Investment Perspectives

Emerging Markets: Why and Where

The opportunity in emerging markets (EM) is vast and expanding. EM comprise over 85% of the world's population and have contributed 52% of global GDP[1] growth since 2000.

Economic growth in EM has outpaced that of developed markets over the past two decades, and we believe this trend will persist. EM are benefiting from advancements in education and technology, which have bolstered productivity. More market-friendly policies have created favorable environments for businesses and investors. Positive demographic trends, such as larger middle-class populations, and rising urbanization are fueling demand for various goods and services. Companies that strategically tap into these burgeoning markets should reap significant rewards. Given their immense potential for growth and development, EM offer fertile ground for innovation, investment, and economic development.

As EM have grown in importance, their weight within major global indices has also increased. For example, the MSCI Emerging Markets Index (MSCI EM) as a percentage of the MSCI ACWI Index is now 2.4 times larger than it was in 2000.[2] Moreover, MSCI's definition of EM continues to evolve, incorporating new countries into the fold, reflecting an expanded universe of investable opportunities. The MSCI EM currently includes 24 countries versus only 10 at the Index's inception.

Despite their increasing prominence, EM equities remain underrepresented relative to their economic significance. The MSCI EM represents 11% of the MSCI ACWI, yet companies based in EM or whose businesses largely serve EM[3] comprise 30% of total global market capitalization.

EM Performance: A Tale of Three Periods

Given the economic growth in EM, how have EM equities performed since 2000? As shown in Figure 1, EM significantly outperformed developed markets (represented by the MSCI World Index)[4] from December 2000 to 2010, but have underperformed since then. Here's why:

- **December 2000 to December 2010:** EM companies had exceptionally strong sales growth that outpaced developed markets. Consumer demand drove growth across various sectors and attracted significant inflows into EM equities.
- **December 2010 to December 2019:** After the global financial crisis, many EM economies expanded. However, EM underperformed due to margin compression, currency headwinds, and a lack of multiple expansion.[5]
- **December 2019 to March 2024:** The COVID-19 pandemic disproportionately harmed EM, resulting in their significant underperformance during and after the pandemic. Increasing global geopolitical tensions, China's struggling economy, the dominance of a few U.S. technology giants (known as the Magnificent Seven),[6] and less direct exposure to transformative technologies (e.g., artificial intelligence) further widened the performance gap.

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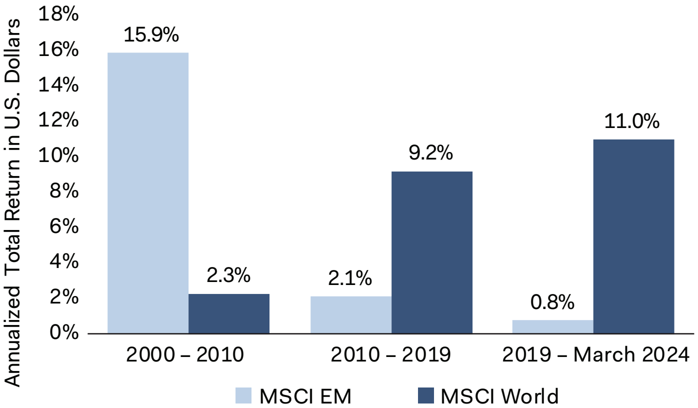
EM investing is akin to prospecting for hidden gems. It requires patience, diligence, and a keen eye to spot opportunities. While many investors focus on well known, larger EM companies, there are a wealth of opportunities for astute investors willing to take the time to dig deeper and explore smaller companies that may not yet be on everyone's radar.

In this paper, we discuss the historical performance of EM equities and highlight the compelling investment opportunities we see in EM.

Figure 1. MSCI EM Outperformed Significantly in 2000-2010



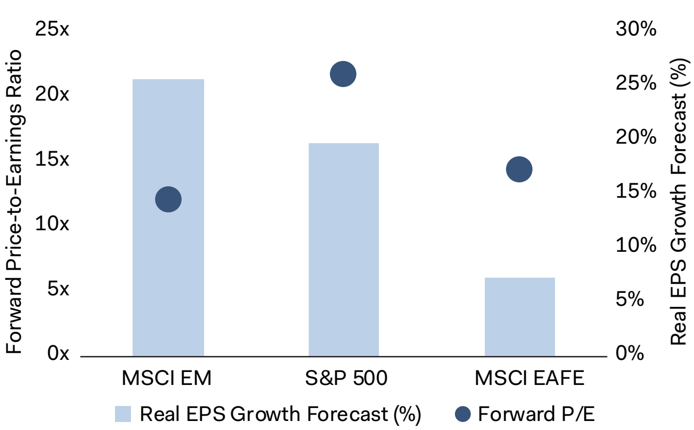
Source: MSCI. Returns are in U.S. dollars.

