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# EM equities: adding alpha through active management and a consumer sector focus


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## KEY POINTS

- Growth in emerging market economies and equity markets continues to be driven by rising levels of income and consumer spending by an expanding middle class.
- Complementing this ongoing secular theme is increased consumption in specific discretionary categories amid the COVID-19 pandemic.
- At Nuveen, greater discretion in stock selection has enabled our actively managed EM Equity strategy to consistently generate alpha.
- Our strategy emphasizes consumer-oriented sectors that we believe may benefit the most from long-term EM consumption trends.

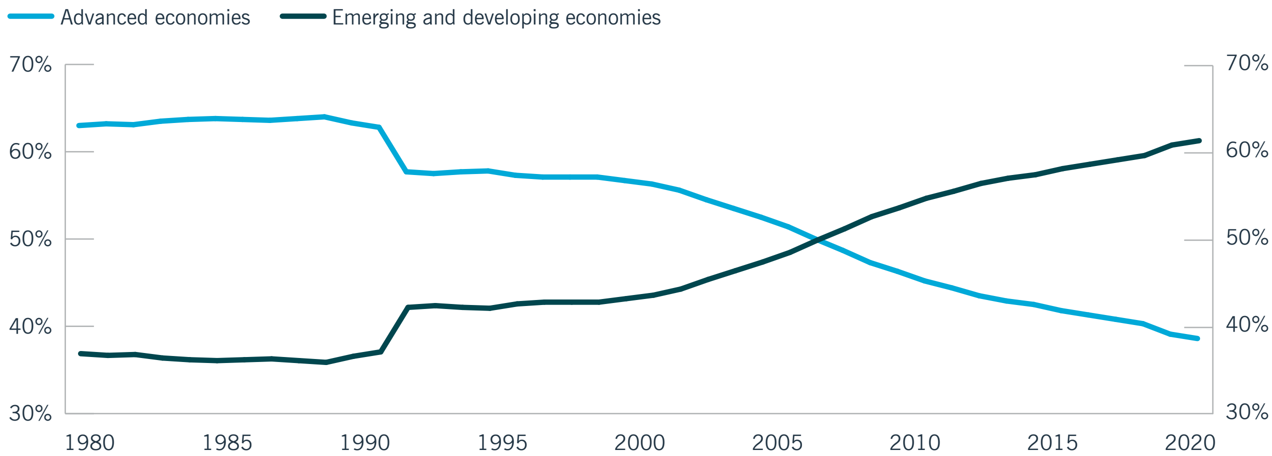
## EM: A GROWING SHARE OF GLOBAL GDP AND MARKET OPPORTUNITIES

Economic growth in emerging markets (EM) continues to outpace that of developed markets (DM). Having eclipsed DM economies a decade ago with a larger and faster-growing share of world output, EM countries now account for roughly 60% of global GDP, according to International Monetary Fund (IMF) data, as shown in Figure 1.

This steady growth trajectory has provided an expansive backdrop for the development of EM equity investing. Since its inception as an investable asset class in 1987, the EM equity universe has grown at an exponential rate.

**Figure 1. EM economies now make up 60% of global GDP**

*Based on purchasing-power-parity share of world total*




Source: IMF World Economic Database, June 2020. Data after 2019 is projected.

Today it represents $24.5 trillion in market capitalization — nearly a third of the world's total (Figure 2).[1] Investors seeking alpha and well-diversified global equity exposure in their portfolios can ill afford to ignore the opportunities that EM equities offer.

## A RISING MIDDLE CLASS DRIVES EMERGING MARKETS GROWTH

Critical to the growth trends in EM economies and equity markets is rising consumption by middle-class EM consumers. In larger EM countries, the middle class is typically a family earning $3,000 to $10,000 per year when measured in equivalent purchasing power.[2] The consumer base in these EM economies is young, made up of hundreds of millions of people and growing three times more rapidly than in the developed world.[3]

Across the broad EM universe, consumption trends may vary widely depending on a country's stage of economic development. When gross national income (GNI) rises and countries begin to develop a middle class, discretionary spending typically accelerates. Plotting GNI per capita against household consumption per capita for multiple EM countries results in what we call a consumption "S-curve," shown in Figure 3. The farther a country's position along the curve, the higher its income level and the more established its middle class. The majority of EM countries, however, are closer to the front end of the curve — meaning they are still in the earlier stages of income and consumption growth, and therefore may offer extremely attractive long-term investment potential.

