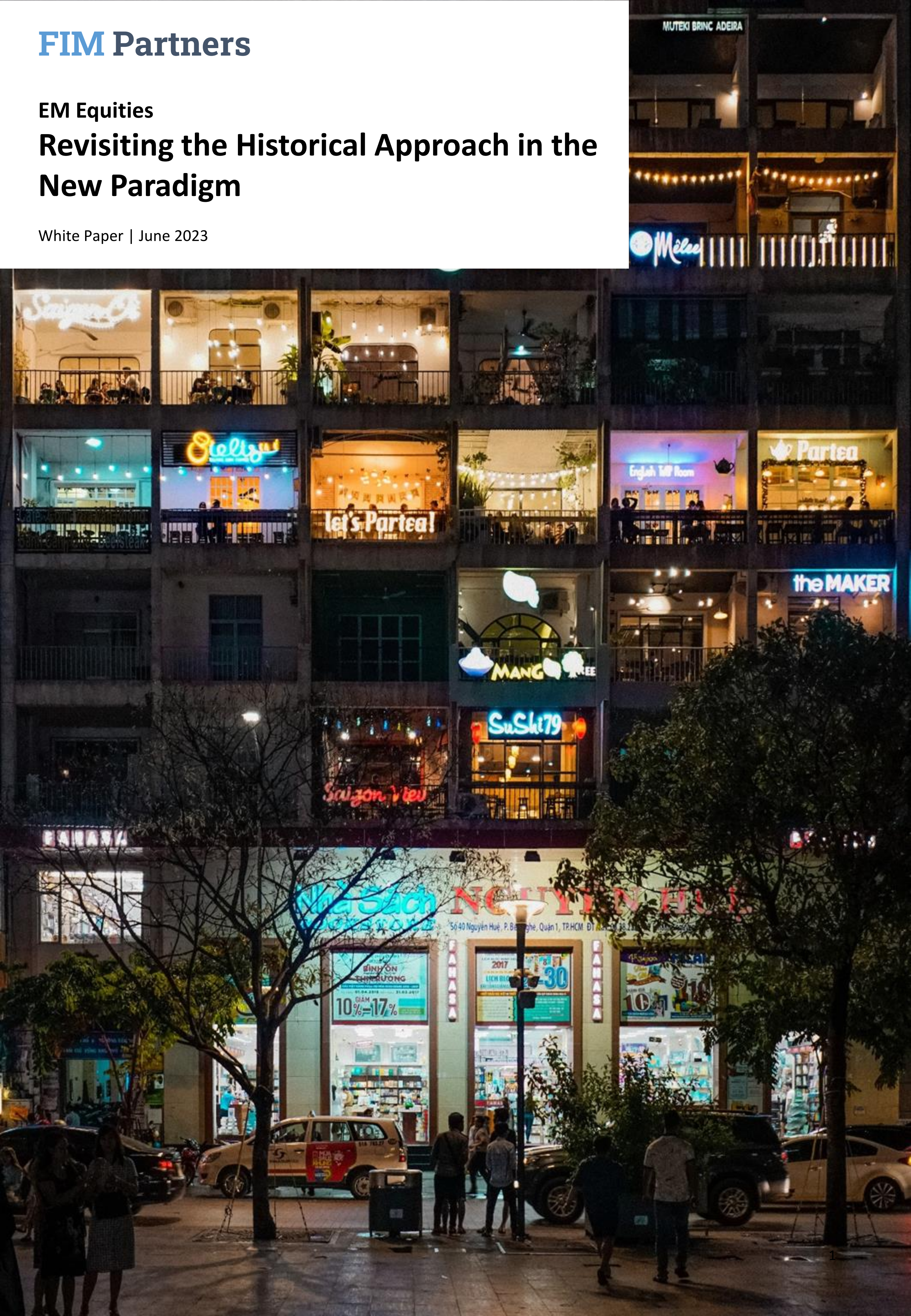
FIM Partners

EM Equities

Revisiting the Historical Approach in the New Paradigm

White Paper | June 2023



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Introduction

Emerging Market (EM) equities have delivered lacklustre returns over the last decade; a +1.8% annualized US$ return for the world's fastest growing economies and largest demographic group just does not suffice. But looking back to 2003-12 (the Golden era), EM equities lived up to these expectations when they delivered a 16.8% annualized return. As investors today bank on a weaker US Dollar and/or US Fed pivot as the catalysts for a Golden era re-run, we have a contrarian view. The Golden era was the confluence of perfectly timed factors including, structural tailwinds and inefficient capital markets supported by a conducive external environment, that are all unlikely to be replicated. Furthermore, the benchmark aware investment style of active EM Funds i.e. with a strong allocation bias towards the GEMs, is inconsistent with the structural pivot in emerging markets.

Mohammed Ali Hussain
Head of Research
malihussain@fimpartners.com

However, we see Golden era traits emerging in the Next Generation of Emerging Markets (Next GEMs), from structural tailwinds supported by enticing demographics and inefficient capital markets conducive to generating diversified uncorrelated returns. Given the new paradigm, we advocate revisiting the legacy approach of primarily allocating to EM funds and including a Next GEMs allocation in the mix; markets that are highly under-represented in global equity portfolios, let alone conventional active EM funds with ample liquidity that has gone largely unnoticed.

Key Terms

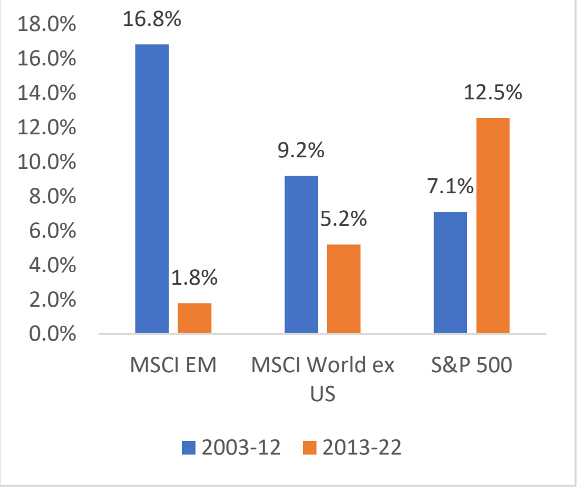
GEMs: Emerging markets which have historically combined for 75-80% of the MSCI EM country allocation including Brazil, Russia, India, China, South Africa, S. Korea, and Taiwan

Next GEMs: The remaining 18 countries in the MSCI EM index (excluding the GEMs) and select countries in the MSCI FM index. For this paper, we have focused on the ASEAN-5 (Philippines, Indonesia, Malaysia, Thailand, and Vietnam) and the GCC bloc (Saudi Arabia, U.A.E., Kuwait, and Qatar)

GEMs – Structural Pivot

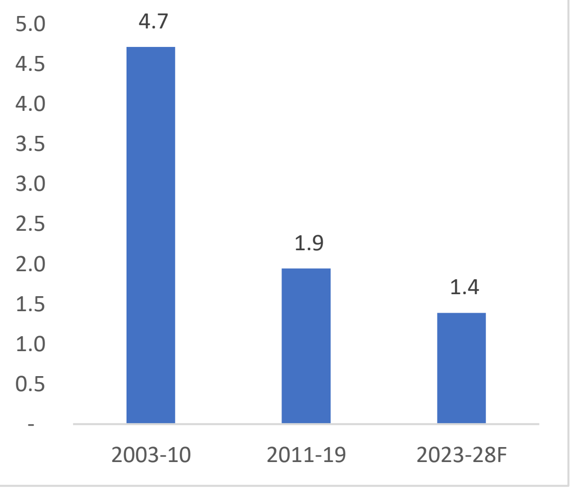
Golden era EM equities were beneficiaries of powerful structural tailwinds benefitting the GEMs as they revolutionized global supply chains by reducing manufacturing costs with their abundant cheap labour and technological prowess. Add to that the opportunity to capture the consumption evolution story of 2.8 billion people representing 45% of the global population in the world's fastest growing economies at the time and you couldn't ask for a better investment proposition considering the slowdown in Developed Markets (DM).

