Emerging markets: From niche to necessity

Executive summary

Antoine Van Agtmael first coined the term “emerging markets” 36 years ago – a catch-all concept that pooled together a diverse and heterogeneous group of countries. The term is still used today as shorthand to group countries that have varied levels of economic development, growth drivers and political risk. Such simple categorization may be leading some investors to think about emerging markets (EM) in a way that does not necessarily reflect the dynamic nature of EM assets.

To help investors navigate the shifting role of EM assets – from a niche exposure to a core portfolio holding – we have authored this guide, which covers:

• Becoming mainstream

  Return and yield potential, diversification benefits, improving fundamentals, and greater accessibility have all played a role in making EM debt and equity core allocations – particularly for cross border institutional investors.

• Revisiting long-held beliefs

  Despite the growth of EM investing, many investors carry some assumptions about EM assets that may no longer hold: EM risk is singular and static, currency makes EM investing too risky, EM indexes are heavily-titled to commodities and EM no longer offers diversification. We revisit these assumptions in the paper.

• Benchmark evolution

  EM bond and equity indexes have evolved significantly over the years, but changes set for the future have the potential to dwarf anything seen over the last decade: the potential inclusion of China A-shares, Saudi Arabia and China local debt entering major EM indexes, the potential reclassification of South Korea from EM to developed market (DM), and Saudi Arabia’s privatization program. New ways of accessing EM are under way as well: GDP-weighted indexes and factor indexes offer innovative approaches for EM index investors; China may become a standalone asset class in both equities and fixed income.
**Becoming mainstream**

**A growing market and investor base**

EM assets have been growing at a remarkable pace (see *Emerging exponentially*). Over the last few decades, investing in EM debt and equity indexes has been increasingly embraced by investors as evidenced in the growth of Exchange Traded Products (ETPs) and other investment vehicles giving exposure to EM assets. Initially, allocations came from institutions and were later joined by retail – although the flows from the latter have largely gone hand in hand with market performance, with strategic retail allocations to EM remaining relatively small. More recently, we have also seen a rise in the domestic investor base¹.

**Emerging exponentially**


<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>LC sovereign</td>
<td>HC sovereign</td>
<td>EMFX</td>
<td>EM corporates</td>
<td>LC corporates</td>
<td>EM equities</td>
<td>LC inflation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


**The growing appeal of EM bonds and equities**

**Potential for higher return and yield.** Developed market (DM) government bond yields at historically low levels have pushed fixed income investors to look beyond DM bonds for sources of yield. In equities, we believe that stronger earnings and GDP growth in emerging markets suggests the potential for outperformance of EM stocks in the near term.

Investors tend to assign a higher risk premia to EM assets compared to DM assets for a number of reasons. The amount and types of assets are relatively scarce, liquidity and trading turnover are lower, asset characteristics are less standardized, and the number of trading venues is fewer.

In addition to potential higher returns, our analysis indicates EM assets generally have a positive historical correlation to risk sentiment, as evidenced by the positive correlation between EM assets and BlackRock’s proprietary Risk Tolerance Index (RTI), which measures the overall appetite for risk in markets. EM equities show a strong positive correlation to this index, while EM bonds show a moderately positive correlation (see *Capturing the upside*).

**Capturing the upside**

Risk appetite and EM assets correlation, 2001 to present

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>EM FX</td>
<td>EM hard currency total return</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: BlackRock, Risk and Quantitative Analysis (RQA), as at 7 April 2017. *RTI: BlackRock’s Risk Tolerance Index. RTI measures the overall appetite for risk in the markets by ranking correlation between risk and return for 14 different asset classes. If the risky asset classes are outperforming low risk asset classes, the RTI will be high, and vice versa. By construction, the index can take values between -1 and 1. The period covered by the calculation is from 01/12/2001 to 03/31/2017. EM FX is represented by the JP Morgan Emerging Market Currency Index (EMCI). EM hard currency total return is represented by the total return of the EMBI GD Index, EM equities are represented by the MSCI EM Index.

