Investment Insights Series

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Emerging Markets Equity: What Do They Know?

Do leading endowments know something the rest of us are missing?

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Introduction

Emerging markets equity (EME) exhibits the highest long-term expected return across the three public equity regions: U.S., non-U.S. and emerging markets. In fact, at the index level, it is the only region that exceeds the long-term required rate of return (7% to 8%) of most U.S. institutional investors, and yet most U.S. investors have neglected their allocations to emerging market equities. In what follows, we examine the current allocations to EME across different investor types and challenge the conventional practice of following the regional allocation as indicated by the MSCI All-Country World Index (ACWI). We challenge the conventional practice because, in our opinion, the latter may not achieve the required rate of return of most investors.

When examined across different types of investors, the under-allocation to emerging markets is most pronounced for individual investors. The Yale, Harvard and Stanford university endowments – arguably three of the most sophisticated U.S. institutional investors – are at the other extreme of the allocation range to emerging markets. Their extreme overweight to emerging markets clearly indicates that they favor EME over U.S. and non-U.S. developed market equities in their strategic asset allocations. Their EME allocations "appear downright imprudent in the eyes of conventional wisdom"[1] and when compared to the MSCI ACWI's regional breakdown. What is so compelling about emerging markets equity that they would overweight the region so significantly, despite the perceived risk? Or, to put it another way, what do the Yale, Harvard and Stanford university endowments know that the rest of the investment community is missing?

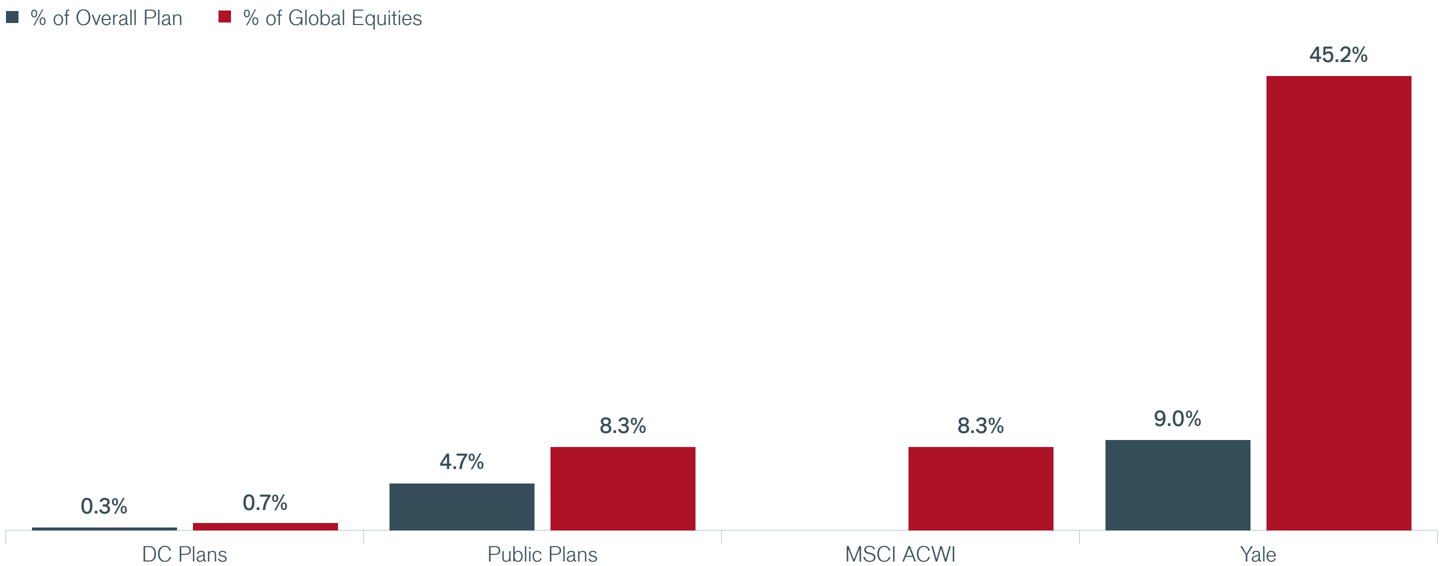
Read Inside

- Emerging markets equity exhibits the highest long-term expected return among all public equities, but EME allocations across different investor types vary greatly.
- Investors seem to embrace the return potential of private equity, but not of EME, with many investors simply matching their allocation to the MSCI ACWI.
- Return-seeking investors should revisit their emerging markets equity allocations given the relative attractiveness of EME to developed market equities.

[1] "Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment" by David F. Swensen, pp. 8. Simon and Schuster, 2000, 2009.

