

Emerging Markets Equities: Think Big, Go Smaller

Nathalie Wallace, a senior portfolio manager on Batterymarch's Emerging Markets team, points to overlooked growth opportunities among smaller emerging markets stocks.

The investment potential in emerging markets has become a familiar story, thanks to attractive fundamentals at both the sovereign and stock levels. During 2010, as risk aversion eased, investors poured nearly US \$100 billion dollars into the emerging equity markets. Although flows have recently been rotating back to developed markets, we believe that the growth trajectory for emerging markets will remain intact over time—and that these markets will continue to provide outstanding opportunities for investors with a longer-term perspective.

For most emerging markets investors, the focus has traditionally been on larger, better-known companies. Consequently, one of the most promising areas in emerging markets—small to mid-size stocks—remains overlooked.

Smaller companies often bounce back quicker during an economic upturn. This has held true in emerging markets, where smaller stocks outperformed other asset classes following the market trough in 2009 and continue to offer superior growth prospects. Small and midcap companies, which tend to be closely tied to the local economy, can give investors a more direct route to emerging markets growth than large caps. In addition, this segment of the market still faces inefficiencies that can reward accomplished stock-pickers.

Better Access to Emerging Markets Growth

Growth in emerging markets has historically been driven by large exporters and commodities producers doing business in the global economy. However, this balance has been shifting as a result of the economic progress in emerging markets over the past decade.

During the second half of the 1990s, as the US economy outperformed those of the developing countries, smaller stocks in emerging markets lagged larger, export-oriented securities. Since then, sustainable structural improvements in the emerging economies, such as fiscal and monetary disciplines, have been instrumental in the development of local demand as well as more private and public investment.

Government and corporate debt-to-GDP ratios in many of these countries have decreased over the past 10 years, and consumer leverage remains low on average relative to international standards. With fiscal trends generally moving in the right direction, personal and corporate tax rates have been falling and are expected to drop even further, supporting higher domestic consumption and investment over the next three to five years.

Rising consumption, coupled with the demands of massive infrastructure development, have been responsible for an increasing level of growth from within. Although some large cap companies are involved in infrastructure-related activities—construction, for example—it is generally smaller companies that are best positioned to benefit from the growth in domestic-driven areas.

This is reflected in the make-up of the emerging markets benchmarks. The large cap MSCI Emerging Markets Standard Index is heavily weighted toward energy, materials and financials. The largest companies in the benchmark—multinationals such as Samsung Electronics and energy giant Petrobras, for instance—derive a significant portion of their revenues away from home. Meanwhile, the smaller cap MSCI Emerging Markets Small-MidCap Index is broadly diversified across faster-growing, locally based sectors such as industrials, real estate, consumer durables, retailing and health care. Smaller stocks also offer greater exposure to the Asian economies that represent a substantial portion of emerging markets growth, based on factors such as population size and infrastructure requirements.

Valuations support the superior growth story for emerging small to midcap stocks, whose two-year EPS growth statistic is 23.5% as of February 25, 2011, much higher than the 18.8% figure for emerging large caps. Smaller cap growth also comes at a lower price, with price-to-book ratios for the MSCI EM Small-MidCap lower than those of the MSCI EM Standard indices.

More Opportunities

Incorporating small to midcap securities in an emerging markets allocation can allow long-term investors to participate more fully in the world's fastest-growing economies.

Smaller stocks significantly expand the opportunity set for emerging markets investors. Today there are nearly triple the number of securities in the MSCI EM Small-MidCap Index versus the MSCI EM Standard, and the number of listed securities keeps climbing. Emerging markets dominated developed countries in the number of stock IPOs in 2010, including hundreds of smaller cap issuances, and this trend is expected to continue in the coming three to five years.

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