EM Equity: An Attractive Asset Class

As a result of recent underperformance, EM companies are collectively trading at relatively inexpensive valuations, as illustrated in Figure 2. Importantly, they also have attractive earnings growth[7] prospects. Earnings growth in EM is expected to be higher in both absolute and relative terms compared to growth in the United States and other developed markets. On March 31, the MSCI EM traded at 12.1 times forward earnings, compared to 21.7 times for the S&P 500 Index and 14.3 times for the MSCI EAFE Index.[8] Starting valuations matter—lower starting valuations can provide a margin of safety. Having a long-term investment horizon and analyzing securities on a bottom-up basis also helps investors identify compelling opportunities.

There are risks to consider when investing in EM, including greater political instability, less established legal and regulatory regimes, and currency fluctuations. Nevertheless, the combination of attractive valuations, robust growth prospects, and potential diversification benefits (discussed below) make EM equities an appealing asset class for long-term investors.

Figure 2. EM: Inexpensive with Higher Growth Prospects



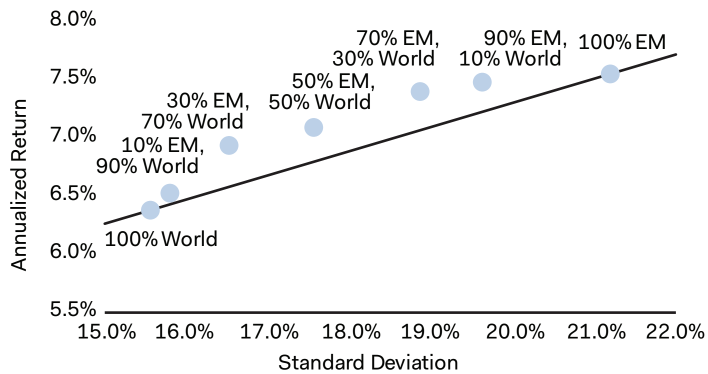
Source: FactSet, MSCI.

EM Exposure May Improve Risk-Adjusted Returns

EM equities offer unique opportunities and risks that can complement a diversified portfolio. Investing in EM is typically considered riskier than investing in developed markets. Indeed, since 2000, the MSCI EM has been more volatile than the MSCI World, using the standard deviation[9] of monthly returns as a proxy for volatility. Over the same period, the MSCI EM generated higher returns than the MSCI World. That may not be surprising.

However, a portfolio reflecting a blend of emerging and developed markets indices would have generated higher returns than a developed markets-only portfolio, with only a small increase in volatility. Figure 3 shows the performance of various blends of the MSCI EM and MSCI World Indices. These returns illustrate the important role that EM equities can play in a portfolio.

Figure 3. Average Annual Total Return of Portfolios of MSCI EM and MSCI World Rebalanced Monthly (1999 through March 31, 2024)[10]



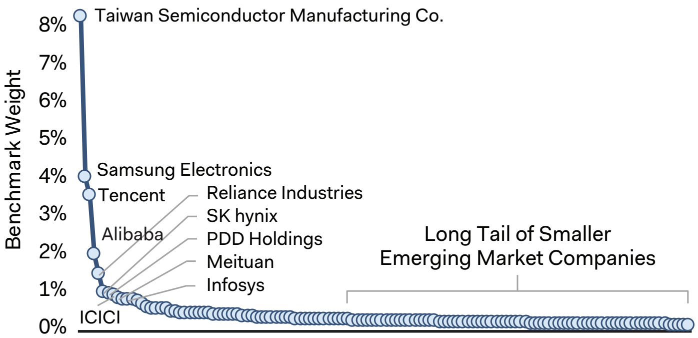
Source: Bloomberg, MSCI. Past performance is no guarantee of future results. Index returns include dividends, but unlike Fund returns, do not reflect fees or expenses. Returns are in U.S. dollars.

Small-Cap EM: Greater Diversification and Market Inefficiencies

Smaller companies often operate in niche markets or serve local needs, providing a different risk-return profile from larger, more globally oriented firms. As shown in Figure 4, 69% of the MSCI EM's constituents are less than 0.05% positions (versus 34% of the S&P 500 and 45% of the MSCI EAFE). Investing in this long tail of smaller EM companies can help spread risk across a broader spectrum of industries and regions. For example, in the Industrials sector, there is only one larger company that has a weight greater than 0.20% in the MSCI EM, but there are 195 smaller companies with weights less than 0.20% (see Figure 5).

