Does Active Management Add Value in Emerging Markets?

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by Larry Swedroe

I continue my series on the ability of actively managed funds to add value for their investors with an in-depth look at the asset class that is the “poster child” for an inefficient market – emerging markets. Can active managers outperform a passive index, given the supposed abundance of mispriced emerging-market stocks?

For instance, in a recent Wall Street Journal article on the subject of emerging markets, columnist Michael Pollock wrote: “Managers of active funds can make distinctions among that huge range of stocks that an index-tracking fund doesn’t make.” Pollock quoted Jan Van Eck, chief executive of Van Eck Global, who believes there are compelling arguments for active management in an emerging markets fund. According to Van Eck, whose firm manages the Van Eck Emerging Markets Fund (GBFAX), with each of the countries in the category at a different point in its development cycle, “you absolutely don’t want to have exposure to all countries at all times.” He went on to add that “there are a lot of junky companies included in indexes.” Thus, “you want someone who can shift the company, [industry] sector and country exposure over time.” Van Eck concluded: “If you want to have one fund for emerging markets, active is the way to go.”

This story about active managers and their ability to win in “inefficient markets,” such as emerging markets, is one I hear all the time. With that in mind, I’ll turn to my trusty videotape.

Consistent with the analysis I performed in my article on international small-cap funds, to keep the list to a manageable number of funds, I’ve chosen to examine the performance of the 10 actively managed emerging market funds with the largest amount of assets under management as of the end of 2015. And then, as before, I’ll expand the analysis to include the entire universe of funds that survived the full 15-year period I used for my evaluation.

To ensure that I examine long-term results through full economic cycles, I’ll analyze the performance of funds over the 15-year period ending December 31, 2015. Furthermore, when there is more than one share class of fund available, I’ll use the lowest-cost shares that were obtainable for the entire period.

As I noted in the article on international small-cap funds, this methodology creates a substantial bias in the data. I am considering only funds that survived the full period, and a significant number of actively
managed funds disappear each year. Second, the AUM of a fund that has beaten its benchmark will not only benefit from that strong performance, but it will also benefit from the investor cash flows that tend to follow. Thus, the funds with the strongest past returns will tend to be the largest.

This doesn’t mean, however, that investors actually earned the same returns over the full period, since they may not have been invested over the entire term. Therefore, the results are not truly reflective of what investors in these actively managed funds actually earned – they are biased upward.

We should expect funds with the largest AUM to have outperformed, although the research demonstrates their large asset size is likely to hinder future performance. Thus, the real questions I’ll answer are the following: First, if you were smart or lucky enough to identify these 10 stellar performers ahead of time, by how much did you benefit versus using passive alternatives? And second, was it worth the risk that you might have been wrong in your selection?

Keeping the aforementioned bias in mind, the table below shows the performance data for the 10 largest actively managed emerging market funds as of year-end 2015. My standard practice is to compare the returns of these funds to the returns of comparable funds (based on their Morningstar categorization) from the leading provider of index funds, Vanguard, and a prominent provider of passively managed structured asset class funds, Dimensional Fund Advisors (DFA). (Full disclosure: My firm, Buckingham, recommends DFA funds in constructing client portfolios).

I should note that DFA funds can be purchased through some 529 and 401(k) plans but, generally, are available only through an advisor. An investor would incur fees from that advisor; those fees can vary greatly (in some cases they are very low) and cover the full range of financial planning services the advisor provides. Also, John Hancock recently introduced a series of ETFs that are managed through DFA (with expense ratios that differ from the DFA funds cited in this article). Those ETFs can be purchased directly by investors. All Vanguard funds can be purchased directly by investors.

While my preference is to use live funds as benchmarks (so that we can see realizable returns, after implementation costs), because neither Vanguard nor DFA offers an emerging-markets large-growth fund, I’ve used the MSCI Emerging Markets Growth Index as the benchmark for this asset class.