**Diversification: a matter of time.** The potential diversification benefits of EM assets underscore the investment case for including them as a core, strategic allocation for an investor with longer time horizons. The globalization of the EM investor base and greater integration of EM into global financial markets – also a product of DM-listed firms having a higher exposure to EM sales – has led to higher short term correlations between EM and DM assets at times. Nevertheless, over the long term, both EM equity and debt have displayed diversification benefits: Our analysis shows that the correlation between EM assets and DM assets decreases over longer time periods (more than 12 months).

**Stronger fundamentals.** On a macro level, balance sheet management has improved in many EM countries. Following the Tequila and Asian crises of the 1990s, governments and central banks took steps to become more economically secure and build greater buffers – as evidenced by the increase in FX reserves (see *More reserved*). Increased fiscal responsibility has also resulted in lower public debt-to-GDP ratios, relative to DM countries.

¹ Source: CrossBorder Capital, as at 2017
The transition from fixed to floating currencies in most EM countries over the past two decades has helped during periods of stress. Currency moves have been able to absorb the effect of a challenging global environment – a more favorable outcome versus an immediate devaluation often seen with fixed currency arrangements that can lead to greater market shocks.

Growth in domestic ‘onshore’ funded EM assets has been helped by increased maturity, transparency, and breadth of local capital markets and can also help minimize volatility. Contractual savings institutions, which sprang up in Latin America and Asia in response to previous crises, along with the savings needs of aging populations, create domestic demand for assets, which can smooth fluctuations from more volatile cross border flows.

**More reserved**

Foreign exchange reserves, 1997 to present

![Graph showing foreign exchange reserves from 1997 to 2017](image)

Source: BlackRock, Bloomberg, data as at March 2017. The period covered by the calculation is from March 1997 to March 2017

**Improving governance.** On a micro level, the external financing needs of EM countries, globalization and even geopolitical events have contributed to improved corporate governance. According the IMF, internationalism of funding typically leads to higher standards of governance, as emerging market equities that trade on U.S. stock exchanges through ADRs tend to have higher firm-level governance scores.

The adoption of more liberal economic policies in China and India also appears to have contributed to the development of freer markets and the emergence of companies with sound businesses.

Better corporate governance typically shows up on multiple fronts. Balance sheets improve, debt can be issued over longer maturities at lower rates, resilience in periods of shock increases, valuations rise and equity prices become more reflective of fundamentals.

There remains room for improvement in EM corporate governance. Many EM corporates are family and state owned (see **Who is in charge here?**). As a result, minority investors still rank lower in the corporate structure than in DM companies.

**Who is in charge here?**

EM and DM corporate ownership breakdown, at April 2017

![Bar chart showing corporate ownership](image)

Source: Ecstrat, as at April 2017. EM calculation implies MSCI EM universe, while DM calculation implies MSCI World universe. ‘Dispersed’ stands for companies not having a controlling shareholder.

Higher credit ratings mean that the credibility of EM entities has increased. A material proportion of EM bonds are now available to institutional investors who are restricted from holding bonds below investment grade. 50% of EM hard currency debt is issued by borrowers who are rated investment grade, a marked improvement from almost 0% in 1993 (see **Let me upgrade you**).

**Let me upgrade you**

Credit rating breakdown of dollar denominated emerging market debt (EMD) 1993 to present

![Credit rating chart](image)

Source: J.P. Morgan, as at 28 April 2017. The index is the JP Morgan Emerging Market Bond Index (EMBI). Legend is credit ratings. Unrated securities (NR) do not necessarily indicate low quality. Below investment-grade is represented by a rating of BB and below. A rating above BB is considered investment grade (IG). Residual represents bonds where data was not available. The period covered by the calculation is from December 1993 to April 2017.

