WEATHERING EMERGING MARKETS STORMS WITH FACTOR INVESTING

By Paul Moghtader

Our Equity Advantage team believes a systematic approach that neutralises macro exposures and focuses on the fundamental drivers of emerging markets equities leads to smoother returns over the long term.

- Emerging countries boast favourable long-term demographic trends, enviable economic growth rates, and have capital markets that are growing in scale.
- Despite the tremendous opportunity, emerging markets equity returns have historically been more volatile relative to developed markets owing to the heterogeneity of the asset class, raising the importance of managing country and currency risk.
- We believe an active multi-factor approach helps investors achieve controlled results, targeting better returns while lowering volatility.

The case for investing in emerging markets has grown in recent years, owing to the extended period of under-performance since 2010 - which has pushed valuations to multi-year lows - alongside still-favourable long-term demographic trends. However, anticipating macro risks, which can be especially severe in emerging markets, can be particularly challenging and have a deleterious effect on returns (Figure 1).

Our Equity Advantage team believes a systematic approach that neutralises the impact of macro exposures and focuses on the fundamental drivers of emerging markets equities, leads to smoother returns over the long term relative to many other approaches, allowing investors to exploit the depth of opportunity the asset class offers with significantly less volatile active returns.

At the end of 2017, both developed and emerging markets were trading at a premium to their long-term averages. However, volatile market conditions in 2018 resulted in developed countries unwinding that premium, while in emerging markets the sell-off has been so pronounced that emerging markets equities are now trading at a significant discount. With the MSCI Emerging Markets Index having lost almost 15% in 2018, extending the underperformance that began in 2010, many investors may be wondering whether now might be an optimal entry point for allocating to the asset class. Indeed, valuations are looking attractive on an absolute and relative basis with emerging markets equities trading at a significant discount relative to historical averages.

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While empirical analysis has shown that lower equity market valuations tend to be followed by higher returns, investors have witnessed previous false dawns in emerging markets rebounds, as in 2016, when assets recovered over the short term only to go on to deteriorate further. Rather than attempting to anticipate market events or sidestepping market volatility by selecting regions or specific countries to over/underweight, we believe deviations from the benchmark should be limited by controlling industry, sector, country, and market capitalisation exposures - as performance across these macro factors is highly cyclical and could lead to more volatile returns. Our experience shows that it is possible to generate less volatile and more consistent excess returns over the long term, irrespective of the direction of emerging markets, when macro risk factors are neutralised in this way and bottom-up stock selection is the primary driver of excess returns.

Employing a pure bottom-up quantitative stock selection process with fundamental inputs across a broad opportunity set can drive successful stock picking - and ultimately excess positive returns - over full market cycles. Managing portfolios to maintain consistent exposures to the key drivers of stock price returns, with balanced exposure across the principal factors - value, growth, quality, and sentiment - means no single factor or style tilt dominates returns over time.

When stocks are selected using a quantitative investment process that evaluates each stock - with the use of fundamental inputs - relative to its competitors in a sector, industry, and within a global context, a true perspective of a company's relative appeal can be gained, enabling an investor to maximise exposure to the most attractive securities within the benchmark so that security selection drives consistent and incremental excess returns, not market factors.

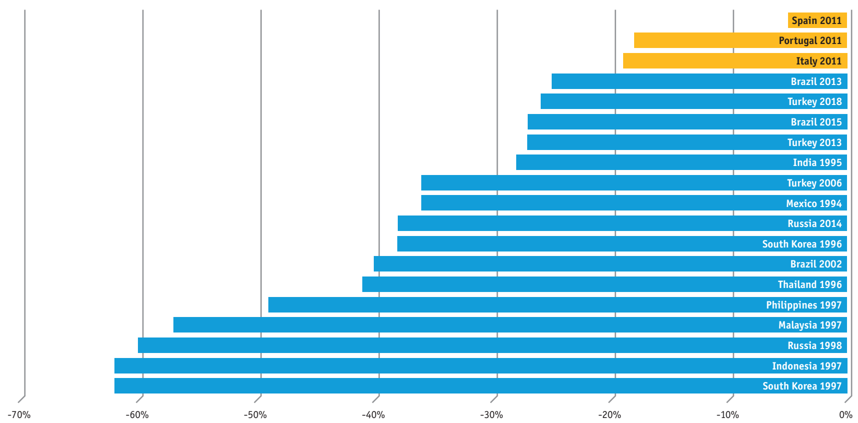
We believe a quantitative approach to stock selection - one that systematically exploits attractive sources of returns - is a compelling investment approach, particularly when investing in emerging markets. While this investment approach can be applied across different segments of the global equity market, it is particularly effective in emerging markets, as the depth and breadth of the asset class and the heterogeneity of the countries that comprise it give rise to greater market inefficiencies and mispricing opportunities.

Noteworthy market events—including the tech bubble of 2000 and the global financial crisis of 2008/2009—have reinforced the significance and value of two central elements of this investment approach: that stock selection should be driven by a balanced set of investment inputs; and that investment decisions must be pragmatic and objective. This approach ensures full transparency of the process and seeks to avoid the drawbacks that often accompany 'black box' models of quantitative investing.

Our approach allows us to systematically analyse approximately 3,500 stocks globally on a daily basis, maintain a current investment view across all of them, and implement investment decisions that we believe will truly add value and meet clients' specific criteria, including considerations around environmental, social, and governance issues. Our growing capabilities in data science ensure that the sources of information we use to assess the underlying drivers of equity returns remain relevant, comprehensive, and robust while also offering further opportunity to incrementally enhance excess returns.

In our view, current valuations, favourable long-term demographic trends, and the greater level of market inefficiencies that exist in emerging markets build a compelling case for the asset class. However, investing in emerging markets in particular requires careful management of country and currency risk factors. Our process seeks to neutralise the impact of this and other macro risk events on the portfolio's relative returns to insulate investors against market turbulence - a common feature of emerging markets investing - and ensure that steady excess returns are originated from genuine stock-level insights. «

Figure 1: Macro Upsets Roil Emerging Countries Harder Relative to Developed Peers



As at 30 November 2018

European country performance is relative to the MSCI World Index. Emerging country performance is relative to the MSCI Emerging Markets Index. Since the Mexican peso crisis of 1994, there have been multiple episodes where individual emerging country underperformance has been significantly greater than 25%, while among developed countries, the number of episodes have been far fewer and the associated losses materially lower.

Source: Bloomberg, FactSet, FTSE, MSCI, S&P Dow Jones

This article was written by Paul Moghtader, Managing Director and Portfolio Manager/ Analyst, Lazard Equity Advantage.