Emerging Opportunities

The Case for Growth Investing in Emerging Markets

Emerging markets growth equities can be an extraordinary investment opportunity, offering exposure to the potential of emerging markets—its demographics, growing wealth, and transition from manufacturing to services. In addition, emerging markets companies have become leaders in innovation and have developed cutting-edge technology. Investors, however, should weigh each company’s growth potential and its price. The potential in more expensive equities may be dramatically lower—and the risk much higher—than less expensive, overlooked peers.

To access this opportunity, we believe investors should consider partnering with an active manager that has demonstrated skill in identifying strong emerging markets growth companies at relatively inexpensive valuations. Lazard Developing Markets Equity strategy has done just that. The strategy is designed for investors who are optimistic about emerging markets and who want exposure to the upside potential of the asset class.
Emerging Markets Growth Opportunity

Emerging markets represented nearly 60% of global growth, with China and India the largest drivers (Exhibit 1). The region accounts for 86% of the world’s population and 36% of its exports, but only 12% of its equity market cap. Over the past two decades, emerging markets have expanded at an extraordinary rate, driving higher consumption by both individuals and governments. We expect this growth will continue as emerging markets develop, through infrastructure investments, market reforms, and deepening capital markets. Emerging markets annual real growth could surpass 5% on average per year over the next five years (Exhibit 2), or about 3% more than developed markets.

Emerging markets growth companies offer exposure to this investment opportunity as they have adapted and innovated to meet consumer needs. In addition, growth equities represent an extraordinary opportunity because of the way emerging markets have evolved over the past several years. Emerging markets today are no longer just supplying cheap labor, raw materials, and goods to developed markets. They are home to new, entrepreneurial firms that in some cases have leapfrogged developed markets. Through technology, these companies are producing top-tier products and services in their local markets—especially in shopping and banking, education, and entertainment. These growth companies offer opportunities for investors to gain access to the region’s favorable characteristics and the asset class’s true potential.

Technology: From Followers to Leaders

Paradoxically, emerging markets have taken the lead in many areas of technological advancement because emerging markets lacked a technological infrastructure at the outset of the data revolution in the 1990s. There was nothing to overtake and disrupt—no shopping malls, no credit cards, and no easy means to get from one place to another in its sprawling cities. As a result, innovators faced fewer regulatory hurdles and gatekeepers. They were able to implement original technological solutions to exploit opportunities and meet growing demand in social media, shopping, entertainment, and education.

Earnings Drive Stock Prices over Time

- Since the MSCI EM Index launched at the end of 1987, earnings (in US dollars) overwhelmingly drive price returns and outweigh the negative currency impact.
The information technology sector, which accounted for 2.3% of the MSCI Emerging Markets Index’s total capitalization weight in 1995, represented nearly 30% of the index at its recent peak. The total (which includes securities listed under the consumer discretionary and the communication services sectors that MSCI reclassified to accommodate the explosive growth of the internet) surpassed financials as the index’s biggest constituent (Exhibit 3). In contrast, traditional industries such as telecom services, utilities, and materials have fallen substantially, eclipsed by the sectors most commonly associated with developed economies.

Innovations in Shopping and Finance

The widespread adaptation of the latest technology has driven innovation and will likely continue to do so in the future. Chinese ecommerce—the virtual shopping mall—has grown past $1 trillion since the introduction of the Android smartphone in 2009, or about twice as large as the comparable figure for the United States. Much of the internet opportunity lies in expanding services online. Internet merchants have already moved beyond goods into services as diverse as insurance and food delivery. The market is large and growing in China’s largest cities, and the demand is also evident in the smaller metros. Moreover, such services have provided the Chinese internet giants a vehicle for overseas expansion.

For example, Chinese tech companies are competing for access to the payment system in India, which is a contested market. The Indian government is favoring electronic payments over cash in an effort to modernize the economy and improve tax collection. Alibaba has acquired a share of India’s leading digital payments system, which uses its Alipay model to bypass both brick-and-mortar banks and plastic credit cards.

