Does Style Matter in Emerging Markets?

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The emerging market equity universe has become bigger, broader, and deeper. Over the last five years, clear style distinctions among investment managers have emerged; these style groups have generated differentiated patterns of performance—patterns that, in some cases, are negatively correlated.

In our view, this differentiation presents an opportunity to blend style exposures, smooth portfolio volatility, achieve higher risk-adjusted returns, and better determine asset class entry and exit points.

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U.S. equity manager style distinctions have been measurable and comparable since at least the late 1980s, in the form of indices and style peer groups. Non-U.S. equity manager styles have also evolved over the last 20 years, from top-down and bottom-up classifications to ones focused on growth, value, and core styles (see Exhibit 1).

The advantages of style diversification within developed market equities have long been tested and implemented with success. The following analysis suggests that investors can now also exploit the benefits of style diversification across emerging market equities by structuring portfolios along style lines.

The Evolution of the Emerging Markets Equity Universe

As has occurred with other major asset classes, the structural changes, and resulting expansion, of the number of investable companies and countries has broadened the emerging markets opportunity set.

Exhibit 1
Evolution of Style Indices

Bill Sharpe developed the concept of returns-based style analysis in 1988

1987
Frank Russell large-cap style indices
Wilshire small- and large-cap style indices
MSCI Emerging Markets Index

1992
S&P and BARRA large-cap style indices

1995
Morningstar begins categorizing managers according to style boxes

1996
S&P and BARRA small-cap style indices

2000
MSCI Emerging Markets Growth Index
MSCI Emerging Markets Value Index

2003
S&P/Citigroup Emerging Markets Value Index
S&P/Citigroup Emerging Market Growth Index
S&P/IFCI Emerging Markets Value Index
S&P/IFCI Emerging Markets Growth Index

2005
S&P Select Frontiers Index

2006
FTSE Emerging All Cap Index

2007
S&P/IFCG Frontier 150 Index
Russell Emerging Markets Index
Russell Emerging Markets Large Cap Index
Russell Emerging Markets Small Cap Index

2008
Russell Emerging Markets Growth Index
Russell Emerging Markets Value Index

Source: Casey, Quirk & Acito, "Style Is Dead! Long Live Style," August 2001, Bloomberg, MSCI Barra, S&P/Citigroup, Russell Investments

Exhibit 2 shows the expansion in capitalization of the broad MSCI indices. As it demonstrates, the market cap of the MSCI Emerging Markets Index has grown 200% over the last five years, outpacing all other broad indices.

Exhibit 2
Market Cap of Key Equity Indices

	31 March 2005 ($ Trillion)	31 March 2010 ($ Trillion)	% Increase
MSCI Emerging Markets Index	1.1	3.3	200
MSCI USA Index	10.5	11.0	5
MSCI EAFE Index	8.9	10.4	16
MSCI World Index	20.0	22.8	14

As of 31 March 2010
Source: MSCI

Clear Style Distinctions among Investment Managers Have Developed in the Last Five Years

To answer the question, "Does style matter in emerging markets?", we examined the emerging market equity manager universe,[1] categorizing managers into five groups (Deep Value, Relative Value, Core, Growth-at-a-Reasonable-Price or GARP, and Growth), based on portfolio holdings, manager-professed style, and z-scores (as discussed below). We further examined portfolio characteristics, tracking error and style-based regression to establish style-group "pureness."

Our goal was to determine whether the five style buckets were discrete, and if emerging market equity styles had evolved. Exhibit 3 plots these five style groups on a holdings-based matrix[2] for the five-year period ending 31 December 2009.

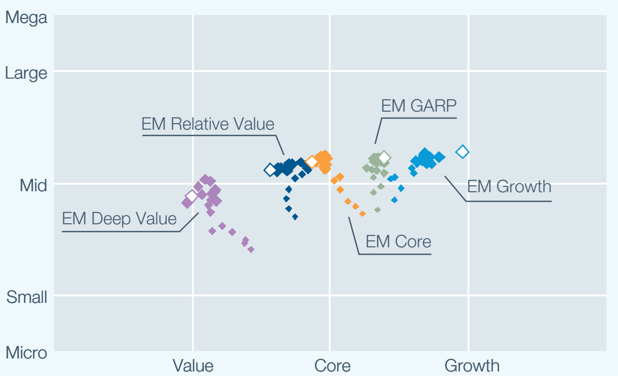
The graph demonstrates that there are now five unique and non-overlapping emerging market equity styles.

