ADVISORY RESEARCH®
INVESTMENT MANAGEMENT

Emerging Markets: Active vs Passive

Investors have deserted active strategies en masse since the Great Financial Crisis and have replaced them with passively-managed portfolios. One cannot fairly and confidently attribute millions of decisions and billions of dollars' worth of flows to any single cause. That said, conventional wisdom holds that the key force behind this huge trend has been a notion that paying active management fees for market-matching or even below-market returns was counterproductive.

While we agree investors would be wise to maximize their net-of-fee (and after-tax) returns, doing so is not the same as seeking out the lowest cost option in every part of an overall portfolio. So, to be clear, we think the move to low-cost passive products in the highly efficient U.S. stock market has benefited many investors and makes good investment sense. In emerging markets, however, passive products are not universally inexpensive and the markets do not appear to be highly efficient. As we intend to show below: the prevailing emerging market index (the basis of many passive emerging markets products) has not historically delivered manager-beating performance, and there are structural reasons supporting our view that active managers have an advantage over emerging markets benchmarks going forward.

While index funds have benefitted many investors, during the ongoing passive tsunami a key part of their rationale seems lost.

While index funds have benefitted many investors, during the ongoing passive tsunami a key part of their rationale seems lost. Surely, paying relatively low fees has always been one key part of the passive plan. But the other critical tenet was the Efficient Markets Hypothesis (EMH). EMH says all known information about a market is captured in that market's prices. Therefore, EMH holds it to be impossible—or at least virtually impossible—to beat an efficient market over long periods of time. Connecting both underlying principles, it makes sense to pay very low fees and capture as much of the market return as possible rather than pay higher fees in the vain hope of beating the market. And so we come to emerging markets.

From the beginning of 2014 through the third quarter of 2017, $43 billion flowed into passive emerging markets strategies while nearly $27 billion flowed out of active emerging markets institutional accounts, according to eVestment figures. Yet over this period the data was remarkably clear that active managers soundly outperformed the prevailing benchmark, the MSCI Emerging Markets Index. Below are the index's returns and its percentile rank among actively-managed emerging markets equity strategies then in the eVestment database—more than 300 of them.

Data as of Sept. 30, 2017	1-year	3-year	5-year	7-year	10-year	15-year
Total number of active EM strategies	321	298	245	175	125	67
Median EM Active Strategy annualized return %	23.38	6.55	5.98	4.26	2.81	14.06
MSCI EM Index annualized return %	22.46	4.90	3.99	2.54	1.32	12.49
Index Percentile among active EM strategies	59%	74%	87%	85%	86%	91%

The performance shown does not guarantee or predict the performance of any investment. Indexes are unmanaged and it is not possible to invest in an index directly. The Emerging Markets strategies referenced above include all the actively-managed separate accounts in the emerging markets equity category within the eVestment database. Performance above is shown gross of fees; advisory fees would apply.

