
The Evolving Opportunity in Emerging Markets Equities

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Executive Summary

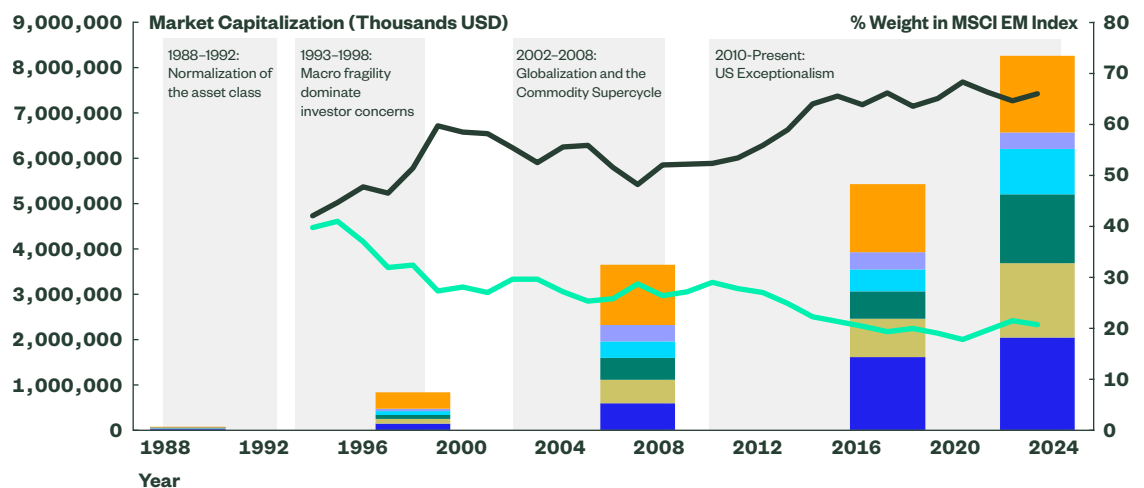
The investment case for Emerging Market (EM) equities remains strong. In this paper, we explore the evolution of EM equities over the last 30 years, the current opportunity set available to investors, and the spectrum of Systematic Equity solutions that State Street Global Advisors can provide to clients across a range of objectives and risk tolerances.

Evolution of the EM Equity Opportunity Set

The investable opportunity set in Emerging Markets has changed dramatically in a 30-year period, as economic growth has translated into increased breadth, depth, and maturity in the EM capital markets.

- When the MSCI Emerging Market (EM) Index was first introduced in 1988, it represented 10 **countries**, each roughly characterized as “underdeveloped, but growing rapidly.” By the end of 2023, there were 24 economies reflected in the Index.
- In **regional** terms, Asian firms made up nearly 46% of the EM Index at inception. In 2024, that number has jumped to over three-quarters of the Index, with China alone at over 25%.¹
- At a **sector** level, the EM Index is much more diversified. The tilt has shifted from production to consumption, with the financial, technology, consumer discretionary, and communications sectors displacing, to some extent, materials, staples, and industrials.
- Finally, in terms of **market cap**, mega- and large-cap stocks² now make up over half of the EM Index versus less than 20% twenty years ago.

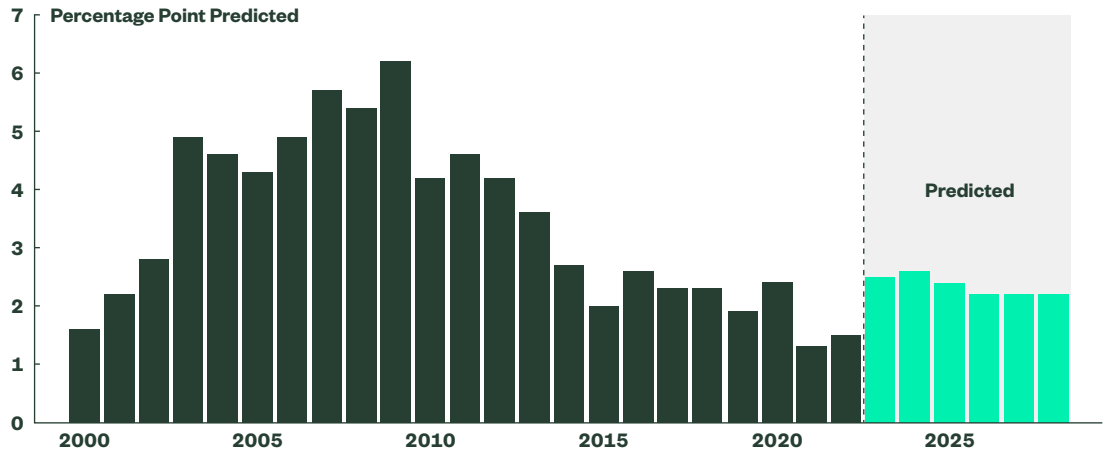
Figure 1
Growth and Evolution of the Emerging Markets Equity Opportunity Set