Figure 1: MSCI EM vs. DM Annualized Returns



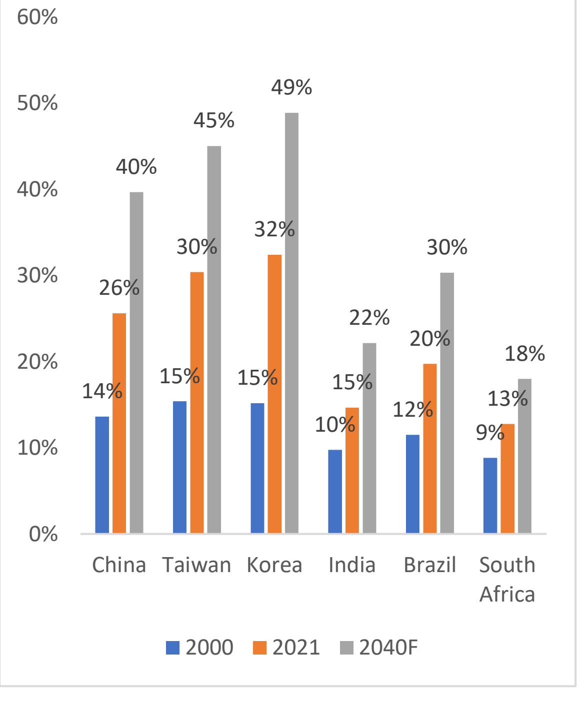
Source: Bloomberg & MSCI

Figure 2: GEMs GDP Delta to G-7 (%)



Source: World Economic Outlook Database

Figure 3: GEMs population over 55 years



Source: UN Population Division

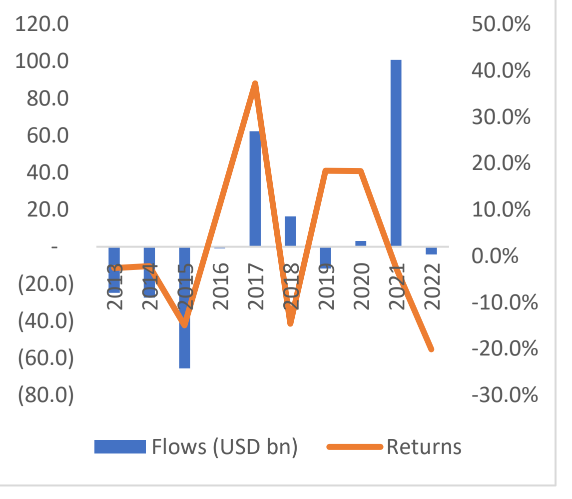
However, the strong economic growth cycle of the Golden era appears behind the GEMs with an increasingly shrinking economic growth delta to DM (Figure 2). While this partially stems from base effect considering the exponential growth these economies witnessed since the 90's, policies centred on "growth at all costs" deployed by the likes of China have a shelf life at the end of the day. The bridging of this delta is imperative in the risk reward equation as rising economic linkages have made the GEMs increasingly susceptible to global demand dynamics and reduced their secular appeal.

The demographic story also appears saturated as the population growth and urbanization story has likely played out across most GEMs, except India (Figure 3).

While Brazil and South Africa look attractive, the structural challenges of these countries dilute these attributes. But the bigger challenge facing the GEMs (except for India) is their rapidly ageing populations. The 55+ years age group in China, Korea, and Taiwan will account for 40-49 percent of the total population, which is above the 36 percent projected for DM. The expected ageing and slowdown of population growth portrays a tepid outlook for the GEMs consumer story; a sharp contrast to it being the hallmark of the Golden era.

On their part the GEMs have not given investors much respite considering the post 2010 economic policy mishaps in South Africa and Brazil combined with rising China specific risks over the years (US-China Trade war, prolonged Zero- Covid policy, the tech sector crackdown, and the recent China-Taiwan friction). The combination of these factors have made investors more sensitive to EM risks as depicted in the volatility of returns and foreign flows over the last decade, with MSCI's 2017 China-A share index inclusion providing the only notable inflow prior to the pandemic (Figure 4).

Figure 4: EM Flows vs. Returns (2012-22)

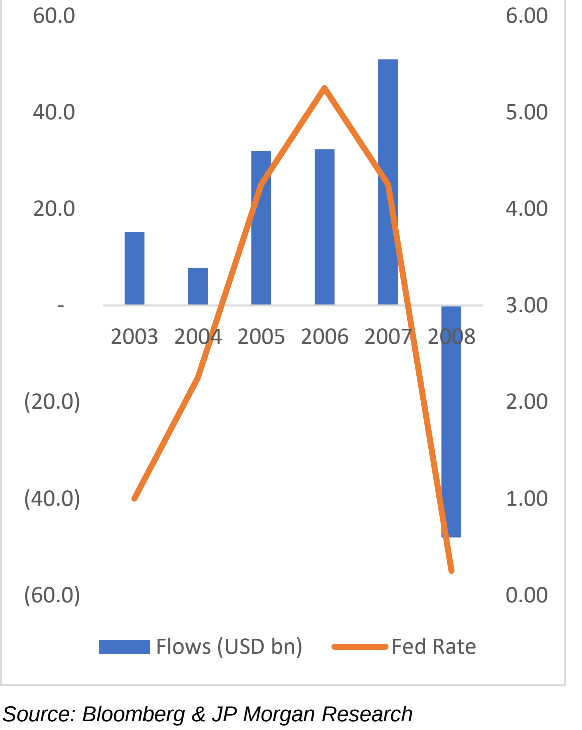


Source: Bloomberg & JP Morgan Research

Equities – Searching for Alpha

For equity investors, GEMs initially ticked the boxes in terms of: (i) low correlation to DM, (ii) inefficient capital markets with high information asymmetries dominated by unsophisticated local investors, and (iii) negligible foreign ownership levels; ideal alpha generation attributes whilst achieving the golden tenet of portfolio diversification. Supporting these lucrative dynamics was a conducive external environment as the economic slowdown in DM and associated US Dollar weakness supported a higher risk appetite and hunt for yield. This partially explains the strong inflows into EM equities despite rising Fed interest rates; an unfathomable proposition in today's environment (Figure 5).