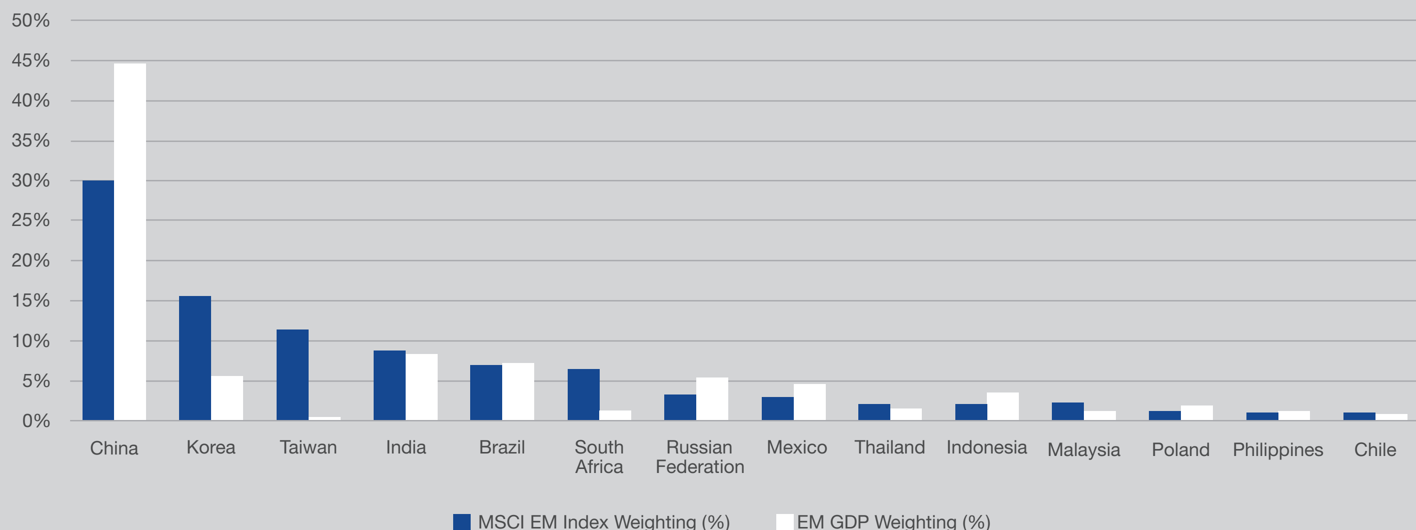
As you can see, the MSCI EM Index was below-average over all the standardized time periods. More surprisingly, the index was bottom quartile for the 5-year, 7-year, and 10-year periods and bottom decile over the trailing 15 years. (To keep this comparison as close to apples-to-apples as possible, we have shown gross returns before any applicable fees alongside the index, which has no fees.) Moreover, the index's low standing versus active managers did not appear time-sensitive. We ran rolling 3-year returns dating back to the MSCI EM Index's launch in January 2001, and in all 56 time periods the index finished below the average return of the actively-managed emerging markets group. Finally, if conventional wisdom regarding the big passive push is correct—that investors especially prefer to avoid underperformance in a down market—the news has been bad for the MSCI EM Index. In the 15 negative three-year periods (out of the 56 noted above), the index underperformed the active manager group every time and by an average of 2.25% on an annualized basis. Finally, over the multi-year periods listed above, active managers had standard deviations—which measure volatility and serve as a proxy for risk—below the benchmark, showing they were not systematically taking on extra risk to achieve higher returns.

Before exploring why we think active managers were able to dependably outperform in emerging markets, a quick aside on fees. As noted, all the returns referenced above were before management fees. While investors may assume passive products are generally dirt cheap, it has not always been true in the case of emerging markets. The largest emerging markets ETF, the iShares MSCI Emerging Markets ETF (EEM), recently held $38 billion in assets despite a 0.72% expense ratio—a cost investors paid in addition to any transactions fees. In addition, this ETF, along with some of its counterparts, has done a poor job historically at tracking its benchmark due to time zone differences, lower liquidity, and higher trading costs. David Blitz and Joop Huij, in "Evaluating the Performance of Global Emerging Markets Equity Exchange-Traded Funds," concluded the average emerging markets ETF underperformed its gross benchmark index by 0.85% annually over the course of their study.

...we think the predominant emerging markets benchmark does not provide efficient or complete exposure to developing countries' economies.

Now we turn from historical performance to current structure and the future. From a number of angles, we think the predominant emerging markets benchmark does not provide efficient or complete exposure to developing countries' economies. In the U.S., we comfortably assume the large-cap S&P 500 captures our economy's changes in value. After all, the index covers only one country, with one currency and one government. Moreover, the largest companies are worth more than a half-trillion

1 An index is not subject to fees, taxes, charges, or expenses. For separate account strategies, if fees, charges, and expenses were taken into account, returns would have been lower.



dollars each and thus collectively represent a very significant part of the U.S. economy. For emerging markets, the situation is quite different. The MSCI EM Index recently held companies from 23 countries with different currencies, governments, and economies. Moreover, the weightings of different countries in the index and their relative GDPs diverged substantially. For instance, Taiwan accounted for about 1% of the emerging markets' GDP but composed 11% of the MSCI EM Index. And the inverse was true for China: its $11 trillion of GDP accounted for about 44% of the total emerging markets GDP, but its stocks composed 30% of the benchmark. In other words, the market and index have not been an economic match, and thus to our minds have represented an inefficiency active managers can seek to exploit.