Source: MSCI, FactSet, State Street Global Advisors. As of 09/30/2024 in USD.

Even as the composition and characteristics of EM change, we believe one thing remains consistent: **EM equities continue to offer investors the opportunity to add value to their portfolios. One of the biggest draws to EM for investors has been the potential for higher growth.** EM economies have consistently demonstrated higher gross domestic product (GDP) growth than their developed counterparts, and this differential is expected to grow back to the pre-COVID baseline, as we show in Figure 2.

Figure 2
EM Offers Access to Higher Growth

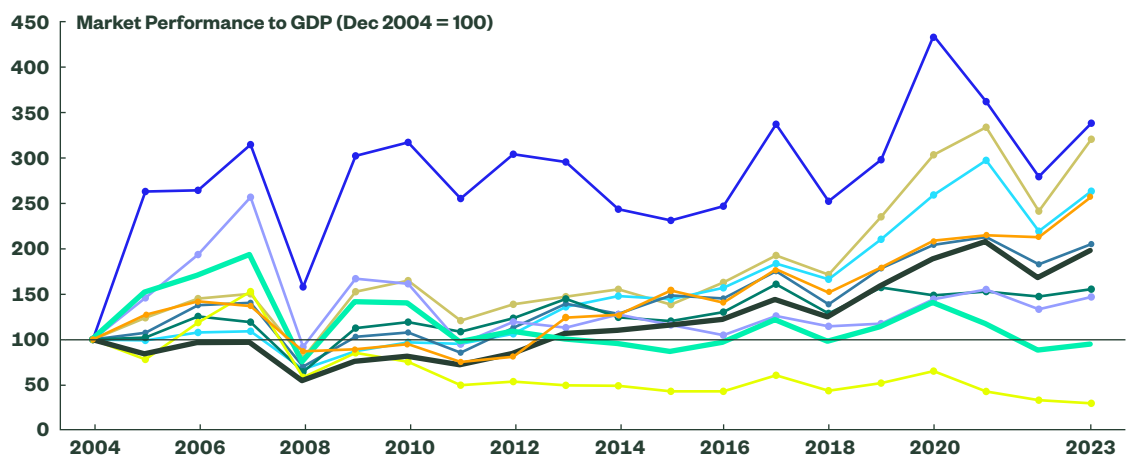


Source: IMF World Economic Outlook, State Street Global Advisors calculations, as of January 2024.

Indexing is Effective, but Consider an Active Approach

However, the EM growth advantage hasn't led to superior index returns, as we show in Figure 3. Why? The short answer is that economic growth hasn't always translated into strong corporate profits that can drive index returns, as often happens in developed markets. What's more, there's a growing divergence between country/regional GDP and equity market growth. For example, Taiwanese and Korean markets have effectively turned their economic growth advantage into equity performance, while the Chinese equity index has lagged the major developed and emerging equity markets despite significant economic growth.

Figure 3
High GDP Growth Does Not Always Equal Superior Index Performance in Emerging Markets



Source: FactSet, IMF, State Street Global Advisors calculations, as of Dec 31, 2023. Equity performance is measured using total returns in USD for the respective MSCI country/region standard indices. GDP is measured in current dollar terms. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income as applicable.

