EMERGING MARKETS UPDATE

September 2020

We last shared our thoughts around emerging market (EM) equities two years ago, after EM had a difficult start to 2018. We explained our conviction in EM equity exposure despite the market's downturn – a conviction we continue to hold today. In this paper, we dive into our differentiated strategy for EM equity investing, which utilizes a targeted, bottom-up approach to bypass the suboptimal exposure of the passive emerging markets options.

Emerging Markets Strategy

Our EM public equity strategy is driven by our bottom-up approach to investing and edge in manager selection. Consistent with Makena's core investment beliefs, we emphasize a quality bias in our search for emerging markets businesses. Over the years, emerging markets have been the breeding ground for new innovative businesses and dominant consumer franchises. By targeting quality businesses fueled by secular emerging market growth tailwinds, investors can construct portfolios that grow revenue faster than the index and are more profitable and capital-efficient. This quality bias shined during the recent sell-off in 2020.

Due to our bottom-up approach, our EM portfolio looks very different from the passive index in terms of geographic exposure, sector exposure, and underlying holdings. Makena's edge in manager selection means that our far-reaching industry network provides a select funnel of potential investment opportunities. Our investment team and operational due diligence team are tasked with narrowing that funnel and proposing investments to our Investment Committee, which approves every investment included in the portfolio. When it comes to emerging markets, allocating proper time and resources to manager selection efforts can reward investors handsomely due to the inherent inefficiencies in EM. To exploit these inefficiencies, we seek to partner with managers who have distinct local market expertise as well as sector expertise. Whereas a passive index is cap-weighted, our strategy of partnering with proven, local managers translates into a portfolio of quality business which have little or no presence in passive EM options. Stated differently, unless investors partner with skilled local managers, they may be missing out on the most attractive investment opportunities in EM.

Our differentiated approach to EM results in a large active share, the portion of underlying company exposure that deviates from that of the benchmark. Relative to the benchmark, our portfolio is overweight high growth sectors such as healthcare and consumer staples which directly benefit from increasing demand for domestic services and consumption. Our portfolio is relatively underweight sectors that are heavily influenced by government entities (e.g., telecommunications, commodities and financials). While our EM approach is rooted in acknowledging that emerging markets are not uniform, our bottom-up approach leads to sectors that avoid a set of risk factors common across target markets. We highlight these risk factors below.

Geographically, we target allocations to countries with deep, inefficient equity markets – namely, China, India, and Russia; however, we will only enter a certain geography if we feel we are able to partner with a manager who meets our strict criteria. We avoid pseudo-developed countries like Taiwan and South Korea, which are still considered emerging markets. These geographic and sector expressions are not the result of top-down views. We do not have an edge in timing the entry and exit of these different markets. Instead, our approach is the byproduct of our core competency: sourcing and researching exceptional investment managers. This process is labor-intensive and time-consuming, requiring travel to these various geographies to build local networks. Over time, these networks have produced concentrated allocations to high-quality managers, most of which are now closed to new investors.

Risks in Emerging Markets

In our last update, we highlighted three risks that impacted EM equities in 2018: currency, political instability, and geopolitics. These risks should be considered under the broad category of macro risks. Two years later, these same macro risks persist. The COVID-19 pandemic has unsurprisingly spurred a flight to safety, which has adversely impacted EM currencies. Through the end of June, the MSCI EM Currency Index – which measures how EM FX has performed relative to USD – returned -4.5%. In other words, nearly half of the drawdown in the MSCI EM index (-9.8%) was due to the currency decline. This drawdown in EM FX is closely related to domestic political volatility and regional geopolitics.

Geopolitical turmoil is a risk across all markets, but it is typically more severe and ever-present across emerging markets. The latest drama with the US-China relationship is an example of this. The increasingly strained relationship has moved from a dispute over trade to broader national security and human rights issues. These recent events have reaffirmed three things for us. First, as long as non-democratic regimes govern emerging market countries, there will continue to be geopolitical volatility. Second, geopolitical risk inevitably leads to periods when the performance of EM equities diverges from underlying fundamentals. Finally, we have no crystal ball that can predict the next geopolitical event and how it will play out. Although the current China situation is a risk we are monitoring, it is possible that the heated rhetoric with China will subdue after the November US Presidential election. We believe the return potential of the underlying businesses and our managers' ability to find these high-quality, fast-growing companies overwhelms such macro risks.

Diversifying a portfolio across multiple countries helps reduce macro risk. However, the quality of managers and the underlying companies is the best way to manage emerging market risk. It is critical to stick to our core competency of identifying best-in-class managers that can exploit inefficiencies in select emerging markets. The most under-appreciated risk in emerging markets is corporate governance. We rely on our managers to not only underwrite business quality, but also corporate governance: the quality of the people leading these companies and their alignment with shareholders. This corporate governance risk exists across the world but is especially acute in emerging markets. We spend a lot of effort assessing our managers' abilities to manage this risk.

Ultimately, we believe that maintaining high manager quality, combined with the inefficient opportunity set, the underlying businesses, attractive valuations (EM CAPE of 19.0x P/E vs. US CAPE of 31.0x P/E[1]), and growth, make a significant EM allocation worth the risks.

Summary

We continue to believe that EM equities are an inefficient asset class. The markets are deep, under-researched, and dominated by retail investors. Macroeconomic and geopolitical factors often overshadow underlying company fundamentals, creating opportunities for long-term investors. These factors support our investment approach and the need to have an edge in sourcing and selecting the most talented investment managers in these markets. Moving forward, we will continue to manage our existing EM portfolio and to source and evaluate new managers across these markets. We expect that our EM portfolio will be concentrated – by manager, company and country – to allow us to maintain our long-term attractive absolute and relative returns.

[1] Source: Shiller, Morgan Stanley, Bloomberg, CEIC, Makena Analysis. CAPEs as of 07/31/2020.

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