Consulting Practice Note

Implementing an Actively-Managed Allocation to Emerging Markets Equity

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Issue

How should investors implement an actively-managed allocation to Emerging Markets Equity?

Response

Russell typically advises its clients to use specialist Emerging Market Equity managers. Intuition suggests that clients can earn greater risk-adjusted returns this way. Empirical studies support this view, albeit without strong statistical significance.

Generally, clients choose one of these three forms of Emerging Market Equity management:

1. *Specialist* Emerging Market Equity managers
2. *Generalist* Developed Market Equity managers that "dabble" in the emerging markets
3. *Hybrid* managers. Developed Market Equity specialists that use their specialist Emerging Market Equity portfolios to achieve broad foreign equity coverage.

In doing so, clients should consider the potential impact on five key factors. The first two are more product-specific, the final three are more client-specific:

1. Impact on the foreign equity portfolio's expected return after fees
2. Impact on the foreign equity portfolio's active risk
3. Size of the client's allocation to Emerging Markets Equity – in monetary terms and as a percentage of the total fund
4. Maximum number of relationships with investment firms that the fund can administer
5. Client's current foreign equity managers - both developed and emerging

We evaluate the three forms of management by considering their effect on these five factors.

Doing so, we find that hiring the same firm to run both specialist Developed and Emerging Market Equity satisfies most of these factors. But although this hybrid approach usually brings cost savings, it often reduces expected out-performance. Clients should therefore evaluate hybrid mandates appropriately: as two separate portfolios, both specialist in nature.

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Background

1. Impact on the Foreign Equity Portfolio's Expected Return after Fees

Russell predicates its belief in specialist management on the view that specialists outperform generalists on average over the longer term. (This is despite the recognition that fees for specialists will usually be slightly higher than for generalists.)

Data and intuition support this view.

Intuitively, investors with an edge should achieve superior long-term returns, all other things equal. In the emerging markets, advantage accrues to investors with access to local expertise. This suggests that specialist managers should prosper over generalists as they typically make greater use of local expertise. Examples of the advantages that accrue from local expertise are:

- *Information advantage*. Equity returns of individual emerging market countries are often relatively uncorrelated. Predicting the performance of one country based on the prediction of another is therefore unwise (i.e. knowing about events in Indonesia gives little insight into events in Brazil). This provides country experts with an edge. This edge is particularly strong, as an emerging stock's country of origin drives its performance more than any other factor[1].
- *Implementation advantages*. Understanding alternative investment options (like American Depository Receipts, Global Depository Receipts and country funds) provides an implementation advantage. Knowledge of, and access to, new local listings is also valuable.
- *Operational advantages*. Many countries require investors to register locally, establish local trading and custody accounts, and retain local tax professionals[2]. Investors with access to locals therefore have an operational advantage.

Data is also available to test whether specialists have outperformed generalists in Emerging Market equity. The results support the use of specialist managers.

Russell's Adam Goff (1998) used Russell/Mellon data to examine whether EAFE managers invest as well as specialists in Emerging Markets Equity. Goff found that specialist managers were "the best choice for implementing an active emerging-market equities allocation over the period examined". The sample period used in his research was short, though. His analysis used four years of performance and portfolio data to June 1996.

We have learnt that a more recent study by InterSec strengthens Goff's conclusions. It shows that specialist managers clearly perform better on a risk-adjusted basis. This suggests that specialist managers are better than generalists at spending risk in Emerging Market Equity.

2. Impact on the Foreign Equity Portfolio's Active Risk

Specialist portfolios are also much more diversified than most generalist portfolios.

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[1] Research by Morgan Stanley Dean Witter shows this clearly. See Related Reading.

[2] The recent research from Citigroup presents this well. See Related Reading.

Anecdotal evidence suggests that most EAFE-Plus portfolios hold around 10 to 25 Emerging Market equities. The corresponding range for specialist Emerging Market portfolios is much higher, at around 100 to 200 equities. Yet, while Emerging Market Equity specialists may hold many stocks, they are not passive managers.