Exhibit 1: Emerging Markets Equity Allocations by Investor Type

Extreme differences exhibited in EME allocations



Source: Callan Market Pulse 2Q 2017, Money Market Directories (MMD) 2017, MSCI as of September 30, 2017, and the Yale Endowment Report 2016.

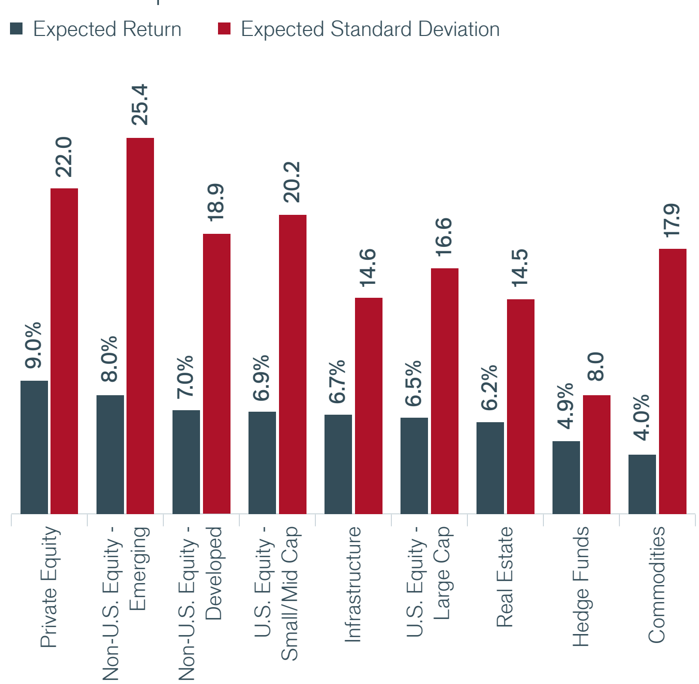
The Dissonance between EME Expected Return and Allocation

The required rate of return for U.S. investors ranges from 7% to 8%. According to a recent capital market assumptions survey[2] of institutional investors, as shown in Exhibit 2, emerging markets equity and private equity (PE) are the only two asset classes whose long-term geometric returns[3] are expected to exceed that required rate of return.

Institutional investors have been inconsistent in this regard: they seem to embrace the future expected return of private equity, but not of emerging markets equity even though the aforementioned survey indicates that both asset classes are expected to generate the highest returns. This behavior is puzzling when one considers that private equity requires a long-term lockup of capital, investors cite the level of asset valuations as their greatest concern (shown in Exhibit 3), and the volatility estimates for this asset class are highly questionable due to the lack of daily mark-to-market. Despite these issues, institutions have been actively allocating to private equity while neglecting their EME allocation.

Exhibit 2: Expected Returns and Standard Deviations of Various Asset Classes

Only emerging markets equity and private equity exceed investors' required rate of return



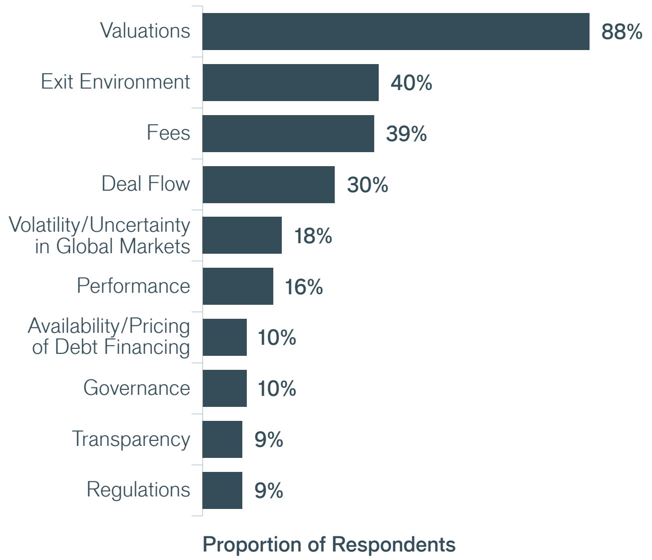
Source: Horizon Actuarial Services 2017 Survey of Capital Market Assumptions. Expected returns and standard deviations are over a 10-year time period.

[2] 2017 Horizon Actuarial Services Capital Market Assumptions Survey.

[3] We stress expected geometric returns because they already account for the higher volatility associated with these two asset classes.