Figure 5: EM Flows vs. Fed Rate (2003-08)



Source: Bloomberg & JP Morgan Research

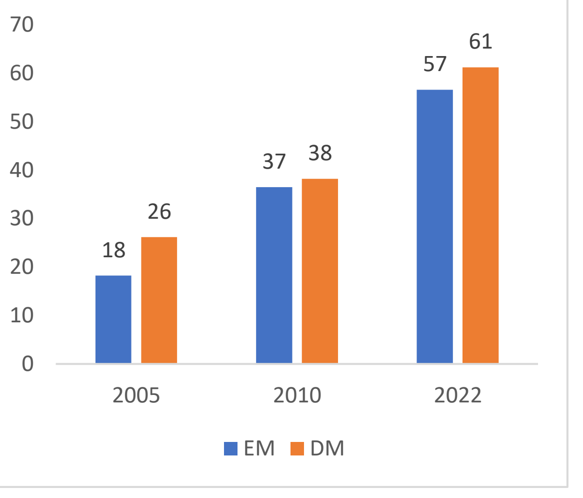
But all that has changed over the last decade as the GEMs have become increasingly correlated to DM, in part from higher synchronization into the global economic engine and narrowing information asymmetries. Taking research analyst coverage as a yardstick, the average number of analysts covering the top 5 EM and DM stocks has been at par since 2010. In fact, there are more analysts covering Tencent (78) and Ali Baba (70) than Amazon (68) and Microsoft (67) today (Figure 7).

Figure 6: GEMs Historical Correlation to DM [1]

	2000-04	2005-09	2010-14	2015-19
China	36%	67%	62%	70%
Taiwan	35%	63%	65%	64%
Korea	50%	73%	71%	66%
India	34%	66%	63%	47%
S. Africa	55%	78%	73%	57%
Brazil	49%	85%	71%	46%
MSCI EM	68%	88%	81%	76%

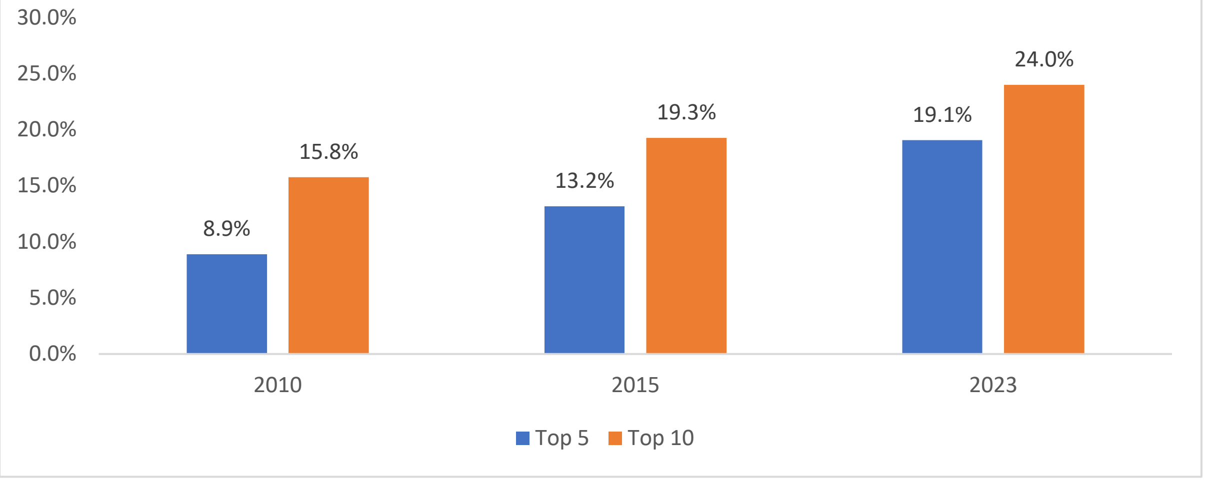
Source: Bloomberg

Figure 7: Avg. Analyst Coverage of Top 5 Stocks



Source: Bloomberg, MSCI

Figure 8: MSCI EM – Aggregate Weights of Top 5 and 10 Securities

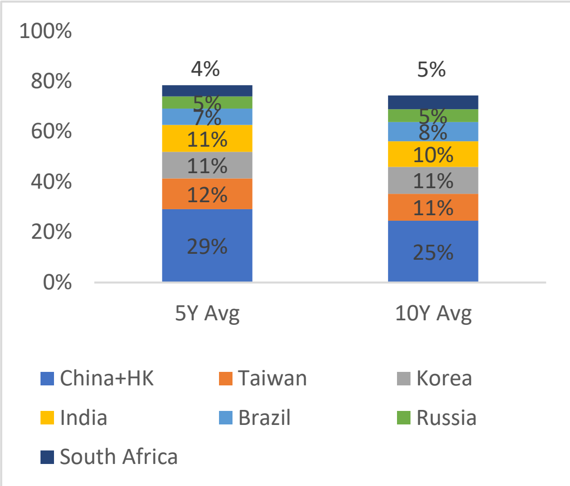


Source: Bloomberg, MSCI

While the rising share of China in the EM index is a frequent discussion topic, the heightening concentration of the top securities tends to fly under the radar (Figure 8). Although rising index concentration should not be a material consideration in a high conviction approach, our analysis of active EM funds country allocation indicates a high overlap to the EM index (Figure 9 & 10).

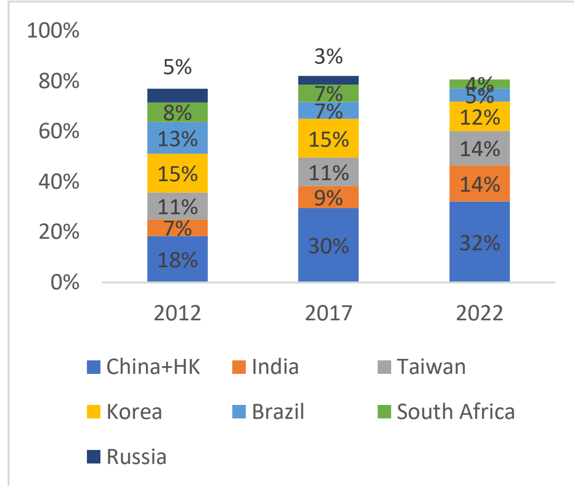
1. Weekly Correlation data

Figure 9: Active EM Funds Country Allocation



Source: JP Morgan Research

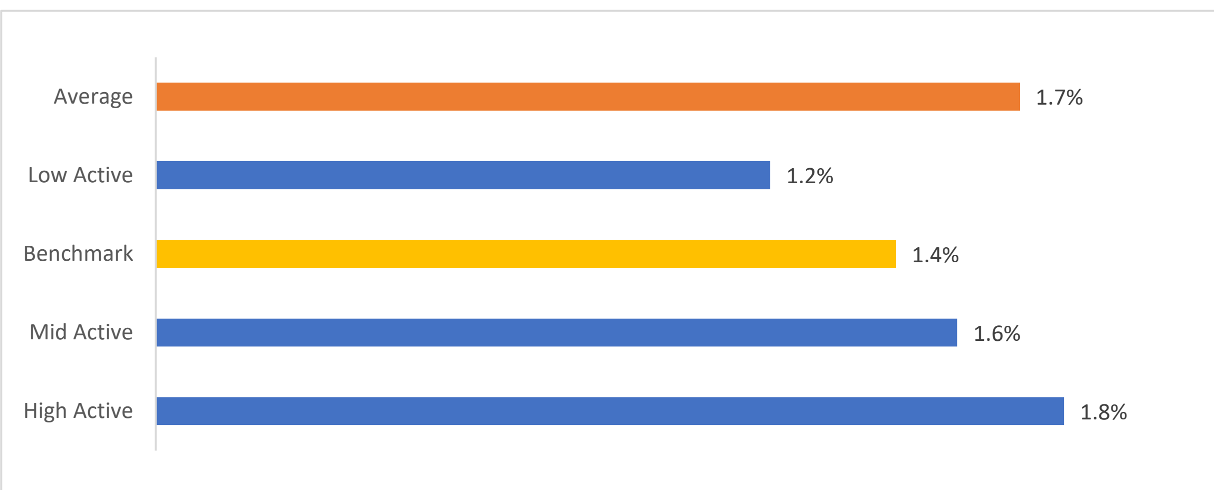
Figure 10: MSCI EM Country Weights Snapshot



Source: Bloomberg & MSCI

Data from Copley Research on the 10-year performance of 278 active EM equity funds, representing US$ 365 billion in AUM, supports our assertion as they have delivered a mere +275bps of cumulative alpha, with returns indistinguishable when comparing across active share levels (Figure 11) [(2)]. Furthermore, a separate analysis of 337 funds [(3)] as of 1Q 2023 shows 54% have an overweight position in the largest index security (6.6% weight), raising the question if this allocation is the product of high conviction or merely consensus.