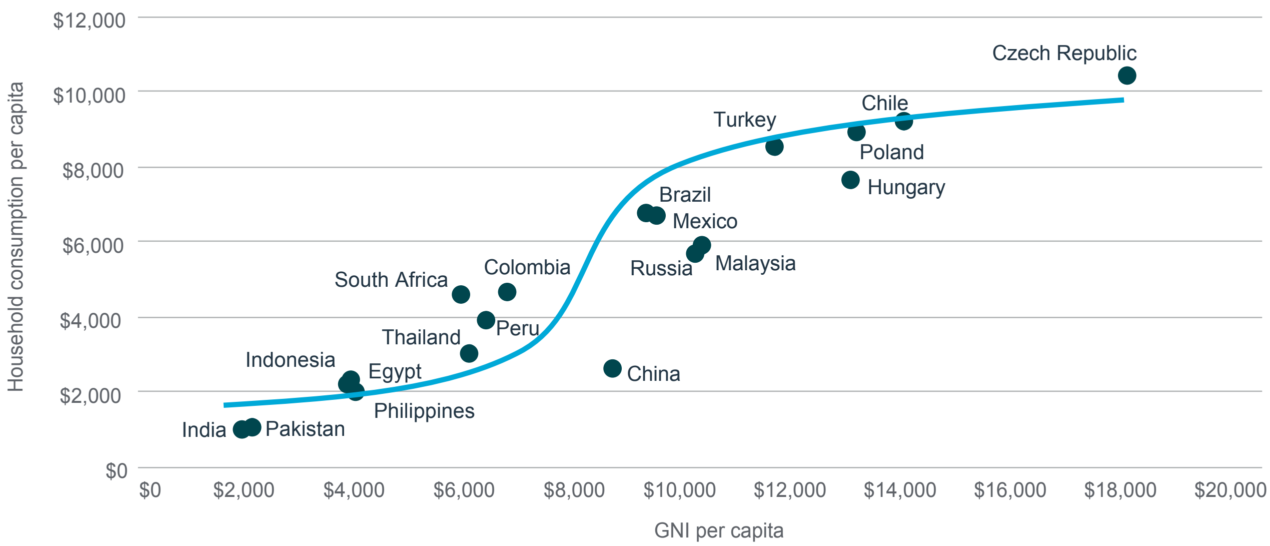
**Figure 2. EM equities: A $24 trillion asset class too big to ignore**

*% share of global stock market capitalization*


Source: FactSet as of 31 May 2020.

## Figure 3. The "S" curve: EM economies are on a path of rising income and spending

*Per capita levels of income and consumption*




Source: WorldBank. World development indicators as of 31 Dec 2018.

### What are EM consumers spending money on?

Personal consumption expenditures (PCE) on discretionary items are significantly higher in certain EM countries than in DM economies. Emerging consumers, on average, spend from 50% to 75% of their disposable income on consumer products. For people living at the subsistence level, that share of income is often 100%. Middle- to upper-income EM consumers allocate as much as 35% of their income to items such as clothing, jewelry, fresh food and automobiles.[4]

### A "new normal" environment for consumption

Although COVID-19 has swept the globe without regard for borders or the personal life stories of its victims, the pandemic is affecting EM consumers differently compared to their DM counterparts. EM consumers are both fearful from a medical standpoint and guardedly optimistic about their financial future in the current market environment[5] – a yin-and-yang tension shaped by the characteristics of these markets and their swelling middle-class and more affluent populations. These consumers overwhelmingly recognize the health dangers,[6] and many have been forced to change their lifestyles, often by government decree.

## Figure 4. Spending on select items is higher in key EM countries

| PCE as % of aggregate per capita spending | Emerging markets | | Developed markets | |
|---|---|---|---|---|
| | China | India | Japan | U.S. |
| Clothing and footwear | 5.8% | 5.9% | 2.8% | 2.2% |
| Jewelry and watches | 2.2% | 3.8% | 0.6% | 0.6% |
| Autos/Services | 10.0% | 15.2% | 10.9% | 8.8% |
| Fresh food | 15.5% | 24.2% | 7.1% | 2.7% |

Source: Goldman Sachs as of 31 Dec 2018.

Even so, they remain optimistic about the future of their economy and still plan to boost spending in many more categories than DM shoppers. In particular, EM consumers are still buying an expanding basket of goods and services. They're also rapidly increasing spending in e-commerce — even older consumers who in the past favored traditional stores and markets. The five-year average growth rates for e-retail in India (59%), Indonesia (32%), and China (46%)[7] have pushed each of them into a more advanced stage of digital maturity.

Once e-commerce takes hold in an emerging market, it tends to grow rapidly. In fact, EM aggregate e-commerce sales surged 300+% in the first week after the COVID-19 outbreak (versus the same period last year).[8] And over the next four years, digitally influenced retail purchases in EM are expected to approach $4 trillion.[9] This shift is a wake-up call for all manufacturers and retailers operating in these markets.