Other emerging markets financial systems are also developing and face similar questions—what technology to use, what companies will run it, and how to best serve customers? In Brazil, banks have a significant retail customer base and thus would likely prefer plastic credit cards. However, digital disruptors may find an opening. They can use the Alipay model to onboard online customers who have digital access but no bank accounts. They can sign up the micro-merchants and street vendors that thrive in emerging markets but have businesses too small to afford the costs and paperwork entailed in a formal banking relationship.

Innovations in Education

Another area that has been changing rapidly due to technological innovation is education. The growing emerging markets middle class is looking for the career and intellectual advantages from formal, private schooling. In China, educational enrichment is expected to reach vastly greater numbers through pure online learning and a combination of online classes and in-person tutoring. A tutor can thus assess and address the needs of dozens of students simultaneously rather than being limited to a one-on-one interaction. The internet has helped scale the formerly handcrafted trade of tutoring to meet the needs of the mass consumer over a broad geographical area.

Further, education companies are starting to explore and leverage new ways to educate and measure success, including artificial intelligence. Early applications have demonstrated promise for delivering individualized learning on an unprecedented scale, as big data processing capability and automated analysis of user behavior develop optimized pedagogy across the full range of learning styles.

The Next Generation of Market Leaders

We believe the innovation in emerging markets will continue, offering extraordinary opportunities for investors. R&D spending in China is currently expected to exceed that of the United States in 2018, and China has graduated five times as many engineers per year than has the United States. R&D in Asia (ex-Japan) may already outpace that of the United States and Europe (Exhibit 4). Korea just surpassed Israel to be the global leader in R&D as a percentage of GDP. While these trends are most visible in North Asia, we see some pockets of innovation elsewhere in emerging markets as well, such as Russia, South Africa, and Brazil. Increasingly, the intellectual property behind this innovation is housed within the emerging world, which is reflected in the sharp rise in patents out of China and other emerging nations.

As of 31 March 2019
Source: Bloomberg, MSCI
The emerging markets currently host three of the world’s top four mobile handset manufacturers, dominate semiconductor memory and fabrication, and are global leaders in fields such as solar and wind power. We are also seeing rapid investment in newer technologies, such as artificial intelligence (AI), big data, facial recognition, and language translation. In terms of funding, KOSDAQ in Korea and the Shenzhen (A-share) market in China are becoming to Asia what NASDAQ is to Silicon Valley.

New Emerging Markets, Same Old Valuations

Despite these dramatic changes to the asset class, the markets continue to price emerging markets close to averages that have prevailed for more than a decade (Exhibit 5). Even in technology, long-term multiples are hardly elevated (Exhibit 6).

This represents an opportunity in our view. Simply buying companies with growth potential misses a chance for higher returns. By acquiring equities at relatively inexpensive valuations, investors can realize gains from both earnings growth and from a re-rating of valuations as the markets become aware of the company’s potential. Thus, returns for investors who can identify growth cheaply can be significantly higher than for investors who focus only on growth. At the same time, equities with lower valuations than fundamentally justified may carry lower risk, thus boosting the stock’s risk-adjusted potential return.

Lazard Developing Markets Equity

Lazard Developing Markets Equity is designed for investors who want full exposure to the upside potential of emerging markets. We have sought out leading emerging markets companies that are at the forefront of innovation and development, which is reflected in their disruptive business models and above-average earnings growth. At the same time, we have focused on those companies that remain unrecognized by the markets and cheaply valued. Thus, investors can benefit from higher earnings as well as a potential re-rating of the stock’s multiples.

We have a comprehensive approach to risk, and environmental, social, and corporate governance (ESG) analysis is a crucial part of our process. Our ESG analysis helps us identify previously non-quantifiable operational risks. Clients have become more concerned about the potential impact of their investments on the environment and social issues, such as labor. In addition, and just as important, is governance, which we believe is likely to remain a key issue as emerging markets companies often have complex relationships with the state. Thus, our ESG risk control factor can significantly alter a security’s target price and, therefore, our investment thesis.

We believe investors should consider Lazard’s Developing Markets Equity when making an allocation to emerging markets equities. For more than a decade and through various macroeconomic environments, our team has consistently implemented our relative value philosophy and process. They have navigated the changing opportunities in emerging markets equities, delivering the potential of the asset class to clients at what we believe is appropriate risk.
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Published on 28 August 2019.
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