

# An Enhanced Approach to Broad Emerging Markets Equity Exposure

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Once considered a speculative, high-risk asset class, emerging markets have become a core allocation in a diversified portfolio. But are investors now treating emerging markets equities too much like their developed market counterparts — specifically with index tracking solutions? In this article, we discuss some unique characteristics of the EM index, the drawbacks of passive investing in EM, and why the asset class is better suited for a more sophisticated approach.

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Emerging markets have evolved dramatically in the five decades since our Systematic Equity Active Team began investing in the asset class. In their nascent beginnings in the 1980's, emerging markets equities (EM) represented less than 1% of the MSCI All Country World Universe. Today, they make up more than 10% of global equities and are integrated across global supply chains — from raw materials and capital goods, to more advanced technologies such as semiconductors, solar energy, electric vehicles, and Artificial Intelligence. This development and growth shifted the perception of the asset class over time from a speculative, high-risk allocation to an essential component of a diversified global portfolio. Although EM has graduated to a core allocation, we fear that investors have become too quick in applying a developed market mentality, specifically the utilization of a passive indexing approach. While we understand the attraction of a low-cost, low-risk investment, we believe there is a superior alternative for emerging markets core exposure.

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## Challenges to Index Investing in Emerging Markets

The objective of an index strategy is to produce a portfolio that mimics, as closely as possible, a frictionless benchmark by minimizing tracking or slippage from the index. Two of the primary challenges portfolio managers face when seeking to achieve this objective are index turnover (due to index reconstitution) and the costs associated with trading. In developed markets (DM), the decision to use an index solution has strong merits; the index has relatively low turnover, stocks are liquid, transaction costs are low, and markets are fairly efficient. Conditions are more challenging, however, in emerging markets; index turnover is nearly three times that of DM,<sup>1</sup> trading costs are typically more than double<sup>2</sup> and markets are significantly less efficient.

Thus, while EM investors are enticed by the ever-decreasing costs of EM index funds, they often experience higher tracker error than developed market index funds with the possibility of underperforming the index. For this reason, we strongly believe that emerging markets equities are a fertile asset class for a slightly more active approach that can substitute unintended tracking error with more refined index deviations that deliberately seek to generate positive alpha.

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## An Alternative Solution

Our Systematic Equity Active Team's Emerging Markets Enhanced Strategy offers a portfolio with the look and feel of the index but with the benefits of a sophisticated, bottom-up alpha model or stock selection model. The model utilizes a state-of-the-art infrastructure, collecting and analyzing the latest fundamental, technical, and macroeconomic data available on over 5,000 emerging markets stocks (as of June 30, 2024). When combined with our systematic optimization process, we are able to construct a well-balanced portfolio with a tilt to names with strong fundamentals, improving market sentiment, and attractive valuations (Figure 1).<sup>3</sup>

Figure 1  
**Strategy Characteristics Versus Benchmark**

	Price to Earnings	Price to Cash Flow	Interest Coverage	Dividend Yield	ROE	Latest Quarter % Surprise	Number of Holdings
Emerging Markets Enhanced Strategy	10.77	7.86	-3.04	3.15	16.24	8.91	670
MSCI Emerging Markets Index	12.13	8.61	2.06	2.60	15.25	7.46	1330