Separately, EM internet users currently outnumber DM internet users by more than two to one, and the difference is widening. Between now and 2022, EM countries will contribute approximately 900 million new internet users, versus about 80 million from the world's already heavily connected developed markets.[10] Put another way, more than 90% of all new internet users in the next two years will come from emerging markets.

Other EM spending trends that are becoming part of the new normal in the COVID-19 era: EM consumers expect to buy more fresh food, household care items, communication services and preventive health care products, while cutting back spending on travel and eating outside the home. For example, refrigerator penetration in Mexico is roughly 90%, and television penetration in China's coastal cities is nearly 100 percent. In India, an estimated 66% of consumers are trying to avoid unnecessary contact,[11] which we expect will lead to continued growth of curbside pickup or home delivery.

Among the industries that stand to benefit from these new consumption trends is at-home leisure, which includes e-gaming, streaming TV, online education and mobile electronics. All of these have become more important in the coronavirus era, creating demand for 5G bandwidth, expanded data storage and memory capacity.

Another emerging theme is the growing use of financial technology (fintech) instead of "bricks-and-mortar" financial institutions. Consumers are embracing e-wallets in Asia, while Latin American savers have migrated away from traditional banks and toward online brokerage platforms amid persistently lower rates. Based on our proprietary research, by the end of 2020 we expect the fintech market to reach $47 trillion in China alone.

## THE CASE FOR ACTIVE MANAGEMENT

While trends in some equity markets have favored passively managed over actively managed strategies in recent years, active managers have consistently proven their ability to generate excess returns in the EM space. As shown in Figure 5, Morningstar's average actively managed EM mutual fund peer outperformed the largest ETF in the category by 0.40% annualized over the 10 years ended 31 December 2019. In contrast, the active international developed-market category trailed an ETF proxy for the MSCI EAFE Index by 0.39% over the same period. This 79-basis-point relative performance edge for active EM supports the view that emerging markets are less efficient than developed markets, thereby providing opportunities for active stock-pickers.

In addition, the ability of active managers to exercise their judgment to overweight, underweight or avoid exposure to specific stocks or sectors relative to the index — and to hold stocks outside of the benchmark, if permitted by their investment guidelines — provides an advantage that passive strategies simply don't have.

## Figure 5. Active EM equity outperformed passive over the past 10 years

| As of 31 December 2019 | 10-yr total return | Excess over ETF proxy (bps) | Hypothetical 10-yr category rank |
|---|---|---|---|
| U.S. Active Fund Diversified Emerging Markets Category Average | 3.25 | +40 | – |
| iShares Emerging Markets Equity ETF (EEM) | 2.85 | | 79 |
| U.S. Active Foreign Fund Large Blend Category Average | 5.02 | -39 | – |
| iShares MSCI EAFE ETF (EFA) | 5.41 | | 47 |

Source: Morningstar as of 31 Dec 2019.

## Our active approach favors EM's rising consumption theme

Increased consumer spending provides an opportunity for Nuveen to target certain investable areas of the EM universe that are (1) likely to benefit from this secular trend and (2) less correlated to other EM sectors, industries and the MSCI Emerging Markets Index as a whole.

The table in Figure 6 compares the cross-correlation of returns among companies within EM sectors, as well as correlations for each sector relative to the index, using a threshold of 0.5 to represent moderately positive correlation. The higher the percentage of companies with cross-correlations above 0.5, the more likely it is that companies within the sector will produce similar performance. Likewise, for each sector, the higher the percentage of companies with correlations above 0.5 relative to the overall index, the more closely the sector's performance is likely to resemble that of the index.

As shown in the table, the consumer sector has among the lowest percentages of companies above the 0.5 level. This means it's driven more by independent company variables and is less susceptible to changes in broad macro factors. The combination of lower correlations and potential to benefit the most from secular EM consumption growth is why the consumer sector is an important focus of Nuveen's actively managed EM strategy.

Other industries and companies that may be bolstered by higher consumption can be found in the information technology sector, and in financials, aided by the increased banking and insurance needs of both consumers and businesses. In addition to specific sectors and industries, certain EM regions and countries — such as Latin America and China —also stand to benefit from secular consumption growth.