Figure 11: Active EM Equities 10-yr Annualized Returns by Active Share [(2)]



Source: Copley Research

To summarize, the Golden era secular tailwinds appear to be waning for the GEMs with heightened geo-political risks feeding into volatility of returns. For equity investors, in addition this, increasingly efficient capital markets in tandem with benchmark aligned country allocations constrains alpha generation. Although India is an exception in this regard with its strong GDP growth outlook and demographic dividend, we are sceptical of the logic behind allocating to an active EM fund to merely capture the country's 13% weight versus a dedicated country allocation.

2. High Active (>75% Active Share), Mid Active (60-75% Active Share), and Low Active (<60% Active Share). (https://copleyfundresearch.com/emerging-market-funds-performance-attribution-in-2022/)
3. https://copleyfundresearch.com/tsmc-crowded-trade/

Next GEMs – The New Golden Era

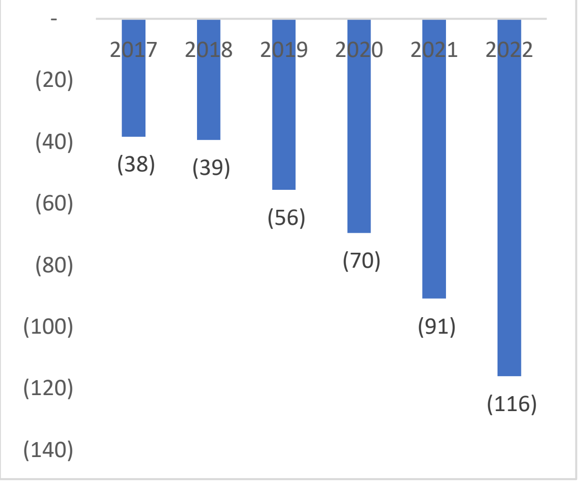
As the sun appears to set for the GEMs, the next GEMs are in pole position to benefit from powerful structural tailwinds reminiscent of the Golden era.

Theme 1: Global Supply Chain Realignment

Chinese dominance of global supply chains has come under increased scrutiny over the last few years. With the advent of the 2018 US-China trade war, prolonged zero-Covid policy, and recent friction with Taiwan, there is an increased urgency to relocate supply chains away from China. In this regard, we believe the ASEAN-5 are ideally positioned.

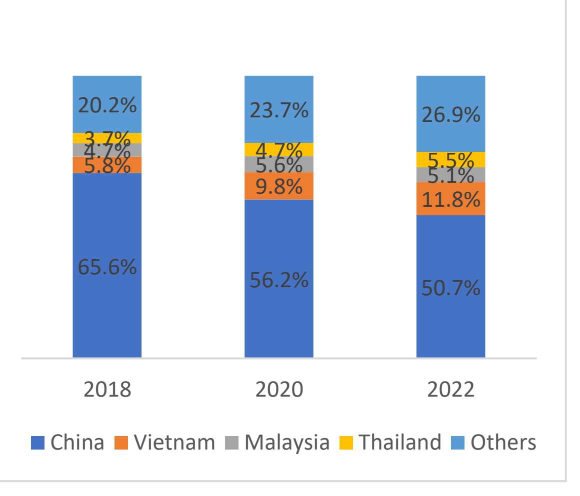
Vietnam, which historically had been chipping away at China's dominance in the low value manufacturing chain, has accelerated its share of US imports since the advent of the US-China trade war. Recent data shows Vietnam has captured a significant share of Chinese exports of textile and electrical equipment, contributing to the widening US trade deficit with Vietnam (Figure 12). Vietnam is also moving up in the global value chain as global manufacturers such as Samsung, Foxconn, and LG have stepped up investments in the country with Vietnam expected to account for a higher share of their global production. For instance, Apple recently announced the Vietnam will account for 65% of the production of Air pods by 2025 as it plans to expand its manufacturing facility in Northern Vietnam.

Figure 12: US Mfg. Goods Trade Deficit with VN ($ bn)



Source: U.S. Census Bureau

Figure 13: US Mfg. Goods Share of Imports from Asia

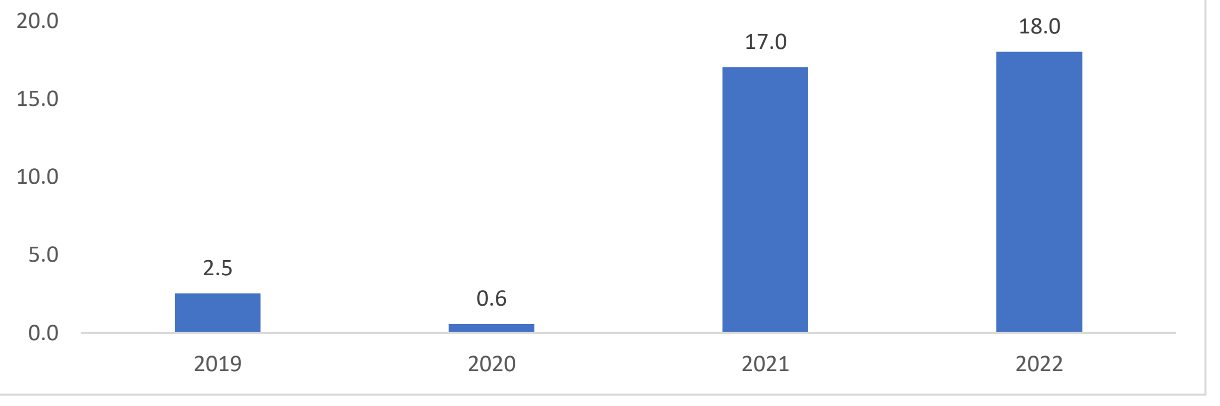


Source: Kearney Reshoring Index (2022)

The ASEAN-5 are poised to benefit from a substantial opportunity emerging from the global EV and semi-conductor value chains supported by domestic policies and external legislation such as the Inflation Reduction and CHIPS Acts. The Inflation Reduction Act is directing nearly US$ 400 billion to boost clean energy but importantly reduce China's global dominance in batteries. While the high inter-dependence between China, Korea, and Taiwan in the semiconductor value chain makes a complete decoupling from China unlikely, a logical compromise will likely come from establishing new capacities in the ASEAN-5 as a complete onshoring to the U.S. is cost prohibitive with recent estimates indicating a USD 7 trillion price tag. Foxconn's recent announcement of building Malaysia's first 12-inch semiconductor manufacturing plant with a monthly capacity of 40,000 wafers is indicative of this trend.

