Ninety One

Investing for a world of change

EM equities: a decade of transformation

Emerging markets have changed dramatically over the last decade, resulting in a more diverse and higher-quality asset class.

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Greater diversity as China's share of the market recedes

A major transformation has taken place in the emerging market (EM) equity market over the past decade, with China the key protagonist.

Propelled by the inclusion of ADRs and the decision to award Chinese A-share equities a larger index allocation, by the end of 2020, China's share of the MSCI EM equity index had risen to 39%. Crucially, these companies entered the index at elevated valuations and subsequently saw their earnings growth and multiples derate meaningfully.

Causes include an abrupt shift in China's regulatory environment and a tightening of macroeconomic policy aimed at addressing the imbalances of the country's growth model. Both developments have proven difficult for market participants to digest. Add to that the negative impact of geopolitical tensions and China's share of the index has shrunk to 26%.

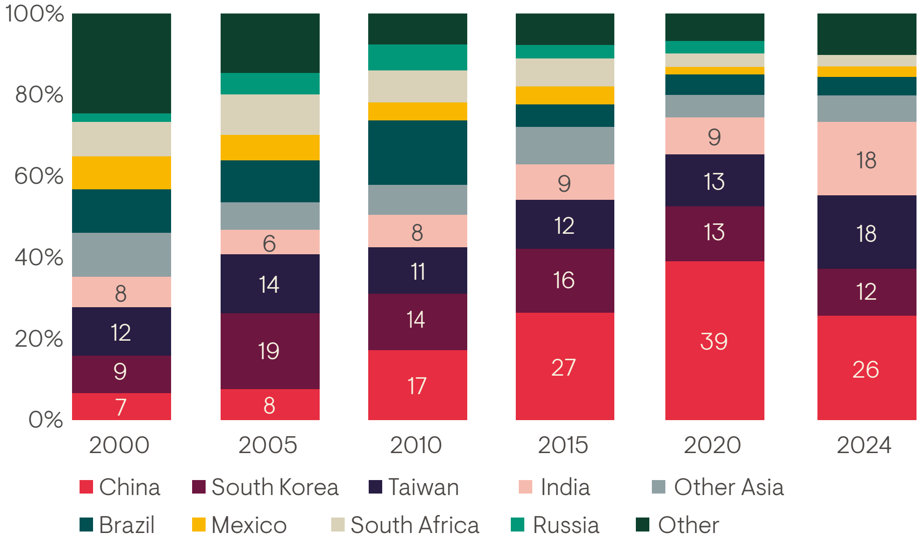
With some 5,000 listed companies across a wide range of industries, the world's second largest economy still offers compelling stock-picking opportunities. However, China's reducing dominance has changed the make up of the index, providing greater choice and diversity.

The EM ex-China universe is characterised by very different political backdrops in emerging Asia, Latin America and the Middle East. Typically, though, these are resilient economies where ease of doing business is high. In contrast to a decade ago, today's EM equity market is a richer opportunity set for active investors to search for alpha.

Just as China's dominance has receded, India has emerged as a new super-power in recent years – now accounting for almost a fifth of the index (Figure 1). The COVID pandemic was a catalyst, accelerating trends that have been particularly beneficial to India's corporate sector. A clear example is the tech sector: demand for India's IT infrastructure and cloud migration services was effectively brought forward by 8-10 years as companies across the globe ramped up capital expenditure and remote working took hold.

Unsurprisingly, that has led to a surge in inflows into India's equity market in recent years, resulting in lofty valuations at the index level. But alpha opportunities remain significant for active investors able to conduct extensive research on the ground. For instance, our research trips have enhanced our fundamental research into well run companies across this vast country that are beating expectations, operating in a variety of sectors as we discussed here.

Figure 1: Geographic share of flagship EM equity index



Source: MSCI, Bloomberg, Ninety One, 31 May 2024.
MSCI Emerging Markets Index: Weighting by geography.
For more information on indices please see Important information section.

