Emerging Opportunities:

Exploring the True DNA of Emerging Markets

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"BACK TO THE PREMISE OF EMERGING MARKETS, A PLACE OF PROGRESS, DYNAMISM, AND EXCEPTIONAL GROWTH OPPORTUNITIES." [1]

As markets move past the peak of pandemic-induced volatility, many institutional investors are reviewing their asset allocation to ensure not only risk-return efficiency, but also balanced representation from the broadest possible set of global equity opportunities. Naturally, emerging markets – currently 11.8% of global market cap and 24.5% of global revenue[2] – are drawing investor attention. Whether considering an initial allocation or reviewing current exposures to emerging markets, investors should consider the best way to gain truly representative exposure to the asset class.

In this paper, we explore the inherent characteristics of the emerging markets (EM) asset class through an economic lens and discuss the key investment criteria that differentiate emerging markets from developed markets. We also challenge the influence of existing benchmarks, which feature significant concentration problems at both the issuer and country level, on investors' asset allocation decisions and managers' security selection. In fact, just three countries – China, Korea, and Taiwan – comprise two-thirds of the index, amplifying such country-specific risks as China's recent regulatory crackdown on certain sectors. Similarly, the ten largest stocks in the MSCI EM Index comprise about one-third of the index. Emulating such a concentrated benchmark with a similarly concentrated, low-active-share portfolio is arguably not prudent, nor "emerging."

INVESTORS SEEKING TO PARTICIPATE IN THE MORE RAPID GROWTH OF THE DEVELOPING WORLD WILL NEED TO SOURCE ACTIVE, NON-BENCHMARK-ORIENTED, ALL-CAP MANAGERS TO FULLY EXPLOIT THE BREADTH OF OPPORTUNITIES.

A review of the EM market capitalization ranges shows that the majority of EM companies are under $7.5 billion[3] in market cap, with only a select group (primarily Chinese internet/tech and finance companies) in the mega-cap realm.

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[1] Antoine van Agtmael – 1981 IFC. The outlook and opportunities noted throughout this document are prospective, based upon the opinions of Altrinsic as of the date of this document and are subject to change without notice. There is no guarantee that any investment in the perceived opportunities referenced in this document will be profitable. Please see important additional disclosures found at the end of this document.

[2] FactSet data as of Dec 31, 2020.

[3] Unless otherwise stated, all dollar figures in this paper are in US dollars.

Such top-heavy mega-cap index weighting belies the far broader nature of the true EM investment opportunity set. Yet many EM investors, experienced and novice, do not fully appreciate the scope of opportunities missed by such narrow benchmark-driven implementation.

Passive and benchmark oriented flows into EM equities have further aggravated country- and security-level concentration in investor portfolios. Amid such narrow flows, the breadth of analyst coverage and level of information has similarly decreased over the last several years as research organizations focus their work on the biggest benchmark constituents. Perversely, this has increased the information arbitrage available to locally connected, experienced, and truly active EM investors.

In addition to the informational advantage, valuations within the smaller, underfollowed countries and companies are more attractive than those of the overall, top-heavy (by capitalization and country) EM universe. Diversification potential to US equity should also improve as one goes down the cap spectrum, further bolstering the portfolio efficiency argument for a higher active share in EM. Since the introduction of the EM index, several billion consumers have entered the global economy. Technological advances will continue to accelerate, driving EM productivity. In some cases, companies within these markets will catch up to – or even leapfrog – those in developed economies, as exemplified by the rise in fintech-based banking services previously unavailable. We believe this has, and will continue to, unlock an enduring entrepreneurial spirit that will contribute to further innovation, disruption, and opportunity.

> While the current Top Ten companies [of the MSCI EM Index] have been highly successful, the next decade will likely feature a new generation of winners, perhaps in India or other up-and-coming nations like Vietnam.

The next generation of EM leadership may not be the same countries and companies that have come to dominate today's index, as capitalization weighting is an inherently backward-looking exercise that reflects historical winners. Investors seeking to capture the full array of secular growth opportunities across the EM landscape should consider increasing the overall active share of their EM manager line-up.

