

# INVESTMENT INSIGHT

Janus Henderson  
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The dangers of index investing in  
global emerging market equities



For professional investors only

# The dangers of index investing in global emerging market equities

There is an increasing trend for investors to allocate to emerging market equities using an index-based approach. We believe that this overlooks a number of key drawbacks and the potential benefits of active management. Many indices are weighted by market capitalisation, rather than conviction in a business and its long-term performance, and this distortion may expose index-based investors to increased risk within emerging markets. On the Janus Henderson Global Emerging Market Equities Team, we believe that a selective approach is paramount to balance the long-term opportunities against a wide range of risks.

Since the 17th century, a famous piece of art depicting the “three wise monkeys” has been placed above the door of the Tōshō-gū shrine in Nikkō, Japan. The carving embodies the phrase, “See no evil, hear no evil, speak no evil.” The three wise monkeys have been interpreted within Western culture to mean “look the other way – don’t ask the difficult question.”

Within global emerging market equities, as in other equity classes, there has been a significant shift within the asset management industry towards passive investing and a willingness to look away from active management. The Financial Times reported in August 2017 that exchange-traded funds (ETFs) tracking emerging market (EM) assets now represent almost a fifth of total emerging market mutual fund assets, up from over a tenth just two years ago. The incremental flow of dollars into the asset class has overwhelmingly voted against active management by a factor of two to one. We believe that there are three key drawbacks of benchmark investing. Long-term investors with an absolute return mindset may be wise to question the prevailing orthodoxy.

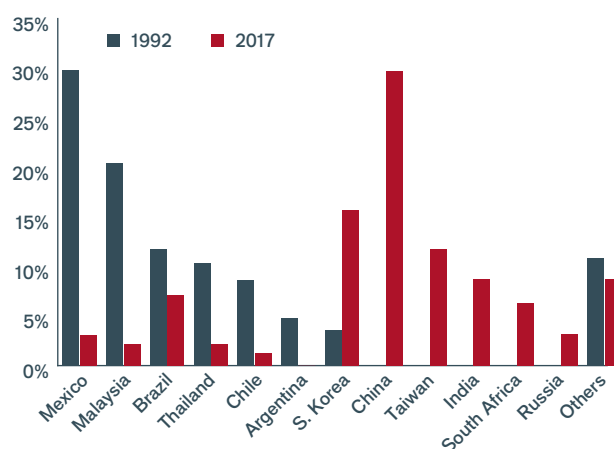
## See no evil

Emerging market equities present attractive opportunities for long-term investors, predominantly because of the positive long-term secular trend of favorable demographics. Significant projected population growth primarily in less-developed economies, rising standards of living and an emerging middle class offer fertile ground for investors to seek to capitalise on.

The MSCI Emerging Markets Index, the predominant emerging markets benchmark, by comparison, is constructed in such a way that it reflects where large pools of capital have been attracted or created. It does not necessarily reflect where future opportunities for long-term investors lie. The index is weighted by market capitalisation, which means it is influenced by the scale of a business and its equity base. Therefore, index-based investments and returns are often shaped by company size rather than the investor having conviction in a business and its performance over the long term.

The EM index has a long track record of such distortion. As shown in Chart 1, Mexico, at around 30%, was the largest country weight in 1992. This was a result of former President Carlos Salinas de Gortari’s privatisation spree of large, state-controlled enterprises which attracted capital flows from foreign investors. This meant that an investor in a passive or index-focused approach at that time would have had around a third of their money invested in Mexico. Taking an index-based approach to EM would have left investors heavily exposed to Mexico’s then weak regulation, corruption and political and economic instability. What followed was a mid-1990s financial crisis, which was fueled further by a credit boom and a level of inflation higher than the US, Mexico’s main trading partner, thus making exports from Mexico more expensive and imports from the US cheaper.

Chart 1: MSCI Emerging Markets Index country breakdown in 1992 and 2017



Source: MSCI as at 31 December 1992 and 31 October 2017

Index-based EM investors would not have invested in advance of the emergence of China, Taiwan, India, South Africa and Russia, which all subsequently opened up as markets for foreign investors. In 1992 the country weightings of the index were entirely backward looking. They did not reflect what was expected to happen in terms of economic development or investment returns. We believe that the index is showing similar signs of distortion today.