## Figure 6. The EM consumer sector is a leading source of opportunity

| | Consumer* | Financials | Info Tech | Comm Services | Materials | Energy | Industrials | Health Care | Real Estate | Utilities |
|---|---|---|---|---|---|---|---|---|---|---|
| Weight in MSCI EM Index | 23.6% | 20.1% | 16.7% | 12.5% | 7.0% | 6.2% | 4.9% | 4.0% | 2.7% | 2.4% |
| % of companies with >0.5 cross-correlation | 1% | 13% | 4% | 1% | 7% | 17% | 2% | 2% | 28% | 1% |
| % of companies with >0.5 correlation with the index | 8% | 72% | 16% | 12% | 44% | 48% | 20% | 0% | 48% | 4% |

Source: Bloomberg data. This table uses the 25 largest companies in each sector of the MSCI Emerging Markets Index as a proxy for the sector as a whole. Data is based on weekly correlations over the 10 years ended 31 May 2020. *Includes both consumer discretionary and consumer staples.

Another aspect of consumption-driven sectors that makes them especially compelling: their constituent companies tend to have more focused business models, making it easier for our research analysts to model how increased household wealth and spending will translate to stronger sales and margins, which in turn should lead to stronger earnings growth and higher stock prices. Companies in these sectors aren't necessarily more attractive on a valuation basis, relative to those in other EM sectors; rather, the fundamentals driving their valuations are more transparent.

Beyond better business models, we also seek superior management teams with track records demonstrating their ability to successfully lead and grow their companies. Such leadership typically results in more predictable investment outcomes. These higher-quality, better-managed companies also tend to be less sensitive to broader macro trends in the market.

## NUVEEN'S DISTINCT EM EQUITY ADVANTAGES

To optimize alpha generation, our active EM equity portfolio managers seek to take advantage of market inefficiencies inherent in the asset class, while capitalizing on specific areas poised to benefit as the growing EM middle-class consumer base steadily increases spending over the long term. This approach is driven by bottom-up, fundamental research that's complemented by top-down perspectives and supported by specialized EM sector analysts—several of whom were born and raised in the countries they cover and are fluent in the languages and business cultures of the markets they invest in.

In addition to emphasizing research, each analyst directly manages EM assets within their respective areas of expertise. By running their own "real" portfolios of stocks, they are able to convey their best investment ideas to the portfolio management team. This enables the portfolio managers to focus on constructing a concentrated portfolio of high-quality companies in which they have the strongest conviction.

## ESG INVESTING IN EMERGING MARKETS

### *A key differentiator to our approach*

Nuveen is a recognized leader in responsible investing, incorporating environmental, social and governance (ESG) factors across all asset classes. Within emerging markets, prudent corporate governance is crucial when considering the long-term viability of a company as an investment. According to MSCI, firms in the MSCI EM universe, on average, score lower on governance criteria than firms in the MSCI World Index. While EM businesses generally face the same governance issues as their developed market peers, certain issues are more prevalent in the EM sphere. For example, the majority of EM firms (measured by market capitalization) are state-owned-enterprises (SOEs) or have single-principal shareholder ownership structures.

Consequently, our analysts are keenly focused on strong corporate governance and transparent management practices as a means to avoid bad investments. This analysis includes measuring corporate data, evaluating management quality and flagging potential fraud.

Relative to SOEs, non-SOE firms are typically better managed to maximize shareholder value, generate strong free cash flow and maintain healthy balance sheets. Additionally, SOEs are more common in "old economy" sectors, such as utilities and telecommunication services, where it's more challenging to find the higher-quality companies we seek to invest in. There are far fewer SOEs in the consumer and information technology sectors that we favor.

Importantly, Nuveen's active Emerging Markets Equity portfolio management team brings deep experience to their discipline, having invested in emerging markets for over 30 years, which includes generating consistent alpha in the strategy since 2014.

**For more information, please visit nuveen.com.**

**Endnotes**

1 FactSet
2 Boston Consulting Group
3 Boston Consulting Group
4 strategy+business.com, “6 Truths About Emerging-Market Consumers.”
5 BCG Edition 1: “COVID-19 and the Emerging-Market Consumer—Five Trends to Watch,” April 2020
6 BCG Edition 1: “COVID-19 and the Emerging-Market Consumer—Five Trends to Watch,” April 2020
7 Forrester Research Group; Boston Consulting Group
8 Boston Consulting Group, COVID-19 Consumer Sentiment Snapshot #2: Racing the Clock, March 2020; Alibaba news release; WeChat data; Tmall International data; Taobao online shopping data
9 BCG Center for Customer Insight
10 Forrester Research Group; Boston Consulting Group
11 McKinsey

**Glossary**

An **exchange-traded fund (ETF)** is a marketable security that tracks an index, a commodity, bonds, or a basket of assets like an index fund. An ETF trades like a common stock on a stock exchange. The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The **MSCI EAFE Index** consists of the following 21 developed market country indexes: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The **MSCI Emerging Markets Index** consists of the following 23 emerging market country indexes: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

**A word on risk**

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