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Understanding four forces of structural change in EM

KEY POINTS

We believe:

- Economic development is generating four forces of structural change: greater inclusiveness, enhanced productivity, improved living standards and better sustainability.
- Countries that make progress towards economic development offer more fertile environments for investing.
- Traditional indexes are underexposed to the forces of structural change in emerging markets.
- An unconstrained, thematic approach can offer targeted access to development opportunities.

THE TAILWIND OF ABOVE-TREND GROWTH shaped the emerging market (EM) investment environment over the past 20 years. This growth tailwind has now faded and we see no reason to think it will return with the same strength in the near future. A change in policy priorities together with an environment of slower but steadier growth is creating different investment opportunities from those that characterised the last cycle. Our research agenda is focused on trying to understand this transition and its investment implications. This short paper isolates four key forces of structural change across emerging markets, and offers a framework for identifying potential beneficiaries at the country, industry and company level.

Focus on development rather than growth

Policy objectives across emerging markets have been evolving away from a narrow focus on growth, towards broader measures of economic prosperity. "Growth at all costs" without due regard for its impact or stability is no longer an accepted approach to economic planning. This evolution should challenge how investors think about emerging markets. Specifically, we believe that "economic development" has begun to surpass "economic growth" as the dominant force for structural change and that it will likely be a powerful lens to use when searching for attractive investment opportunities in the future.

Economic development is different from economic growth. Typically measured by gross domestic product or gross national income, economic growth centers on changes in the aggregate output of an economy.

Economic development, on the other hand, is a much broader economic measure that takes into account a range of variables and higher-value-added outcomes within an economy — outcomes that allow new industries and services to grow, that foster cooperation between the public sector and private enterprises, and that broaden societal participation in economic prosperity, all without being detrimental to future generations.

In the short to medium term, economic growth without significant economic development is possible, often as a result of large-scale resource extraction or demographic dividends. There are numerous examples of economies (across sub-Saharan Africa, Central and South America and Oceania) that have generated robust growth without development, only to revert to weak and unstable growth patterns once the benefits of increases in the factors of production have been realised.

> We prefer to focus on these under-appreciated and more enduring changes, rather than getting distracted by the short-term cyclical noise.

Tune out the noise, tune in to the signal

Markets are often quick to respond to the ups and downs of cyclical news flow. For example, the potential impacts of oil prices on EM exporters and importers can result in short-term dislocations. On the other hand, markets are often slow to recognise structural change. We prefer to focus on these underappreciated and more enduring changes, rather than getting distracted by the short-term cyclical noise. In our view, there are four key forces of structural change related to economic development (**Figure 1**).

Figure 1

Four forces of structural change

Greater inclusiveness: broadening the range of beneficiaries of economic progress.	**Impact:** access to health care, education and basic sanitation; less inequality; better life expectancy.
Better sustainability: using available resources with due consideration for future generations and the environment.	**Impact:** recycling, water and waste management, energy efficiency, alternative energy sources, better testing and diagnostics.
Improved living standards: ensuring stable progress in the quality of life of the whole population.	**Impact:** changing patterns of behaviour and preferences in how money and time are spent.
Enhanced productivity: increasing the efficiency of all available factors of production.	**Impact:** use of technology, promotion of innovation, support for training/higher education, institutional reform.

About the authors

Dáire Dunne and **Simon Henry** manage a thematic emerging market equity approach focused on economic development. Their top-down background in emerging markets allows them to focus their research efforts on understanding evolving development trends. They make use of Wellington Management's many stock-level experts to pick the individual companies most likely to adapt to and benefit from each theme in their portfolio.

Santiago Millàn is an authority on emerging market economies who concentrates on China and Asia generally but provides guidance on many other countries and global economic and financial issues. He is a key source of information and ideas for portfolio managers and analysts across Wellington Management.

These structural forces can have a material impact on a country's economic prosperity and the structure of its capital markets. Countries where these forces take hold tend to evolve with more industries, greater innovation and knowledge sharing, a wider variety of goods and services and less inequality. These factors typically result in deeper financial markets with more listed companies, along with positive tailwinds for profitability, offering a fertile environment for investment opportunities.