Exhibit 4 shows what this chart looked like five years ago—i.e., the same style groups mapped for the five-year period ending 31 December 2004. At that time, manager styles were more blurred.

Another way to evaluate style exposure is to use a growth/value z-score framework (which measures a portfolio's growth/value characteristics using other quantitative measures).[3] Negative scores indicate value bias and positive scores indicate growth bias. Based on this methodology, Exhibit 5 also confirms the existence of five differentiated emerging market equity style groups.

Exhibit 3
By the End of 2009, Five Emerging Market Style Groups Had Emerged

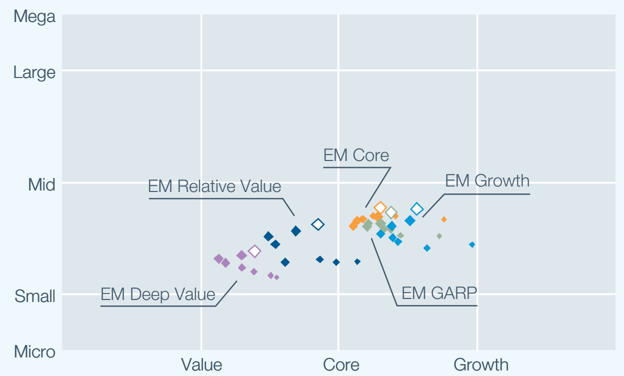
Rolling 4-quarter holdings-based equity style map for 5 years ended 31 December 2009



Source: Lazard, Callan Associates

Exhibit 4
At the End of 2004, Emerging Market Styles Were Just Beginning Their Evolution

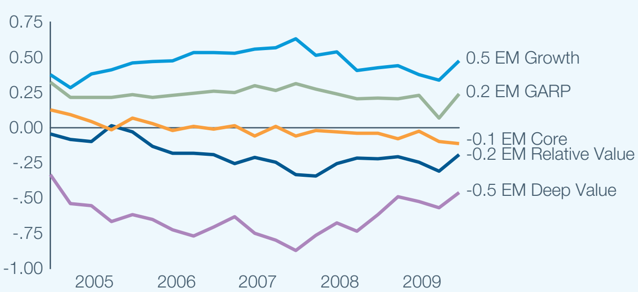
Rolling 4-quarter holdings-based equity style map for 5 years ended 31 December 2004



Source: Lazard, Callan Associates

Exhibit 5
The Five Style Groups Are Discrete and Non-Overlapping Through Time

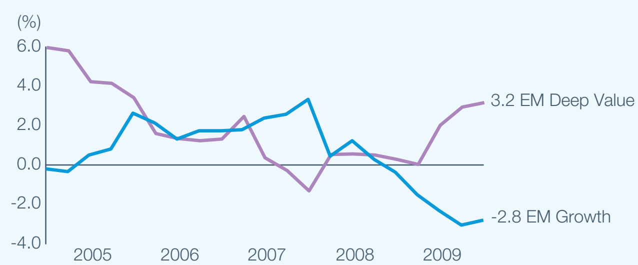
Combined z-score for 5 years ended 31 December 2009



Source: Lazard, Callan Associates

Exhibit 6
Deep Value and Growth Manager Performance Is Divergent

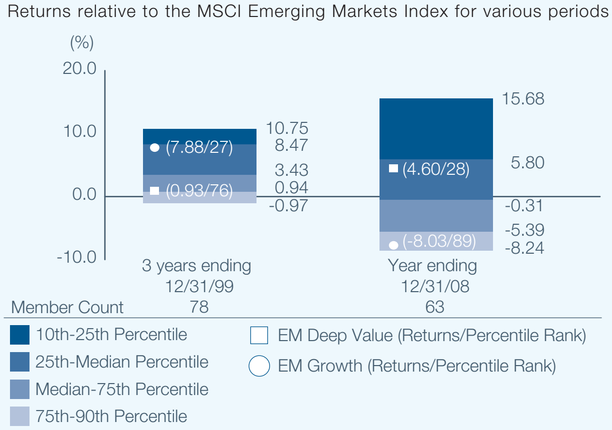
Rolling 12-quarter alpha relative to the MSCI Emerging Markets Index for 5 years ended 31 December 2009