**Easier access.** Changes in regulation vary significantly from country to country, but the trend has been towards higher international participation. Relaxation of

---

2 Source: IMF, Global Financial Stability Report, as at October 2016

3 Source: MSCI, as at 2016
borrowing market rules in some EM countries could also contribute to increased liquidity in local equity markets. The introduction and rapid growth of a number of readily available efficient financial instruments and vehicles has also contributed to the democratization of EM investing, thus enabling investors to more efficiently express their views.

**Revisiting long-held beliefs**

From an index perspective, EM can be difficult to quantify and define. As economies advance or deteriorate, they’re often reclassified or new standalone country indexes are launched (see *The times they are a-changing*). To add to further confusion, the market classification and criteria for inclusion varies from one index provider to another, with some favoring economic developments over things like liquidity or accessibility, which is critical in the implementation phase.

**Challenging common assumptions**

In equities, from 1988 to the present day, there have been 33 country changes in the MSCI EM Index. By contrast, the MSCI World Index, representing developed markets as defined by MSCI, has had only seven country changes over the same period.\(^5\)

The growth of China is perhaps the best example of significant country change: 20 years ago it was barely featured in the MSCI EM Index; today it is the largest single country exposure (see *China emerges*).

**China emerges**

Country decomposition of MSCI Emerging Markets Index, 1997 to present

[Diagram showing country weight changes from 1997 to 2017]

*Source: BlackRock, MSCI, as at 31 March 2017. Category “Other” includes: Argentina, Chile, Colombia, Czech Republic, Egypt, Greece, Hungary, Indonesia, Israel, Israel - Non Domestic, Jordan, Malaysia, Morocco, Pakistan, Peru, Philippines, Poland, Portugal, Qatar, Sri Lanka, Thailand, Turkey, United Arab Emirates, Venezuela. The period covered by the data is from March 1997 to March 2017.*

\(^5\)Source: BlackRock, MSCI, as at May 2017.

\(^6\)Source: BlackRock, Bloomberg, FTSE, JP Morgan and MSCI, as of May 2017. Note: SEMD represents dollar hard currency EM debt.

\(^*\)As classified by MSCI.
In fixed income, investors are buying an increasingly diverse basket of bonds in hard and local currency EMD indexes (see Losing count and Localised changes). The number of sovereign hard currency issuers has gone from 38 in 2006 to 72 today. Fifteen years ago South Africa and Poland were the two largest local debtors, today they are Brazil and Mexico.

**Losing count**

These changes reflect the fluid nature of EM indexes. Some commonly held assumptions may no longer hold and should be revisited.

**Assumption 1: EM risk is singular and static**
Investors often refer to the growth and risks within EMs more broadly even though the level of economic development may vary significantly in some cases. Flow data shows that most asset flows in recent years have been into broad EM equity exposures.

While a common set of factors may affect the broad-based EM universe, we believe it is crucial to look under the hood to understand the drivers of returns.

**Equities:** Country risk has come down in recent years, but remains the highest contributor to cross sectional volatility, relative to industries and styles (see More than a little bit country). This contrasts with DM where industry risk is dominant. The dominance of country risk in EM equities may persist in the future partly due to the inherent heterogeneity of the countries within EM universe.

Concentration risk is also a factor in EM equity investing. Despite a fall since the 1990s, the concentration of top company holdings within the MSCI EM Index compared to

**Fixed income:** Historically, across both hard currency and local currency debt classes, the duration of EM debt indexes has typically been lower than DM equivalents. The growing ability of EM countries to issue in longer maturities has helped average duration rise steadily to levels comparable to the DM indexes (see Movin’ on up).
**Not so different after all**

Difference between a maximum and a minimum monthly return for individual MSCI EM country indexes and MSCI EM Index, 1988 to 2016

![Dispersion between max and min return](image)

Source: BlackRock, Thomson Reuters DataStream, MSCI as at December 2016. The period covered by the calculation is from December 1988 to December 2016.

When investing in hard currency EMD, investors get credit spread exposure versus the hard currency yield curve (e.g. US, EUR, GBP). When investing in a local currency EMD equivalent, investors get interest rate exposure in local EM currencies.

