InvestmentMetrics

Stability Translates to Success within Emerging Markets

by InterSec Research

InterSec Research has been studying market volatility since the Financial Crisis. Earlier this spring, we collaborated with Russell to apply their Third Dimension of Style as another way to analyze our Global Equity Universe in the context of this unprecedented environment. Client reception urged us to apply the same stability analysis to emerging markets.

InterSec has conducted a significant amount of research focused on the importance of mitigating losses within equity markets over the last three years. In early 2013, the InterSec consulting team paired up with Russell Investments to analyze InterSec's institutionally competitive global equity universe through a new lens; that of the Russell Stability Index Series [1]. Using the InterSec Research returns based style analysis tool, we were able to give each manager a valuation and a stability score to conduct peer group analysis. InterSec's model analyzes managers stated monthly portfolio returns against country-specific growth and value style indices – in this case we used Russell valuation and stability style indices to appropriately classify managers. There were a number of takeaways from the global memo that differ slightly when the same methodology is applied to emerging markets; as seen in Chart 1, emerging managers are more evenly distributed along the stability spectrum, whereas within global equity, over 85% of managers had a defensive tilt [2]. Since the market crash, downside protection has grown in importance for plans when deciding how to allocate assets to equity products. InterSec's database on initial fundings supports this finding. Over the last four years, low volatility fundings (within global equity specifically) increased from 6% to almost 25% of all products funded [3]. This increase directed us to focus on downside risk within the Global Russell Stability analysis, and we found that the clearest distinction between the defensive and dynamic dimensions became apparent when examining manager performance in up and down markets. We concluded that while there was no identifiable trend when looking at managers' performance along traditional style lines in either bull or bear markets, a more distinct pattern of product behavior could be observed using the Stability lens [4]. Similar trends are seen, though not as stark, when looking at emerging markets. In Chart 2, products with a dynamic style designation tend to perform below median in down markets over the trailing three years compared to only one of the defensive products.

With increased volatility across all equity markets, changing risk tolerance may be the explanation for the increased interest in products with defensive characteristics. As seen in the first chart on the following page, at the time of the financial crisis, assets allocated to emerging markets strategies were evenly distributed to both dynamic and defensive products. Since then however, the fundings have shifted drastically; defensive products have won an overwhelming percentage of new mandates. Since 2009, an average of 70% of products funded had a defensive tilt, and that number topped 75% in 2012 alone [5].

Mangers that are building portfolios designed to mitigate some of the market swings have been rewarded with a return that is more than double that of the broad universe median. Over the trailing three years, the median within the defensive sub sample outperformed the MSCI EM Index by over 500 basis points, and the full Emerging

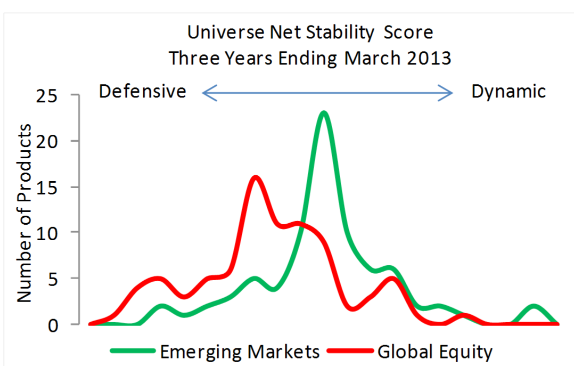


Chart 1.

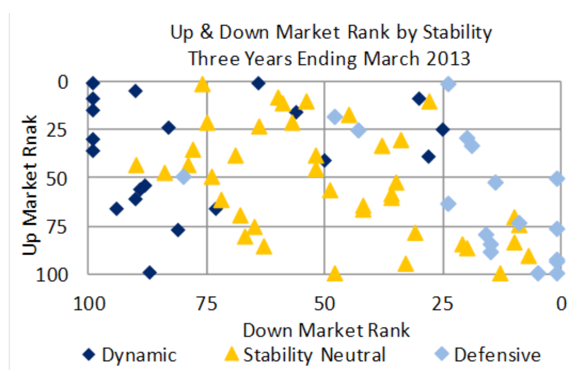


Chart 2.

1 For an overview of Russell Stability Indexes, please refer to the addendum.
2 For the Global Equity paper, please click here
3 Global equity funding chart in addendum

4 Global equity up/down chart in addendum
5 Funding chart since 2007 in addendum

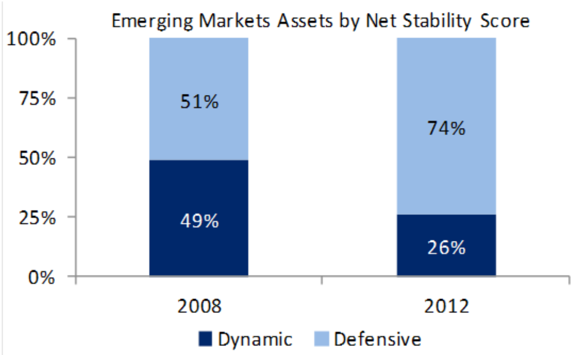


Chart 3.