Annual tracking errors of specialists averaged 8.7% over the last five years (when measured against the MSCI Emerging Markets Free Index[3]). Holding an additional specialist manager would have reduced this tracking error to 7.2% p.a., on average. Diversifying the portfolio with two complementary managers would have lowered tracking error even further. Russell therefore advocates the use of multiple complementary specialists, wherever possible.

Goff's analysis also compared the number of different countries represented in the equity holdings of each portfolio. As his table shows below, the exposures of generalist portfolios are often so highly concentrated (and correlated with other managers) as to make them unacceptable as stand-alone portfolios.

Portfolio concentration in Specialist and Generalist Emerging Markets Equity structures. Concentration measured by the cumulative order of country weightings.

	1	**2**	**3**	**4**	**5**	**6**	**7**	**8**
EAFE Portfolios' EM Segment	65%	80%	85%	89%	93%	95%	96%	97%
Specialist EM Portfolios	14%	23%	33%	41%	48%	53%	60%	65%

(For example, the top four emerging countries held by EAFE-Plus managers account for 89% of their emerging portfolios. The corresponding number for specialist managers is 41%.)

However, the presence of a developed equity portfolio in an EAFE-Plus mandate masks the impact of these emerging market exposures on return volatility. That is unfortunate. Investors would therefore be prudent to monitor the Emerging Markets sub-portfolios of generalist managers as separate, specialist portfolios.

Three Other Client-Specific Factors

Clients should also consider three other factors when implementing an actively-managed allocation to Emerging Markets Equity:

3. *Size of the client's allocation to Emerging Markets Equity – in monetary terms and as a percentage of the total fund.* The bigger the monetary allocation to a given manager structure, the lower its manager fees. Specialist structures utilizing multiple managers are

[3] MSCI Emerging Markets Free Index: A market capitalization weighted index of over 850 stocks traded in 22 world markets. The index is unmanaged and cannot be invested in directly.

Investments in emerging or developing markets involve exposure to economic structures that are generally less diverse and mature, and to political systems which can be expected to have less stability than those of more developed countries. Securities may be less liquid and more volatile than US and longer-established international markets.

therefore particularly well-suited to larger allocations.

Specialist structures are also well-suited to funds with high percentage allocations to Emerging Markets Equity. High allocations increase the need for a well-diversified portfolio of Emerging Markets Equities, and this favors specialist management.

The converse is also true. As an investor's percentage allocation to Emerging Markets Equity drops, so does his priority for diversifying the Emerging Markets Equity portfolio. This helps to explain why clients with small percentage allocations to Emerging Markets Equity often employ hybrid managers.

4. *Maximum number of relationships with investment firms that the fund can administer*. The lower this figure, the more hybrid managers or manager-of-managers solutions are favored. While institutional investors cannot always articulate this maximum number, their staffs face genuine time constraints. These constraints limit the maximum number of investment relationships that a particular institutional fund can administer. They can also affect the decision to use pooled or segregated investment vehicles.
5. *Client's current foreign equity managers - both developed and emerging*. The existing manager structure impacts which managers to use as hybrid managers, which to use as strong complements to specialist managers, and which to terminate.

Conclusions

Russell advises clients to employ complementary specialist Emerging Markets Equity managers, if they have sufficient assets and staff time to do so. Three options exist where this is not the case. Listed in descending order of recommendation, they are:

- to hire a manager-of-managers portfolio (which is a means of employing complementary specialist Emerging Markets Equity managers)
- to hire hybrid managers
- to hire generalist managers

Clients should evaluate all structural options by analyzing the five aforementioned factors.

Related Reading

Goff, A. "Emerging Market Equity Investing: Two Key Decisions", *Russell Research Commentary*, May 1998

Liodakis, M and J-P Smith. "Sector Investing; As Inevitable As Globalisation?", Morgan Stanley Dean Witter, October 26, 2000

"The Case for Emerging Markets Equity", Citigroup Asset Management, February 2002