	11.0	25.9	235
MSCI EAFE Index	8.9	14.0	157
MSCI World Index	20.6	41.3	200

As of 30 June 2019
Source: MSCI

Exhibit 2
Definite Distinctions: Analysis Identifies Five Differentiated EM Investing Styles Today

Rolling 36-Month International Equity Style Map for Five Years Ended 30 September 2018

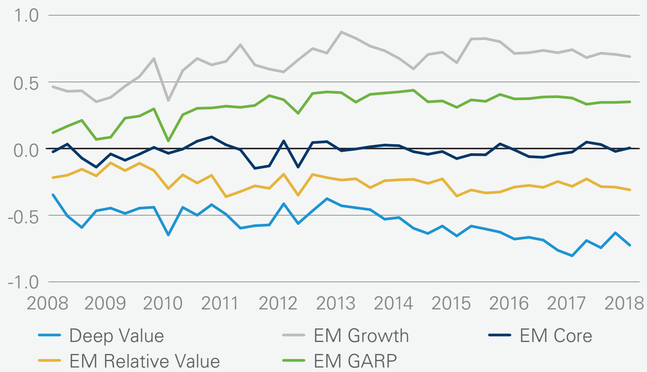


As of 30 September 2018
Source: Callan PEP

Exhibit 3

Z Scores Chart Consistently Divergent Paths

Combined Z-Score (five years ended 31 Dec 2018)



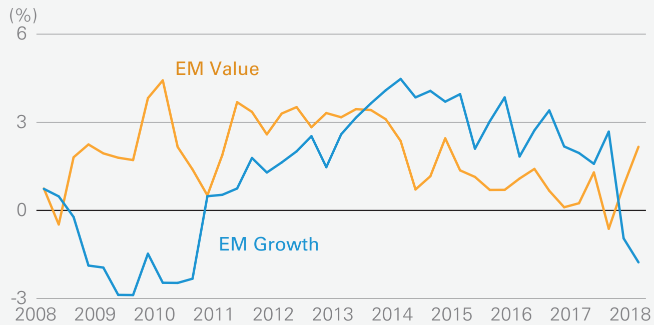
As of 31 December 2018

Source: Callan PE

Exhibit 4

Shifting Advantage: EM Value Has Regained the Spotlight after Being Long Overshadowed by Growth

Rolling Three-Year Excess Return relative to MSCI EM Index (10 years ended 31 Dec 2018)



As of 31 December 2018

Source: Callan PE

Another lens for evaluating style exposure applies a growth-versus-value z-score framework to measure by standard deviation how far each style ranges from the mean, or average, growth and value characteristics of the emerging markets universe as a whole. Negative scores indicate value bias, positive scores indicate growth bias. This methodology shows that style differentials have become more pronounced over time—the 2005 differential between growth and value managers ranged from -0.30 for deep value to +0.30 for growth. By 2018, it had widened nearly two-and-a-half times to -0.75 for deep value to +0.70 for growth (Exhibit 3).

Recent Trends in Patterns of Performance

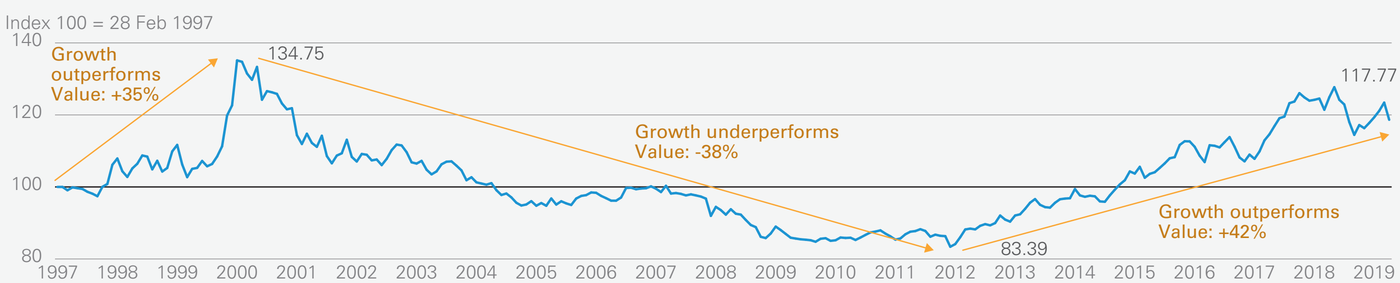
Style groups have generated differentiated patterns of performance, most obviously in the contrasting paths of growth, with its emphasis on nimble, fast-growing technology and internet-related stocks, and deep value, largely invested in heavy industry companies, many of which are state-owned (Exhibit 4). Deep value's excess return relative to the broad MSCI Emerging Markets Index peaked at more than 400 basis points at the end of 2010, reflecting both the style's strong performance towards the end of the commodity super-cycle that preceded the global financial crisis and the substantial correction that growth stocks suffered during the crisis. Subsequently as the global economy recovered, and commodity prices resumed a more typically volatile trajectory, growth investing consistently topped value styles.