Over the past 10 years, with the exception of a handful of countries such as Argentina, the majority of EM local government debt has had lower yield volatility versus DM counterparts. From January 2007 to April 2017, the JP Morgan GBI-EM Global Diversified Index yield averaged 6.5% with a monthly volatility of 0.5%, compared to the GBI-DM Global Diversified index yield of 2.4% and monthly volatility of 0.9%.

Contrary to conventional wisdom, local EM yield movements are the least volatile within the EM universe – most of the volatility is driven by currency exposure. From the credit quality perspective, local currency EMD scores higher versus its hard currency equivalent.

**Assumption 2: Currency makes EM investing too risky**

Smaller financial systems, greater exposure to cross border flow and limited liquidity in some currencies – which leads to increased hedging costs – remain realities of EM investing. EM currencies in general are subject to higher volatility than DM currencies. Both EM equities and local denominated debt have currency as a major risk contribution.

Investors have been harmed by EM currency crises in the past, from the Mexican peso in December 1994 to worries about China ‘devaluing’ the RMB in August 2015. Yet many of the structural reforms that have supported EM investing date from the aftermath of these crises. Analysis by the London Business School shows the highest returns for EM equity and local currency debt investors have come from

**Movin’ on up**

Average debt duration of fixed income indexes 2001 to present

![Average debt duration of fixed income indexes](image)


Depressed currency levels – as seen in Brazil over the last 18 months. Depressed currency valuations are associated with capital flight, which, in turn, lowers valuations. Depreciations can boost trade balances albeit with a time lag and thus reduce dependence on imported capital, the substitute effect.

Cheap currencies and assets provide an attractive investment backdrop as such currency sell-offs have tended to be associated with dips in the economic cycle and profits. Buying distressed assets at economic troughs in depressed

**Expect the unexpected**

Annualized returns of markets sorted by currency levels and GDP growth, 1976–2013

![Annualized returns of markets sorted by currency levels and GDP growth](image)

Source: Elroy Dimson, Paul Marsh, and Mike Staunton using data from the DMS database, the IMF, Mitchell, Maddison, and Thomson Reuters DataStream. Rotation strategies within developing markets 1976 – 2013; ranking countries in quintiles by factor (GDP or FX) the study followed a market-rotation strategy over a period of typically a year.

---

10 Source: BlackRock and Bloomberg, as at May 2017
11 Source: JP Morgan, as at April 2017
12 Source: BlackRock, RQA, as at April 2017
currencies has historically been a good investment strategy: The best returns in EM have been in the years after years when yields were the highest, currencies were weakest and GDP growth was lowest (see Expect the unexpected). There is some evidence that investors are catching on to this point on currency sell-offs, for instance the rapid rebound in the Mexican peso from lows seen around the November 2016 US presidential election.

**Assumption 3: EM indexes are heavily-tilted to commodities**

Single country EM equity indexes often do not resemble the economic structure of the respective country. State ownership of assets – often in the natural resources space – skews EM indexes away from GDP contributions. A similar pattern is observable in fixed income indexes, particularly when comparing EM corporate debt with DM corporate debt. Many businesses never make it to public markets and remain in government or private hands. Thus, financial market opportunities often fail to match or reflect either GDP structures or growth rates, leading to the confusion between economic exposure and market exposure.

