Emerging Market Equities: A Golden Era for Alpha Gen?

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Systematic factors have been shooting the lights out for several years. In this Emerging Market Equities review, we dig a little deeper into what is driving these conditions, and share some thoughts on the risk environment and our views going forward.

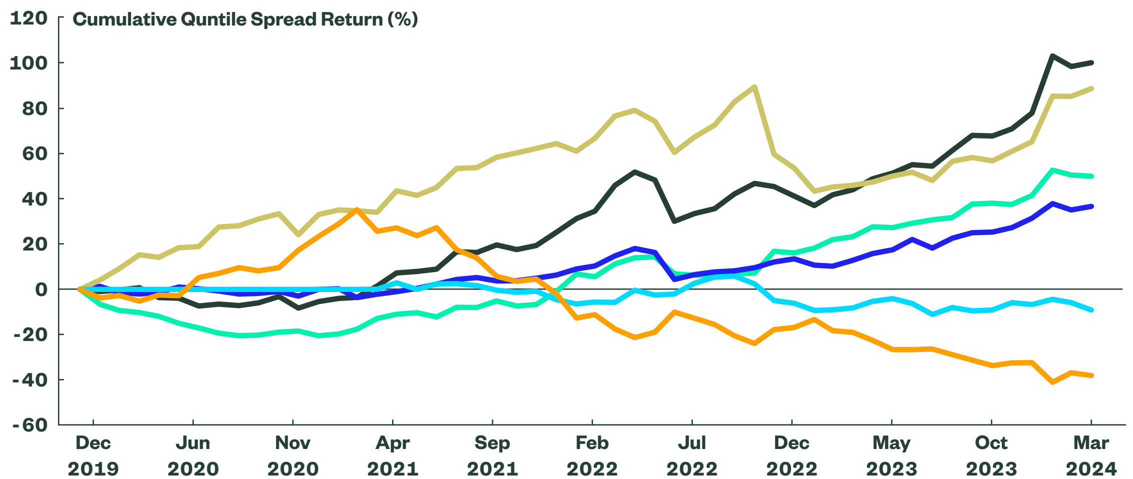
In the second quarter of 2024, the market environment for emerging market equities feels pretty normal overall, despite geopolitical risks and what seems like an eternal tussle between those postulating about inflation, growth, and interest rates. Rather than dwell too much on these prognostications, we want to focus on the dynamics of factor returns and systematic processes more generally.

The idea is straightforward — develop models using data inputs to generate insights and an investment opinion on the broadest universe of stocks possible for the investment manager to apply/act on. The edge we have is robust data that we are able to apply across the entire investment universe, rather than focusing fundamentally on a smaller subset. In short, we are looking to build efficient portfolios that tilt towards value, quality, and positive sentiment. Risk controls are embedded to prevent truly extreme situations.

If we look at the specifics in the first quarter and over the last year, we saw a nearly 15% and 40% spread return, respectively, from our alpha model.[1] This is one of the strongest stretches we have experienced in our seasoned history of managing emerging market equities — albeit not the only one — and really a continuation of strong alpha performance since the Covid crisis began to abate. 2020 was certainly a volatile period as we went through this tectonic shift in the global economic environment. Everyone was hit with a shock simultaneously and with an intense abruptness reminiscent of the Global Financial Crisis period in 2008. This period was often referred to as the “quant winter,” as the violent swings kept systematic strategies from gaining much traction.

But it is always darkest before dawn: this volatile period led to a remarkably favorable environment for our approach. The risk and growth environment has generally been benign — changes have mostly been slow moving, allowing factors to generate substantial traction. The geopolitical events are serious but, thus far, have remained regional with less impact on the major economic engines. Investors without convictions on the direction of the fundamentals have been following the price trends to make their decisions. Consensus trades, where they exist, have largely stayed in place or shifted slowly. In short, life in emerging market equities has been rather ...boring. And quant models have been loving this 'boring' (see Figure 1).

Figure 1
Emerging Markets Factor Payoffs Have Been 'Golden' Over the Last Several Years



Source: State Street Global Advisors, as of March 31, 2024. Factor returns represent the returns of our model and its components of the factors from high to low, rebalanced monthly, which have been grouped methodically based on their factor exposure. The performance assumes no transaction and re-balancing costs, so actual results will differ. Past performance is not a reliable indicator of future performance.

