InvestmentMetrics

# Product Capacity in Emerging Markets

by InterSec Research

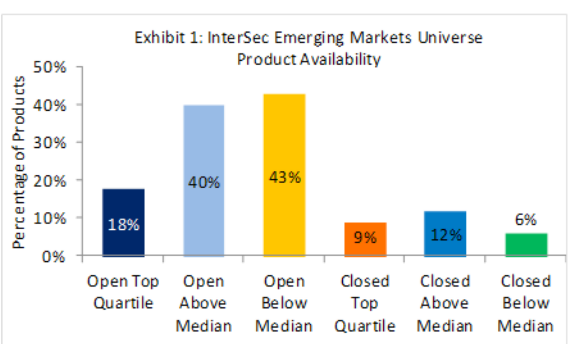
*Herein we glance at the emerging markets product landscape and see an area that has benefited from solid investment flows and strong rolling three year performance. It is an interesting asset class that has led to many articles discussing the limited product availability. However, we still see nearly 40% of our universe open and out-performing the benchmark and the median manager.*

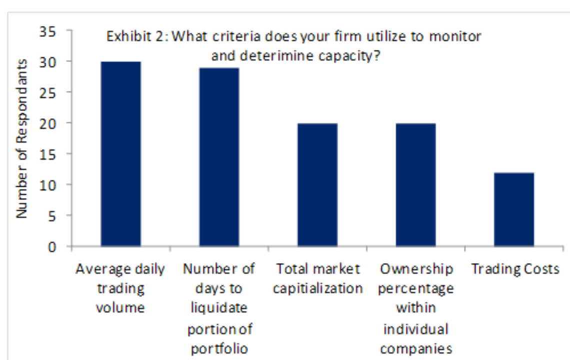
In the aftermath of 2008, pension plans have increased their target emerging markets allocations. During the last two calendar years, InterSec Research has tracked record high flows into both emerging equity and debt products from U.S. tax-exempt institutions. Albeit volatile, emerging markets performance has been strong. The MSCI Emerging Markets Index has returned 18% or more in each calendar year since 2003 (except for 2008 and 2011 when the index lost 53% and 18% respectively). Additionally, the projected growth expectations for emerging market economies outpace those of developed markets. Bottom line, emerging markets represents a different opportunity set for investors. The MSCI World Index represents 1,626 constituents and total market capitalization of $23,566 billion (as of June 30, 2012). The MSCI Emerging Markets Index on the other hand, has 819 names and represents $3,367 billion in adjusted market capitalization (as of June 30, 2012).

InterSec tracks approximately $170 billion of U.S. tax-exempt assets in global equity products which accounts for less than 1% of the MSCI World Index's total market cap, where as the $163 billion of U.S. tax-exempt assets tracked in dedicated emerging markets products amounts to approximately 5% of the MSCI EM Index's total market cap. While there is higher percentage of assets invested the emerging markets equity strategies compared to the Index's market capitalization, the total number of products is relatively low compared to other asset classes (there are less than 75 constituents comprising the InterSec Research Emerging Markets Universe, whereas the Global Universe tracks nearly 90 products and the EAFE Plus Universe tracks over 130 products). As seen in Exhibit 1, as of June 2012, only 40% of the products in the Universe are both open to new investors and performing above the median (18% are open and top quartile performers). The interest in these markets coupled with opportunity set differences (fewer total constituents, less liquidity, higher percentage of institutional assets and product availability) makes capacity a key topic among consultants, managers and plans.

This summer, InterSec sent a survey to investment managers attempting to understand how they define overall capacity limits. In this memo, we will share some of the highlights from the forty-four respondents.

There are key differences behind defining capacity targets; (1) how a firm calculates product capacity and (2) how it defines liquidity. It is first important to point out that not all firms utilize a specific, objective formula. In fact, 60% of the respondents do not use a formula at all to determine capacity. However, within this subset of managers that incorporate a formula, many report that they monitor average daily trading volume, market capitalization, and their ownership stake within individual companies. Overall, nearly 80% of our total respondents utilize average daily trading volume and the number of days to liquidate a defined portion of the portfolio (ranging from three to seven days) to define capacity constraints (Exhibit 2). Additionally, 50% of the managers reported ownership with individual companies as a factor, while only 30% focused on trading costs (although these tend to be managers running emerging markets small cap or frontier portfolios, of which there are less products and firms).



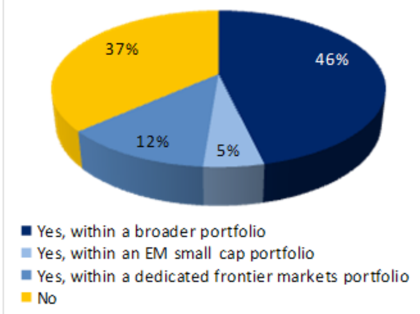


Exhibit 3: Does your portfolio include frontier markets securities?

At the median level, out-performing the index has been increasingly difficult since 2006. This has prompted managers and investors to search for other areas of differentiation and higher alpha. As seen in Exhibit 3, more than 40% of the respondents reported including both emerging small cap and frontier markets securities in the broad emerging markets portfolios. By including these securities, capacity concerns escalate as investment managers face higher transaction costs, less trading volume and therefore less product capacity.