In the case of equities, evolution of index composition may also be a driver of the mismatch between investor expectations and the reality of a sector breakdown of the MSCI EM Index. In the late 2000s, energy and materials made up almost 31% of the MSCI EM Index14. Today, EM equity indexes provide more exposure to domestically-focused sectors, such as IT and financials – also the leading sectors in the MSCI World Index (see Overcoming differences). As a result, investors who want to express a proxy view on commodities through EM may

**Overcoming differences**

![Sector breakdown of MSCI EM Index and MSCI World Index, at December 2016](chart)

<table>
<thead>
<tr>
<th>Sector</th>
<th>EM</th>
<th>DM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer Disc.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consumer Stap.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Financials</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Health care</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Industrials</td>
<td></td>
<td></td>
</tr>
<tr>
<td>IT</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Materials</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real Estate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real Estate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real Estate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real Estate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real Estate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real Estate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real Estate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real Estate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real Estate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real Estate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real Estate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real Estate</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: BlackRock, MSCI, as at 31 December 2016

**Not all about oil**

Sector breakdown of individual MSCI country indexes, at April 2016

![Sector breakdown of individual MSCI country indexes, at April 2016](chart)

Over time, sector evolution in EM may allow investors to get more exposure to the demographic dividend and consumer growth – the latter is deemed by McKinsey to be “the biggest opportunity in the history of capitalism”15.

**Assumption 4: EM no longer offers diversification**

The degree of financial market integration between EM and DM financial markets has risen over recent years. EM assets correlations and sensitivity to DM have risen across the board (see Don’t stand so close to me), prompting some investors to question whether EM can still provide potential portfolio diversification benefits. We find that although EMs can be sensitive to short-term shocks in global markets, diversification benefits have persisted in the long term.

---

13 Source: Elroy Dimson et al, as at 2013
14 Source: MSCI, as at April 2017
15 Source: McKinsey, as at August 2012
**Don’t stand so close to me**

Sensitivity of the MSCI EM Index to the MSCI World Index, 1997–2017

Source: BlackRock, RQA, MSCI as at 29 March 2017. The period covered by the calculation is from March 1997 to March 2017. Beta is a measure of the volatility of a security or group of securities in relation to the market as a whole.

While short term correlations were high, they declined materially over a longer holding period and at 3-5 years a strategic allocation to EM assets – across equities and bonds – appears to have been an effective diversifier of DM risk (see *You can’t hurry diversification*).

**Benchmark evolution**

Material evolution has taken place in EM over the past 30 years. We believe the next 10 may also bring radical shifts that have the potential to change the way investors approach EM.

**Market composition**

From a country composition perspective, we believe the changes that lie ahead have the potential to overshadow changes seen in the past.

Some countries stand out in the near term, such as China, India and Saudi Arabia. China is already the third largest government bond market in the world at $7 trillion, and India follows closely at $3 trillion\(^{16}\). Both giants run persistent, largely domestically financed, fiscal deficits and seek to provide long term savings vehicles for their citizens, which suggests these markets could continue to grow.

International investors have been largely excluded so far from accessing the onshore market in both China and India. However, authorities have expressed commitment to opening the doors to global finance over the long term.

Saudi Arabia made its debut in international debt markets last year with the government raising $17.5bn in a sovereign bond sale\(^{17}\) – a record for an EM. A low oil price and squeezed domestic issuers suggest further offshore issuance is likely.

We have remodelled the JPM Government Bond Index-Emerging Markets Global benchmark to include China

\(^{16}\) Source: JP Morgan, as at April 2017

\(^{17}\) Source: FT, as at October 2016

\(^{18}\) Source: JP Morgan, as at December 2014

**You can’t hurry diversification**

Correlation of EM and DM equity returns, 1988–2017

Source: BlackRock, Thomson Reuters DataStream, MSCI as at 31 March 2017. EM equity returns are based on MSCI Emerging Markets index; DM equity returns are based on MSCI World index. The period covered by the calculation is from May 1988 to May 2017

Correlations of EMD indexes and DM bonds, 2014–2017

Source: JP Morgan, BBG Barclays as at 28 April 2017. HC sovereign is represented by the JP Morgan Emerging Markets Bond Index Global Diversified (EMBI GD). LC sovereign is represented by the JP Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM GD). HC corporates is represented by the JP Morgan Corporate Emerging Markets Bond Index Broad Diversified (CEMBI Broad). DM is represented by the BBG Barclays Global Aggregate ex EM Index. The period covered by the chart is from April 2014 to April 2017

and India local government debt at their full market caps (see *Waiting on the world to change*). In practice, investors follow a country capped (10%) version – the JP Morgan GBI-EM Global Diversified Index – which has estimated assets of $191bn benchmarked against it\(^{18}\). This tells us that approximately $19bn of assets could rebalance upon official China or India inclusion.