Following a sharp decline in 2011, deep value bounced back throughout 2012, partially reflecting the impact of the $585 billion economic stimulus program China launched in 2009. Since then, deep value has been eclipsed by growth, which began its steady climb in 2011. The collapse of commodity prices and China's on-again, off-again economic stimulus partially explain the higher degree of volatility deep value has experienced, compared with the steady expansion of technology in the growth constellation. Growth slipped in 2018, as some of the most

Exhibit 5

Sudden Peaks, Lengthy Valleys: The Varying Cycles of EM Style Performance Underscore the Prudence of a Blended Approach

MSCI EM Growth/Value Performance



As of 31 May 2019

Source: MSCI

expensively valued securities, particularly out of China and within the technology and internet-related sectors, retreated on concerns over slowing GDP, increased regulation, and escalating trade tensions between the United States and China. The 2018 experience underscored the fact that the premium valuation growth stocks have enjoyed over the past decade has exposed the group to larger drawdowns relative to the drawdowns experienced by their deep value peers, despite deep value's greater volatility.

Altogether, the return differences from style to style can be sizable (Exhibit 5). For the three-year period ending December 1999, for example, growth, as measured by the price return of the MSCI EM Growth Index relative to the MSCI EM Value Index, outgained value by 35%, a pattern that gradually reversed itself over the following decade, completely eroding the growth premium that had built up between 1997 and 2000. The next leg in the cycle showed that return dispersion has been even more dramatic over shorter periods—over the 12 months ending December 2017, the MSCI Emerging Markets Growth Index outpaced its value counterpart by nearly 20%.

We also compared capitalization levels of deep value and growth managers as reflected in the cumulative price performance of their shares (Exhibit 6). Deep value managers historically have had lower market capitalization (average and median) relative to growth managers, but starting in 2014 the spread between value and growth market caps extended out as Chinese ADRs entered the MSCI EM Index, including the tech giants like Baidu, Alibaba, and Tencent, the so-called BATs. Even after growth's pullback in 2018, its market cap was still more than two-and-a-half times greater than deep value.

Capitalization weight is one of many examples we found that highlight "source of return" differences which contributed to differentiated patterns of performance over medium to long time periods—country and industry are two others. Differing valuations explain to a great extent the difference in market cap. As market cap is a function of profitability, a company's stream of earnings, and the multiple that an investor will pay for those earnings, companies that can grow their earnings faster usually command a higher multiple in anticipation of higher prospective earnings. As of 31 March 2019, investors, on average, were paying nearly twice as much for growth companies, at a P/E of 19x than for value businesses, at a P/E of 10x. This valuation differential widened from a much tighter spread in 2011 (Exhibit 7).

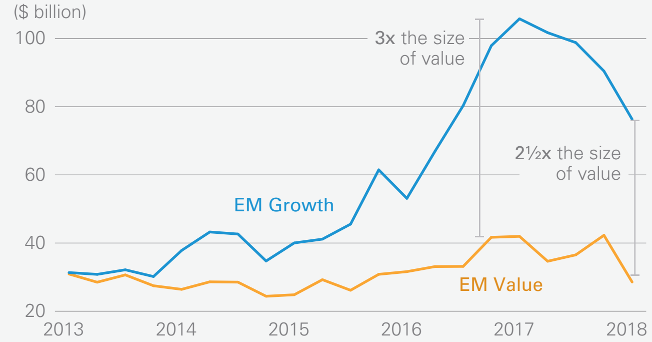
The Virtues of an Inefficient Asset Class

Active emerging markets equity managers have historically added a healthy return premium over the benchmark regardless of style. The 15-year average of the rolling three-year excess return for the median manager in the relative value style group averaged nearly 2.4% return per annum above the benchmark as of 31 December 2018, despite a downward trend that set in early in the present decade. The median GARP manager did slightly better, averaging 2.6% excess return per annum, and the average excess return of the median managers in the deep value, core, and growth styles ranged between 1.5% and 1.8%.