Exhibit 3: Investor Views on the Key Issues for Private Equity in 2018

Valuations are the greatest concern



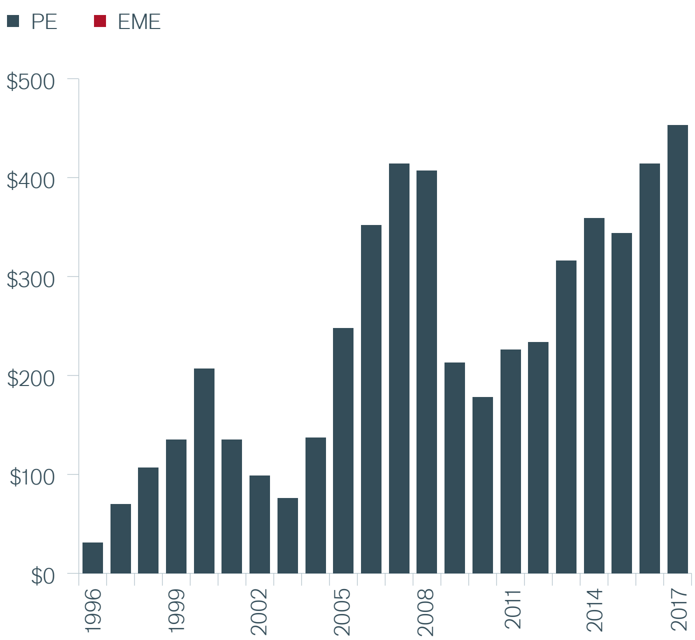
Source: 2018 Preqin Global Private Equity & Venture Capital Report.

According to Preqin, global private equity fundraising has been on a tear, as Exhibit 4a shows, reaching an all-time high of $453 billion/year in 2017, and "total AUM for the asset class now stands at $2.85tn...at June 2017 (the latest data available)..."[4] In contrast, as shown in Exhibit 4b, EME has been an "asset non grata" compared to private equity based on net asset flows. There has been a great deal of capital-pursuing private equity funds, but investor interest in EME has been waning for the past several years. It appears that institutional investors are underestimating the relative attractiveness of EME, while overestimating the relative attractiveness of private equity.

Exhibit 4: Funds Raised by Private Equity vs. Net Flows into Emerging Markets Equity ($B)

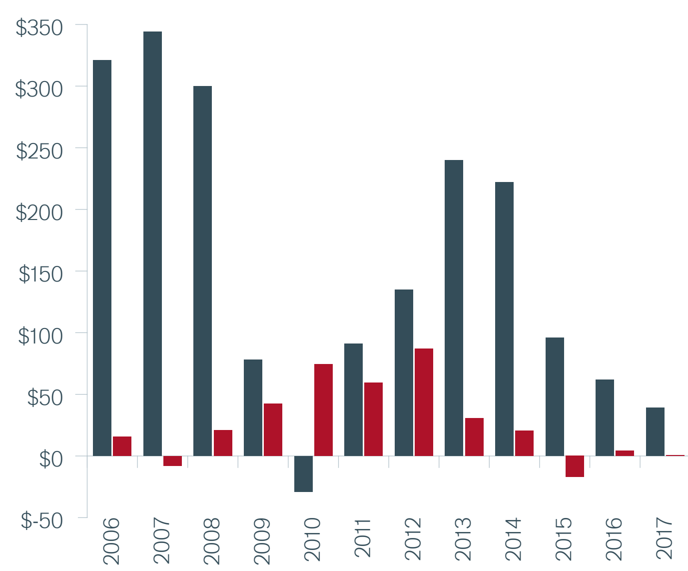
PE fundraising has been on a tear, while EME is an asset non grata

Ex. 4a: PE Gross Fundraising (1996-2017)



Source: 2018 Preqin Global Private Equity & Venture Capital Report.

Ex. 4b: PE Net Fundraising vs. EME Net Flows (2006-2017)



Source: 2018 Preqin Global Private Equity & Venture Capital Report and eVestment. PE net fundraising amounts were estimated as follows: gross funds raised in calendar year (CY) 11 minus gross funds raised in CY 1. Private equity's average life is 10 years; therefore, one can estimate the net flows by taking the difference in amounts raised in CY 11 and CY 1, CY 12 and CY 2 and so on.

[4] 2018 Preqin Global Private Equity & Venture Capital Report.