In equities, the index weight of China – the second largest equity market in the world – could increase, in particular given the potential gradual addition of China A-shares to indexes.

Other potential upcoming country changes include the inclusion of Argentina and Saudi Arabia to MSCI EM Index.

South Korea, the second largest country weight in the MSCI EM Index, may be ultimately reclassified as DM.
Waiting on the world to change
Model JPM GBI-EM Global (uncapped), at April 2017

![Chart showing index weighting for GBI-EM, +China, +China+India, and +India.]

Source: BlackRock, JP Morgan, as at April 2017. The chart uses hypothetical data for the ‘+China’ and ‘+China+India’ model benchmarks. The model benchmarks assign 30% weight to China and 20% weight to India representative of their market value outstanding.

The model MSCI EM Index we have constructed excludes South Korea and includes the MSCI China A Index\(^\text{19}\), the MSCI Saudi Arabia Domestic Index, the MSCI Pakistan Index, the MSCI Argentina Index, and the IPO of Saudi Aramco, with a floating factor of 5% (see Modelling the future).

The rise of new “asset classes”

We believe that new inclusions have the potential to alter how investors approach EM index investing, driving new investment behaviours and the development of new index vehicles used to access EM.

A dramatic increase in the weight of a country like China may spur investors to take a ‘building block’ approach to EM equity by utilizing single country or regional exposures alongside broader EM vehicles. In this sense EM could follow a DM path where investors often make allocations to countries or regions – as opposed to broad benchmarks such as the MSCI World Index – to be able to express a positive, neutral or negative view on this particular geography.

One important driver could be the potential full opening up of China, which could represent around 50% of MSCI EM Index just as the weight of the U.S. in the MSCI World Index is over 50%\(^\text{20}\). Based on some estimates, around $1.6tn of assets is benchmarked against the MSCI EM Index\(^\text{21}\), so the full opening up of China – which currently represents around a quarter of the index – could trigger a significant reallocation of assets. China could well become a standalone asset class.

In fixed income, China’s local debt could be introduced into the Bloomberg Barclays Global Aggregate Index and Citigroup World Government Bond Index (WGBI), which are investment grade indexes that can include DM and EM currencies as long as the markets meet investment and liquidity criteria. Both index providers estimate a 5-6% weight assigned to China upon inclusion and $2tn of assets benchmarked against both indices\(^\text{22}\).

We believe these are conservative estimates that tell us at least $200bn of assets may be forced into motion. This could strengthen the potential for China as a standalone investable asset class in terms of portfolio construction.

Local currency corporate index vehicles. Within the universe of tradable public EM assets, local corporate debt and loans are undoubtedly the least mature or liquid. It was not until 2013 that an index representing this asset class (BoFA Merrill Lynch Local Markets Non Sovereign Index) was launched. Although the amount of outstanding local non-sovereign debt is estimated to be over $4tn, the market cap of the index, which aims to track parts of the market regarded as investable, stands at $99bn\(^\text{23}\). Such

---

\(^{19}\) Note: based on MSCI assumptions as at April 2017

\(^{20}\) Source: MSCI, as at April 2017

\(^{21}\) Source: MSCI, as at December 2016

\(^{22}\) Source: Bloomberg Barclays and Citigroup as at April 2017

\(^{23}\) Source: BAML, as at April 2017
assets are still largely held by domestic banks at issue and hardly trade. In times of stress, correlation between liquidity premiums and strength of currency of local corporate debt may compound risk for investors.

Local currency corporate debt is the fastest growing segment within EM. Demand for this segment is driven by the global search for yield. Even if global yields increase over the next five years, they may remain low relative to long-term history and investors may continue to seek out new yield opportunities wherever they arise.

