BETA, MACRO AND ACTIVE MANAGEMENT IN EMERGING MARKETS (EM) EQUITIES

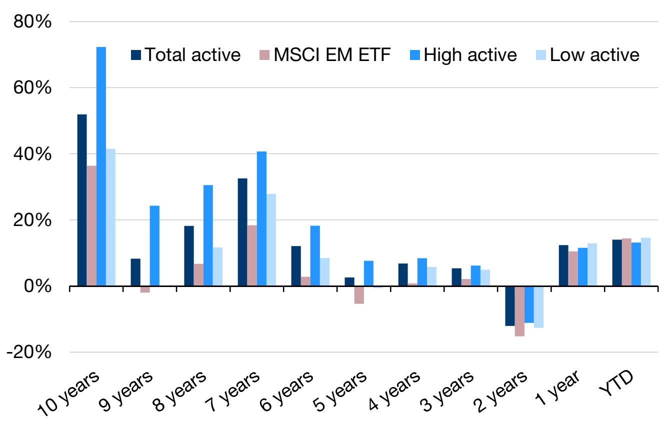
By Edward Cole and Simon Pickard

November 2016

Ringing the death knell of active management has become a popular pastime. Spurred on by a seemingly burgeoning number of underperforming strategies, asset allocators have been jumping on the passive train with some aplomb. Across 2015 it is estimated that actively managed equity funds lost USD124bn excluding performance, whilst passive, by contrast, won inflows of USD200bn[1]. At the same time as commentators are reading eulogies to alpha in developed markets (DM), however, even the most bombastic have been more reticent to declare the same fate for EM. In the academic circles, even diehard aficionados of the Efficient Market Hypothesis (EMH) admit that its application to EM may be more nuanced, given the greater opacity and variety of many of the component countries.

As active EM investors, we obviously welcome such sentiments. Given that we have a dog in the fight, however, we do need to substantiate them more empirically. Figure 1 shows the performance of the biggest active EM funds, representing AUM of almost USD248bn[2]. Over every single timeframe other than YTD[3] the average active fund has outperformed its passive equivalent. Intriguingly, funds with high active share (defined as greater than 80%) have starkly outperformed those with lower levels of benchmark differentiation. Conviction investing in EM, it seems, has not just been viable, but also desirable. In our opinion, the average large EM business is of poor quality, which gives a qualitative explanation for this trend. The weighted ROIC on the MSCI EM Index is just 7.8%[4]. Given that even the most permissive EM WACC calculation would be a good deal higher than this, investing in EM beta essentially amounts to buying a basket which does not cover its cost of capital, and is therefore value destroying. We cannot believe that this is the smart money play.

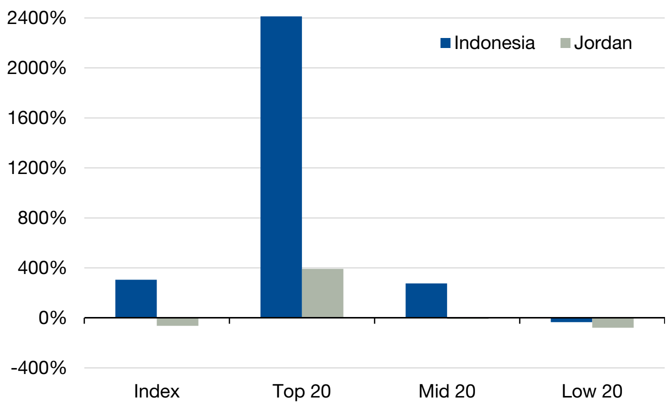
Figure 1. Active bets have reaped rewards in EM[5]



The question remains, however, as to how alpha should best be captured. EM is a big place, after all, by some estimates accounting for 90% of the world's population[6]. Outperformance may well exist, but tracking it down will still require considerable elbow grease. At this point the debate splits into a classic top-down versus bottom-up standoff. The macro enthusiasts claim that the rising tide argument is of almost unilateral importance in EM, given the outsized effect of commodity price moves and exchange rate fluctuations, as well as the wide disparities between nations in terms of demographics and monetary policy. The stock pickers counter that the macro is simply too unpredictable to accurately analyse, particularly in an environment where many countries are just a coup away from a complete systematic transformation that would take decades in DM. Many EM investors spend their entire careers in one camp or the other but, in the least self-aggrandising way, we think that our process spans the divide.