The returns data in the table below covers the 15-year period ending December 2015.
<table>
<thead>
<tr>
<th>Fund</th>
<th>Symbol</th>
<th>Expense Ratio (%)</th>
<th>Annualized Return (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Emerging Markets Large Growth</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>American Funds New World A</td>
<td>NEWFX</td>
<td>1.04</td>
<td>8.4</td>
</tr>
<tr>
<td>Oppenheimer Developing Markets A</td>
<td>ODMAX</td>
<td>1.30</td>
<td>11.4</td>
</tr>
<tr>
<td>Virtus Emerging Markets Opportunities I</td>
<td>HIEMX</td>
<td>1.30</td>
<td>10.5</td>
</tr>
<tr>
<td>T. Rowe Price Emerging Markets Stock</td>
<td>PRMSX</td>
<td>1.24</td>
<td>8.2</td>
</tr>
<tr>
<td>Fidelity Emerging Markets</td>
<td>FEMKX</td>
<td>1.03</td>
<td>8.2</td>
</tr>
<tr>
<td>JP Morgan Emerging Markets Equity</td>
<td>JMEIX</td>
<td>1.15</td>
<td>8.5</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td></td>
<td></td>
<td><strong>9.2</strong></td>
</tr>
<tr>
<td>MSCI Emerging Markets Growth Index</td>
<td></td>
<td></td>
<td><strong>7.7</strong></td>
</tr>
<tr>
<td>Emerging Markets Large Blend</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wells Fargo Emerging Markets Equity</td>
<td>EMGYX</td>
<td>1.48</td>
<td>9.9</td>
</tr>
<tr>
<td>Harding Loevner Emerging Markets Advisor</td>
<td>HLEMYX</td>
<td>1.28</td>
<td>9.6</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td></td>
<td></td>
<td><strong>9.8</strong></td>
</tr>
<tr>
<td>Vanguard Emerging Markets Stock Index I</td>
<td>VEMIX</td>
<td>0.12</td>
<td>8.4</td>
</tr>
<tr>
<td>DFA Emerging Markets II</td>
<td>DFETX</td>
<td>0.34</td>
<td>8.7</td>
</tr>
<tr>
<td>Emerging Markets Large Value</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GMO Emerging Markets IV</td>
<td>GMEFX</td>
<td>0.97</td>
<td>9.5</td>
</tr>
<tr>
<td>Lazard Emerging Markets Equity</td>
<td>LZEMX</td>
<td>1.09</td>
<td>9.6</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td></td>
<td></td>
<td><strong>9.6</strong></td>
</tr>
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The following is a summary of the results:

- In the large-growth category, relative to the MSCI index benchmark, all six of the actively managed large growth funds outperformed. The average outperformance was by 1.5%.

- In the large-blend category, both active funds outperformed the comparable Vanguard fund by an average of 1.4% and the comparable DFA fund by an average of 1.1%.

- In the large-value category, both active funds underperformed the comparable DFA fund by an average of 1.0%.

There’s one more important point to consider when evaluating the data in the above table, which shows that eight of the 10 emerging-market funds outperformed their comparable index or passively managed fund(s). Before going into the details, however, you need to know that during this 15-year period the MSCI Emerging Markets Small Cap Index returned 11.0% and the MSCI Emerging Markets Value Index returned 9.8%. Both of these indices outperformed the average return of active large and large-blend funds that did beat their benchmarks. That brings us to what’s known as Dunn’s Law (named after a southern California attorney who provided the insights).

Dunn’s Law states that when an asset class underperforms, active managers have a greater chance of outperforming their benchmark index. The logic is simple. Generally, index funds achieve the greatest exposure to the relevant risk factor responsible for the vast majority of the returns while active managers have the ability and tendency to “style drift.” In this case, it’s possible that the eight active growth and blend funds that beat their benchmarks did so because they style drifted and owned small and value stocks, which produced higher returns than their benchmarks.

With Dunn’s Law in mind, let’s consider the performance of the 10 largest actively managed emerging-markets funds that survived the full period. Their average return was 9.4%. Given that six of the 10 active funds were in the lowest-returning asset class of large growth, another way to look at this would be through the average return of active funds in each asset class. That raises the return to 9.5%.

There are three DFA emerging markets funds: the Emerging Markets Fund (DFETX), which returned 8.7%, the Emerging Markets Value Fund (DFEVX), which returned 10.6%, and the Emerging Markets Small Cap Fund (DEMSX), which returned 12.0%. The average return of these three DFA funds was 10.4%, 1.0% greater than the average return of the 10 largest actively managed funds and 0.9% greater than the average of active funds in the three asset classes. Thus, even if you had that perfectly clear crystal ball that would have told you which actively managed funds would have the most AUM at the end of the period, and built an equal-weighted portfolio of those funds, you would have underperformed an equal-weighted portfolio of the three DFA funds. And we know that no one has that clear of a crystal ball.