On the supply front, regulatory efforts such as Chinese and Indian relaxation of capital controls, local issuer efforts on reporting, increasing issuance sizes and making bonds ‘Euro-clearable’ are encouraging. Specific segments in EM, such as Islamic finance in the form of Sukuk bonds, have been issued steadily in the recent years. We believe the eventual overcoming of liquidity constraints will encourage the eventual birth of the index vehicles tracking local currency corporate debt benchmarks.

**Beyond market caps**

**GDP/debt weighting.** We also believe the demand for non-market cap weighted indexes is growing as we have seen EM market cap weighted indexes do not always reflect economic reality.

These could include GDP-weighted equity indexes that could offer higher exposure to countries with stronger growth as opposed to the largest market cap.

In fixed income, market cap weighted indexes give investors exposure weighted according to the amount of debt issued by each country or company. This could potentially increase issuer concentration risk, and consequently default risk exposure to the issuer with the highest weight. An alternative methodology, such as debt-to-GDP weighting for sovereign debt, tilts index weights relatively more towards countries with high GDP levels rather than absolute amount of debt. Other similar measures could be used. For example, the Blackrock Sovereign Risk Index (see Gauging risk), goes one step further, quantifying each country’s credibility using fiscal, financial and institutional metrics – which has been highly correlated with the riskiness of sovereign CDS spreads.

**Factor indexes.** Factor investing could gain traction in EM as it has done in DM. Many EM factor indexes have historically outperformed their parent indexes over the long-term on both an absolute and risk-adjusted basis. The return differential between factor exposures and parent indexes has been persistently higher than equivalent DM exposures (with the exception of size).

Some of the higher factor premium versus DM could be explained by higher cross sectional dispersion of returns versus DM. Some of this, however, could also have been driven by stronger relevance of country bets within EM factor indexes versus DM factor indexes. Indeed country risk has a higher contribution to the cross sectional volatility in EM versus DM. For instance, EM momentum is currently overweight Brazil, quality is overweight India and China, and value is overweight Korea.

---

24 Source: MSCI, as at April 2017

25 Source: BlackRock, MSCI, as at March 17, as measured by MSCI factor and parent indexes. Note: Factor investing is an investment strategy where securities are selected based on specific attributes. For the full description of the respective factors see the end of this document. There can be no assurance that performance will be enhanced or risk will be reduced by implementing a factor strategy.

---

**Gauging risk**

BlackRock Sovereign Risk Index, Q2 2017
ETPs investors are only just beginning to invest in EM factor exposures: Smart beta EM funds represent only 7% of total EM equity assets. The majority of indexed EM factor assets today are concentrated in multifactor, dividend and low volatility exposures (see Tapping into EM factors), suggesting that there is room for investors to become more selective and specific about the factor exposures they include in portfolios.

Tapping into EM factors
Breakdown of global ETP AUM invested in EM smart beta funds, in US$ millions, at March 2017

![Breakdown of global ETP AUM invested in EM smart beta funds](image)

Conclusion
After falling out of favor among many investors after the taper tantrum of 2013, emerging markets have come back. They are not the same as they were 10 or 15 years ago. Some countries are ‘graduating’ to developed status (or from frontier to emerging), sector composition is constantly evolving, and new investment approaches (like factor investing) are appearing. The role of EM is evolving.

Yet, we believe that both the diversification benefits and potential for return are still valid reasons to consider EM assets. Most importantly, in the coming years, EMs could play an increasingly important role both in the global economy – and in investors’ portfolios (see A glimpse into the future).

