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BNP Paribas Investment Partners' update on Emerging Markets
Issue #8 – April 13th, 2016

EMERGING MARKETS INSIGHTS

Do country specific factors add alpha?

The answer is yes, according to recent research by BCA Research (EM Equities: Country effects still dominate sector influence, 23 March 2016). In fact BCA quantitatively demonstrates that country-specific factors, or 'macro', can add alpha to both developed and emerging market equity asset allocations. However, the significance of macro's alpha contribution is not the same for emerging and developed economies.

In emerging economies, country effects largely outplay sector influences when it comes to excess returns (BCA's benchmark is 160 equally-weighted sectors, i.e. 16 main developing MSCI countries multiplied by 10 MSCI sectors). Indeed, the calculations by BCA's authors show that in emerging equity markets, country effects have generated systematically more alpha than sector effects over the past 10 years. In recent years they have added as much as twice the alpha to an emerging market equity portfolio than sector effects.

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This was generally not the case in developed equity markets (DM), where both input types were shown to be approximately equally significant in terms of their contributions to excess return to an 80-sector, equal-weighted benchmark (eight main developed MSCI countries multiplied by 10 MSCI industries/sectors) over the past ten years. And recently, sectors specificities have even become more important than country effects, according to BCA.

What are the macroeconomic rationales behind these quantitative findings?

BCA Research puts forward three interesting observations:

Firstly, as DM stock markets are largely dominated by global players they tend to be more correlated and sector considerations thus play a greater role than country-specific factors.

Secondly, advanced economies tend to be structurally and cyclically more stable, i.e. they present fewer country-based idiosyncrasies than emerging economies.

Thirdly, banks and financials account for an almost 10% bigger share of market capitalisation in emerging markets than in developed ones. Banks and financials are typically more strongly and directly linked to top-down factors influencing monetary policies, which tend to differ more in emerging economies compared to developed ones.

We would add some further rationales to those brought forward by BCA:

Emerging economies and stock markets are generally less diversified than their developed counterparts. Many of them are substantially skewed to specific sectors. This increases the importance of country-specific macro factors.

Also, statistical "depth" is still generally shallower in emerging economies than in developed ones, although strong progress has been made on this front in the past few years. Statistics are also less harmonised and often more difficult to obtain in emerging markets than in developed economies.

Finally, international investors, who are arguably often the main influence behind emerging equity markets swings, focus closely on currency volatility and thus the risks associated with that when it comes to investing or disinvesting in this asset class. Currencies are more volatile in emerging economies than in developed ones and their drivers are essentially of a macroeconomic nature.

The investment conclusions of these findings are straightforward, in our view. Since country effects can add alpha to emerging equity allocations it make sense to consider disaggregating the asset class instead of playing it as a basket. Conversely, country selection among developed economies has become less rewarding in terms of alpha generation as sector effects are at least as important as country effects. This means that playing developed markets as an asset class does not necessarily substantially reduce country allocation alpha.

We think BCA's findings have to be interpreted carefully, but tend to agree with them. In fact our own emerging equity markets asset allocation tools provide the proof that country allocation can add alpha to an emerging markets portfolio, and thus that macro does matter. However, we also found that country alpha has become much more difficult to generate over time in the MSCI emerging equities universe. This is certainly due in part to these countries' economic models starting to converge. Another explanation is that, in the past, increasingly more investors of different types invested in this asset class as a basket (often through ETFs or index funds) leading to increasing correlation between the countries composing it. Let us hope that the search for additional yield in a "low returns for longer" world will soon motivate more investors to look more closely at arbitrage opportunities among emerging economies instead of just buying the basket.

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