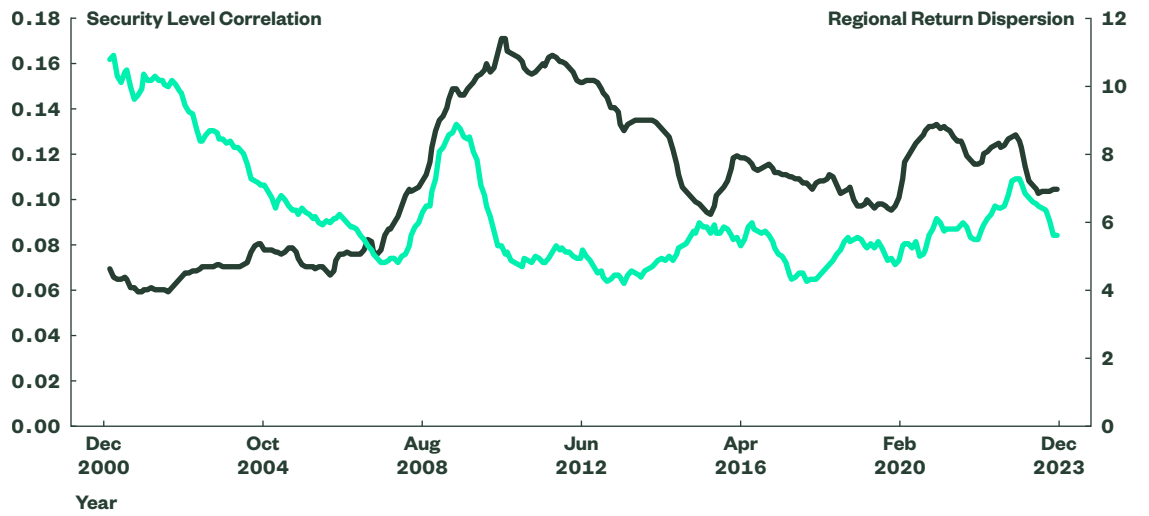
Given this disconnect between GDP growth and equity returns, there is ample opportunity for those investors looking to generate alpha in EM, but the asset class may be better suited for a security selection approach rather than country selection.

- **EM markets are less efficient** — that is, asset prices do not reflect their true value. Part of the reason for this inefficiency is information asymmetry, when the amount of public knowledge about a stock or economy is significantly less than in developed markets. This scenario offers skilled active managers scope to uncover alpha opportunities.
- **Country bets don't work like they use to.** Once the prevalent approach in EM investment, country return dispersion has declined significantly (Figure 4).

- In contrast to this dwindling top-down dispersion, **stock-level correlation in emerging markets has been declining** from its post-GFC peak, after having picked up during the pandemic (see Figure 7).
- The implication is a **preference for bottom-up portfolio construction versus top-down country rotation**.

Figure 4
Declining Country-level Return Dispersion and Stock-level Correlation

■ Security Level Correlation
 ■ Country Return Dispersion



Cross Sectional Dispersion — Source: MSCI Emerging Markets data, January 2000–December 2023 (Monthly), Gross Return in US Dollars. Cross-sectional dispersion for a month is calculated as the standard deviation across all MSCI EM country monthly returns for that month. Pairwise Correlations — Source: FactSet, State Street Global Advisors calculations, as of December 31, 2023.

EM Small Cap Opportunities

Within the asset class, EM small caps offer a potentially larger alpha opportunity without the concentration risk inherent in the standard EM Index. As we have pointed out, active equity management builds on the foundation of market inefficiency. An analysis of factor spreads confirms that over the last 20 years, the investment themes that have prevailed in DM have worked in EM, and in fact, comparing DM and EM factor spreads suggests that **EM are relatively less efficient**. In general, **inefficiencies in EM create a higher potential for outperformance in active management**.