Source: Lazard, Callan Associates, MSCI

Exhibit 7
Return Differences Can Be Sizeable Over Short- and Longer-Term Periods

Returns relative to the MSCI Emerging Markets Index for various periods



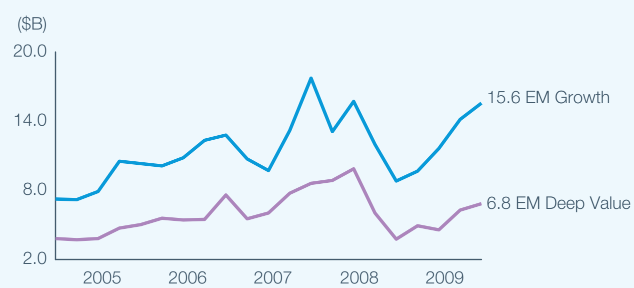
As of 31 December 2008

Source: Lazard, Callan Associates, MSCI

Group: Callan Associates emerging market broad style

Exhibit 8
Market Capitalization Differentials Exist

Weighted median market capitalization for 5 years ended 31 December 2009



Source: Lazard, Callan Associates

The data also shows that style differentials have become more pronounced over time—the 2005 differential between Growth and Value managers ranged from -0.30 to +0.30. In 2008, it had widened to a range of -0.75 to +0.60.

Differentiated Patterns of Performance

Style groups have generated differentiated—in some cases negatively correlated—patterns of performance.

Manager performance (as tracked by the Deep Value and Growth style groups) reveals a pattern that is differentiated and was negatively correlated during 2005, 2007, and 2009, as illustrated in Exhibit 6.

As shown in Exhibit 7, return differences can be sizeable. For the three-year period ending December 1999, for example, Growth managers outperformed Deep Value managers by almost 700 basis points, annualized. Return dispersion can also be dramatic over short periods of time—over the 12 months ending December 2008, Deep Value managers outpaced Growth managers by over 1,250 basis points.

We also compared capitalization levels of Deep Value and Growth managers. Deep Value managers historically have had lower market capitalization (average and median) relative to Growth managers (see Exhibit 8).

The difference in market cap can be explained by valuations. As market cap is a function of profitability and the multiple that an investor will pay, companies that can grow their earnings faster command a higher multiple in anticipation of higher prospective earnings.

Market capitalization is one of many examples we found that highlight "source of return" differences (e.g., capitalization, country, industry), which contributed to differentiated patterns of performance over medium to long time periods.

The Emerging Market Asset Class Is Inefficient

Emerging market equity managers have historically generated alpha. Exhibit 9 plots the 15-year average excess return for the median manager in the Relative Value style group and shows how the median manager averaged more than 3% excess return per annum. Similar results can be observed in all other style groups. Therefore we can conclude that active management has added a healthy return premium over the benchmark regardless of style.

Where the Opportunity Lies

Exhibit 10 depicts the Information Ratio advantage of blending Relative Value and GARP managers. Notably, this "blended style" strategy ranks consistently in the top third of the broad emerging markets universe. Similar results were achieved by blending the Deep Value and Growth style groups, although this blend was more volatile through time.

Conclusion

The development of emerging markets as an asset class over the past ten years has provided managers the opportunity to exploit growing country, industry, and security investment trade-offs. This has allowed investors to benefit from specialized patterns of return and risk, according to their objectives.

Growth, value, core, and sub-style cycles exist within emerging markets and blending styles can now be considered at a portfolio structure level.