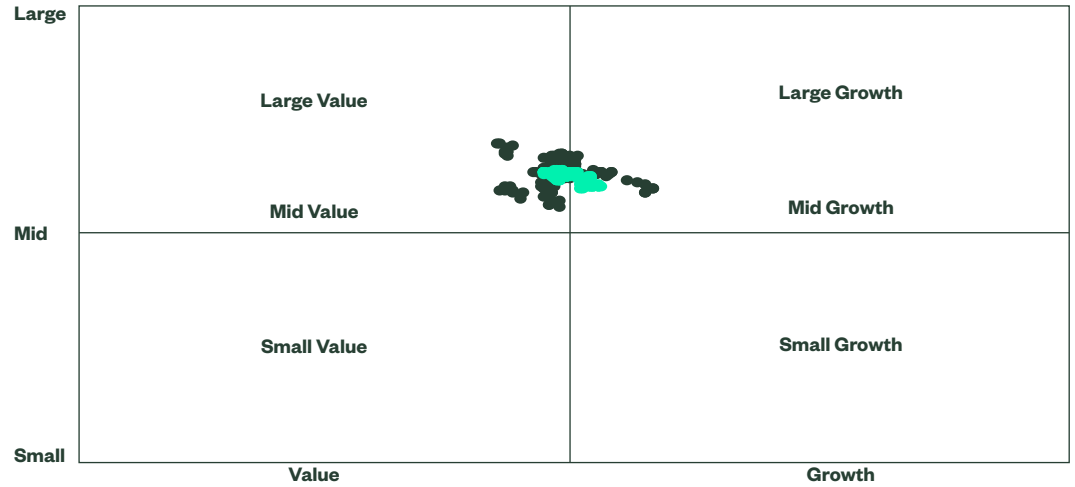
Source: State Street Global Advisors, FactSet, MSCI. As of June 30, 2024.

Index characteristics are as of the date indicated, are subject to change, and should not be relied upon as current thereafter. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Past performance is not a guarantee of future results.

To ensure the portfolio provides core index-like exposure, we allow only small active deviations from the index, diversifying risk across hundreds of securities. The end result is an alpha-seeking strategy that delivers only a slight increase in style drift when compared to a leading Index fund (Figure 2).

Figure 2  
**Style Map Comparison  
 Against Index Fund**

■ State Street Global Advisors  
 Emerging Markets Enhanced  
 Strategy  
 ■ Representative Index Fund

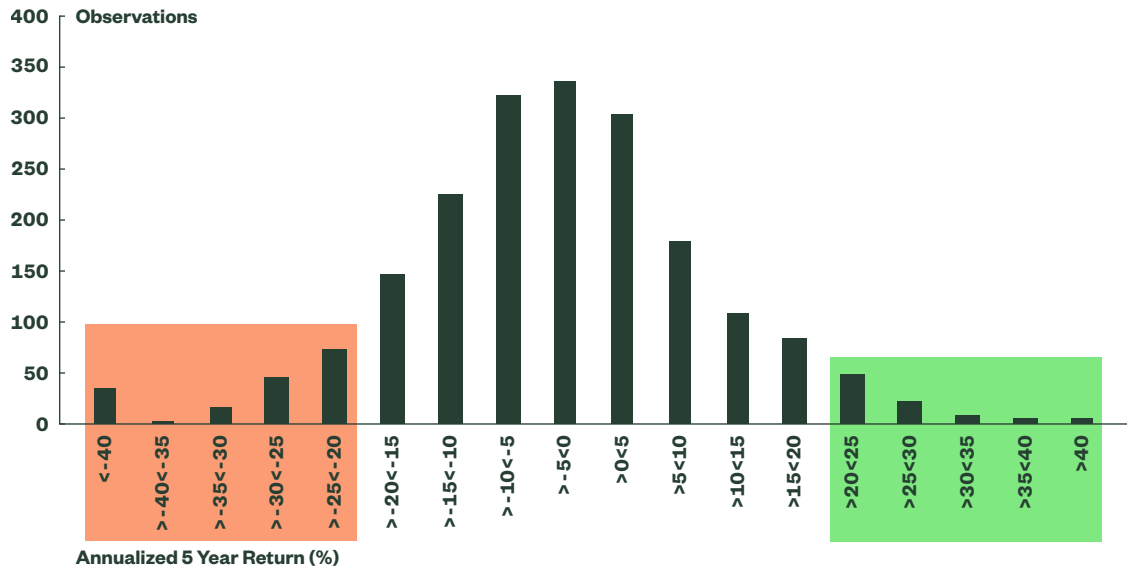


Source eVestment, State Street Global Advisors. As of June 30, 2024. Rolling 36-month Style back to inception of Emerging Markets Enhanced Strategy (July 2007) using MSCI EM Style Universe. Representative Index Fund is BlackRock Emerging Markets Index Fund.