In the pages that follow, we explore the following elements of emerging market equity investing:

How are emerging markets defined?

Why invest in emerging markets?

Does the original emerging markets thesis still hold?

What are the implementation challenges?

I. WHAT IS THE TRUE DEFINITION OF AN EMERGING MARKET?

The term "emerging markets" was coined 40 years ago in 1981 by an International Finance Corporation (IFC)[4] economist, Antoine van Agtmael, who was tracking an index of ten developing countries. These markets were demonstrating "progress, dynamism, and exceptional growth opportunities."

Today, the International Monetary Fund (IMF) classifies world economies either as advanced or as "emerging market and developing economies." The classifications are based on three key criteria[5]:

1. Systemic presence
2. Market access
3. Income levels

The IMF's classification includes 20 countries[6] which account for 34% of the world's nominal GDP in USD terms and 45% in purchasing power parity (PPP) terms.

More intuitively, an emerging market economy is transitioning from a low income, less developed, often pre-industrial economy toward a modern industrial economy with a higher standard of living. Emerging market economies are thus expected to generate higher returns (and risk) due to their faster growth.

From an investment standpoint, emerging markets represent an expansion of the investable opportunity set as well as a complementary source of diversifying macroeconomic drivers. As has been the case for decades, these attributes warrant consideration of EM assets for a meaningful risk allocation in investors' portfolios.

Yet implementation remains a challenge. Most institutional investors currently have exposure to what they believe to be emerging markets. However, upon closer examination, that is often not the case. As certain emerging economies have grown, so have their weights in the benchmark. Nearly one-third of the MSCI EM benchmark is now represented by just two countries – Taiwan and South Korea. Taiwan's GDP per capita (2019 PPP terms) exceeds that of Germany, and South Korea's GDP per capita exceeds that of Japan; both more closely resemble developed market countries than emerging market peers.

> EMULATING SUCH A CONCENTRATED BENCHMARK WITH A SIMILARLY CONCENTRATED, LOW-ACTIVE-SHARE PORTFOLIO IS ARGUABLY NOT PRUDENT, NOR "EMERGING."

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[4] https://www.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/about+ifc_new/ifc+history/1980s

[5] Systemic presence: The size of the country's economy (nominal GDP), its population, and its share of exports in global trade. Market access: The share of a country's external debt in global external debt, as well as whether it is included in global indices used by large international institutional investors and the frequency and amount of international bonds issued. Income level: A country's GDP per capita in nominal US dollars – IMF Finance & Development Report, June 2021

[6] Argentina, Brazil, Chile, China, Colombia, Egypt, Hungary, India, Indonesia, Iran, Malaysia, Mexico, the Philippines, Poland, Russia, Saudi Arabia, South Africa, Thailand, Turkey, and the United Arab Emirates

II. Investor Rationale – Why Invest in Emerging Markets?

Despite formal recognition in academic and economic circles beginning in the 1980s, EM was typically only considered in the investment realm opportunistically within broader mandates starting in the 1990s. For example, many global developed and EAFE investors' guidelines allowed their managers to hold up to 10-20% exposure to EM companies, but few dedicated EM mandates existed. By the early 2000s, the emergence of China, India, Brazil, and other countries led to more widespread institutional adoption of dedicated EM mandates.

Believers in a strategic, dedicated allocation to EM (as opposed to an opportunistic sleeve in a developed markets portfolio) see these markets as one of the last untapped growth opportunities in equity investing. From an asset allocation perspective, emerging markets have long presented a compelling set of attributes arguing for their inclusion in a broad portfolio:

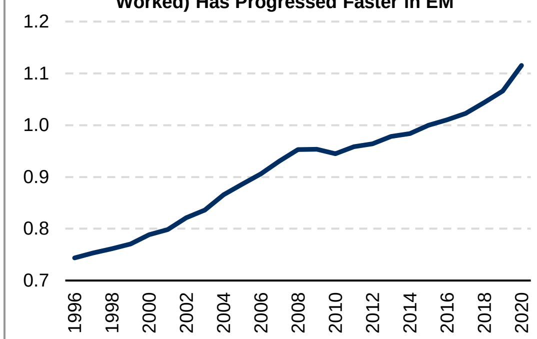
1. **Growth**: higher GDP growth and productivity growth versus the developed world
2. **Diversification / Opportunity Set Expansion**: lower correlation, improved portfolio efficiency
3. **Valuations**: high implied discount rates
4. **Alpha**: informational inefficiencies