In addition, emerging markets stocks often have a disjuncture between domicile and economic exposure. Many global companies domiciled in emerging markets countries more closely track developed market economies than emerging markets. In the U.S. we are not used to this mismatch: while many predominant S&P 500 constituents are global companies, they tend to make a large share of their sales and profits in the U.S. and other developed markets that are fairly similar to the U.S. Global companies headquartered in an emerging market tend to be like other global companies: they make a great deal of money in developed economies—rather than in their emerging market home. So these companies often say something about the global developed economy but less about the emerging markets economy in which they are domiciled. The alternative can also be true–there are examples of developed market listed companies (in the U.S., UK, Japan, or Europe) where the majority of revenue or assets are derived from emerging markets. We believe that these types of situations are typically not represented in the emerging markets benchmarks; however, they do represent an opportunity for active managers. We think it is important for investors to understand the true economic exposures of the companies in the emerging market sleeve of their portfolios given these nuances.

That brings us to another key inefficiency in many emerging markets that appear prominently in their benchmarks: State Owned Enterprises—or SOEs for short. Such structures are quite common in emerging markets. Although they may make profits for investors, State Owned Enterprises often have other implicit or explicit mandates: boosting the national economy, furthering political goals, advancing social considerations (such as full employment), or a combination of these. According to our research, more than 75% of the top 100 companies in the MSCI

***...many active managers have historically proven the predominant emerging markets index inefficient by soundly and consistently beating it over time*.**

Emerging Markets Index recently had some direct ownership by governments. Surely in some cases the companies have been well-run and have provided good investment opportunities, but the corporate governance of these entities has varied widely. Therefore, we believe it is important that managers in emerging markets incorporate corporate governance as part of their due diligence process in order to help avoid situations where other priorities by major shareholders or management are present. We believe that the current passive products on the market do not adequately accomplish this goal.

Taken altogether, we think it is clear that investors have options other than a passive emerging markets portfolio. As above, we find significant evidence that the very broad and deep emerging markets asset class may not be an efficient market. We see the indexes designed to cover this market as suboptimal. Many of the constituents of the benchmark are global companies depending on developed markets rather than their home emerging market countries'. In addition, many of the largest emerging markets companies are SOEs—at least in part—which require additional due diligence in order to determine objectives and motivations. Finally, and probably of central concern for most investors: many active managers have historically proven the predominant emerging markets index inefficient by soundly and consistently beating it over time. We strongly believe investors should consider finding an experienced team of managers who actively exploit the inefficiencies across emerging markets through a sensible, repeatable investment strategy and charge a fair fee for that service.

ABOUT ADVISORY RESEARCH INVESTMENT MANAGEMENT

Advisory Research, Inc. manages more than $7 billion in assets across a broad spectrum of traditional and alternative investments as of 12/31/17. Strategies managed include U.S. value and growth, international value, global equity and MLP and energy infrastructure. Our roster of clients includes a global list of institutional investors and sophisticated high net worth individual investors. We offer separate account management as well as several mutual funds. Advisory Research is an investment adviser registered with the Securities and Exchange Commission. Advisory Research's clientele consists of taxable and nontaxable individual and institutional accounts.

IMPORTANT INFORMATION

The information provided does not constitute a solicitation of an offer to buy, or an offer to sell securities in any jurisdiction to any person to whom it is not lawful to make such an offer. Foreign investments present additional risks due to currency fluctuations, economic and political factors, lower liquidity, government regulations, differences in securities regulations and accounting standards, possible changes in taxation, limited public information and other factors. The risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economies. Small Cap stocks are more susceptible to market volatility because smaller companies may not have the management experience, financial resources, product diversification and competitive strengths of larger companies. Smaller company stocks tend to be sold less often and in smaller amounts than larger company stocks. Risk may increase due to potential for concentration in the Financial Sector. **Investors should consult the Fund's Prospectus and Statement of Additional Information for a more detailed discussion of the Fund's Risks. The Fund's prospectus, or summary prospectus which is available upon request by calling (888) 665-1414, includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.**

Advisory Research Funds are distributed by IMST Distributors, LLC.