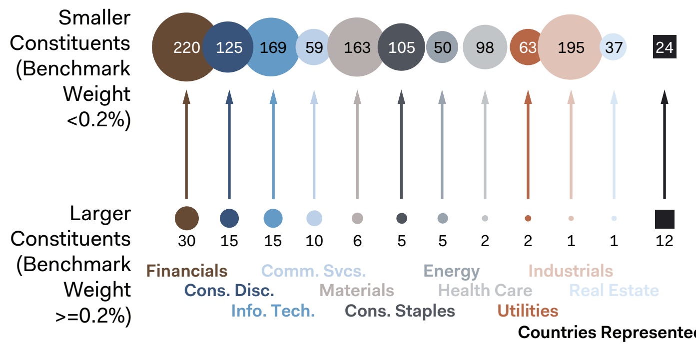
The broad EM universe[3] is approximately three times larger than the MSCI EM. As market capitalizations decrease, sell-side equity research coverage and MSCI EM exposure tend to drop off dramatically (see Figure 6). Smaller companies often fly under the radar of sell-side analysts, and their

Figure 4. MSCI EM Constituents[11]



Source: MSCI.

Figure 5. MSCI EM Constituent Count by GICS Sector & Country



Source: MSCI.

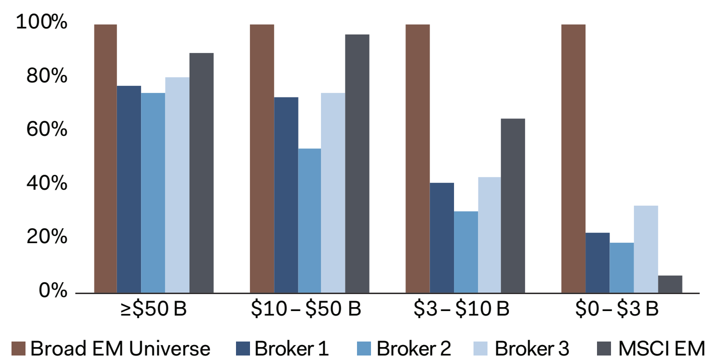
valuations can be attractive. The smallest 80% of MSCI EM constituents by weight trade at a 15% discount[12] to the largest 20%. By tapping into these market inefficiencies, investors can potentially capture higher returns while simultaneously diversifying their portfolios, making smaller EM companies an attractive proposition for those seeking to optimize risk-adjusted returns.

Interested in Hearing More?

EM equities can provide exposure to thriving economies, low valuations, attractive earnings growth prospects, diversification benefits, and potentially higher risk-adjusted returns. We welcome the opportunity to discuss our active, value-oriented approach to investing in EM.

Figure 6. Thinner Broker Coverage Suggests Potential for Market Mispricing/Inefficiencies

Sell-Side Coverage as a % of Broad EM Investable Universe by Market Cap



Source: FactSet, MSCI.

1. Unless otherwise specified, all weightings and characteristics are as of March 31, 2024. Gross domestic product (GDP) measures the monetary value of final goods and services—those that are bought by the final user—produced in a country in a given period of time. It counts all of the output generated within the borders of a country. GDP is composed of goods and services produced for sale in the market and also includes some non-market production, such as defense or education services provided by the government.
2. The MSCI Emerging Markets Index captures large- and mid-cap representation across emerging market countries. The MSCI ACWI (All Country World Index) Index is a broad-based, unmanaged equity market index aggregated from developed market and emerging market country indices.
3. In determining whether an issuer is located in or has significant economic exposure to an emerging market country, Dodge & Cox will consider the issuer's country of organization, the location of its management, the country of its primary listing, its reporting currency, and whether the issuer has significant assets in, or derives significant revenues or profits from, emerging market countries.
4. The MSCI World Index is a broad-based, unmanaged equity market index aggregated from developed market country indices, including the United States. It covers approximately 85% of the free float-adjusted market capitalization in each country.
5. Multiple expansion means that investors were willing to pay more for the same amount of earnings.
6. The "Magnificent Seven" stocks are Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla.
7. Earnings growth is the percentage change in a firm's earnings per share (EPS) in a period, as compared with the same period from the previous year.
8. Price-to-earnings (forward) ratios are calculated using 12-month forward earnings estimates from third-party sources as of the reporting period. Estimates reflect a consensus of sell-side analyst estimates, which may lag as market conditions change. The S&P 500 Index is a market capitalization-weighted index of 500 large-capitalization stocks commonly used to represent the U.S. equity market. The MSCI EAFE (Europe, Australasia, Far East) Index is a broad-based, unmanaged equity market index aggregated from developed market country indices, excluding the United States and Canada. It covers approximately 85% of the free float-adjusted market capitalization in each country.
9. Standard deviation measures the volatility of the Fund's returns. Higher Standard Deviation represents higher volatility.
10. Performance data for the MSCI Emerging Markets Net Total Return USD Index is first available in Bloomberg starting on December 31, 1998. As a result, the first annual period of performance begins on December 31, 1999.
11. The chart shows the top ten constituents in the MSCI Emerging Markets Index as of March 31, 2024.
12. Calculated based on an average of the discounts for three metrics: trailing price-to-earnings, price-to-sales, and price-to-book ratios.