## Where are populations growing?

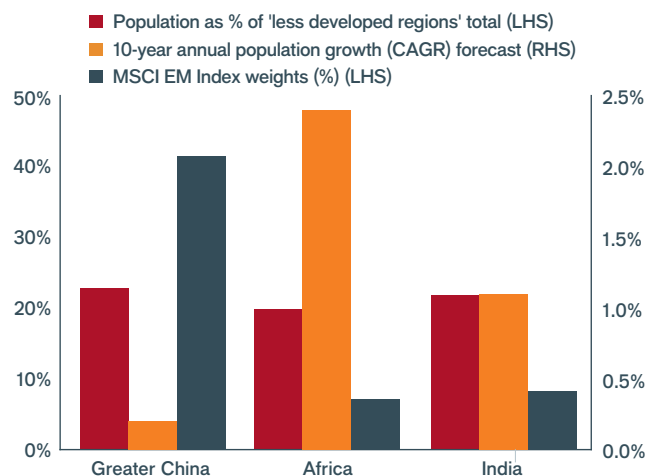
The EM index is now dominated by two countries – China and South Korea. Combined, these two countries make up just under half the index. A large number of companies in the EM index are Chinese-listed state-owned enterprises (SOEs) and internet businesses with complicated ownership structures that offer foreign minority shareholders little or no legal protection. Large parts of the emerging world, where populations happen to also be growing, are underrepresented. Chart 2 provides a breakdown, in percentage terms, of the people living in the developing world and maps this against the allocation of some of the key regions within the index.

Chart 2 demonstrates that China is overrepresented in the EM index relative to its population weighting, while India and Africa are underrepresented. Importantly, the chart also highlights the predicted future population change for these regions. It is clear from this that the index does not reflect where population dynamics, as well as other favourable demographic trends, are perhaps creating the potential for economic growth in the future.



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Chart 2: Index vs. population & growth



Source: Janus Henderson Investors, Factset: MSCI EM Index data as at 31 October 2017. United Nations, Department of Economic and Social Affairs, Population Division (2015), World Population Prospects: The 2015 Revision, Total Population, both sexes, using median fertility, July 2015. Regions as defined by Janus Henderson Investors. LatAm (Latin America) includes Caribbean. CAGR = compound annual growth rate (2016 - 2026 forecast).

In 1992 the index was backward-looking and we suspect this remains the case today. India and Africa currently seem overlooked by the benchmark. Index-based investors again appear to be following the rise of "in vogue" markets, such as China, with its debt-fuelled growth strategy. This comes at the expense of not being able to allocate capital to countries and regions that are arguably better placed to benefit from these predictable long-term demographic changes.

Over the long term, we believe that this index allocation will change. We expect active investors in the equity class to continue to benefit from seeking out long-term opportunities based on the merits of a company and where it is operating, as opposed to taking a backward-looking passive approach.

## Hear no evil

The index appears to ignore the cacophony of political scandal and misallocation of capital conducted by politicians. With increasing geopolitical headwinds across the globe and immature EM legal and political systems, the need for a selective approach to investing is paramount to balancing the opportunities against significant risks. The role of the state in EM corporate ownership and its control of capital markets is significant and we believe it has a negative impact on long-term returns. SOEs make up a substantial proportion of many emerging equity markets, which impacts the overall index. Analysis conducted by our team has identified that there is either significant state influence or direct control in more than a quarter of companies within the EM equities benchmark index as shown in Chart 3. In contrast, our investment philosophy and process lead us to avoid SOEs, except in cases where there are joint ventures or other corporate endorsements in place that align the interests of the management team with minority shareholders.

## The importance of alignment

We are bottom-up investors and prefer to focus on quality companies with proven track records, strong franchises and management teams with a history of integrity. We believe that seeking investments where our interests are aligned with those allocating capital is essential in EM and can lead to superior long-term returns.

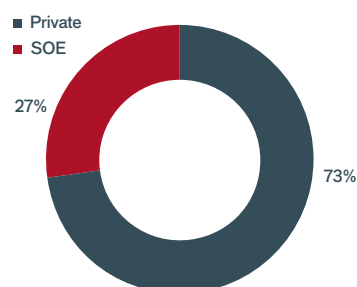
The importance of such alignment can be witnessed with those Chinese companies involved in the One Belt and One Road (OBOR) policy. This initiative has ambitious infrastructure and economic aims, hoping to better connect China with other parts of Asia, Europe, East Africa, the Middle East and Russia. Such global ambition requires unbounded amounts of capital, with estimates ranging from US \$4 trillion to US \$8 trillion. While the built environment – buildings and infrastructure – is able to consume such colossal amounts of capital, it is less certain that those Chinese SOEs investing in this centrally planned initiative will produce a positive return on equity for shareholders.

Many of China's SOEs continue to follow the well-trodden path of "performing national service." By this we mean that many Chinese corporates and SOEs invest equity capital in order to meet the geopolitical and economic needs of the State, rather than to produce a positive return for investors.