All the factors have been working nicely, with few exceptions. And the core pillars — of Sentiment, Value, and Quality — have been performing well Although we would love for this to be the case all the time, the truth is, it doesn't always play out so nicely. Certainly we have seen this dynamic before, but the fact it has persisted for three consecutive years is what has gotten investors attention.

Isn't This Mostly Price Sentiment — aka the 'Riskiest' of Factors?

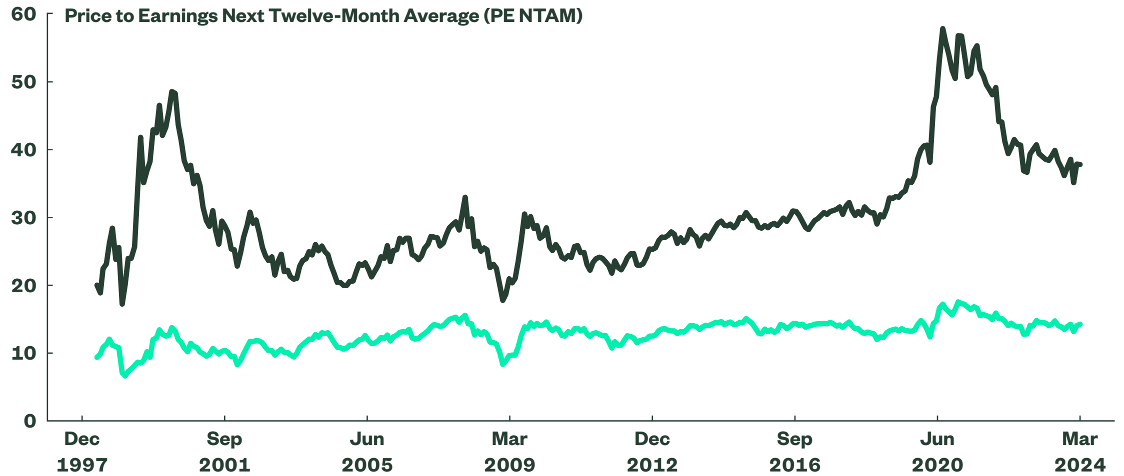
During the peaks of the Covid pandemic, sentiment — which was largely correlated with growth — was (with the exception of high risk) the only factor that gained traction. However, sentiment is not monolithic. It is often correlated with growth, but its correlation has shifted over time — first to cyclical factors, then value, then low risk, and now we are seeing divergence within each country. The relatively slower evolution of market themes has meant that we have not seen too much volatility in the payoff from sentiment positioning. Nonetheless, value has been showing solid — and very steady — positive returns since the fourth quarter of 2020. And this is where we believe we will continue to have some tailwinds. The valuation spreads remain wide, especially so in emerging market small caps.

Value — The Golden Goose That Can Still Provide

When asked about why we would expect some tailwinds to our approach, instinctively we go to value. Value has been working reasonably nicely, but in our definition of the opportunity set (the value spreads) — we have much more support. The value spread has compressed in emerging markets large cap (EMLC), but remains extraordinarily wide in emerging markets small cap (EMSC). In EMSC, the spread has stayed wide for the worst possible reasons — earnings cuts for the most expensive names (see Figure 2).

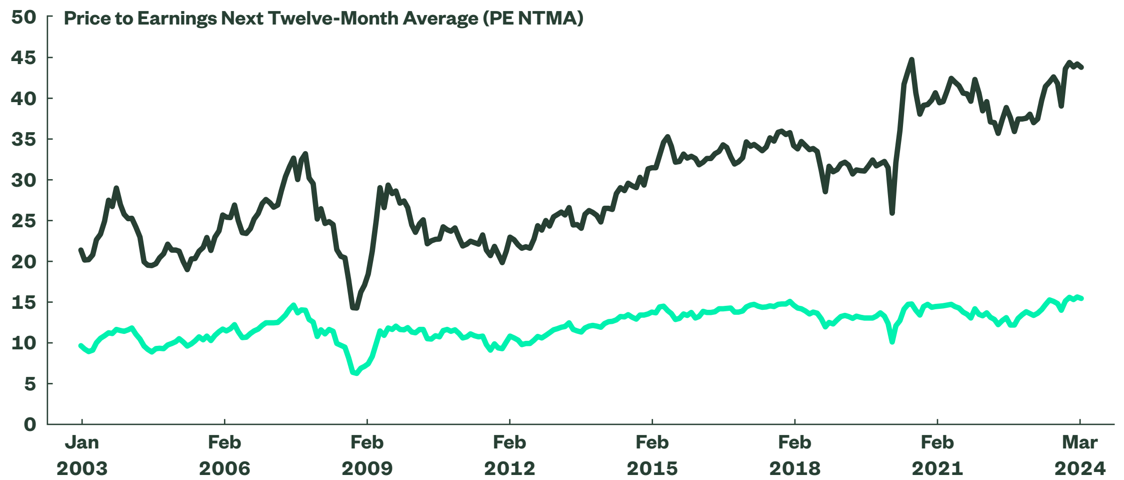
Despite Value Working in EM, the Most Expensive Stocks Are Still Expensive