GROWTH

Over the last 20 years, emerging market economies have grown, on average, 2.1 times faster[7] than those of the developed markets. Given the extent to which these EM economies have been stress-tested with various crises – the 2008-09 financial crisis, the 2013 taper tantrum, China's 2015 market turbulence, the 2014-15 oil crash, and the COVID-19 pandemic – such a growth premium demonstrates persistent resiliency.

With respect to productivity growth, emerging markets have increased their labor efficiency four times faster than developed markets over the last 20 years (**Chart 1**). In our view, the growth and productivity premium of emerging markets relative to the developed world should continue.

Chart 1. Labor Productivity (Real GDP/Hours Worked) Has Progressed Faster in EM



Source: OECD; Note: The following countries have been included: Canada, France, Germany, Italy, Japan, UK, and US.

DIVERSIFICATION & OPPORTUNITY SET EXPANSION

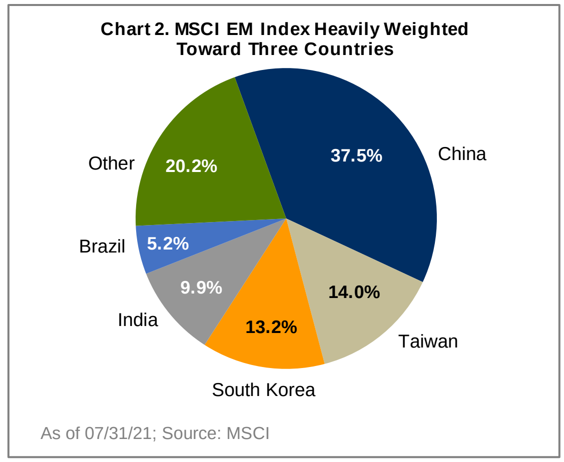
Emerging markets provide a meaningful expansion of the investable opportunity set. As of June 2021, the developed market EAFE index was comprised of 845 companies in 21 countries. The EM index adds an additional 1,412 constituents across another 27 countries. And just in the last 15 years, MSCI launched a Frontier Markets Index with another 81 stocks in 27 additional "frontier" countries, primarily concentrated in lesser developed areas of Africa,

[7] Source: Bloomberg

Central and Southeast Asia, and Latin America. Institutional investors seeking to expand their equity structure beyond developed markets have long recognized the benefits of participating in this broadening investable opportunity set, both from an asset allocation and alpha-generating perspective.

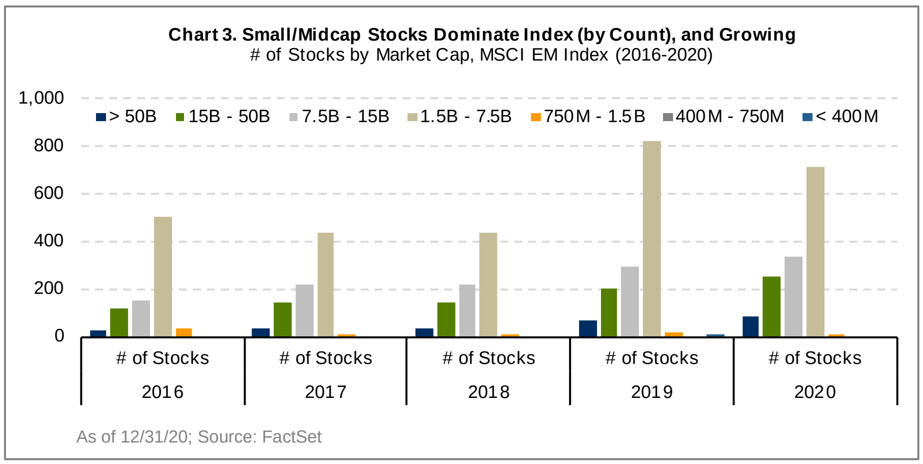
GEOGRAPHY

As dedicated EM adoption became more universal, we entered a historically notable period in the 2010s where North Asia dominated EM growth on a globally material scale. The EM index weightings in China, Korea, and Taiwan ("CKT") expanded to the point where they now comprise over two-thirds of the MSCI EM Index (**Chart 2**). Passive flows, especially into ETFs, have further aggravated this concentration pro-cyclically. Many investors' EM exposures are now heavily dominated by just China, Korea, and Taiwan, but Korea and Taiwan are hardly "emerging."