The Yale Endowment Case Study

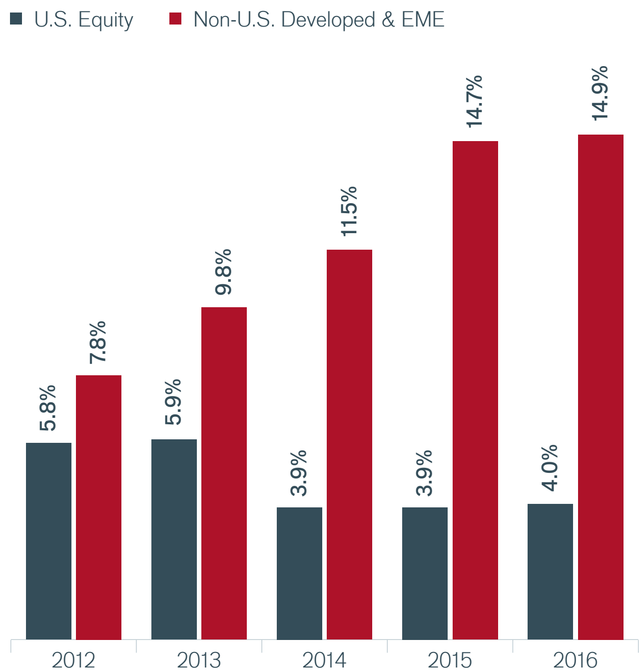
Because Yale is a leader among all institutional investors, it is useful to examine how its portfolio allocation came to look so different from traditional institutional portfolios. From 2012 to 2016, Yale roughly doubled its foreign equity allocation while simultaneously reducing its U.S. equity allocation, as shown in Exhibit 5.

What is even more striking is the allocation difference between U.S. and emerging market equities. In 2016, Yale allocated 9% of its endowment assets to EME versus 4.0% in domestic equities. David Swensen and his team clearly favor emerging market equities over U.S. equities, even though the former is conventionally viewed as riskier than the latter. While Swensen may note that the Yale endowment represents the "most uncomfortably idiosyncratic portfolio,"[5] we observe this same tilt toward EME among its nearest peers, as shown in Exhibit 6.

While renowned leaders in investing and active asset allocation, neither Yale nor its nearest peers are infallible. In fact, one could argue that Yale has been too early in rotating into emerging markets equity from 2012 to 2016. These three endowments are not any more clairvoyant of how the future will unfold than the rest of us. Yet, their asset allocation decisions appear informed and deliberate rather than haphazard. In the next section, we present a possible explanation as to why these leaders have staked such a sizable claim in EME.

Exhibit 5: Yale's Recent Allocations to U.S. and non-U.S. Equities

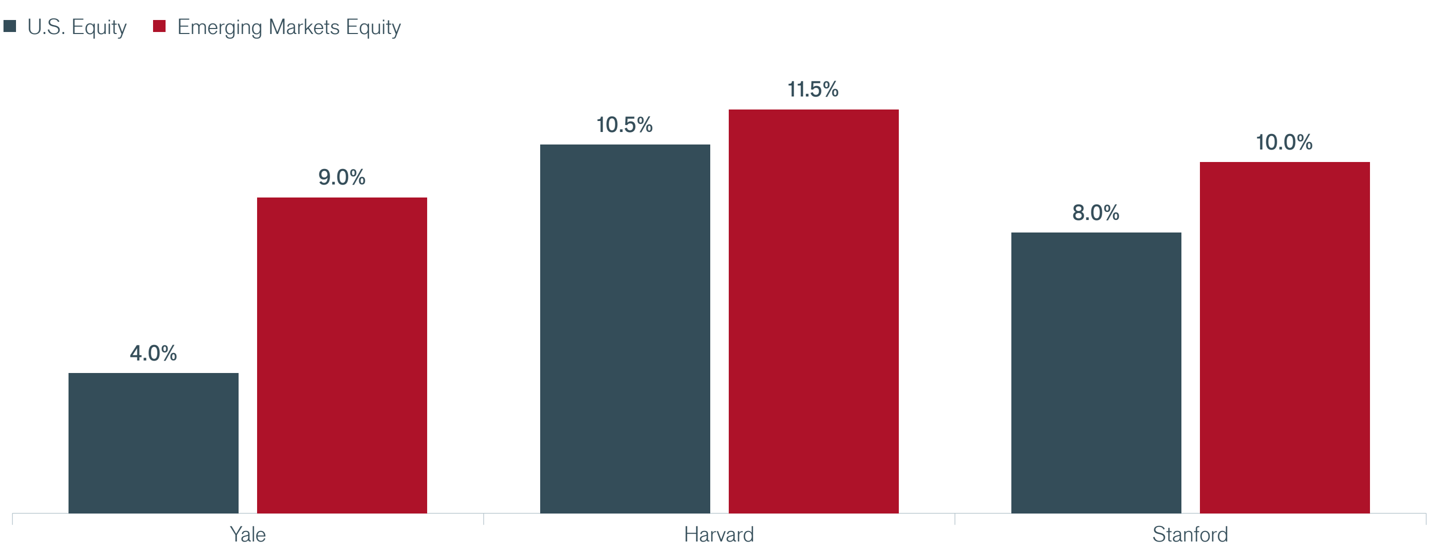
An 'uncomfortably idiosyncratic' allocation to non-U.S. equities



Source: Yale Endowment Reports 2012 - 2016.