Figure 5
Small Cap Quintile
Returns

EM Small Cap (Dec 03–Nov 23)	Low Vol (%)	Value (%)	Quality (%)	Momentum (%)
Q1	11.5	15.4	11.8	15.9
Q2	11.5	9.1	9.1	12.4
Q3	10.3	8.9	7.4	8.2
Q4	8.0	8.0	8.0	4.3
Q5	0.4	1.2	5.4	1.4
EM SC Quintile Spread	11.1	14.1	6.4	14.6
DM SC Quintile Spread	7.5	8.6	2.4	9.0
EM Quintile Spread	6.3	6.2	4.0	7.3
DM Quintile Spread	3.0	1.9	3.4	4.2

Source: FactSet, State Street Global Advisors. Time period from December 2003 to November 2023. Quintile Returns to Smart Beta Factors for MSCI EM Small Cap Index are shown along with a quintile spread comparison across the universes. Factor returns represent the returns of components of the emerging market equity universe (at their cap-weight) 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. Index returns reflect all items of income, gain and loss and the reinvestment of dividends. Performance of an index is not indicative of the performance of any product managed by State Street Global Advisors.

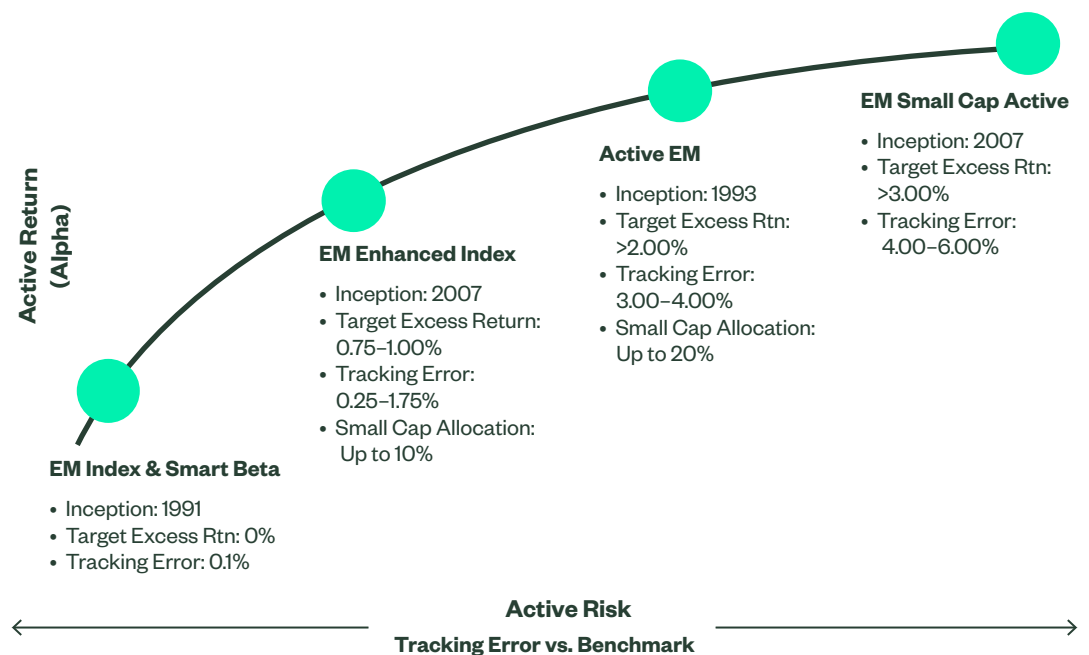
We can see that factor return spreads — already greater in emerging markets than in developed markets — are even wider among EM small-cap firms. This suggests that EM small caps may present a particularly ripe opportunity for active management to drive outperformance, with the caveat that as we move down the capitalization spectrum, these theoretical factor returns can be harder to capture in practice.

Our Capabilities

State Street Global Advisors provides clients with a spectrum of Systematic EM Equity solutions, supported by our:

- Scale
- Infrastructure
- Expertise

Figure 6
Systematic EM Equity Continuum



Source: State Street Global Advisors, as of September 30, 2024.

We have 30+ years of EM Equity investment expertise and as of September 30, 2024, manage **over \$140B in Emerging Markets Equity AUM**. Our multi-decade expertise began with the launch of our EM Index Strategy in 1991, followed shortly thereafter by our Systematic EM Core Equity strategy in 1993.

