MILL CREEK

OUR PERSPECTIVE: Emerging Markets

KEY MESSAGE

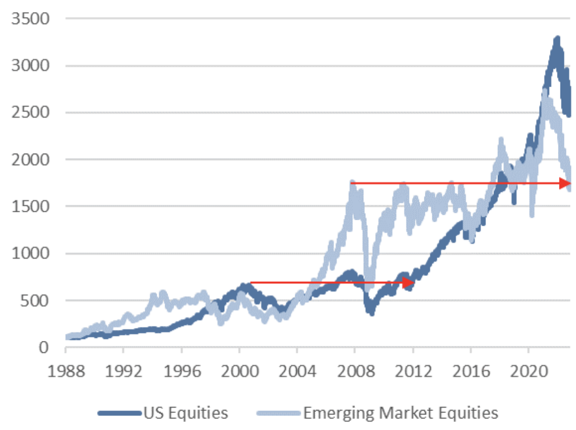
Substantial underperformance over the past decade has driven many investors to question the wisdom of allocating equity assets to emerging markets. In addition to only having 35 years of quality data available, emerging market equities exhibit a return profile that tends to be psychologically challenging to stick with - long periods of lagging performance punctured by short bursts of substantial outperformance. Many other assets that investors ultimately capitulate on, like commodities and managed futures, exhibit similar return profiles.

Despite these challenges, our analysis indicates a modest allocation to EM within equity portfolios enhances the expected value of wealth accumulation over 5–10-year strategic horizons.

OUR VIEW

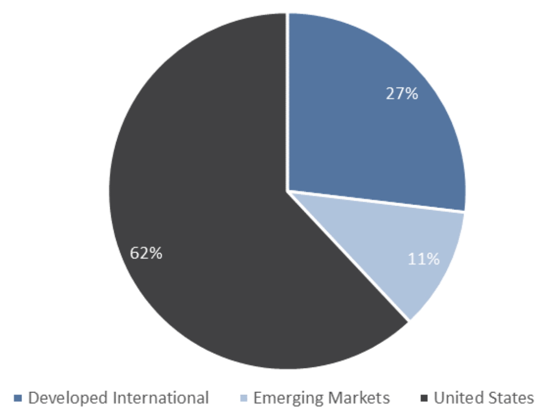
1. **Fifteen years of underperformance**
    - EM has performed poorly on a relative and absolute basis over the last 15 years.
    - The MSCI Emerging Markets Index, MSCI EAFE Index, and Russell 3000 Index have produced annualized returns of 1.1%, 4.7%, and 12.4%, respectively, since the end of 2008.
    - US equities underwent a similar experience – returning 0% between December 1999 and November 2011.
    - Emerging market exposure was particularly beneficial during the "lost decade" in US equities, just as US equity performance has offset EM underperformance over the last ten years.
2. **Relative outperformance has exceeded underperformance**
    - Since 1988, the earliest year for which quality EM equity data is available, EM equities have outperformed developed market equities in 20 out of 34 years.
    - Calendar year outperformance and underperformance have averaged 20.7% and -18.7%, respectively, since 1988.
3. **We are currently underweight emerging market equities**
    - EM equities comprise just over 11% of the global market cap. Academic theory indicates that purely passive investors would hold a market weight.
    - Our quantitative analysis indicates a lower strategic level of EM exposure, 8-10%, is optimal within equity portfolios over the long term.
    - Currently, our target exposure falls even lower, at 6-7% (about 4% total exposure within a balanced asset allocation) due to tactical headwinds.
    - To derive the benefit of emerging markets, investors should rebalance after significant relative outperformance or underperformance to reset their exposure.

Fig. 1: A lost decade and a half for EM



Source: Bloomberg, Mill Creek Period reflects 1988-Nov. 2022

Fig. 2: EM comprises 11% of the equity market



Source: Bloomberg. Morningstar Direct, Mill Creek