Key Questions

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How Does a Portfolio Manager View Emerging Markets?

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Extrapolation of near-term events may cause an investor to miss long-term trends.

As the winds of change blow through global capital markets, investors may occasionally pause and ask themselves, “What does the future hold for emerging markets?” An evaluation of how one’s overall portfolio strategy incorporates emerging markets is a timely topic at this juncture.

The cornerstone of a well-constructed portfolio is the appreciation that an investment strategy must adapt to the evolution of the capital markets; within the emerging world, the scope and pace of change remain broad and brisk. As a result, a significant determinant of an investor’s success will be how successful the investment strategy is in targeting effective reward and risk exposures in this asset class.

The past 20 years have been defined by several significant events, including Covid-19, the Global Financial Crisis, and 9/11. The past two decades have also been marked by equally profound but more gradual changes such as globalization, technological advancement, and the rise of China. Along the way, the importance of emerging markets in investment portfolios has been widely debated as investors have witnessed periods of both underperformance and outperformance compared with US equity markets.

The past 10 years produced much more favorable returns in US markets versus the first 10 years of the twenty-first century when the clear winner was emerging markets. Given the recent period of underperformance, investors may be wary of committing to emerging markets.

To be sure, China’s regulatory crackdown this year on its most esteemed and successful companies does not offer reassurance. However, we caution against extrapolating either of these dynamics as justification to undermine a thesis for investment opportunities in the emerging markets over the coming decade.

Today, over 40% of global economic output is generated directly from emerging market economies. In addition, the share of the global economy represented by emerging markets has grown substantially in a 20-year span, and projections are for this trend to continue. It may therefore be natural to ask, “What level of exposure to emerging markets makes sense in a portfolio?” Each investor’s circumstance is unique, and there is no single answer. That said, it is reasonable to believe that many investors are underexposed to emerging markets and that there are several reasons to believe that emerging markets may hold significant opportunities.

At the highest level, structural forces support the view that many investors should maintain or even consider raising their allocations to emerging markets. These include the growing contribution of emerging markets to the global economy, the ongoing emergence of middle-class consumers due to rising income and wealth levels in these countries, and home-grown innovation and disruption driven by increasingly resourced and intrepid entrepreneurs and business leaders. The interconnected nature of these factors suggests an imminent shift toward economic engines within emerging markets that are powered by a growing consumer class and the genesis of companies that become global leaders, all originating entirely from the emerging markets ecosystem.
It is equally essential to consider differentiation within emerging markets.

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Views of the asset class as one holistic group are increasingly being challenged and for good reasons. The early adoption of emerging markets was largely in the framework of the BRICs, with Brazil, Russia, India, and China combined. While there was and may still be sound logic for grouping emerging markets into a single allocation, significant developments make a case for a more targeted approach.

Innovation in methodology around allocations to emerging markets will evolve. It is credible to predict that investors will target emerging markets in more specialized ways over time. For example, this may be through specific country allocations, e.g., China; specific economic-characteristic allocations such as those based on commodities and the extraction of natural resources, e.g., South Africa and Russia; or growing consumer-oriented countries, e.g., India and Thailand. This specialization could ultimately enhance how investors target specific return drivers.

Therefore, an effective, well-reasoned approach involves seeking active exposure to emerging markets. Active managers can deploy greater differentiation, identify unique return drivers, and exploit cost-benefit analyses to determine whether to invest in a specific country, company, and industry. And the outlook for the coming years suggests that there will be ample opportunity for active managers to target return drivers with precision.

Examples of prospective return drivers include resource-extraction and commodity opportunities geared to the ongoing investment in green infrastructure and transportation, companies with enhanced intellectual property in healthcare and technology, innovators in semiconductor design and manufacturing capabilities, and disrupters in payments and consumer-oriented sectors. These are just a few of the potentially significant return drivers; there are certainly more.

Emerging markets offer the potential for significant returns along with commensurate risks. It is critical to investigate what sets emerging markets apart from other asset classes and to update views, assumptions, and insights over time. An investment strategy can be built and adapted on well-reasoned, sound analysis from such a vantage point. The goal is to implement a disciplined approach toward investing in emerging markets, harnessing opportunities, and managing volatility. The most significant risk of all may be complacency and status quo for investors. In sum, it may be an opportune time for diversified investors to evaluate overall asset class allocations as the world moves into a new decade, with particular attention given to emerging markets.

For more information, please contact your Key Private Bank Advisor.

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