Indonesia and Philippines have a strong advantage in the EV value chain as they are amongst the top 5 countries in terms of global nickel and cobalt reserves. Similarly, both Indonesia and Thailand are the largest automotive production centres in Southeast Asia with critical infrastructure in place to seamlessly integrate into the EV value chain. There has been a sharp surge in EV and semiconductor related investments in the region over the last two years (Figure 14) as global manufacturers are increasingly relocating manufacturing capacities and/or establishing JVs with local players (Table A).

Figure 14: Total EV Supply Chain Investments in MY, ID & TH (US$ bn)

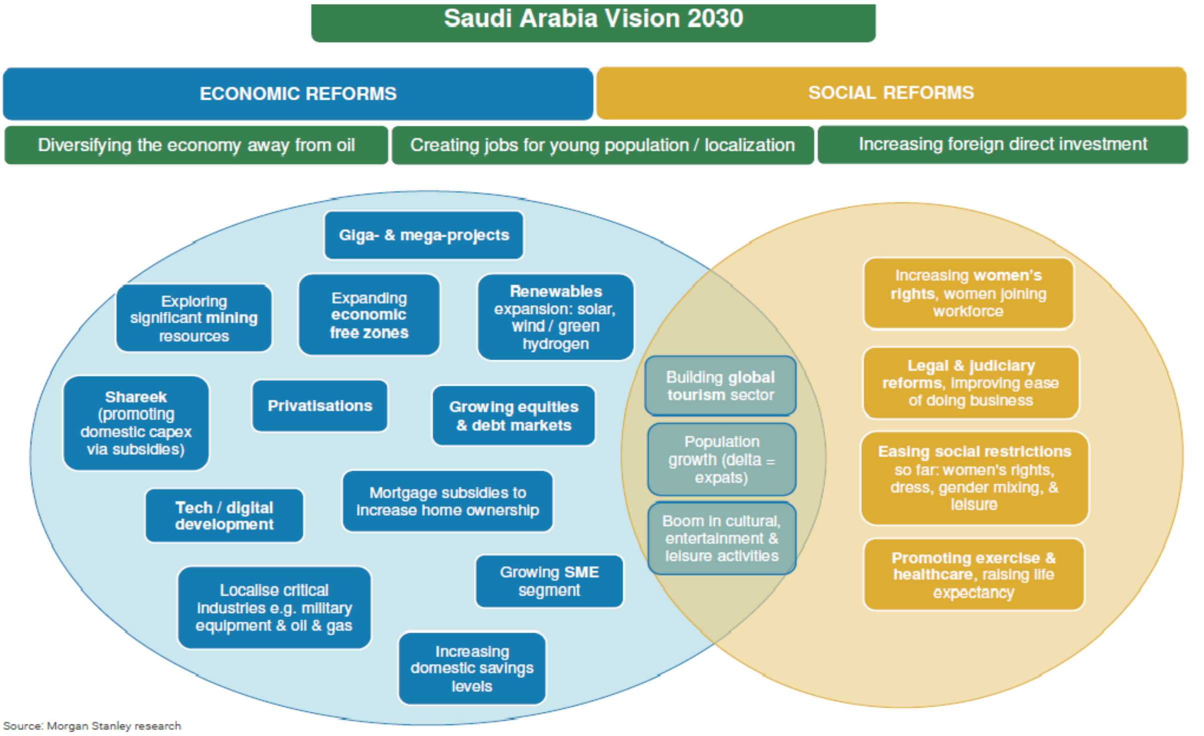


Source: HSBC Research

Table A: Foreign Investment in the ASEAN EV & Semiconductor Space

Country	Company	Segment	Details	Investments (US$ bn)
Indonesia	CATL	EV battery	Battery integration project	6.0
	BASF and Eramet	EV battery material	Production of battery-grade nickel and cobalt	2.6
	Foxconn	EV and battery manufacturing	JV with Indika Energy and Indonesia Battery Corporation (IBC)	1.8
	Hyundai Motor	EV manufacturing	Opened an EV manufacturing plant in Indonesia in 2022	1.5
	Toyota	EV manufacturing	Hybrid and electric cars	1.8
Malaysia	Samsung SDI	EV battery	Electric vehicle battery cell manufacturing facility	1.3
	AT&S	Semiconductor	Manufacturing plant for PCB and IC substrates	2.0
	Intel	Semiconductor	Advanced packaging facility for semiconductors	7.0
	Foxconn	Semiconductor	Chip facility to produce 12-inch chips for Evs	1.0
	SK Nexilis	EV battery	Copper foil manufacturing facility	1.0
Thailand	BYD	EV production facility	150k EV manufacturing facility	0.5
	Great Wall Motors	EV production facility	Plan to double EV investment in TH	0.7
	Foxconn	EV production facility	150k EV manufacturing facility	1.0
	Changan Motors	EV production facility	100k EV manufacturing facility	0.3

Theme 2: GCC Non-Oil Reforms



Source: Morgan Stanley research

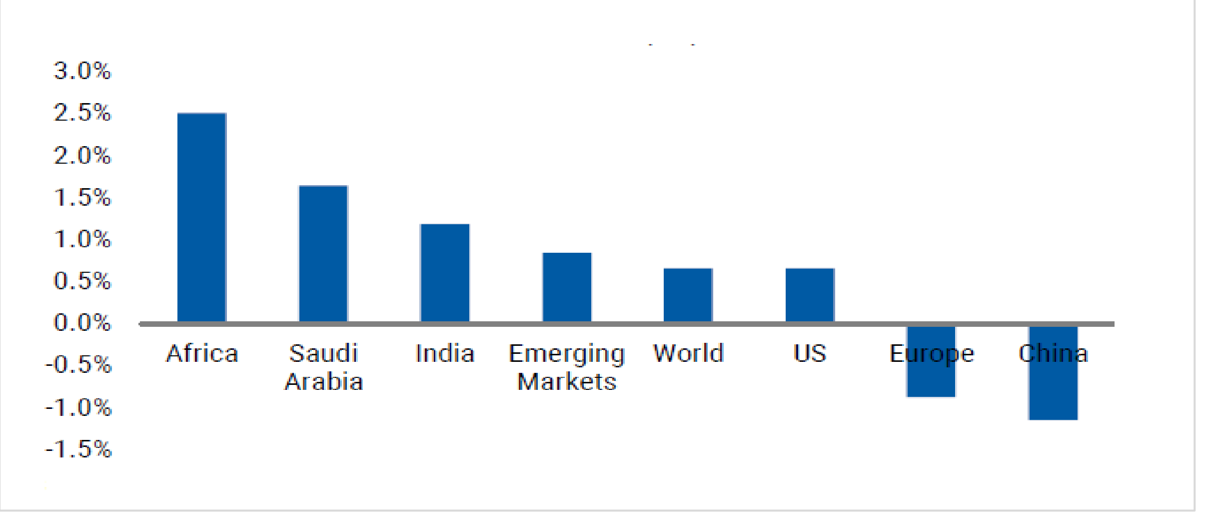
The GCC is amidst a powerful structural shift with recent reform programs aimed at economic diversification via enhancing the share of the non-oil economy. In this regard, a monumental reform agenda is being executed in Saudi Arabia under the “Vision 2030” program, whose targets include:

- US$ 950bn infrastructure spending program to support non-oil economic development
- 59 GWs of renewable energy which will enhance the share of renewables from 0.2% to 50% in the power generation mix.
- Enhance expat population share from 39% to 50%.
- 100 million tourists from 49 million currently whilst enhancing the tourism share of GDP from 3.6% to 10%.
- Increased female labour participation that will lead to a 40% increase in female workers from current levels.