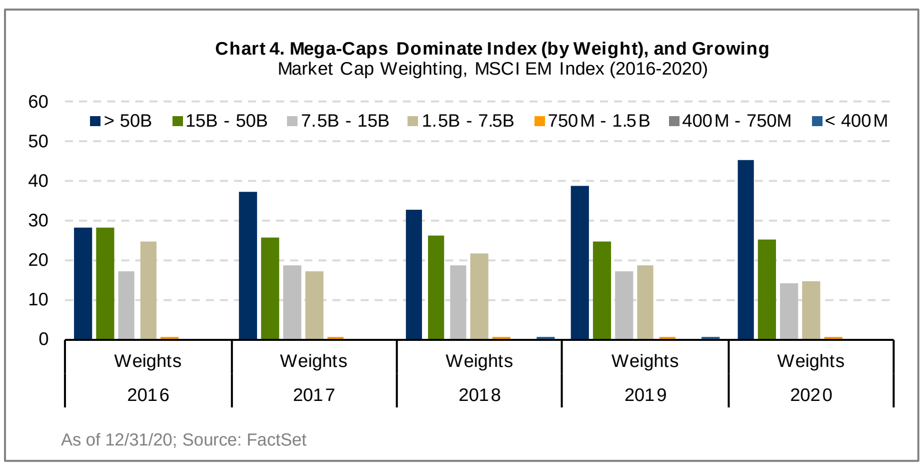


MARKET CAPITALIZATION

Shifting from country diversification to market capitalization, the true opportunity set is best represented in the midcap segment. Over half of the index, by count of companies, resides in small/midcap ($1.5-$7.5 billion) and this count has grown considerably in recent years (**Chart 3**).



Despite smaller companies dominating by count, over the past five years the largest companies (over $50 billion) have grown from a 29% weight to a 46% weight in the index – at the expense of smaller companies (**Chart 4**). Most EM investors, including those with only passive allocations, are exposed almost exclusively to the top two quintiles of EM capitalization.



TOP TEN CONCENTRATION

The crowding is evident when analyzing the index concentration of the top ten holdings. The proportion of the S&P 500 and MSCI EM indices represented by the top ten holdings now exceeds the levels last seen at the peak of the dotcom bubble (**Chart 5**). In these periods of significant concentration, investors tend to be their own worst enemies. Resources and focus are reallocated to the top ten companies, adding to the momentum behind the stocks and the resulting concentration. Too often, unrealistic expectations are discounted into the valuations, leading to disappointing performance and initiating a new cycle of de-concentration and the emergence of new secular themes. While the current top ten companies have been highly successful, the next decade could reasonably feature a new generation of winners, perhaps in India or other up-and-coming nations like Vietnam.

