Introduction to Investing In Emerging Markets Special Issue

Frank J. Fabozzi

INTRODUCTION

This special issue is dedicated to investing in emerging markets. There are 14 articles contributed by six practitioner teams, five academic teams, and three teams comprised of both practitioners and academics.

While the expectation of investors in emerging markets equities is that higher rates of gross domestic product (GDP) growth that is typical of developing economies will translate to better stock market returns, this has not been the case historically. In predicting country-level stock return, empirical evidence reported in several studies of both emerging and developed markets fail to find the hypothesized role of GDP growth. Using data from 15 emerging and 21 developed equity markets over samples ranging from 32 to 120 years, Jason Hsu, Jay Ritter, Phillip Wool, and Yanxiang Zhao confirm the failure of GDP growth as a cross-sectional predictor of returns in their article “What Matters More for Emerging Markets Investors: Economic Growth or EPS Growth?” They find investors are concerned with the growth in the earnings per share (EPS) and dividends per share (DPS) of a listed company, not in the overall growth of economic output of the country where the company is located. Unlike changes in GDP, the authors also confirm that EPS and DPS growth exhibit a strong positive correlation with country-level equity returns. Consequently, for investors in emerging equity markets, in making allocation decisions the focus should be on company EPS and DPS growth, not GDP growth. A surprising finding reported by the authors is that most emerging economies, despite their high GDP growth rate, have low EPS and DPS growth rates. This finding suggests that listed companies may not be representative of the underlying economy.

This special issue is devoted to investing in emerging markets. But how does one define an emerging market? There are several definitions. A prominent one is the MSCI Emerging Market Equity Index, which includes countries that vary greatly in terms of their size, wealth, population, geographical location, and industrial mix. China’s rapid economic growth, as well as its equity market, presents a further challenge that disrupts the standard definition of an emerging market, particularly for market capitalization-based indexes and benchmarks. In “Rethinking Emerging Markets: A Fresh Perspective,” Gerald Garvey and Ananth Madhavan argue that recent advances in machine learning, particularly unsupervised learning algorithms, can be used to provide an objective grouping of country stock and bond markets across...
both developed markets and emerging markets based on similarity of returns. Using unsupervised learning, The authors find that emerging markets contain two distinct groups reflecting Asian manufacturing and commodity exposure. This heterogeneity they argue provides diversification to portfolio managers pursing an indexing strategy and opportunities for return enhancement for portfolio managers pursuing an active strategy. They also report that China is on the edge between the two groups. This is in line with China being a key manufacturer and a major driver of commodities. The authors argue that the current classification of emerging markets should be retained but China should be treated as a separate entity.

According to Josh Davis, Grace (Tiantian) Qiu, German Ramirez, Helen Guo, Ding Li, and Zhihui Yap, the strategic asset allocations of investors seldom include emerging markets. In their article, “Emerging Market Investing: A Multi-Asset, Granular, and Dynamic Portfolio Approach,” they argue that much of this skepticism about emerging market allocations is attributable to a period of weak returns that were exacerbated by the suboptimal construction of the traditional market-capitalization benchmarks. The concentration of risk in single countries that characterize traditional market capitalization indexes is inconsistent across asset classes, failing to reflect the fundamentals of the underlying economies. For that reason, an asset allocation framework comprised of the following two modules is proposed by the authors. The first is a portfolio with balanced risk targeted across regions, countries, and asset classes and the second introduces tilts based on expected returns within a tracking error budget. The purpose of the first module is to geographically balancing risk. By doing so, the portfolio is less vulnerable to the idiosyncratic shocks that are prevalent in emerging markets. The benefit of incorporating expected return assumptions is demonstrated by the authors via systematic value- and carry-based tilting.