The UAE has embarked on a similar program with targets centred around doubling non-oil exports, enhancing the share of industrials in overall GDP and tripling the share of tourism with a target of 40 million tourists by 2031. Like Saudi Arabia, the UAE intends to increase the share of renewables to 50% of the energy mix as part of the plan to reduce the dependency on fossil fuels.

Looking past the economic transformation these reforms represent, a powerful secular play is emerging across regional demographics. The recent residency reforms in the UAE and Saudi Arabia are attracting global expat talent across all fields whilst removing the legacy constraint of residency being tied to employer sponsorship. This is a spurring an increase of talented expats who are now more comfortable relocating their entire families providing a boost to local population numbers, with Saudi Arabia's Gen-Z population growth only behind that of Sub-Saharan Africa. Similarly, female labour participation reforms are enhancing the share of dual income households which benefits household spending and hastens the timeline for real estate ownership.

Figure 15: Gen-Z Population CAGR (1990-2030)

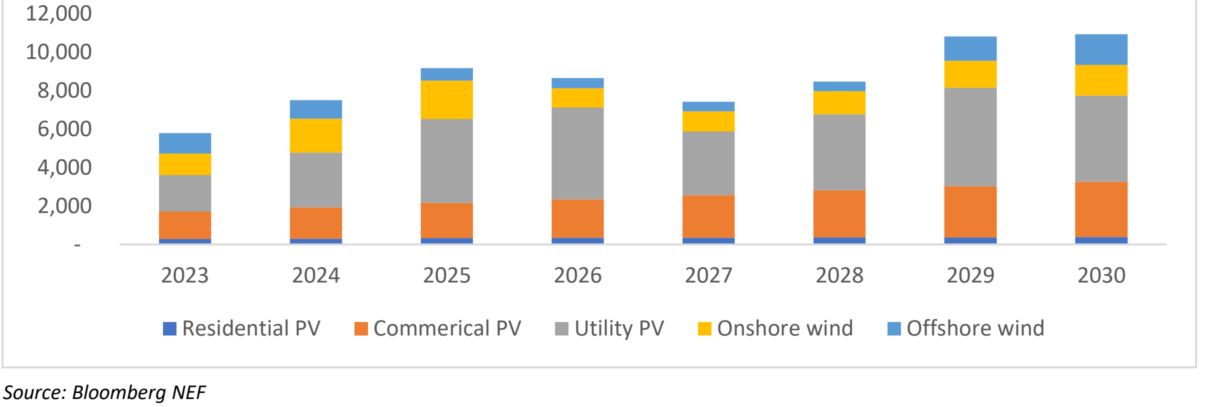


Source: U.N., Morgan Stanley Research

Theme 3: Sustainable Consumption

The next GEMs are home to the world's fastest growing population and concurrently will account for a higher share of global electricity demand. In this regard, we are seeing an aggressive push towards enhancing renewable energy in the energy mix as the Asean-5 will cumulatively add 68 GWs of renewable energy from 2023-30. Combining that with the targets set under Saudi Vision 2030, and that would imply a combined 127 GWs in renewable capacity additions across the next GEMs over the next seven years.

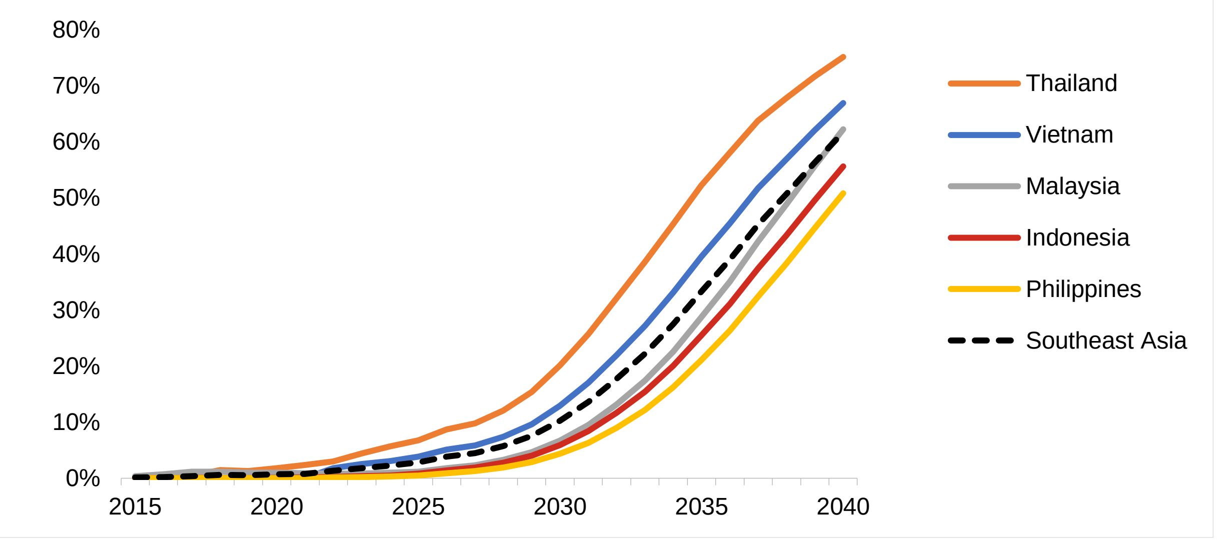
Figure 16: Southeast Asia Solar & Wind Capacity Additions (MW)



Source: Bloomberg NEF

Earlier we discussed the emerging global EV supply chain integration opportunity for the ASEAN-5. In addition to that, the ASEAN-5 will themselves become leading adopters of e-mobility solutions as EV sales are forecasted to account for 62% of vehicle sales by 2040. Recent estimates by McKinsey indicate that Indonesia and Vietnam will be amongst the top three global markets for electric two wheelers sales by 2030.

Figure 17: SEA- EV Share of Vehicle Sales

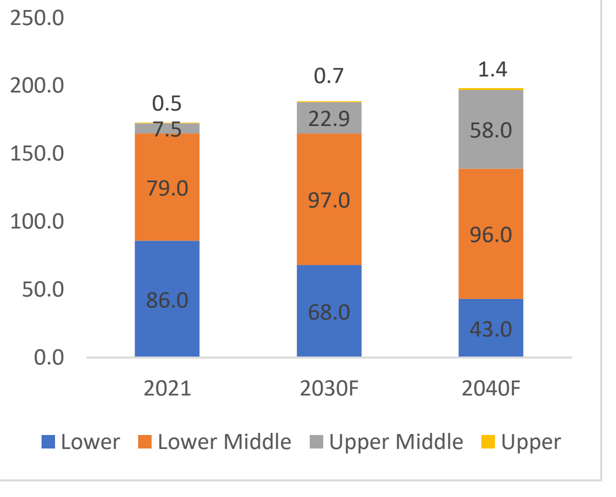


Source: Bloomberg NEF

The Ripple Effect

The aforementioned themes appear more powerful to what we witnessed during the Golden era. On one hand we have the ASEAN-5 benefitting from a global supply chain shift (similar to the Golden era), while the GCC reforms are domestically driven and more importantly uncorrelated to global dynamics, thereby creating a more diverse thematic investment proposition.