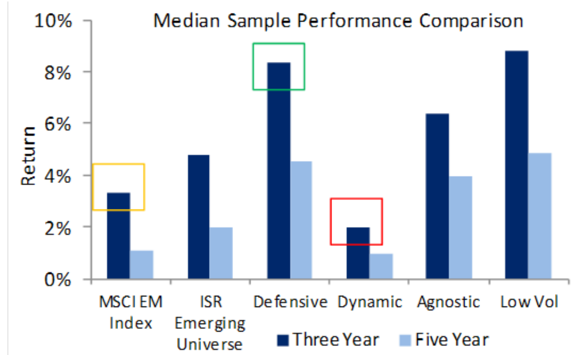


Chart 4.

Markets Universe by 370 basis points. Predictably, the defensive sample has a fair amount of overlap with the Low Vol sample, as both aim for lower standard deviations. The median manager within the low volatility sub sample for example had a standard deviation of 18.6%, and a three year return of 8.8%, while the full universe (ex low vol) has a median standard deviation of 21.4%, and return of 4.8% [6]. Interestingly, dynamic products have been the one group that has struggled to add any significant value, and are the only group that does not have a defensive tilt (in Chart 5, they are the only group on the right of the neutral stability line). Over the trailing three years, taking on greater levels of risk has not resulted in higher returns, as dynamic products underperformed the MSCI EM Index return by 130 basis points.

The Reemergence of Quants

In the last five years, fundings to quantitative emerging markets products have jumped from 2% to roughly a third of all new business. This dramatic shift led InterSec consultants to further analyze the quantitative sample. In terms of stability scores, quant managers are evenly split between defensive and dynamic (which is not a surprise given the full universe distribution), but what is interesting is that all but two of the 16 quant managers are performing above median in up markets. While the recent ability of quant managers to add value in bull markets has been a differentiating factor, 70% of the assets won have still been to products that fall out on the defensive side of the stability spectrum.

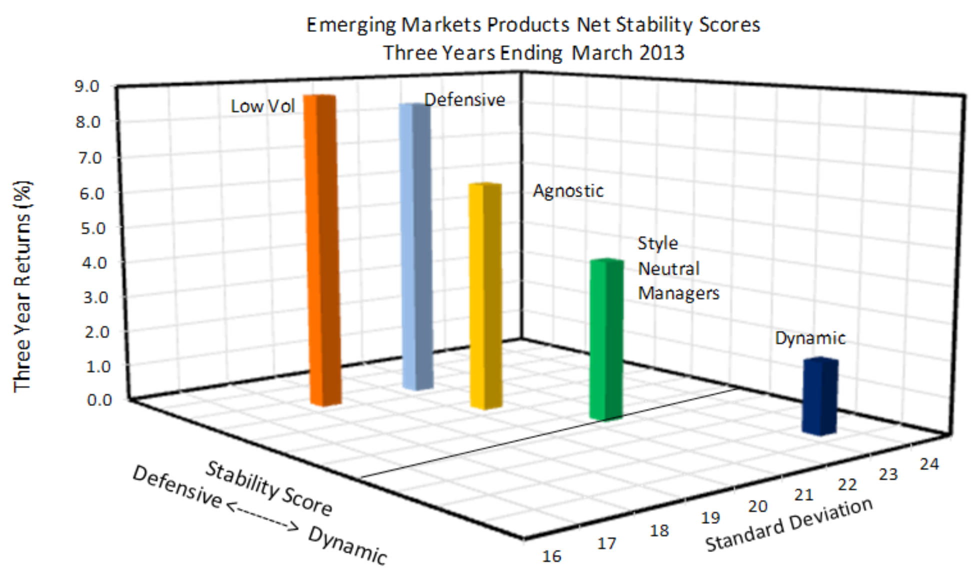


Chart 5.

6 See table in Addendum for sub sample risk / return statistics

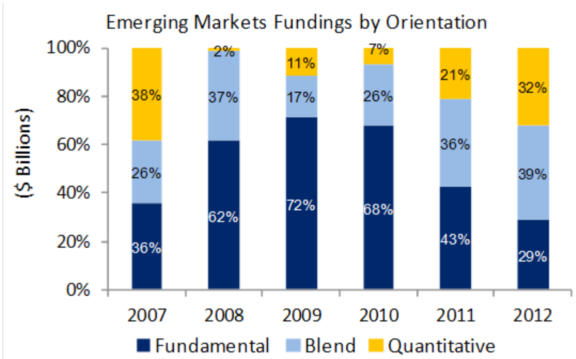


Chart 6.