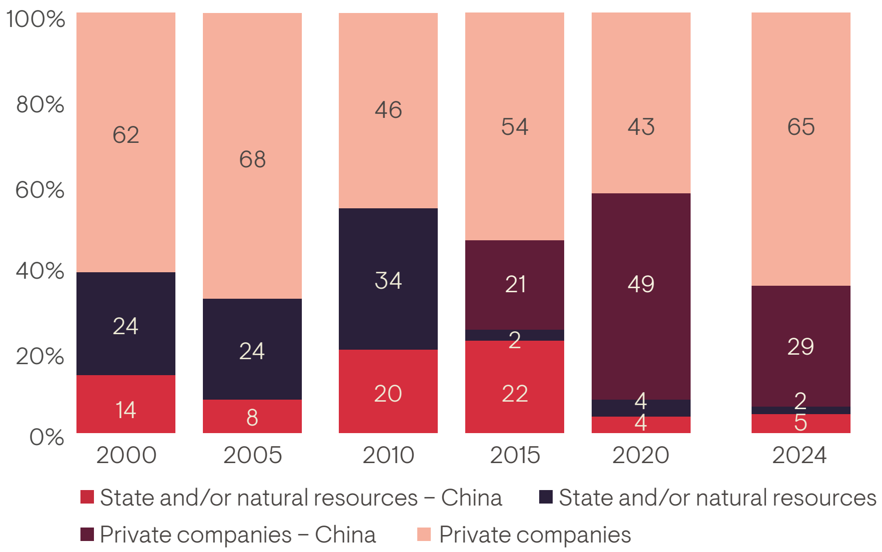
Shifts relating to technology – discussed more later – also underpin the evolution of the investment universe, with tech-exporting economies like Taiwan gaining a larger share of the market in recent years. In addition, geopolitical dynamics are beginning to reshape the market further with Vietnam, Thailand, Malaysia and Indonesia among those reaping the benefits of supply chains relocating out of China. Similarly, in Latin America, Mexico is facing positive tailwinds. Many companies in this market are already starting to benefit in the new multi-polar world economy. We expect the index make-up to continue to evolve over the next decade, providing an increasingly diverse opportunity set.

Privately run companies move to the fore

Within the Chinese market, despite the macro headwinds, there have been significant positive developments. For instance, while state-owned enterprises (SOEs) accounted for more than half of the equity opportunity set in 2010, today, privately owned businesses are the majority component. That, coupled with profitability and growth of SOEs lagging the increasingly (globally) competitive cohort of private institutions, means the private sector now dominates the EM equity market overall.

Considering the market value of the top 20 companies in the MSCI Emerging Markets index, only 7% is now in SOEs/resources businesses, down from 54% in 2010. At the same time, of the privately run businesses, currently one-third are Chinese companies, compared to 2010 when the only Chinese companies that featured in the top 20 were SOEs.

Figure 2: Top companies by ownership/activity



Source: MSCI, Ninety One, 31 May 2024.
MSCI Emerging Markets Index: Split of top 20 companies by index weight according to ownership/activity. For more information on indices please see Important information section.

Chinese listed companies are also becoming more shareholder friendly and ultimately more investable as a result. We are encouraged by the improved corporate governance in recent years, in both levels of share buybacks and dividend payouts (as shown here).

Investing in EM equities today means gaining exposure to a broad range of privately managed, entrepreneurial businesses.

The rise of the tech sector is lifting the quality of the asset class

Another major shift in the overall EM equity market is its sector composition, with the technology sector seeing its weight in the index surge over the past decade. The tech sector – including technology and internet stocks that MSCI categorises in other sectors e.g., communications and consumer discretionary – now represents approximately a third of the EM equity market. This has shifted the quality of the asset class over time as these new-economy companies innovate, disrupt and grow, crowding out the old economy companies that are more capital intensive, less well-run and less focused on profitability. That translates to an abundance of interesting investment opportunities in technology businesses that are innovating, forward thinking and resilient.

Technology as a share of the EM equity market

36%	13%
today	2010

Source: MSCI, Ninety One, 31 December 2023. MSCI Emerging Markets Index: Split (%) including technology and internet stocks that MSCI categorises in other sectors e.g. communications, consumer discretionary etc.

A recent catalyst here is the growing emergence of AI. While American companies own the intellectual property, the infrastructure which it will run on (data networks, data centres, computers and smartphones) will be largely manufactured in Asia. We are seeing Asia emerge as the world's AI factory, driving a widening range of technology sub-sectors.