Figure 18: Indonesia Population by Income Class (mn)



Source: HSBC Research

Furthermore, these themes should not be viewed as sector investment ideas but rather on their powerful ripple effect on overall domestic consumption. In the case of the GCC reforms, rising fiscal spending and growing expat population will positively impact the healthcare, education, and real estate sectors. The relocation of the EV supply chain to ASEAN-5 should stimulate domestic employment, discretionary spending, and the lending activities of financial institutions that will finance these projects. In this regard, Indonesia is an exciting story with total disposable income set to double to USD 1.4 trillion by 2030 with the upper middle class expected to expand at a 13% CAGR. As such, Indonesia is expected to overtake Brazil as the world's fourth largest consumer market.

The ripple effect is complimented by enticing demographics as ~80% of their population is forecasted to be below 55 years of age by 2040. They will be amongst the world's fastest growing populations, adding ~400 million inhabitants with another ~365 million relocating to urban centres over the next 20 years. Finally, while the future population and urbanization growth of the GEMs is largely dependent on India, the same is dispersed across several Next GEMs, creating an exciting opportunity to capture evolving consumer spending patterns at different wealth cycle stages in the individual countries.

Equity Markets – Undiscovered Liquidity & Alpha Potential

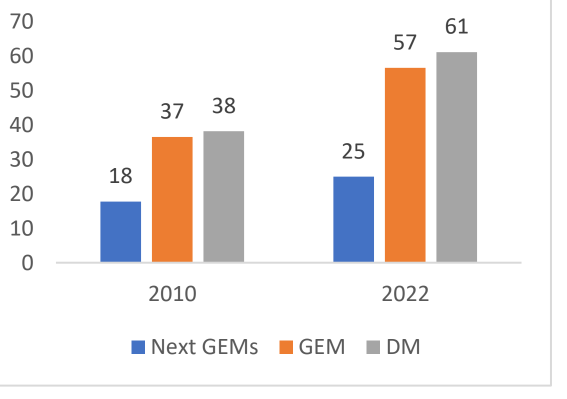
Next GEMs equity markets are reminiscent of the Golden era. In addition to their relatively low correlation to DM, next GEMs remain relatively under-researched, making them ideal for generating diversified uncorrelated returns with strong alpha potential (Figure 19).

Figure 19: Next GEMs Correlation to DM [4]

	2000-04	2005-09	2010-14	2015-19
Argentina	29%	69%	55%	39%
Bangladesh	N.A	-3%	1%	-1%
Colombia	18%	66%	53%	55%
Indonesia	11%	56%	47%	41%
Malaysia	22%	54%	49%	52%
Pakistan	12%	11%	23%	12%
Peru	27%	78%	59%	55%
Philippines	18%	60%	51%	38%
Saudi	9%	17%	16%	30%
Thailand	29%	57%	48%	54%
UAE	N.A	24%	20%	35%
Vietnam	-6%	33%	18%	37%

Source: Bloomberg

Figure 20: Avg. Analyst Coverage of Top 5 Stocks



But more importantly, the liquidity surge over the last five years has made the next GEMs increasingly investible. Their low representation in the EM index and dearth of dedicated research coverage has led to their rising liquidity go largely unnoticed (Figure 21). Case in point, Saudi Arabia and Thailand have already surpassed the 2015 daily liquidity levels (ADTV) of Brazil and S. Africa. But unlike the role of foreign inflows in propelling GEM liquidity, growth in this case is largely at the behest of deepening capital markets and a growing domestic investor base which accounts for the bulk of trading liquidity (Figure 22).

Figure 21: Next GEMs ADTV (US$ bn)

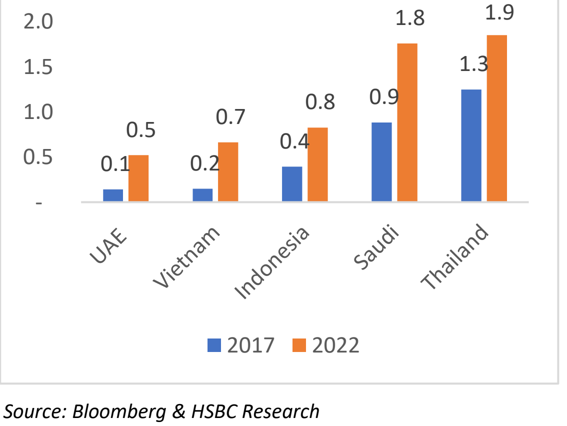
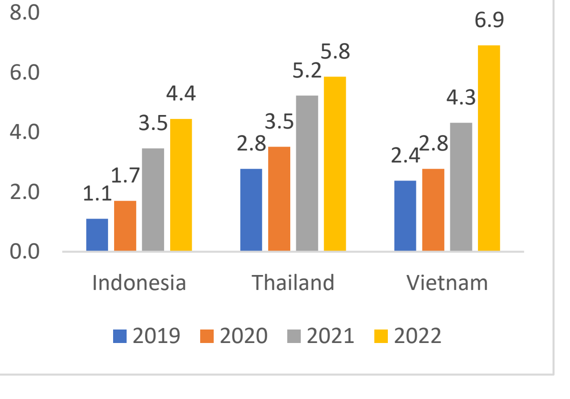


Figure 22: No. of Equity Investor Accounts (mn)



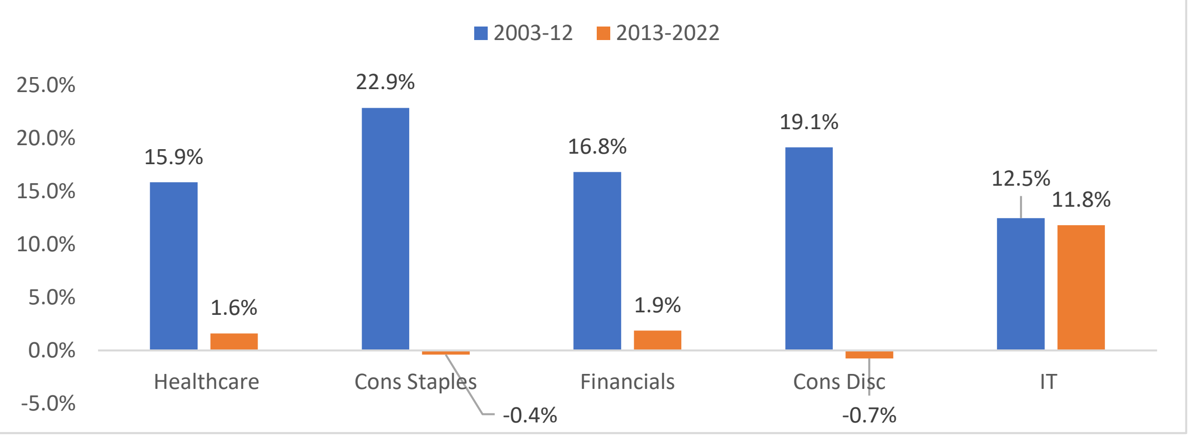
Source: Bloomberg & HSBC Research

4. Using weekly correlation data for local indices

EM Equities Allocation – Capturing the new Paradigm

The benchmark driven allocation of active EM funds is inconsistent with the changing structural tide within emerging markets. Comparing the GEMs dominated MSCI EM sector indices returns over the last two decades, the return compression across most sectors indicates that the broad structural tailwinds benefitting domestic consumption have subsided.