Exhibit 6: Yale, Harvard and Stanford Emerging Markets Equity Allocations

Leading endowments' recent allocations to EME are significant



Source: Yale, Harvard and Stanford Endowment Annual or Investment Reports as of FYE 2016.

[5] "Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment" by David F. Swensen, pp. 8. Simon and Schuster, 2000, 2009.

Shiller P/E

Currently, there is a fair amount of debate about whether U.S. equities are fairly valued or overvalued. Given the incredible run that U.S. equities have had since the depths of the financial crisis (up approximately 340% since the crisis low in February 2009), many find it hard to believe that U.S. equities are undervalued. An ongoing debate about the effectiveness of the Shiller P/E ratio in forecasting future equity returns notwithstanding, it is instructional to relate the current Shiller P/E ratio to the historical forward-looking returns, as well as to compare the Shiller P/E ratios across different regions.

Exhibit 7 compares the U.S. Shiller P/E ratio to the forward-looking returns from January 1881 to August 2017. To clarify the methodology, the Exhibit relates the Shiller P/E ratio at a given point in time to the returns realized in the next three, five, seven and 10 years. For example, the Shiller P/E ratio of 44 at the end of 1999 is compared to the ensuing U.S. equity returns from 2000 to 2002 to estimate the annualized forward three-year return, returns from 2000 to 2004 to estimate the annualized forward five-year return, and so on. This process is repeated on a rolling monthly basis to estimate the average forward-looking returns for each Shiller P/E valuation bucket.

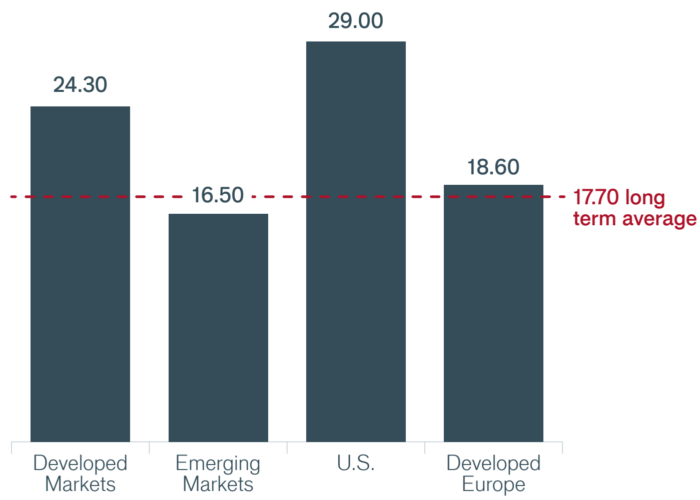
There are a couple of observations worth making: first, there exists an inverse relationship between the level of Shiller P/E ratios and the forward-looking returns; second, when the Shiller P/E ratio was between 30 and 35[6], the forwarding-looking returns for the next three, five, seven and 10 years were quite poor.

When viewed cross-regionally, the emerging markets equity Shiller P/E ratio stood at about a 43% discount to that of U.S. equities (as shown in Exhibit 8 as of September 30, 2017). While not cheap, EME's Shiller P/E of 16.5 seems much more reasonable than the 29.0 level for U.S. equities. We believe this valuation metric illustrates at least one of the reasons why the Yale, Harvard and Stanford endowments favor emerging market over U.S. equities.

However, a word of caution is in order. The Shiller P/E ratio is not meant to be a market timing signal, and we do not advocate using it as such. It provides a measure of relative value across different regions and across time, but it provides no information whatsoever as to when to get in or get out of equities.