Numerous studies have reported that momentum strategies generate significantly positive returns in the US market across asset classes and time periods. In “Momentum and Downside Risk in Emerging Markets” Yigit Attilgan, K. Ozgur Demirtas, A. Doruk Gunaydin, and Imra Kirli examine the momentum effect in a sample of emerging markets and find that a zero-cost strategy that purchases past winners and sells past losers generates significantly positive returns for a large majority of emerging equity markets. Moreover, this momentum strategy outperforms local market indexes in terms of mean returns, Sharpe ratios, and alphas. However, these momentum strategy returns do have a downside—the returns are negatively skewed and negatively exposed to the market. This finding is consistent with crash behavior that has been documented in the literature. Even after calculating performance measures that scale mean returns by various downside risk metrics, they find that the momentum strategy continues to outperform local market indexes even after this adjustment.

Among the various sources of risk, macroeconomic shocks have been found to be the most relevant. Shocks for emerging markets that are integrated into the global economy can originate domestically or internationally. While investors can diversify away domestic shocks by holding assets in several countries, global external shocks are nondiversifiable and are likely to remain one of the main sources of risk. Adrien Alvero and Dalibor Eterovic in their article “Emerging Markets Currency Factors and US High-Frequency Macroeconomic Shocks,” study the impact of macroeconomic shocks on emerging markets currency returns. They do so by establishing the important influence of high-frequency macroeconomic shocks derived from US asset prices on portfolios of long-only and long-short emerging market currencies. The authors identify using an econometric model four shocks to the US economy based on the US Treasury yield curve and the stock market—two fundamental news shocks (growth and money) and two risk-premium shocks (common and hedging). They find that these shocks explain over 40% of the time-series variation of emerging market currency returns, and that growth and common shocks are priced in the cross-section of emerging market currency returns. They also find that a combination of carry and
macro momentum long–short portfolios generate positive and significant alphas and excess returns for their sample, without exposure to any of the macroeconomic shocks. However, all single-factor portfolios have sizable exposure to the four shocks. The authors show that a simple multifactor approach to investing in emerging market currencies eliminates the exposure of excess returns to all macroeconomic shocks.

In constructing emerging market portfolios, analysts’ forecasts, revisions, agreement among forecast revisions, and composite models of stock selection variables in a robust regression model can be used. John B. Guerard, Jr., Robert A. Gillam, and Bijan Beheshti address stock selection modeling and portfolio selection and their implementation in emerging markets in their article “Stock Selection Modeling and Portfolio Selection in Emerging Markets.” Viewing investing in emerging markets as a special case of global investing, they demonstrate how stock-selection models in emerging markets with price momentum and forecasted earnings acceleration factors can be used to enhance returns. They construct index-enhanced portfolios for emerging markets and find superior return-to-risk ratios relative to domestic portfolios can be obtained. Guerard, Gillam, and Beheshti report that based on back testing and in real-time performance, an emerging market portfolio constructed using forecasted earnings and price momentum anomalies can be developed, estimated, and implemented to generate statistically significant excess returns.

The legal and institutional environments in most emerging market countries can be fairly characterized as weak. As a result, there are low levels of predictability and legal certainty. Furthermore, the insolvency framework of most emerging markets can be fairly viewed as being very inefficient, resulting in low recovery rates for creditors. This adds an additional risk for creditors who are contemplating extending credit to companies in emerging markets. How lenders can navigate some of these risks is the subject of “Navigating Insolvency Risks in Emerging Markets” by Aurelio Gurrea-Martinez and Elena L. Daly. Various strategies to mitigate insolvency risks in emerging economies are discussed. For example, the authors note that because of the inefficiency and lack of predictability of insolvency proceedings in emerging markets, when an insolvent debtor company that is operating in an emerging economy is a viable firm, an out-of-court restructuring will generally be a preferred option.

Emerging market debt has undergone a structural evolution over the last 30 years to cover more than 70 countries. As a consequence, this asset class is likely to be misunderstood. In “Evolution of Emerging Markets Debt Investing,” Chialiang Lian argues that for strategic investors, this misunderstanding represents an opportunity to enhance returns by investing in emerging market debt rather than a reason to shy away from this asset class. Over the last three decades, the investment proposition according to the author has evolved dynamically from “what to buy” in the 1990s, to “why invest” in the 2000s, to “how to invest” presently. Within this asset class, the author proposes subsectors that investors with different mandates should consider.