In support of myriad client risk tolerances and return objectives, our Systematic Equity investment platform has produced a spectrum of solutions to help clients take advantage of the opportunity set in Emerging Markets. In addition, for those clients looking for more customized exposures to Emerging Markets, we offer single country, commingled index exposures to each

constituent country within the EM Equity universe that can be allocated in any proportion desired by our clients. (See the Appendix for a full list.) As of September 30, 2024, our Systematic Equity Portfolio Management team has over 70 Portfolio Managers globally and 25 Researchers, with an average of 20+ years of experience.

We take a pragmatic approach to managing indexed equity portfolios, with an unrelenting focus on efficiency and wealth preservation, by marrying technological innovation with human expertise. To illustrate the point, our proprietary portfolio management system, Cortex, was designed in-house to support our portfolio managers in minimizing implementation frictions, to help build the portfolio in the most cost-efficient manner possible, and to support portfolio manager decisions around optimal cash allocation, rebalancing, and trading strategy. Our investments in people and infrastructure have allowed us to develop the scale and expertise to provide clients with the tightest tracking strategies available on the market today.

Our Active Emerging Markets suite offers balanced and diversified portfolios to investors who seek to generate additional returns over and above the cap-weighted index. We provide solutions across both the market cap and risk appetite spectrums, delivering a core portfolio with the look and feel of the index. Alpha generation is achieved through the systematic implementation of our multi-factor stock selection model or alpha model. Innovation is at our core: over the three-plus decades of managing systematic active strategies, the alpha model has constantly been improved through a rigorous research process with an intentional pace of innovation, capturing our best ideas with the goal of staying one step ahead.

Through the systematic implementation of the model we are able to carefully construct well balanced portfolios that gain exposure to our alpha signals, while minimizing unrewarded exogenous and idiosyncratic risk. By remaining diversified and balanced, we apply a “win by not losing” approach — critical in less-efficient markets like EM – to achieve consistent outcomes for our clients.

Our tenured history managing systematic active strategies in emerging markets gives us the invaluable edge of both experience and insights gained over numerous market events and business cycles.

Furthermore, our trading desk is one of the largest and most experienced in the world.

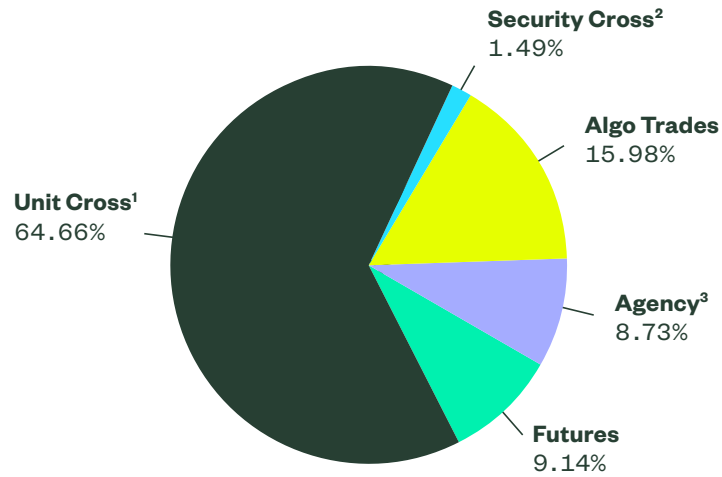
We have three global trading desks which executed \$31B in Emerging Markets Equity trades in 2023 with over 260,000 tickets and 28% lower average commissions relative wto similar-sized peers.

Within our passive suite, we are able to reduce even further our trading costs by employing our proprietary internal cross-trading process. This enables our trading team to benefit from the scale of the organization and utilize internal liquidity to limit the amount of order flow that needs to be traded on the open market. In 2023, less than a quarter of our EM Equity order flow was ever traded on the open market, saving clients an estimated 17bps trading costs per year.