### Consistency is Key

Minimizing dramatic swings from the cap-weighted benchmark is critical for core investors. We look to add incremental alpha that allows the law of compounding returns to work its magic over time. Consistency is the key to this approach, and given the volatile nature of EM, risk control is essential to achieve this desired result, and therefore is a critical component of our process. While all segments of the market are exposed to unknown unknowns — or black swans — EM equities are among the most susceptible. Figure 3 below illustrates the distribution of EM equity returns over the past 5 years. Notice anything?

Figure 3  
**Emerging Markets  
 Equities Exhibit  
 Skewed Returns**



Source: State Street Global Advisors, FactSet, MSCI. As of June 30, 2024. Index characteristics are as of the date indicated, are subject to change, and should not be relied upon as current thereafter. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Past performance is not a guarantee of future results.

Not only does the distribution have ‘fat’ tails, but also negative skew. This is consistent with market inefficiencies that exist within EM, and although they do lead to opportunities for outperformance, the fact there are a greater number of observations on the left hand side implies that concentrated managers run a high risk of holding a negative outlier that can take a long time to recover from. With this in mind, to deliver consistency we must minimize stock-specific risk, and seek to win by not losing.

By applying tight constraints at the security, country and sector level, along with imbedding a risk model within the optimization process, the strategy delivers a highly risk-controlled portfolio of around 700 names, allowing the bottom-up alpha model to drive active stock positions. This helps not only to limit macroeconomic, geopolitical, currency and stock-specific risk, but also to deliver highly consistent returns relative to the benchmark.

Figure 4  
**Rolling 5-Year Batting  
 Average Since Inception**

Outperformed the MSCI Emerging Markets Index in 145 out of 145 Rolling Five-year Periods  
 Since Inception  
 Gross Batting Average: 100%  
 Net Batting Average: 65%



	1 Year	3 Years	5 Years	10 Years	Since Inception
Emerging Markets Enhanced Strategy (Net)	17.72	-3.15	3.98	3.43	2.98
MSCI Emerging Markets Index	12.55	-5.07	3.10	2.79	2.58
<b>Excess</b>	<b>5.17</b>	<b>1.92</b>	<b>0.89</b>	<b>0.63</b>	<b>0.40</b>

As of June 30, 2024. Source: State Street Global Advisors. Past performance is not a reliable indicator of future performance. Returns greater than one year are annualized. Past performance is not a reliable indicator of future performance. Current performance may differ from the performance shown. Returns shown are asset — weighted using Composite member market values, where the Composite member’s return calculations are time-weighted and reflect the reinvestment of dividends and other income. These performance figures are provided both gross and net of fees and expenses but include actual trading fees and expenses, and reflect all items of income, gain, and loss. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income and the reinvestment of dividends (net of withholding tax rates) and other income and are calculated in US dollars. It is not possible to invest directly in an index. Performance returns are calculated in US dollars. Calculation for value added returns may show rounding differences. The above information is considered supplemental to the GIPS presentation for this Composite. A GIPS presentation is available upon request.

## Taking Advantage of the Optimal Segment of the Active Risk Spectrum

Not only does this approach offer consistency, it also allows investors to take advantage of the most fruitful segment of the active risk spectrum where additional alpha can be achieved with the least amount of additional risk, or where Information Ratios (IRs) are typically maximized. No question, investing in emerging markets can be a wild ride — in just the last year we have seen markets impacted by Middle East tensions, an escalation of cross-strait relations between China and Taiwan, and surprise election results in India. It is extremely challenging if not impossible to diversify away these types of systematic risks without avoiding the asset class all together. The most successful investors in these markets are those that are as efficient as possible in their usage of nonsystematic (i.e. diversifiable) risk. The Emerging Markets Enhanced Strategy was designed to maximize return per each unit of risk taken, and this is perhaps best demonstrated via an examination of our *Information Ratio*:

Information Ratio (Efficiency) = Excess Returns/Active Risk (Tracking Error)

Higher IR portfolios are indicative of managers that are most proficient at utilizing risk to generate excess returns. So how does our Emerging Markets Enhanced Strategy stack up on an Information Ratio perspective relative to peers?