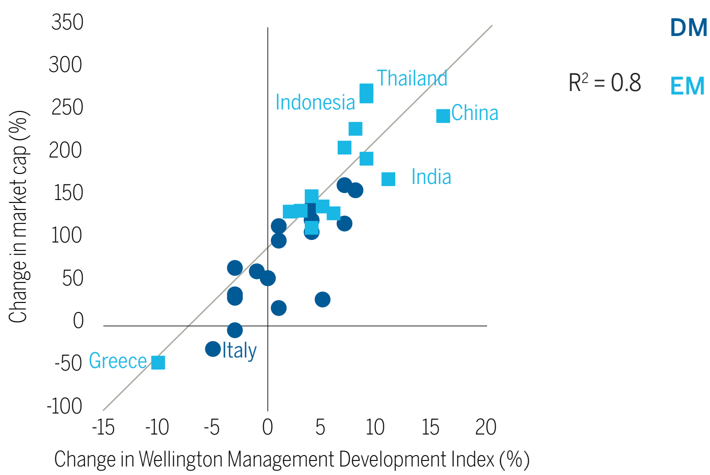
We have constructed our own development index that seeks to track progress along each of these four forces of structural change. Our empirical research confirms that changes in a country's development index tend to be associated with changes in the depth and breadth of its financial markets. There is also evidence of a positive relationship with changes in a country's return on equity. **Figure 2** highlights the relationship between changes in this index and changes in the market capitalisation of domestic stock exchanges from 2000 to 2014.

…changes in a country's development index tend to be associated with changes in the depth and breadth of its financial markets.

Figure 2

The link between economic development and financial market depth

Change in market cap versus change in development index



Data as of 31 December 2014. Please note that the data shown in Figure 2 is the most recent that we have available. We believe the trend presented still persists. The development index combines measures of economic complexity, access to electricity, gender parity, adjusted net savings, gross national income per capita, life expectancy and average years of schooling. | Source: Wellington Management

As shown in **Figure 2**, emerging markets (light blue squares) have experienced a faster rate of economic development as well as significantly faster growth in market capitalisation than developed markets (dark blue circles). For example, China had the highest rate of development from 2000 – 2014; during that period, the country's market capitalisation increased almost 250% and the number of listed companies more than doubled.

We believe markets underappreciate the political determination that exists to make economic progress more stable and inclusive. We expect social pressure and policy support for these development objectives to continue to build, and we have seen evidence of this in spite of slowing domestic growth in many economies. For example, while growth rates across emerging markets have slowed, spending on health care and education continues to rise across all regions, renewable energy continues to gain share, and access to basic sanitation, clean water and electricity remains on a strong positive trajectory.

> Divergences between the beneficiaries of economic development and current market capitalisation have grown substantially over time and represent a unique opportunity for investors...

EM is not spelled "MSCI"

In our view, traditional public market indexes are not the best starting point from which to build exposure to the four forces of structural change. Health care provision is a good example. Demand for health care services and pharmaceuticals in emerging markets is vast. This demand is driven by ageing populations, a rapidly growing middle class, the prevalence of chronic disease and the lack of preventative treatment. As a result, we expect health care's contribution to economic activity and its policy importance to increase substantially over time. Given this outlook, we believe health care is massively underrepresented in the MSCI Emerging Markets Index, at less than 3% of the benchmark's total market capitalisation.

Divergences between the beneficiaries of economic development and current market capitalisation have grown substantially over time and represent a differentiated opportunity for investors willing to take an unconstrained approach to building their emerging market equity exposure.

Interestingly, over the past decade, capital flows from private equity have been much more closely aligned with the sectors where we see the most compelling development opportunities (e.g., health care, consumer services and technology). On the other hand, capital flows into publicly listed emerging market companies have been biased towards energy, materials, financials and other areas that often represent a significant proportion of traditional benchmarks — at the expense of less explored and more idiosyncratic industries and companies.

An additional benefit of concentrating more on development sectors is the potential for greater diversification. As emerging market indexes have evolved over the last 30 years, their correlation to developed markets has more than doubled. This is driven in part by the dominance, in risk terms, of more globally oriented sectors like those we have mentioned (energy, materials and financials), which we believe are less attractive when viewed through the lens of economic development.

From backward-looking benchmarks to forward-looking portfolios

Our beliefs lead us to a different approach to investing in emerging markets. We seek to build high-conviction views on economic development trends related to each of the four forces of structural change and then establish targeted thematic exposures that align with those trends. Once we have identified a theme and the universe of stocks that should be affected by it, we believe it is critical to differentiate between "winners" and "losers". This is particularly important at the stock level, given that there will likely be significant creative destruction as economic development trends play out.