Figure 2a
Emerging Markets Large Cap Valuation



Source: State Street Global Advisors, as of March 31, 2024. Shows the valuation of the value factors, equal weighted.

Figure 2b
Emerging Markets Small Cap Valuation



Source: State Street Global Advisors, as of March 31, 2024. Shows the valuation of the value factors, equal weighted.

Value is generally supported by higher rates and, in an important note, our Global Head of Active Quant Equity Portfolio Strategy, Kishore Karunakaran, has shown that in periods of debt consolidation, generalized quant factors can have long and positive returns. We may well be entering into one of those periods when debt levels (as a percentage of GDP) have gotten very high in a number of large economies.

How do Risk Models Work in This Golden Era?

Risk models do what they are told to do. From our perspective, risk modelling is multidimensional. We like to think of risk models as "belt and suspenders," in that we use both formal risk models and portfolio construction to keep our alpha models in check. For example, we would normally expect to capture about 15–20% of the quintile spread. In effect, this is what has been happening. The large excess returns have been driven by the strong performance of the alpha — and they have been curtailed by the risk models — as we should expect.

Risk models are effective tools, but they are not magic. When they work, they keep investors from experiencing extremes — both on the positive and the negative side.

What Risks Are Still Out There?

Based upon our analysis, high periods of excess return do not, by themselves, lead to a painful "mean reversion." In fact, periods of high outperformance generally revert to more normal returns. The caveat being, there is always a chance of large-scale quantum shifts, where a portfolio that is underweight to expensive and risky stocks gets penalized. These environments can be tricky. The main risk we see at the moment is a major change in policy course in China to socialize the debt overhang problems. This would cause a major reversal in portfolio flows — particularly in Asia — as investors look to make a punt into more speculative stocks in China. Other risks would involve a major conflict in Taiwan or South Korea that heavily stretches the US government to respond. Our belief is that these risks remain less likely, but we are monitoring the situation carefully.

The Bottom Line

We would remind clients it is often **after** these quantum shifts occur that is the best time to invest in factor-based strategies. Buy when no one else wants to invest. Always understand the risks, but stick with the winners. We continue see an environment that remains supportive, but expect more normal returns going forward.

The overall recommendation is to stay neutral in emerging market equities, but favor small caps over large.

Emerging Markets: Value Is Clear, Performance Catalysts Are Less So
While the conditions outlined above have been favorable for alpha generation, investors remain tepid in their macroeconomic outlook for Emerging Markets. The 'higher for longer' environment is not ideal for the cyclical nature of the asset class, and concerns persist surrounding China's economic slowdown and housing downturn, as well as the economic impact of Eastern European and Middle East tensions.

That said, we see reasons for optimism in the form of a sizable valuation discount relative to developed markets, and favorable growth dynamics on both the macro (GDP — beyond just China) and micro (i.e. earnings) side. Emerging market small-cap equities in particular can present an attractive mix of beta and alpha opportunities. From a positioning perspective, we continue to favor Taiwan and South Korea, which offer an attractive blend of value and sentiment, and where our quality factor has been effective in identifying the real winners.

Endnote

1 State Street Global Advisors, FactSet, MSCI. As of March 31, 2024. Reflecting proprietary SEA (Systematic Equity — Active) Alpha Factors. Factor returns are calculated using the difference between top and bottom ranked quintile returns. Quintile returns are equal weighted stock returns and are calculated monthly.

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* Pensions & Investments Research Center, as of December 31, 2022.
† This figure is presented as of March 31, 2024 and includes ETF AUM of $1,360.89 billion USD of which approximately $65.87 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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