Improved governance and economic sustainability

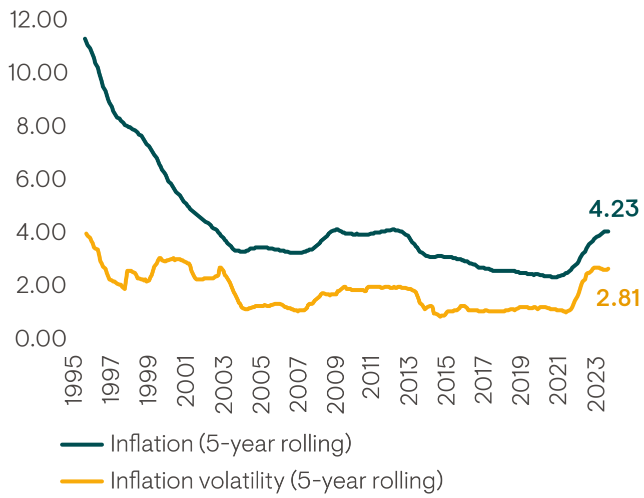
The macroeconomic foundations underpinning EM equity markets is a vital consideration and another area of considerable strengthening in recent years. Behind this is a steady improvement in the standard of stewardship by governments in key economies across the EM universe, as shown in Figure 3, resulting in structurally lower economic volatility and lower average inflation rates (Figure 4).

Substantial progress has been made across macroeconomic and corporate fundamentals in emerging markets. In recent years, thanks to prudent monetary and fiscal policy, many EM economies have mitigated external vulnerabilities, improved institutional frameworks, and established fiscal sustainability. Today, debt-to-GDP ratios are typically much lower than in many developed markets, and primary fiscal balances are healthier. Furthermore, with inflation trending down, many EM central banks have already embarked on rate-cutting cycles. The structural foundations in EM economies are robust.

Figure 3: Governance effectiveness - top 5 markets ex-China

Source: Bloomberg, Ninety One. 31 December 2023. Chart shows combined score for India, Taiwan, South Korea, Brazil, Saudi Arabia.

Figure 4: Inflation – EM ex-China (%)



Source: Bloomberg, Ninety One. 31 December 2023.

A blurring of lines between EM and DM

Last year, our Co-head of Emerging Market Fixed Income, Peter Kent discussed the 'blurring of lines' between developed and emerging markets (EM) debt that has taken place in recent years. Outlining developments – such as proactive rate cutting – that have underpinned a strengthening of EM fundamentals, he also drew contrasts with the shift that has taken place in the developed market universe to result in a much more volatile macro and political backdrop there.

Similarly, our Investment Institute have observed EM equities are now less volatile than developed market equities in this paper.

At the micro (corporate) level, these positive macroeconomic developments have been accompanied by a push for higher standards of operating performance and corporate governance. The upshot is that there is no shortage today of companies based in emerging markets that are global leaders in their industries. There has also been notable broadening and deepening of liquidity alongside improvements to the infrastructure underlying capital markets. EM volatility has also been trending down, both in terms of macroeconomics and capital market performance.

In the absence of negative headlines, there is increasing recognition among investors of the importance of an EM allocation, not least given the significant diversification impact that stems from a lower beta to developed markets. Of course, this is a highly diverse investment universe and there are plenty of exceptions to the above, necessitating careful analysis and a selective investment approach.

In summary

Today's investors in EM are buying a more diverse and higher-quality asset class. While selectivity will always be key in this richly diverse opportunity set, the market provides exposure to compelling growth stories and plenty of companies – including those in the technology sector – that are at the forefront of global developments. Corporate governance and standards of operating performance have improved substantially, as has the governance of the economies in which they operate, resulting in robust structural foundations for continued growth and a compelling investment case for EM equities.

Explore the Deliberating EM equities series

General risks. The value of investments, and any income generated from them, can fall as well as rise. Past performance is not a reliable indicator of future results. Environmental, social or governance related risk events or factors, if they occur, could cause a negative impact on the value of investments.

Specific risks. Emerging market (inc. China): These markets carry a higher risk of financial loss than more developed markets as they may have less developed legal, political, economic or other systems.

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