Exhibit 8: Cross-Regional Shiller P/E

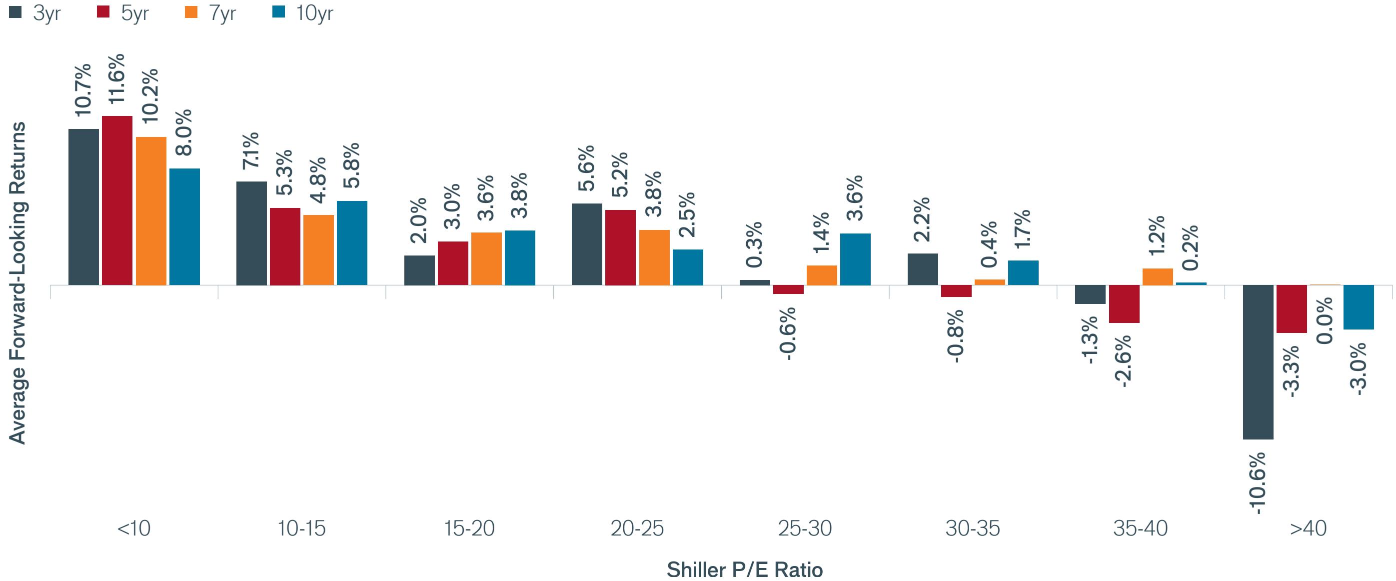
EME appears relatively attractive compared to other regions



Source: StarCapital Research, "Long-Term Stock Market Expectation." As of September 30, 2017.

Exhibit 7: Shiller P/E and Forward-Looking Returns

An inverse relationship exists



Source: http://www.econ.yale.edu/~shiller/data.htm and Bloomberg.

[6] We estimate the Shiller P/E ratio as of December 31, 2017, to be approximately 32.

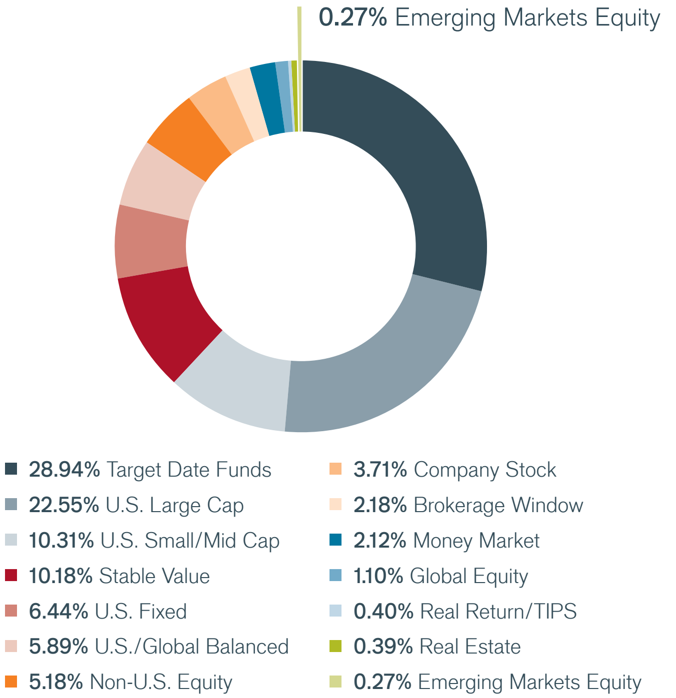
Emerging Markets Equity: What Do They Know?

Defined Contribution Plans

If the Yale endowment stands out for its outsized allocation to emerging markets equity, DC plan participants, in contrast, stand out for their under-allocation to this asset class.

Exhibit 9: DC Plans' Aggregate Asset Allocation

DC plans significantly underweight EME



Source: Callan Market Pulse Q2 2017.

As of June 30, 2017, as shown in Exhibit 9, DC plan participants' aggregate allocation to the standalone emerging markets equity option amounted to a paltry 0.27% of total plan assets, according to a Callan Associates' report. Certainly, some plan participants gain exposure to emerging markets equity through target date funds – which is a positive development – but even accounting for this exposure in target date funds, DC plan participants remain significantly underweight emerging market equities.