Exhibit 6

BAT Mountain: EM Tech Valuations Have Retreated from the Summit of their Steep Ascent

Weighted Median Market Capitalization (five years ended 31 Dec 2018)

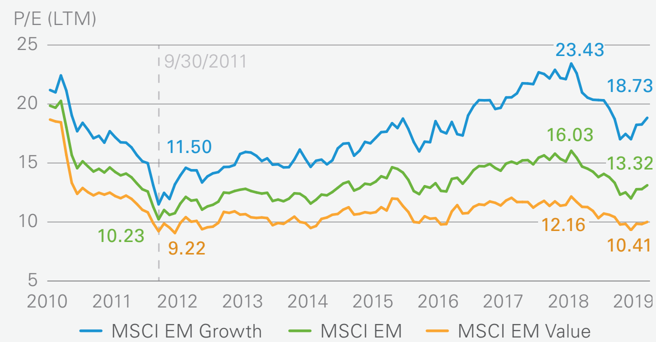


As of 31 December 2018

Source: Callan PEP

Exhibit 7

Parting Ways: Valuation Levels Have Diverged over the Past Eight Years



As of 31 March 2019

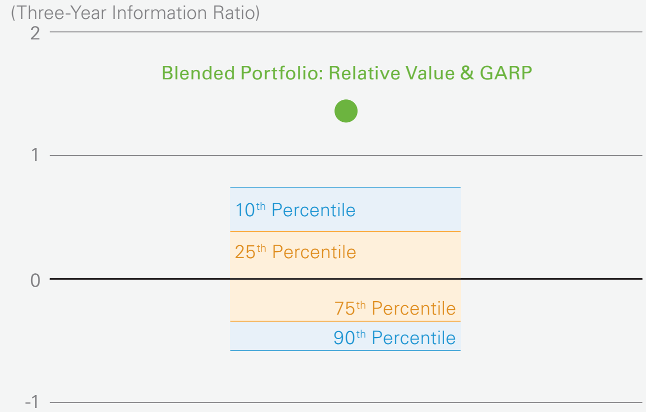
Source: Callan PEP

The Next Steps in Emerging Markets Styles

1. Style Blends

The development of emerging markets as an asset class has increasingly enabled active managers to exploit growing country, industry, and security investment tradeoffs. EM inefficiencies have thus enabled investors to benefit from specialized patterns of return and risk, according to their objectives. Our research leads us to conclude that emerging markets style distinctions will continue to evolve. The emerging markets' pronounced growth and value cycles make an effective blending of styles a feasible and attractive portfolio construction alternative. The information ratio advantage—a measure of excess returns compared to the volatility of those returns, of blending styles, either growth with value or relative value and GARP—has ranked consistently in the top half of the broad emerging markets universe (Exhibit 8).[3]

Exhibit 8
Style Synergy: Blending Investment Styles in an EM Portfolio Has Improved Its Information Ratio



As of 31 December 2018
Source: Callan PEP

2. Adding Small Cap and Frontier to a Strategic Allocation

Although active managers have identified a wealth of opportunities across the emerging markets universe, the majority of investors is still overweight mid- to large- and even mega-cap allocations in their emerging markets portfolios. Yet with more than 2,500 companies, the emerging markets small-cap opportunity is vast and growing. Small-cap companies command a higher risk premium due to illiquidity and greater economic, political, and social risks, but they hold the potential of a compelling reward. Their domestic focus gives them more direct exposure to the world's fastest-growing economies.