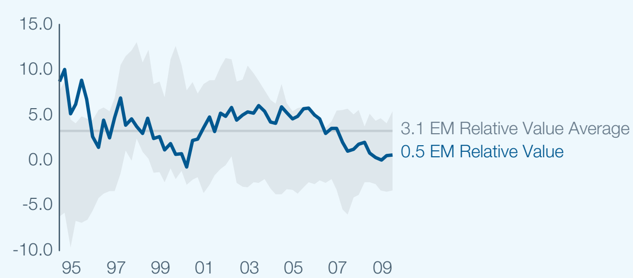
We believe that diversifying emerging markets equity exposure by manager style presents an opportunity to:

- Blend style exposures
- Smooth portfolio volatility
- Offer higher risk-adjusted returns relative to single manager mandates
- Allow investors (or managers) to better determine asset class entry and exit points

Moving to a multi-manager structure may require close evaluation of sub-style patterns of performance in the context of manager selection (e.g., a Relative Value manager may better complement a GARP manager than a Core manager). We expect that emerging market style distinctions will continue to evolve with the transformation of the asset class.

Exhibit 9
There Is an Active Manager Premium

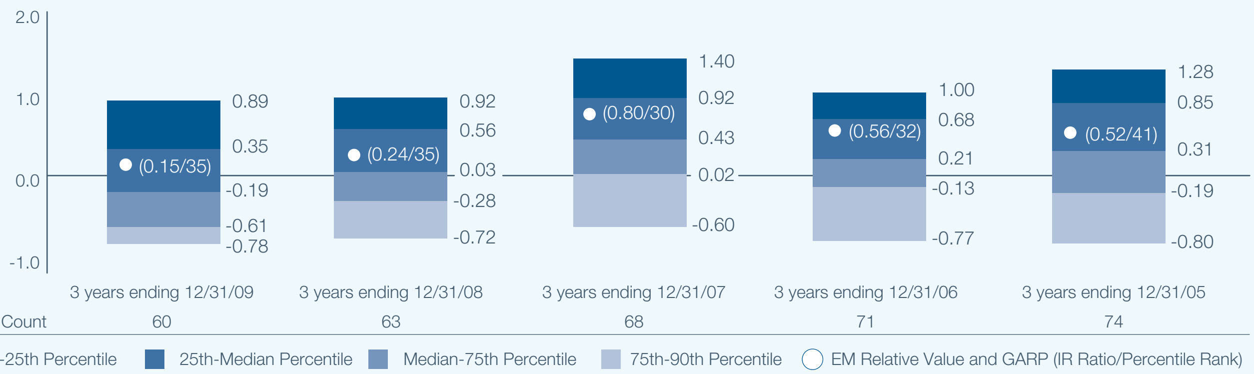
Rolling 12-quarter excess return relative to the MSCI Emerging Markets Index for 15 years ended 31 December 2009



Source: Historical Active Management Premiums by Asset Class and Style, Callan Associates, December 31, 2009

Exhibit 10
Blending Styles Results in Higher Risk-adjusted Returns

Information ratio relative to the MSCI Emerging Markets Index for 12-quarter rolling periods



Source: Callan Associates
Group: Callan Associates emerging market broad style

The Next Frontier

Some emerging market managers have launched emerging market small cap and/or frontier strategies (and ETFs) to potentially take advantage of higher return and lower country correlations across an even broader opportunity set.

These strategies command a higher risk premium due to illiquidity and greater economic, political and social risks. Exhibit 1 shows that major index providers have created a number of small cap and frontier indices. Interest may increase as specialist managers prove their ability to add alpha in these areas.

Notes

1 Universe as defined by Callan Associates.

2 MSCI has developed security-level style scores based on multiple fundamental ratios that classify stocks as "value" or "growth."

3 The growth/value z-score methodology was pioneered by MSCI. It uses three value factors—Book Value / Price, 12-Month Forward Earnings / Price, and Dividend Yield—to determine a value z-score for individual stocks. It uses five growth factors—Long-Term Forward EPS Growth Rate, Short-Term Forward EPS Growth Rate, Current Internal Growth Rate, Long-Term Historical EPS Growth Rate, and Long-Term Historical Sales/Share Growth Rate—to determine a growth z-score for individual stocks.

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