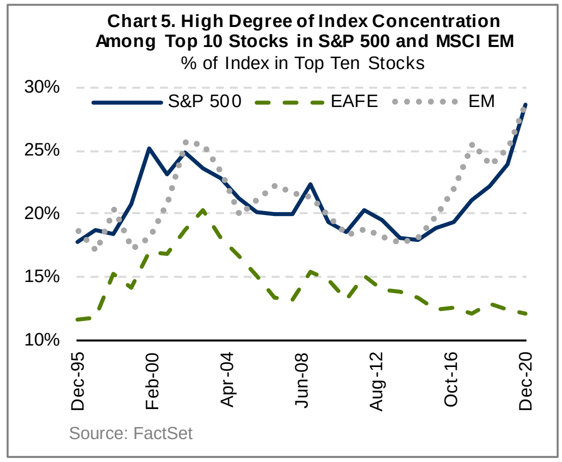
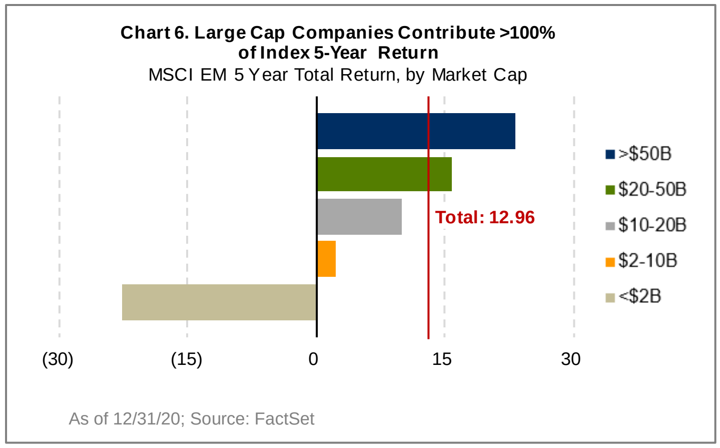


Chart 6 shows returns by market cap quintile, further demonstrating the trend of investor crowding into large-caps. Over 100% of the index return in the past five years has come from the large-cap companies. Collectively, the two-thirds of EM index companies in the small/midcap realm have been languishing for years.



SECTOR EXPOSURE

Sector exposure varies markedly between CKT and ex-CKT, advancing the argument for a broad approach to the opportunity set (**Table 1**). Low active share and passive strategies will be biased toward technology and against materials and real estate.

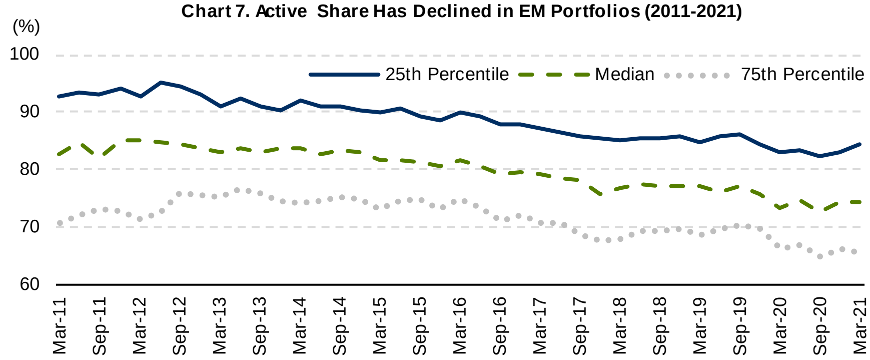
Table 1. Notably Varied Sector Exposure, CKT v. ex-CKT

Sector	S&P 500	MSCI EM		MSCI EM ex-China, Korea, Taiwan		MSCI EM China, Korea, Taiwan	
	Exposure	Exposure	# of companies	Exposure	# of companies	Exposure	# of companies
Comm. Services	10.8	12.8	86	10.2	41	14.1	45
Cons. Disc.	12.7	17.2	139	5.6	41	23.4	98
Cons. Staples	6.5	5.9	135	9.6	62	3.9	73
Energy	2.3	5.0	61	12.0	38	1.3	23
Financials	10.4	17.9	250	29.5	115	11.8	135
Health Care	13.5	4.7	123	3.4	24	5.4	99
Industrials	8.4	4.4	171	4.8	39	4.2	132
Tech	27.6	20.5	159	5.2	9	28.6	150
Materials	2.6	7.6	149	14.4	68	3.9	81
Real Estate	2.4	2.1	65	1.8	18	2.2	47
Utilities	2.8	2.0	59	3.5	35	1.2	24
	100.00	**100.00**	**1397**	**100.00**	**490**	**100.00**	**907**

As of 12/31/20; Source: FactSet

Active managers have been reducing their active share in recent years, with the median active share dropping by 10 percentage points over the past decade (**Chart 7**). Fewer managers have been able or willing to assume the investment risk – or even career risk – of considering, for example, a Vietnamese property company over a Chinese internet stock.