Exhibit 9
Correlation Deflation: Small Caps and Frontier Markets Are Less Correlated to Developed Markets Stocks than the Broad EM Index

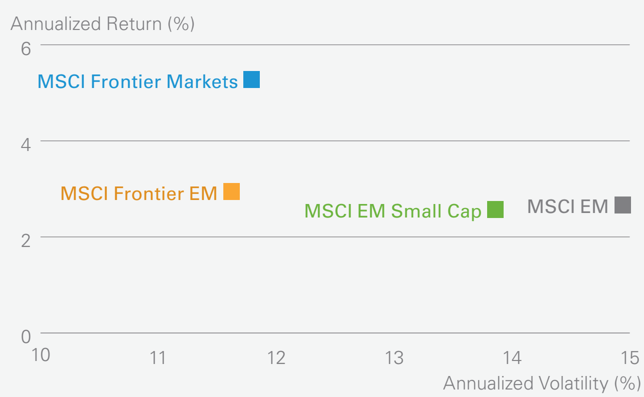
Description	MSCI World Index	S&P 500 Index	MSCI EM Index	MSCI EM Small Cap Index	MSCI Frontier EM Index	MSCI Frontier Markets Index
MSCI World Index	1.00	–	–	–	–	–
S&P 500 Index	0.96	1.00	–	–	–	–
MSCI EM Index	0.79	0.69	1.00	–	–	–
MSCI EM Small Cap Index	0.74	0.64	0.92	1.00	–	–
MSCI Frontier EM Index	0.63	0.56	0.73	0.72	1.00	–
MSCI Frontier Markets Index	0.44	0.40	0.45	0.48	0.83	1.00

As of 30 June 2019
Source: Lazard, MSCI, Standard & Poor's

Their sector composition differs from large caps', so they can introduce new sources of return to a broad emerging markets portfolio even as they reduce correlations to developed markets equities (Exhibit 9).

An added value over the past seven years, EM small caps have been less volatile than EM large caps' so that the potential diversification that an allocation to emerging markets small cap companies affords can not only enhance the portfolio's overall return potential, it can also moderate its volatility. An allocation to frontier markets, as the newest entrants in the asset class are known, would have reduced overall volatility still further—volatility in the MSCI Frontier Emerging Markets Index was nearly a quarter less than in its large cap counterpart (Exhibit 10).

Exhibit 10
Shock Absorbers: EM Small Caps and Frontier Markets Are Significantly Less Volatile



Seven years ending 31 March 2019
Source: eVestment

Twenty years ago, global and regional emerging markets small cap equity funds barely existed. In fact, as recently as 2006, there was only a total of seven EM small cap funds available in the

United States. Today, more than 60 active and passive emerging markets small cap funds are available to investors,[4] and as the category evolves, we would expect some of the same style trends to take shape that have occurred over the past thirty years in the EM large cap arena.

An Asset Class Comes of Age

With their impressive growth and increasing diversity, the emerging markets have made the transition from opportunistic to strategic investment. Within the asset class itself, the sources of return have become differentiated enough to curb the volatility characteristic of opportunistic investing. At the same time, the low correlation of the emerging markets to developed markets securities has persisted. All in all, the scale and variety of the investment universe, comprising thousands of securities traded over a wide range of exchanges, as well as the low level of investor involvement make the emerging markets well suited, in our view, as a strategic allocation for active managers who add value through fundamental, bottom-up stock selection.

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 The rolling three-year correlation between the emerging markets growth and value styles since 2008 is -0.12.

2 Z-scores were calculated based on a variety of variables used to specify value and growth characteristics. Variables to determine value characteristics include price-to-book value ratio, 12-month forward price-to-earnings ratio, and dividend yield. Variables to determine growth characteristics include long- and short-term forward EPS growth rates, long-term historical EPS growth, and historical sales per share growth.

3 Universe denoted as Callan Emerging Broad Universe. Information ratio calculated for five calendar years ended 31 December 2018 for three-year rolling periods.

4 As of 31 December 2017, eVestment All Emerging Markets Universe; also see Discovering Tomorrow's Leaders, Lazard Asset Management, April 2018.

Important Information

Published on 13 August 2019.

The performance quoted represents past performance. Past performance does not guarantee future results.

The MSCI Emerging Markets Index is a free-float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. The MSCI Emerging Markets Index consists of 24 emerging markets country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates.

The MSCI Emerging Markets Value Index measures the performance of companies in the broader MSCI Emerging Markets Index with lower price-to-book, lower price-to-forward-EPS ratios, and higher dividend yields.

The MSCI Emerging Markets Growth Index measures the performance of companies in the broader MSCI Emerging Markets Index with higher EPS growth estimates over the short term and long term, internal growth rates, long-term historical EPS, and long-term sales growth rates.

The indices are unmanaged and have no fees. One cannot invest directly in an index.

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