Figure 5  
Information Ratio, Excess Return per Unit of Risk

	1 Year	3 Years	5 Years	10 Years
5th Percentile	3.09	1.91	1.11	0.87
25th Percentile	1.80	1.02	0.79	0.58
Median	0.85	0.48	0.43	0.41
75th Percentile	-0.76	-0.40	0.02	0.16
95th Percentile	-2.46	-0.81	-0.49	-0.16
<b>State Street Global Advisors Emerging Markets Enhanced Strategy</b>	<b>4.12</b>	<b>1.66</b>	<b>1.11</b>	<b>1.11</b>
<b>RANK</b>	<b>1</b>	<b>7</b>	<b>5</b>	<b>2</b>

As of June 30, 2024. Source: State Street Global Advisors, eVestments. All figures reflect the full eVestment Global Emerging Markets Large Cap Core Equity Universe. Past performance is not a reliable indicator of future performance. Performance returns for periods of less than one year are not annualized.

Safe to say, very well. We have delivered top-decile Information Ratios across 1-, 3-, 5-, and 10-years by remaining disciplined and resisting the temptation to assume more risk.

Our research clearly indicates that the first incremental risk additions generate the highest returns per unit of risk. As funds take on more risk they encounter diminishing returns (those fat tails again!), and we are quite comfortable living in the sweet spot that the Emerging Markets Enhanced Strategy provides.

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## Evolution

While we take great pride in the success of our Emerging Markets Enhanced Strategy, we are acutely aware that emerging markets are constantly evolving, and to stay ahead, our alpha model must also evolve alongside them. Recent research projects that have been incorporated into the product include applying AI technology to interpret management earnings calls, an analysis on the unique structure of the China A universe and the opportunities it presents, along with a multitude of others. An in-depth review on the State Owned Enterprises has also been completed (as of July 2024) and is in the process of being integrated into the live model.

On the product side we have had great success in evolving the EM Enhanced strategy to meet various offerings. Our disciplined approach and great alpha signal lends itself to portability and scalability, and we are now able to offer investors sustainable versions of the strategy with similar performance track records. More recently, we have also successfully adapted the strategy to customized indices for clients, without sacrificing alpha.

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## The Bottom Line

Over the last three years there has been a growing consensus with investors that the economic growth reacceleration story within EM is appealing. Net flows into EM equities have been positive every year since 2021, but the vast majority of this capital has flowed to passive ETFs. We urge investors to pay attention to index turnover, transaction costs, and fees that are inherent within emerging markets — the efficiency with which developed markets indices are replicated does not necessarily translate to emerging markets. These inefficiencies all too often result in performance drag with costly consequences.

We strongly believe that our disciplined, systematic active process may be a preferable option that has the ability deliver consistent excess returns relative to the index, while providing core index-like exposure at a competitive fee.

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## Endnotes

- 1 MSCI Emerging Markets Index and MSCI World Index turnover as of 05/31/2024.
- 2 Virtu's Financial — EM and Global Peer Universes, rolling 12 month transactions costs market orders as of 12/31/2024.
- 3 Interest Coverage used as proxy for Quality, Price to Earnings and Price to Cash flow as a proxy for Value and Latest Quarter Surprise in EPS as a proxy for Sentiment.

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For four decades, State Street Global Advisors has served the world's governments, institutions, and financial advisors. With a rigorous, risk-aware approach built on research, analysis, and market-tested experience, we build from a breadth of index and active strategies to create cost-effective solutions. As pioneers in index and ETF investing, we are always inventing new ways to invest. As a result, we have become the world's fourth-largest asset manager\* with US \$4.42 trillion<sup>†</sup> under our care.

\* Pensions & Investments Research Center, as of December 31, 2023.

<sup>†</sup> This figure is presented as of June 30, 2024 and includes ETF AUM of \$1,393.92 billion USD of which approximately \$69.35 billion USD is in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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Actively managed funds do not seek to replicate the performance of a specified index.

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