The result is a portfolio that looks very different from traditional market-cap-weighted benchmarks and that, accordingly, may complement core emerging market exposures. This approach leads us away from past "winners", and instead directs our attention to areas where we expect to find future outperformers — those that can thrive on the disruptive nature of economic development. **Figure 3** highlights sample themes tied to each of the four forces of structural change.

Figure 3
Emerging development themes

Enhanced productivity	Automation and robotics	Better affordability, supported by rising wages and technological innovation, should encourage significant catchup to developed peers.
Better sustainability	Energy efficiency	Policy initiatives to reduce energy intensity are in place, fuelled by aggressive targets for emissions reductions, and to lower consumer costs and bolster energy security.
Greater inclusiveness	Financial market deepening	Penetration of financial products and services is very low and governments are motivated to improve financial literacy and access.
Improved living standards	Convergent consumption	As basic needs for food and shelter are met, new consumers emerge and begin to engage with branded goods.

The digital disruption theme, for example, is likely to benefit from continued expansion of the tertiary sectors in many developing economies as well as from tapping into the emergence of the "on-demand" generation. Regulatory and policy tailwinds aimed at improving the access to and efficiency of services should continue to drive growth in the service sectors. There is also scope for online players to take significant market share from incumbents and offline competitors — supported by rising disposable incomes, demand for transactions to be fulfilled rapidly or instantaneously and efforts by online entities to improve security and build trust with their customers. This theme may also benefit from better connectivity, reduced data storage and manipulation costs and the continuing shift towards higher-density living.

Conclusion

The tailwind of above-trend growth in emerging markets has faded, and economic development is likely to shape the investment environment in the future. We believe that there are a wide variety of attractive investment opportunities available for investors who are able to unshackle themselves from traditional benchmarks. Using a thematic approach focused on the four forces of structural change (greater inclusiveness, enhanced productivity, improved living standards and better sustainability) can help unearth these opportunities and potentially generate attractive risk-adjusted returns while complementing existing, broad-based exposures.

Emerging Market Themes[1]

The Emerging Market Themes approach seeks to outperform broad emerging market equity indexes over a three- to five-year time horizon. The portfolio includes five to 10 independent, focused and dynamic investment themes that align with economic development trends in emerging markets. The selection of and allocation to the themes is expected to drive the majority of the portfolio's risk and return. Within each theme, the managers draw on industry and company specialists from around the firm for active stock selection.

[1]The characteristics presented are sought during the portfolio management process. Actual experience may not reflect all of these characteristics.

ALL INVESTING INVOLVES RISK. IF AN INVESTOR IS IN ANY DOUBT AS TO THE SUITABILITY OF AN INVESTMENT, THEY SHOULD CONSULT AN INDEPENDENT FINANCIAL ADVISER.

Principal risks

Currency risk

Investments in currencies, currency futures contracts, forward currency exchange contracts or similar instruments, as well as in securities that are denominated in foreign currency, are subject to the risk that the value of a particular currency will change in relation to one or more other currencies.

Equity market risks

Equity markets are subject to many factors, including economic conditions, government regulations, market sentiment, local and international political events, and environmental and technological issues.

Foreign markets risk (includes emerging markets)

Investments in foreign markets may present risks not typically associated with domestic markets. These risks may include changes in currency exchange rates; less-liquid markets and less available information; less government supervision of exchanges, brokers, and issuers; increased social, economic, and political uncertainty; and greater price volatility. These risks may be greater in emerging markets, which may also entail different risks from developed markets.

Issuer-specific risk

A security issued by a particular issuer may be impacted by factors that are unique to that issuer and thus may cause that security's return to differ from that of the market.

Liquidity risk

Investments with low liquidity can have significant changes in market value, and there is no guarantee that these securities could be sold at fair value.

Manager risk

Investment performance depends on the portfolio management team and the team's investment strategies. If the investment strategies do not perform as expected, if opportunities to implement those strategies do not arise, or if the team does not implement its investment strategies successfully, an investment portfolio may underperform or suffer significant losses.

Smaller-capitalization stock risk

The share prices of small and mid-cap companies may exhibit greater volatility than the share prices of larger capitalization companies. In addition, shares of small and mid-cap companies are often less liquid than larger capitalization companies.

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