Chart 7. Active Share Has Declined in EM Portfolios (2011-2021)



Source: eVestment; Notes: Universe: eVestment Global Emerging Markets All Cap Equity. Results displayed in USD using Spot Rate (SR).

ACTIVE MANAGER CONCENTRATION

We also observe a rather concentrated active manager universe. Half of EM assets are managed by just 21 managers, with a median AUM of $14 billion, a median China weight of 36%, and a median allocation of 44% to companies over $50 billion in market cap[8]. Yet only 69 companies over $50 billion in market cap exist in the EM realm.

The crowding within EM – both in terms of index exposure and in terms of managers participating – fuels a propensity for redundant bets. Additionally, many high-AUM strategies lack the nimbleness required to trade effectively or build a needle-moving position in smaller, less liquid markets.

What can we conclude about the diversification potential in EM? We would argue that the opportunity set expansion has continued impressively, yet few investors are consciously availing themselves of the full universe. Investors seeking to participate in the rapid growth of the developing world will need to source active, non-benchmark-oriented, all-cap managers to fully exploit the breadth of opportunities.

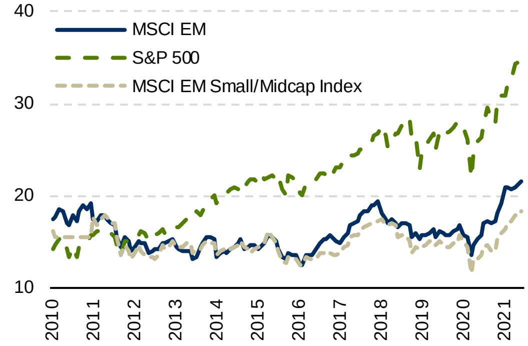
ADDING A COMPLEMENTARY ACTIVE EM MANAGER WILLING TO VENTURE OFF THE NARROW, BEATEN PATH OF TODAY'S BENCHMARK COULD PROVIDE NOTABLE PORTFOLIO BENEFITS OVER THE LONG-TERM.

[8] Source: eVestment Emerging Markets All Cap peer group as of Sep 30, 2020

VALUATION

In addition to growth potential and diversification, investors have long been attracted to EM assets because of the often disproportionately high discount rates, creating valuation anomalies for global investors. Though warranted to an extent, excessively high discount rates often point to nothing more than negative sentiment and/or informational asymmetries. As we assess the markets today from a long-term perspective, EM equities remain attractive on a cyclically-adjusted price-earnings (CAPE) ratio relative to developed markets (**Chart 8**). From a bottom-up perspective, we are finding compelling idiosyncratic opportunities on a regular basis, particularly in the small/midcap and ex-CKT realm.

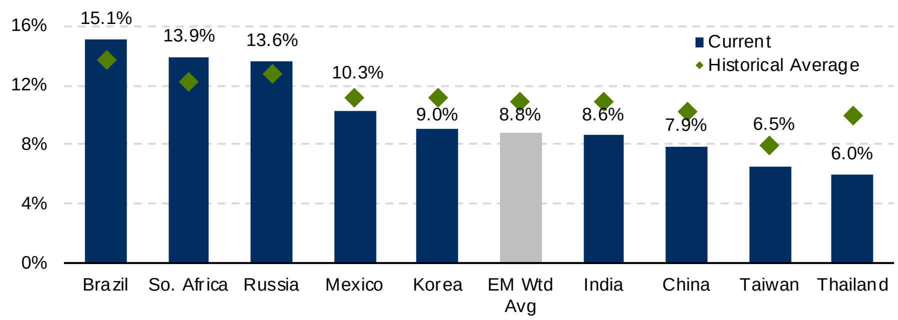
Chart 8. EM Equities Attractive Versus DM
Long Term Price Earnings Ratio



As of 06/30/21; Source: Bloomberg

To add another perspective on valuation, implied discount rates at the country level can be imputed from applying consensus analyst estimates to current valuations. Most EM countries are exhibiting discount rates below historical averages, thanks to easy monetary policy and quantitative easing worldwide, but this gap varies widely by country, with Brazil and South Africa both offering historically high discount rates (**Chart 9**). This degree of dispersion across countries further supports an active approach, especially one that can take advantage of bottom-up pricing discrepancies and informational asymmetries.