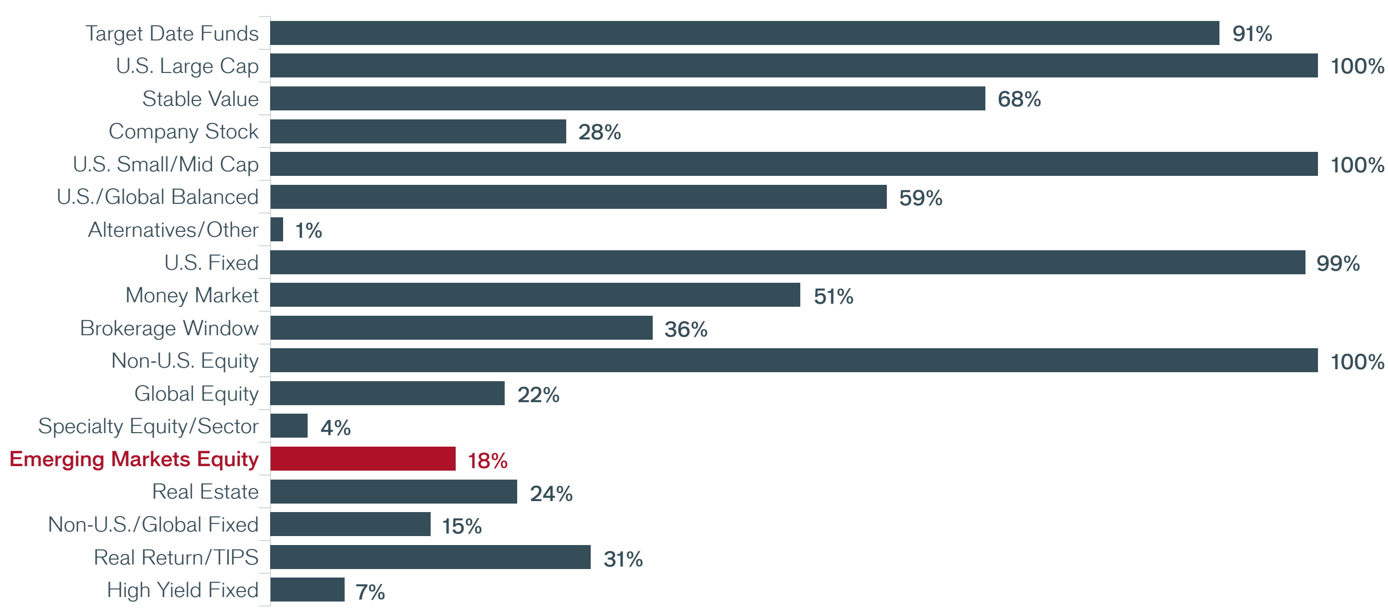
In defense of DC plan participants, however, there is a structural reason why their allocation to EME is so low, as Exhibit 10 demonstrates – the prevalence of emerging markets equity offerings in DC plan investment lineups. DC plan sponsors' hands are tied from a fiduciary and legal liability perspective. Even if it represents an attractive investment option, concerns about fiduciary responsibilities and legal risk may cause DC investment committees to withhold investment offerings like EME – conventionally deemed too risky for individual investors. The upshot is that even if a plan participant wanted to overweight emerging markets equity, outside the brokerage window, it would be virtually impossible for that individual to ever match the levels of the Yale, Harvard or Stanford endowments.

Public Plans

Public funds in the U.S. possess the necessary resources and investment knowledge to express their views on different asset classes. In fact, recently, some public plans have expressed the desire for a more dynamic approach to asset allocation so that they can better adapt to the changing risk-to-return profile of different asset classes. In doing so, they hope to mitigate drawdown risk and to maximize plan level returns.

Exhibit 10: The Prevalence of Emerging Markets Equity in DC Plan Offerings

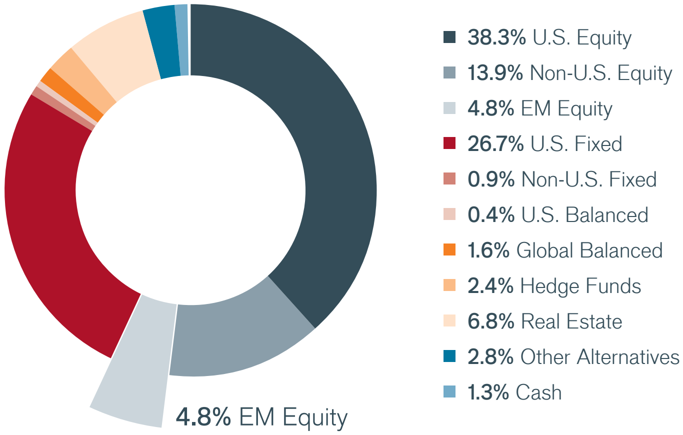
DC EME plan offerings remain low



Source: Callan Market Pulse Q2 2017.

Exhibit 11: Public Plan Average Asset Allocation

EM equity allocations remain close to the MSCI ACWI regional breakdown



Source: Callan Market Pulse Q2 2017. The average asset allocation figures were estimated based on data provided by Callan Associates and MMD as of June 30, 2017. Estimation was necessary because Callan Associates did not separately break out the EME allocation among U.S. public plans.