Figure 7
**EM Cash Flows Traded
 at Low or Zero
 Cost — Passive**

Total Order Flows
 2021-2023 \$52.60B

75% of the MSCI EM Index
 Strategy's CashFlows
 Traded at **Low or
 Zero Cost***



Source: State Street Global Advisors. *For the three most recent calendar years as of 2021-2023. Data based on the weighted average results (by order volume) of one or more of State Street Global Advisors' co-mingled funds participating in crossing activities. The figures above relate to the Total Order Flow, which represents investor-initiated contributions and redemptions into and out of participating funds. There is no guarantee that a particular client transaction will experience the same level of low-cost trading. Low-cost trading percentages are calculated by subtracting agency trades from total trades and then dividing by total trades. Availability of internal crossing may be affected by asset class, vehicle type, jurisdiction, or other factors.¹ Unit crosses are transactions where client contributions/redemptions in a participating fund are matched with offsetting client contributions/redemptions in the same fund.² Security crosses are equity transactions for one State Street Global Advisors managed fund that are matched, where possible, with offsetting equity transactions from other State Street Global Advisors managed funds.³ Agency refers to State Street Global Advisors trading in the market with a program desk (non-Algo). Figures in USD.

The Bottom Line

The EM Equity asset class has evolved significantly over the last 20+ years, with dramatic rotations in country and sector leadership as well as marked increases in liquidity and decreases in trading costs and currency volatility.

Appendix

State Street Global Advisors offers a spectrum of Systematic Equity solutions for EM Equity investors, including high-beta, low-tracking index strategies; enhanced index and defensive; core active and small-cap active; full market exposure, and ex-China solutions.

	Investment Universe	Strategy	Inception Date	AUM
Active Equity	Active Equity Strategies			(in millions)
	MSCI Emerging Markets Index	Enhanced Emerging Markets	2007	4,734
	MSCI Emerging Markets Index	Emerging Markets Active	1993	91
	MSCI Emerging Markets Small Cap	EM Active Small Cap	2007	1,725
Index Equity	Market Index Strategies			(in millions)
	MSCI Emerging Markets Index	MSCI Emerging Markets*	1997	44,001
	MSCI Emerging Markets Ex-China	MSCI Emerging Markets Ex-China	2020	1,251
	MSCI Emerging Markets Small Cap	MSCI Emerging Markets Small Cap	2008	871
	MSCI Emerging Markets Paris Aligned Index	MSCI Emerging Markets Paris Aligned Strategy	2023	137
	MSCI Emerging Markets Ex Fossil Fuels	MSCI Ex-Fossil Fuels Emerging Markets	2016	291
	S&P Emerging Markets Index	S&P Emerging Markets	2007	10,129
	S&P Emerging Markets Ex-China	S&P Ex-China Emerging Markets	2024	5
	S&P Small Cap Emerging Markets	S&P Small Cap Emerging Markets	2008	781
	S&P Emerging Markets APAC BMI	S&P APAC Emerging Markets	2007	346
	MSCI Emerging Markets Strategic Factors	MSCI Emerging Markets Strategic Factors	2014	49
	S&P Emerging Markets BMI	S&P Dividend Emerging Markets	2011	499

* As of October 21, 2024. All 24 MSCI Single Country EM Indexes available as standalone Country Index Strategies.



John Tucker, CFA
CIO, Systematic Equity

CIO, Systematic Equity	Exp Yrs
John Tucker, CFA	35

Team Highlights

Established	1984
Investment Team Members	37
Average Experience Years	16
Average Tenure at State Street	10
Number of CFA Charterholders	13
Number of PhDs	8

Research	Exp Yrs
Alejandro Gaba*	19

Portfolio Strategy	Exp Yrs
Kishore Karunakaran*	26

Portfolio Management	Exp Yrs
Toby Warburton, PhD, CFA*	27

Data and Analytics	Exp Yrs
Minkyu Kim, PhD*	16

Source: As of date December 31, 2023.

* Members of the State Street Systematic Equity Active leadership team. CFA is a trademark of the CFA institute.

Endnotes

- 1 Source: MSCI as of September 30, 2024. MSCI Emerging Markets Index.
- 2 Here, mega-cap refers to stocks with a free-float market capitalization above USD 200 billion, while large-cap refers to stocks with a free-float market capitalization between USD 10 billion and USD 200 billion.

About State Street Global Advisors

For over 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, and 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 \$4.73 trillion[†] under our care.

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

[†]This figure is presented as of September 30, 2024 and includes ETF AUM of \$1,515.67 billion USD of which approximately \$82.59 billion USD 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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