Figure 23: MSCI EM Sector Indices Annualized Returns (%)



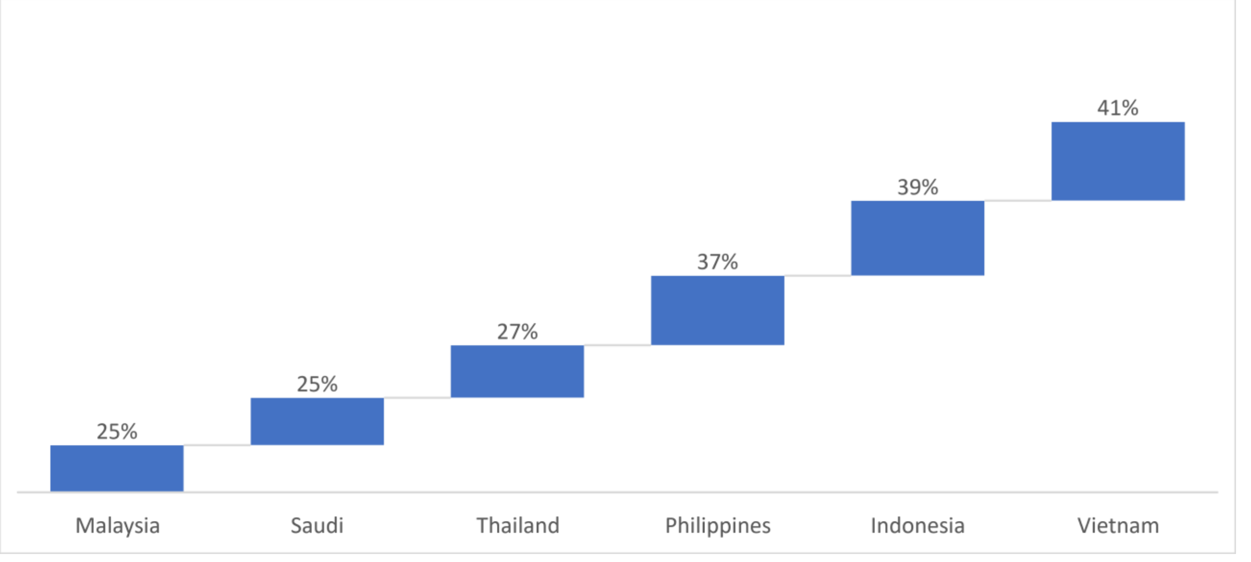
Source: Bloomberg, MSCI

From an investment standpoint, this approach was perhaps more appropriate when the relatively lower liquidity and higher information asymmetries made single country allocations less prudent. Since then, in addition to the narrowing information gap, individual markets such as China and India have attained sufficient liquidity to merit single country allocations.

Given the new paradigm, we advocate revisiting the legacy approach of primarily allocating to EM funds and including a Next GEMs equities allocation into the mix; markets that are highly under-represented in global equity portfolios, let alone conventional active EM funds. With combined next GEMs liquidity at par with Brazil and India and themes playing out in distinct regional blocs, a fund approach encapsulating the various next GEMs is appropriate to maximize diversification whilst balancing liquidity.

The timing is also ideal as the secular tailwinds highlighted earlier do not appear reflected in next GEMs valuations with individual markets trading at a ~32% discount to their 5-year P/E average) with muted foreign interest over the last 5 years (Figures 24 & 25). Saudi Arabia has been an exception largely due to passive inflows stemming from its 2019 MSCI EM inclusion and rising index weight stemming from performance and deepening capital markets. With active EM funds on average 150bps underweight to the country, there is a sizeable inflow backlog should this underweight be bridged. Finally, next GEMs have witnessed robust IPO activity over the last 5 years raising a combined $120 billion in IPO proceeds, which is enhancing liquidity and sectoral diversity (Figure 26).

Figure 24: 2023 P/E Discount to the 5-yr Average



Source: Bloomberg

Figure 25: Net Foreign Flows from 2017-22 (US$ bn)

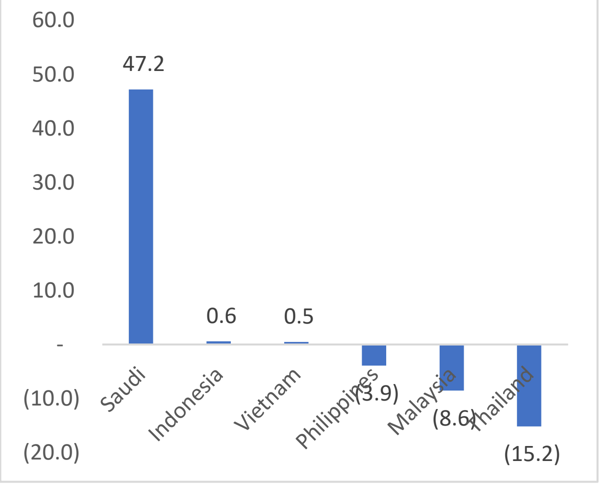
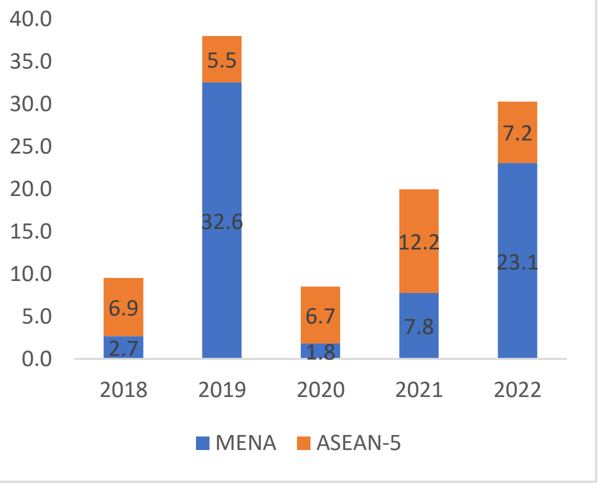


Figure 26: IPO Proceeds (US$ bn)



Source: Bloomberg & JP Morgan Research

We understand that investors find it difficult to classify such strategies in their index driven allocation buckets given the <20% weight of the next GEMs in the EM index. But is it more important that a strategy neatly fit into an index box or be considered on its merits in terms of alpha, portfolio diversification, and ability to deliver uncorrelated returns?

We hope that this paper has provided a unique insight into the exciting next GEMs opportunity and that we leave you with a strong case for a staple allocation within a global equities' allocation.

ABOUT US

FIM Partners – Who We Are

Established in 2008 as a boutique, institutional asset manager in Emerging Markets, FIM Partners has grown over 15 years to cover equity, fixed income, and real estate asset classes. We are headquartered in Dubai, with offices in the United Kingdom, Saudi Arabia, and Oman. FIM Partners currently manages AUMs in excess of $3 billion from a top-tier, long term and institutional investor base.

The firm's assets under management are invested on behalf of university endowments, sovereign wealth funds, insurance companies, outsourced CIO's, and pension plans from North America, Europe, the Middle East, and Asia.

Our investment approach is premised on monetizing domestically driven secular themes through an intensive bottom-up process with an on-ground research emphasis. Sustainability as an integral pillar of our investment process as it comports with our long-term investment approach. The firm has generated an exceptional record of alpha since inception, with its funds consistently ranking at the top of fund league tables.

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