One example of an OBOR project that has not been successful to date is an oil refinery built in Kyrgyzstan, Central Asia, by state-owned Zhongda China Petrol. When built it could only run at 6% capacity because it could not source enough oil. While there are bound to be high-profile disappointments, the auspices and historical precedents for such investment projects do not bode well and this reinforces our belief that it is important to seek investments where our interests are aligned with those allocating share capital.

Notably, investors should be suspicious of companies where politicians are involved. Brazil's recent recession, which was its worst on record, had its genesis in the populist and pro-cyclical lending practices of previous governments. Politicians encouraged the state-owned banks to go on a lending spree to support the economy, while well-managed private banks pulled back on loans due to increased consumer defaults and fear of weaker economic conditions. Capital, the basic resource of the banking industry, is a commodity. The price of this commodity increases when supply is tight and drops when supply is abundant relative to demand. It helps explain the bankers' adage that "the worst loans are made at the best of times, and the best loans are made at the worst of times."

Chart 3: Who controls the index?



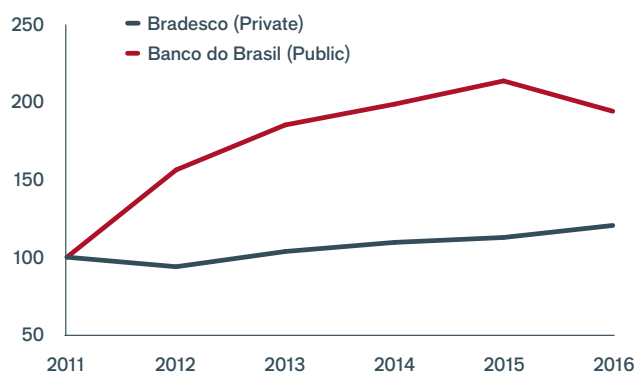
Source: MSCI, Janus Henderson Investors, as at 31 December 2016. Private, SOEs (state-owned enterprises) as defined by Janus Henderson Investors.

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As Chart 4 demonstrates, the politicians encouraged state-owned Banco do Brasil to make significant loans at the best of times. The impact on Banco do Brasil was severe and it had to cut a significant amount of its workforce and shut branches to restore profitability to the bank. This has allowed the private banks to take advantage of the reduction of capital by the public banks and regain market share at a time when the price of risk within the banking sector was attractive.

Chart 4: Politics, not returns, driving loan growth in Brazil's SOE banks

Total loan book of comparable Brazilian banks



Source: Capital IQ as 31 December 2016. Total loan book in Brazilian Real, rebased to 100 in 2011.

The presence of significant political influence over or ownership of a company can also lead to poor governance. From 2003 to 2010 former President Dilma Rousseff was Chair of Petrobras, Brazil's largest oil producer and refiner, in which the Brazilian government owns a majority stake. In an investigation known as Operation Carwash, prosecutors discovered a massive kickback and bribery scheme at the oil company, which has become Brazil's biggest ever corruption scandal. It is alleged that senior figures at Petrobras conspired with construction companies to inflate the value of contracts. A lot of this extra revenue was allegedly funnelled to political parties, including ex-Presidents Lula and Rousseff's left-wing Workers' Party, to fund election campaigns. There has been no direct connection made between ex-President Rousseff and the bribery scandal, but it highlights the need for selectivity when investing in EM and the dangers ignoring the sound of corruption and political influence.

## Speak no evil

The past decade has seen a huge shift away from active management. The New York Times has reported that Vanguard, which is a global leader in passive funds, took in eight times more inflows than the rest of the US mutual fund industry combined in the last three calendar years. We believe that when investing in EM through market cycles, a very active approach (relative to the index), with an emphasis on only owning high-quality companies, can help investors meet long-term goals. That is, in our view, something to shout about.

## Conclusion

Emerging markets can be a risky place for investors. Immature legal and political systems often mean inadequate levels of minority shareholder protection and economic volatility. The opportunities for investment, however, are significant and well documented. We believe that it calls for a selective approach to investing. The issue is that passive investing within the asset class is not selective. It is not designed to filter out businesses which have poor alignment, have low return potential or which are operating in countries with a demographic headwind. The MSCI Emerging Markets Index holds 838 listed businesses in 24 countries\*. It is a low common-denominator approach to investing within EM, based largely on market capitalisation. We believe that it is shaped by the past and not looking to, or taking advantage of, the future. The index contains many companies that we feel are either too high risk or low-return businesses, which could present dangers to investors' long-term capital growth.

\*MSCI as at 31 October 2017



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