The majority of respondents believe their product capacity is greater than $5 billion for broad all cap and large cap global emerging markets portfolios. Not surprisingly, this drops off dramatically for dedicated emerging markets small cap or frontier markets portfolios; nearly half of the respondents target $1 billion or less (Exhibit 4).

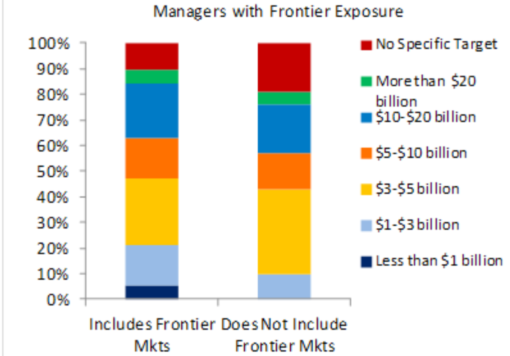


Exhibit 4: Emerging Markets Capacity of Managers with Frontier Exposure

Admittedly, there are many ways to slice this information, however, managers with a fundamental process, lower turnover, and more holdings, tended to have more capacity. As a corollary, products including emerging small cap or frontier markets in their broader products tended to have lower capacity ranges.

In terms of specific ranges, the largest percentage of respondents reported their capacity range as $3-$5 billion for global emerging markets products (including both all and large cap products). Nearly 80% of managers running emerging markets small cap products reported a range below $3 billion (equally split between $1-$3 billion and less than $1 billion, as shown in Exhibit 5).

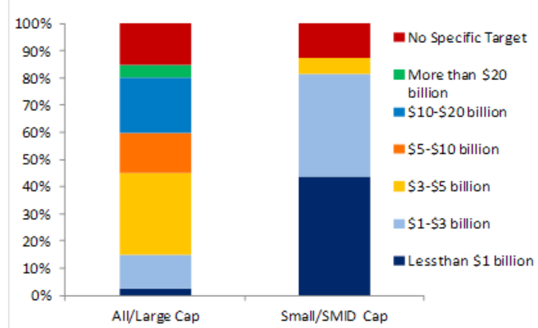


Exhibit 5: Emerging Markets Capacity Ranges

Exhibit 6 below provides the U.S. tax-exempt and total assets (dark and light blue bars respectively) managed as of December 2011 compared to the reported capacity limit ceiling for each manager represented by a red dot (red triangles represent a capacity target greater than $20 billion). Skeptics may not be surprised that most managers view capacity limits well above their current asset levels. However, it is worth noting that of the closed products, only three managers have a capacity target greater than $20 billion. There are seven open managers running more than $20 billion.

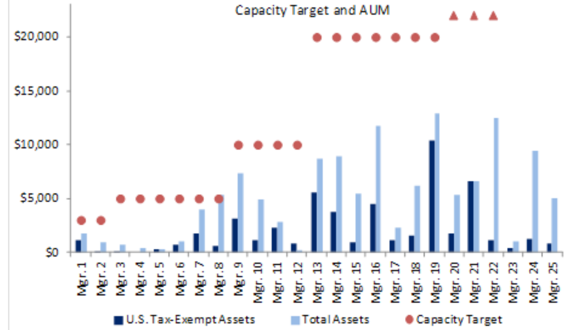
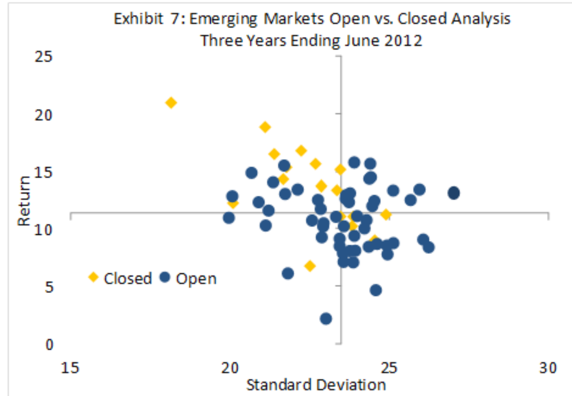


Exhibit 6: Survey Respondents Capacity Target and AUM

Despite some strong years in emerging markets, the MSCI EM Index return over five years ending June 2012 is flat (-0.1% annualized). Half of investment managers have increased their capacity targets over the same time frame. Although trading volume has increased with increased asset flows, the total market capitalization has decreased during this same five year time period.




The question investors are most concerned with is how does capacity effect performance? Exhibit 7 demonstrates that many of the closed products have performed as well, or better than the median return at a lower overall level of risk. While questions around active management persist, it is important to note that a relatively low number of products are closed. Among the open products, many managers have sufficient capacity remaining and have provided consistent relative performance. Despite these generalizations, there are still many variations among products and their approach to capacity. Investment managers utilize various investment approaches and hold different numbers of securities for varying periods of time. It makes the question of, what is the appropriate capacity figure?, nearly impossible to answer unilaterally.

InvestmentMetrics

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