The emerging markets debt asset class is vast and evolves rapidly. Compared to the debt markets of developed countries, the debt market of emerging market countries is less established, both for the types of securities that are issued and for the entities that issue them. The focus of research on emerging debt markets has evolved over time along with the changes in the composition of the market. A comprehensive review of the literature on emerging market debt securities is provided by Marielle de Jong and Frank J. Fabozzi in their article “Emerging Markets Debt Securities: A Literature Review.” This review covers the modern era, from the early 1990s up to today, yet includes a lookback at foregone times. They explain that there were six waves of bond issuance that have taken place successively: (1) the early 19th century, from 1818 to 1829; (2) the mid-19th century, from 1845 to 1876; (3) the 1880s, from 1877 to 1895; (4) before World War I; (5) the interwar, from 1920 to 1930; and (6) the modern era from 1993 onward.
To protect fixed-income investors against inflationary shocks, the governments of developed and emerging markets have issued inflation-linked bonds. Although inflation-linked bonds compensate domestic investors for loss of local purchasing power, whether the bonds protect foreign investors effectively depends on the inflation levels they endure and on the currency hedging costs. The case of an American investor contemplating allocating to inflation-linked bonds issued by emerging market governments rather than to US bonds seeking to reap higher inflation compensation is examined by Marielle de Jong and Laurens Swinkels in their article “The Capital-Protection Capacity of Emerging Markets Inflation-Linked Bonds.” They find that the capital-protection property of inflation-linked bonds over the period 2012 to 2022 suggests that the allocation to emerging market inflation linked bonds would have been worthwhile, even when taking latent risks, notably country default, into account.

Multiple approaches to portfolio allocation in emerging market bonds are tested by Gueorgui S. Konstantinov in his article “Emerging Market Bonds: Expected Returns and Currency Impact.” He finds that different base currencies (US dollars, euros, Japanese yen, and Swiss francs) of a portfolio determine the success of a portfolio allocation strategy, highlighting the enormous importance of the base currency on emerging bond market performance. Comparing traditional optimization techniques such as the minimum-variance framework and alternative allocations, Konstantinov reports that the alternative allocation techniques outperform traditional techniques like the minimum-variance framework.

According to Yeguang Chi, Yu Liu, and Xiao Qiao in their article “Performance Evaluation, Factor Models, and Portfolio Strategies: Evidence from Chinese Mutual Funds,” actively managed stock mutual funds in the Chinese A-share market offer good investment opportunities. They find that in the aggregate such funds outperform stock market indexes, with the best funds offering economically large risk-adjusted returns that persist over time. The performance persistence that is observed at the individual fund level was found to be robust to various factor-model specifications. These results and others reported by the authors suggest that investing in the Chinese A-share mutual fund market can add value when emerging markets.

A second study of the mutual fund in China focuses on liquidity. In “Mutual Fund Illiquidity and Stock Price Fragility: A Study Based on Chinese Mutual Funds,” Jiaxun Song and Jin Gao investigate the economic consequences of institutional investors’ shareholding illiquidity. Using stock holding data of Chinese mutual funds to construct fund illiquidity at the stock level, they show that illiquidity is one of the causes of stock price fragility to individual stock returns. Specifically, to meet investor redemption requirements, illiquid fund managers are forced to sell assets at a fire sale. This selling pressure causes the stock to trade at a price lower than its true value, further increasing stock price collapse risk.

Prior to the COVID-19 crisis that began in the first quarter of 2020, the most serious global health crisis was the 1918 Spanish flu. COVID-19 caused an unprecedented public health crisis throughout the world. Rwan El-Khatib and Anis Samet explore the impact of COVID-19 on a comprehensive sample of 46 emerging countries and assess investors’ perceptions toward credit risk in their article “The COVID-19 Impact on Emerging Markets.” The authors find that although the COVID-19 pandemic has harshly struck the emerging countries, driving sharp declines in stock market indexes, causing an escalation in volatility levels, and widening the premiums on sovereign credit default swaps, it did not yet reach global financial crisis levels in the opinion of the authors. El-Khatib and Samet also examine the response of the International Monetary Fund (IMF), local governments, and central banks to the pandemic.

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Editor