Chart 9. Active Management Supported by Wide Dispersion of Country-Specific Discount Rates
EMs Implied Cost of Equity, Current vs. Historical Average

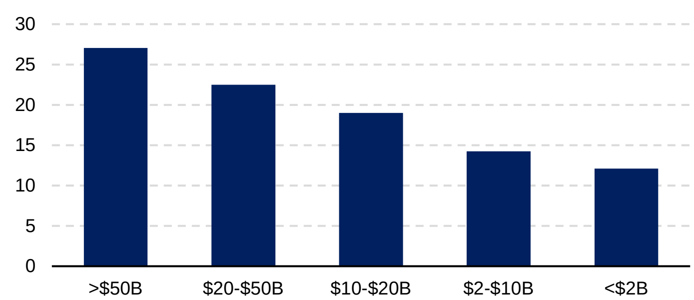


As of 07/2021; Source: MSCI, IBES, Thomson Reuters, Datastream, UBS. Historical average since January 2004 depending upon data availability.

ALPHA & INFORMATIONAL ARBITRAGE

Despite growth in EM exposure from investors in recent years, the sell-side analyst coverage of emerging markets remains heavily skewed toward the mega-caps, in line with the greater mega-cap concentration of the indices (**Chart 10**). While the sell-side bias toward mega-caps impacts investor awareness, it also increases information arbitrage opportunities accruing to those paying sufficient attention to the broader small/midcap segments. Greater alpha potential is likely available for those investing in opportunities outside of the narrow and over-followed CKT large cap space. The ex-CKT region should provide superior, less-trafficked opportunities for active managers with local insights.

Chart 10. Analysts Biasing Focus Toward Mega-Caps
Average # of Analysts Per Stock, by Market Cap Quintile



As of 08/2021; Source: Bloomberg

III. IMPLEMENTATION CONSIDERATIONS

The original emerging markets thesis (1981), which caught investors' attention in the early 2000s, highlighted growth, diversification, valuation, and alpha as key benefits – a set of attributes that continue today.

We believe that many of the next decade's best opportunities in "true" emerging markets reside outside of the top-heavy, concentrated MSCI EM benchmark. We are finding unique business models which exhibit proven financial productivity levels and offer participation in innovative businesses and fast-growing markets. Many of these companies are small/midcap, underfollowed by both buy-side and sell-side analysts, underappreciated by the general public, and influenced by local economic drivers and company-specific idiosyncrasies.

Investors who seek to benefit from full and direct exposure to EM markets should evaluate the extent to which their managers embrace the full spectrum of EM opportunities across all countries and capitalization ranges. For investors whose EM exposure is either passive or embedded within ACWI mandates, adding a complementary active manager willing to venture off the narrow, beaten path of today's benchmark could provide notable portfolio benefits over the long-term.

At Altrinsic Global Advisors, our Emerging Market Equity strategy reflects the true DNA of the asset class. We invest across all sectors, all market cap quintiles, and all countries, including select frontier market opportunities. We seek sustainable, well-managed, financially-productive companies playing a key role in rapid economic transformations. The sheer breadth of opportunities embedded within the emerging markets make us passionate about our approach and excited about the growth and innovation still to come.

About Altrinsic Global Advisors, LLC

Altrinsic Global Advisors, LLC, founded in 2000, is an employee-controlled and majority-owned investment management firm. Altrinsic manages approximately US$10.6 billion[9] in global and international equities, applying a long-term private equity approach to public equities. Altrinsic's clients include corporate and public pension plans, endowments, foundations, sovereign wealth and sub-advisory clients. For more information, please visit www.altrinsic.com or contact Sara Sikes at +1 (203) 661-0030.

About the Authors

Alice Popescu (Portfolio Manager) and Brian Zeiler contributed to the writing of this paper.

[9] As of 07/31/21

IMPORTANT CONSIDERATIONS & ASSUMPTIONS