However, as shown in Exhibit 1 and Exhibit 11, it still remains the case that most public plans continue to closely follow the regional breakdown of the MSCI ACWI and have not quite let go of their home country bias. In stark contrast to leading endowments, public plans on average, still favor U.S. equities over non-U.S. and emerging market equities. With regard to EME, public plans remain neutral to the regional allocation of the MSCI ACWI, with no discernible view one way or another. This neutral stance is counterintuitive especially when the long-term expected compound return is meaningfully higher for emerging markets than for U.S. equities (see Exhibit 2). Favoring EME over U.S. equities seems even more compelling when combined with the relative attractiveness of the Shiller P/E ratio for emerging markets, as shown in Exhibit 6. In an environment where most public plans are being forced to revise downward their long-term expected plan level returns, it behooves them to revisit their current EME allocations as one of the ways to improve their plan level returns.

An Informed and Selective Approach to EME

Although EME currently offers significant and compelling opportunities, we recognize that it poses some challenges as well. Developing countries can be inherently riskier for investors. Immature legal and political systems often mean inadequate levels of minority shareholder protection and increased economic and stock price volatility. This may partly explain why many investors maintain a lower, or neutral, exposure to the asset class.

Currently, there is an increasing trend among EME investors to opt for a passive approach, essentially duplicating the MSCI Emerging Markets (EM) Index. Yet, in these uncertain times of rising geopolitical tensions and populism, the passive approach to investing in emerging markets may not be the most prudent approach. By definition, the EM Index is not designed to filter out businesses that have troubled governance structures, or are based in countries with demographic headwinds. In addition, the EM Index includes broad exposure to state-owned enterprises, which often invest shareholder capital to meet the political agenda or economic needs of a particular country, rather than to maximize shareholder value. Therefore, investing in emerging markets equity necessarily calls for an informed and selective approach that properly balances its significant opportunities against its significant risks.

Conclusion

"Where do you invest when every asset seems expensive?" is a common refrain among investment officers. Due to an incredible rise in equities and the duration of the current bull market since the depths of financial crisis in February 2009, investors are rightfully cautious about equities and most risk assets. Yet, according to institutional investors' own expectations, as well as valuation levels, emerging market equities appear just as appealing as private equity. It is an asset class that is expected to meet investors' required rate of return of 7% to 8%.

Our challenge to plan sponsors is not to blindly follow the leading endowment models, but to reassess whether their emerging markets equity allocations are consistent with their own forward views of return and risk for the asset class. It may be that the Yale endowment has a higher allocation to emerging markets equity simply because David Swensen and his team have a higher risk threshold than the rest of us. But their EME allocation in recent years seems to indicate that they see an investment opportunity that many other investors are overlooking.

In addition, we are not advocating that plan sponsors rebalance away from private equity to emerging markets equity, but rather, to continue to rely on the former while not neglecting the latter in their pursuit of higher plan-level returns. In fact, the leading endowments are doing just that; maintaining higher allocations to both private equity and emerging markets equity. Do not limit higher return opportunities to private equity only.

For DC plans, managed accounts may be an effective solution for offering emerging markets equity to plan participants. Managed accounts are professionally managed, therefore, the risk of misusing an emerging markets equity fund would be greatly minimized. Under this plan design, emerging markets equity would not be available as a standalone offering to all plan participants, but only to those participants that rely on managed accounts services to manage their defined contribution plan assets.

Finally, as remarked earlier, we question passively investing in emerging markets. By nature, emerging markets tend to be a riskier environment to do business and to invest in; therefore, do not throw caution to the wind. Despite its relative attractiveness, caution, patience and selectivity are in order when investing in or increasing allocations to emerging markets equity.

About the Author

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Suny Park is Vice President, Senior Managing Director and Chief Institutional Client Strategist at Janus Henderson Investors. In this role, Mr. Park is responsible for providing thought leadership on key issues and customized client analysis to institutional investors in the United States and Canada.

Prior to joining Janus in 2012, Mr. Park served as the Head of Global Portfolio Solutions and co-head of Investment Research for Rogerscasey in Darien, Connecticut. Past experiences also include international equity research for Northern Trust Global Advisors, business acquisition and distressed loan investing for GE Capital Services, pricing of weather derivatives for Koch Industries, and public accounting for Deloitte & Touche. Mr. Park received his Bachelor of Science degree in Accounting from The King's College and Masters of Business Administration degree in Analytic Finance from the University of Chicago Graduate School of Business. Mr. Park is a CFA charterholder and a non-practicing CPA. He has over 25 years of financial services industry experience.

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