In our view, the evidence is clear that a combination of the two philosophies leads to better results than either one used in isolation. Figure 2 is a good illustration of this. Here we look at the last decade's performance of the 100 largest companies[7] for the strongest EM market (Indonesia – total return of 305%), and the weakest (Jordan – down 64%)[8]. Splitting the 100-stock universe into top 20, middle 20 and bottom 20, we can see that your return for picking the best 20 Jordanian companies would have been 87 points higher than investing in the Indonesian index. But we can also see that picking the median 20 companies in Indonesia rather than Jordan would have left you almost 284 points better off. Tendulkar could bat with his feet tied together and still score heavily, but to really make the most of his talents the shackles would have to come off. In the same way we believe that investors who do not take advantage of all the tools available to them, macro and micro, are leaving significant EM alpha on the table.

Figure 2. Macro makes stock picking more potent[9]



1. Source: EPFR Global. **2.** 100 largest by AUM. **3.** As at 31 August 2016. **4.** Source: Factset. **5.** Source: Copley Fund Research. **6.** Source: Euromonitor. **7.** By trailing 12 month revenue. **8.** Source: MSCI. **9.** Source: MSCI (for indices) and Bloomberg.

Instinctively, our philosophy is geared more toward stock selection than macro analysis and this will not change. We do see the top-down/bottom-up debate as asymmetric in favour of the latter. The US economy has been the runaway winner of the post-WWII world, and yet this has not prevented hundreds of businesses going bust each year. It is comparatively infrequent on the other hand, even amongst the volatile geopolitics of EM, for an entire country to hit the wall. In other words, a poor company in a good macro environment rarely offsets a good company in a poor environment. Having said this, the analysis we discussed in Figure 2 convinces us of the potential opportunities available for tilting the stock specifics into the correct macro tailwinds. To reflect this, our scoring system has a 10% weighting toward assessing how top-down factors will impact corporate earnings.

Over long periods of time these earnings have exhibited a strong correlation with nominal USD GDP, which can itself be decomposed into real growth, inflation and FX moves. Over the short run we feel there is simply too much noise to make sense of – trying to process all the newsflow that has led Brazil to be down 20% then up 60% in the last 12 months[10], for example, would in our view be a Sisyphean task. Over the longer term, however, we think that these factors will have a meaningful impact on returns, and any complete EM approach will necessarily examine them.

Co-author

Edward Cole

Portfolio Manager

Edward co-manages the Unconstrained Emerging Equity strategy having joined Man GLG in June 2015. Previously, he worked for two years with Simon on Carmignac Gestion's GEM equity and balanced funds. Edward's experience on the buy-side includes five years with Ashmore and Finisterre, prior to which he worked as an equity strategist for six years on the sell side for JP Morgan and Unicredit. Edward graduated from the University of Bristol with a BSc in Politics and from the London School of Economics with an MSc in International Development.

Co-author

Simon Pickard

Portfolio Manager

Simon co-manages the Unconstrained Emerging Equity strategy having joined Man GLG in June 2015. Previously, he was Head of Emerging Markets at Carmignac Gestion, running their large and mid-cap EM funds from 2008 after an initial five years covering Pan European equities. His 18 years of equity investing also includes four years with Jupiter and three years with Argos. Prior to his financial career he worked in the shipping industry in Asia for four years with Swire Group. Simon holds a history degree from Trinity College, Cambridge University and is a CFA Charterholder.

10. Source: Bloomberg, as at 31 August 2016.