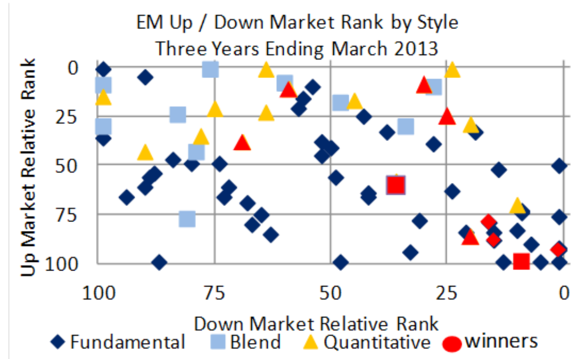


Chart 7.

In addition to up market success, there are unique attribution characteristics of quant managers that are translating to renewed interest. First, quantitative managers are not only underweight to the underperforming and still shaky financial sector, but also have larger active weights in the consumer discretionary sector, thus offering a potential play on the local consumer growth theme [7]. Secondly, many quant products have more favorable risk/reward characteristics than their fundamental counterparts. While hovering around the median in terms of standard deviation, quant managers are adding 80 basis points relative to the MSCI EM Index [8]. Lastly, overall product availability has been limited amongst fundamental products. Of the 25 closed products in the broad InterSec Emerging Markets Universe, 19 of them have a fundamental orientation. Of the limited open products with top quartile performance, almost half are quantitatively managed.

Active managers have struggled to add value in emerging markets since the financial crisis. Prior to 2008, the average median excess return over five years on a quarterly rolling three year basis was 2.0%. Since then, median relative performance has been on a steady decline; the average excess return a mere 0.6%. As highlighted in this paper, defensive strategies, whether fundamental or quantitative, have garnered the most interest since the market crashed. Defensive managers have been able to protect on the downside by creating portfolios consisting of less volatile stocks. The Russell Stability Index Series, when applied to emerging markets, helps to provide a framework for classifying an approach that has worked over the last three years by investing in less economically sensitive companies.

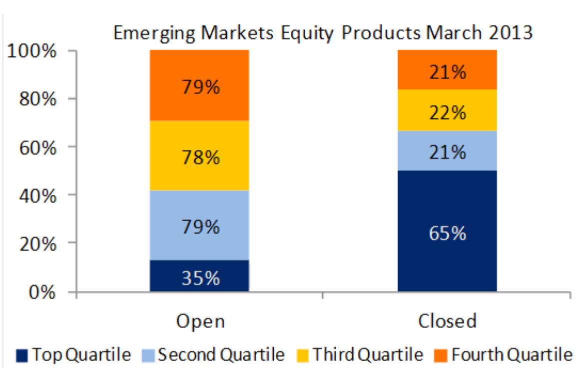


Chart 8.

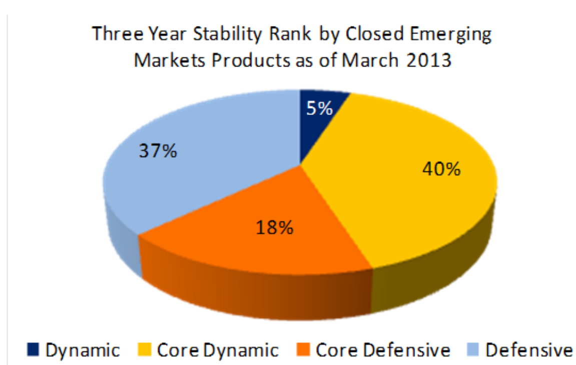
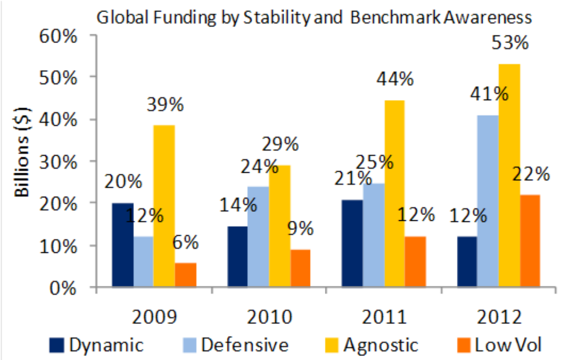
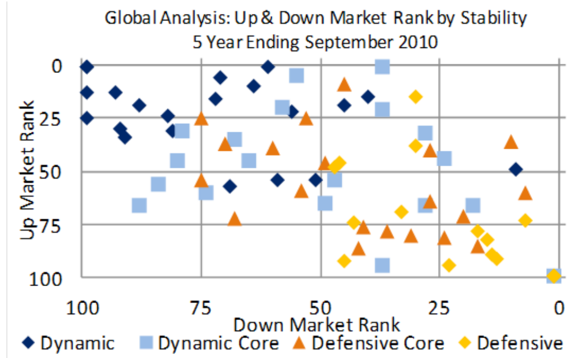