A glimpse into the future
The composition of global capital markets: 2014 (US$ 153tn) and a 2030 projection (US$ 515tn)

![Composition of global capital markets](image)

Source: BlackRock, Global ETP landscape, as at March 2017

---

26 Source: BlackRock, Global ETP landscape, as at March 2017
Authors and contributors

Leland Clemons
Jane Sloan
Wei Li
Ewen Cameron Watt
Senior Advisor to BlackRock

Maria Eugenia Heyaca
Hui Sien Koay
Varia Pechurina

Karim Chedid
Hugh Arnold
Matthew Fowles

Lucia Feyles
Editor: Christopher Thomson
Editor: David Kurapka

Special thanks to contributors
Kate Moore
Richard Turnill
Pablo Goldberg
Gerardo Rodriguez
Marina Evtimova
Richard Steel
James Gnanamithran
Joshua Richardson
Flora Fang
H.T. Kim
Antoniya Smilkova
Eve Velikova
Garth Flannery
This material is provided for educational purposes only and is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. You are solely responsible for evaluating and acting upon the education and information contained in this material. BlackRock will not be liable for direct or incidental loss resulting from applying any of the information obtained from these materials or from any other source mentioned. BlackRock does not render any legal, tax or accounting advice and the education and information contained in this material should not be construed as such. Please consult with a qualified professional for these types of advice.

Index performance is for illustrative purposes only. Index performance does not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

This document contains general information only and does not take into account an individual's financial circumstances. This information should not be relied upon as a primary basis for an investment decision. Rather, an assessment should be made as to whether the information is appropriate in individual circumstances and consideration should be given to talking to a financial advisor before making an investment decision.

The information included in this material has been taken from trade and other sources considered to be reliable. We do not represent that this information is accurate and complete, and it should not be relied upon as such. Any opinions expressed in this material reflect our analysis at this date and are subject to change. The information and opinions contained in this material are derived from proprietary and non-proprietary sources deemed by BlackRock to be reliable, but are not guaranteed as to accuracy. Such information may include, among other things, projections and forecasts. There is no guarantee that any of these views will come to pass. Reliance upon information in this post is at the sole discretion of the reader.

The information presented does not take into consideration commissions, tax implications, or other transactions costs, which may significantly affect the economic consequences of a given strategy or investment decision.

International investing involves risks, including risks related to foreign currency, limited liquidity, less government regulation and the possibility of substantial volatility due to adverse political, economic or other developments. These risks often are heightened for investments in emerging/developing markets and in concentrations of single countries. Frontier markets involve heightened risks related to the same factors and may be subject to a greater risk of loss than investments in more developed and emerging markets.

Fixed income risks include interest-rate and credit risk. Typically, when interest rates rise, there is a corresponding decline in bond values. Credit risk refers to the possibility that the bond issuer will not be able to make principal and interest payments. Non-investment-grade debt securities (high-yield/junk bonds) may be subject to greater market fluctuations, risk of default or loss of income and principal than higher-rated securities.

Important notes for page 7: Unless otherwise noted, relevant country indexes include MSCI Russia, MSCI Hungary, MSCI Poland, MSCI Thailand, MSCI Colombia, MSCI Brazil, MSCI India, MSCI Chile, MSCI Turkey, MSCI China, MSCI Indonesia, MSCI Qatar, MSCI Malaysia, MSCI Korea, MSCI Taiwan, MSCI South Africa, MSCI Peru IMI, MSCI Czech Republic, MSCI Egypt, MSCI Greece, MSCI Mexico, MSCI Philippines and MSCI UAE.

Important notes for page 10: The Minimum Volatility factor selects lower risk stocks relative to the broader market. The Momentum factor selects stocks that exhibits upward price trends. The Value factor selects stocks that are priced at a discount relative to fundamentals. The Quality factor selects financially healthy companies. The Size factor selects stocks with smaller capitalizations relative to larger counterparts. Multifactor strategies combine momentum, size, value and quality factors.

Prepared by BlackRock Investments, LLC (together with its affiliates, “BlackRock”).

©2017 BlackRock, Inc. All rights reserved. BLACKROCK is a registered trademark of BlackRock, Inc. in the United States and elsewhere. All other marks are the property of their respective owners. 164918