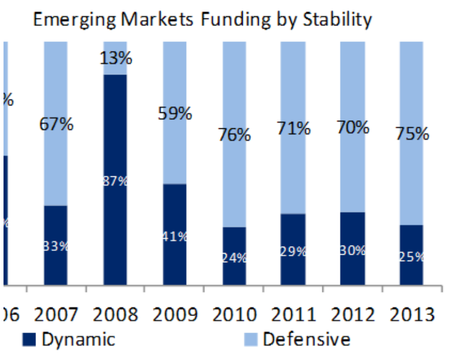
Chart 9.

7 Sector weight chart in addendum
8 Standard deviation / return scatter chart in addendum

Addendum

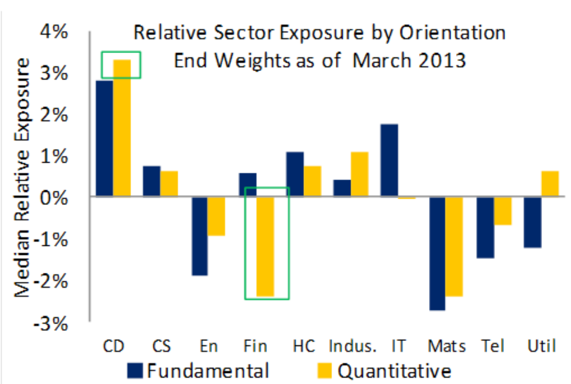


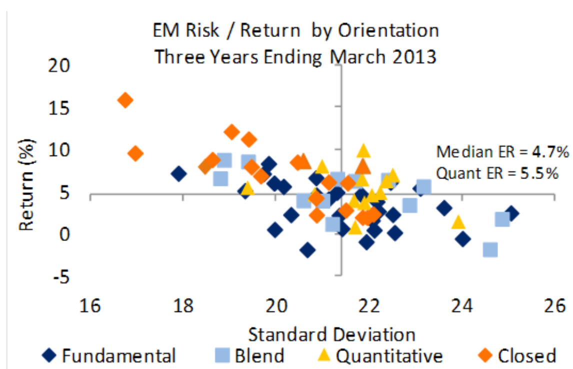




Three Year Sub Sample Risk / Return Stats

Sub Sample	Return	Standard Deviation
MSCI EM Index	3.3%	21.1%
ISR Emerging Universe	4.8%	21.5%
Defensive	8.3%	19.7%
Dynamic	2.0%	22.3%
Agnostic	6.4%	19.9%
Low Vol	8.8%	18.6%
Quant	5.9%	21.9%





Overview of Russell Stability Indexes by Russell Research

In 2010, Russell introduced the methodology behind the Russell Stability Indexes™ as the Third Dimension of Style™, which captures in greater detail the different market segments that are the preferred habitats of active managers [1]. Russell launched the Defensive and Dynamic Indexes to represent the two halves of the Stability style, created by using quality and volatility factors as inputs [2]. The stability style spectrum is distinct from the valuation style spectrum generated by growth and value style indexes.

The Russell Defensive and Dynamic Indexes each represent half of the market value within a specified market capitalization tier, and in their construction Russell uses the same methodology as that for building its growth and value benchmarks. The Defensive Index contains stocks with high financial quality, stable earnings and/or low volatility of total returns. The Dynamic Index contains stocks with more financial leverage, more variation in earnings and/or higher volatility of total returns. Each half represents an existing investment style that is different from those provided by existing size and valuation style indexes.

Since its launch, the Russell Stability Index series has steadily gained acceptance among institutional investors. A number of major U.S. and non-U.S. pension funds have allocated portions of their retirement plan assets to the Russell Defensive indexes, with nearly $3 billion (USD) in passive assets tracking the U.S. and Developed Europe large cap segments. Total active and passive assets benchmarked to the Russell Defensive and Dynamic indexes stood at nearly $6 billion (USD) as of December 2012 (Source: Russell Investments).

1 See "the Third Dimension of Style: Introducing the Russell Stability Indexes," by Dave Hintz, Russell Research, December 2010

2 See "Russell Stability Indexes TM Construction and Methodology." November 2012

InvestmentMetrics

Based in Darien, Connecticut, Investment Metrics is an independent provider of investment performance analytics, manager research, reporting and data solutions for investment consultants, wealth advisors, asset managers and investors.

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For questions, please contact:

Brendan Cooper
Senior Consultant
brendan.cooper@invmetrics.com
203 662-8412