Before moving on to examine the entire universe of actively managed emerging market funds, I’ll unpack the results of the most recent S&P Active Versus Passive (SPIVA) scorecard.
SPIVA scorecard results

The SPIVA scorecard has the benefit of eliminating the previously mentioned survivorship bias. The longest period for which the report provides performance data is the 10-year period ending December 2015. Thus, the following data reflects that period’s results. S&P found that 79% of actively managed emerging funds survived the full period while 21% did not. You can be sure that the 21% of funds sent to the very crowded “mutual fund graveyard in the sky” were ones that underperformed, and likely by wide margins. Fund companies, after all, don’t bury the outperforming funds.

Also, since the data I looked at earlier covered the longer 15-year period, the survivorship bias that results would be even greater. With that said, a full 91% of the actively managed funds underperformed their benchmark, the S&P/IFCI Composite Index. On an equal-weighted basis, the full universe of actively managed funds returned 3.1% and underperformed the benchmark by 1.6%. On an asset-weighted basis, the underperformance was 0.9%.

A deeper dive

Using Morningstar’s database, I will now take a look at the full universe of actively managed emerging-market funds with 15-year track records ending in December 2015. Unfortunately, Morningstar’s data includes only live funds. That creates survivorship bias. Keep this in mind as you review the results.

Large-growth funds

There were 15 actively managed funds in this category (just nine besides the six we discussed previously) that managed to survive the full period. Their average return was 8.4%. That’s 0.7% above the benchmark index. Given the survivorship bias in the data, it’s certainly possible that if the dead funds were included there would be no outperformance. And then there’s Dunn’s Law to consider.

Investors are not only concerned with the odds of out/underperformance, but also with how much they might out/underperform. Ten (67%) of the actively managed large growth funds were able to outperform the MSCI index. Their average outperformance was 1.5%. The five that underperformed did so by an average of 0.8%, producing risk-adjusted odds of outperformance of 3.8:1. That’s a highly unusual finding. It’s far more common to find that outperforming funds do so by much smaller amounts than the margin of the losers’ underperformance. However, we must keep in mind the twin issues of survivorship bias and Dunn’s Law.

Large-blend funds

There were just 18 actively managed large-blend funds surviving the full period. Their average return was 7.5%. The MSCI Emerging Markets Index returned 8.9%, outperforming the average actively managed fund by 1.4%. By comparison, Vanguard’s Emerging Markets Fund (VEMIX) returned 8.4%, outperforming the average fund by 0.9%. Of the 18 actively managed funds, just five (27.8%) outperformed VEMIX. The average outperformance was 1.4%. On the other hand, the average underperformance of the other 13 funds was by -1.7%. Here we see the more typical relationship
between the margins of outperformance and underperformance. The risk-adjusted odds of outperforming were 3.2:1.

Relative to the DFA Emerging Markets Fund (DFETX), which returned 8.7%, five funds (27.8%) outperformed and did so by an average of 1.1%. The 13 funds that underperformed did so by an average of 2.1%, producing risk-adjusted odds of outperformance of 5:1.

Large-value funds

There were only 12 actively managed large-value funds surviving the full period. They produced an average return of 9.3%. The DFA Emerging Markets Value Fund (DFEVX) returned 10.6%, outperforming the average active fund by 1.3%. Three (25%) of the surviving actively managed large-value funds outperformed DFEVX, with the average outperformance being just 0.5%. The nine actively managed funds that underperformed did so by an average of 1.8%, producing risk-adjusted odds of outperformance of 10.8:1. Once again, we see the more typical relationship between the margins of outperformance and underperformance.

Mid-cap funds

There were two actively managed mid-cap funds that managed to survive over the full period. Unfortunately, we don’t have either an index or comparable funds from DFA or Vanguard with which to compare them directly. However, a reasonable benchmark for one of the mid-cap blend funds is the average return of the DFA Emerging Markets Fund (DFETX), which is a large-cap fund, and the DFA Emerging Markets Small Fund (DEMSX). The one actively managed fund returned 9.0%, underperforming the average return of the two DFA funds by 1.3%.

There was also one actively managed mid-cap value fund that survived the period. A reasonable benchmark for that fund is the average return of the DFA Emerging Markets Small Fund (DEMSX) and the DFA Emerging Markets Value Fund (DFEVX), which is a large-cap fund. The active fund returned 6.1% and underperformed the average return of the two DFA funds by 5.2%.

The only category of the five I examined where the average actively managed fund outperformed was in large-growth, which produced an average outperformance of 0.7%. In the other categories, the average underperformance was a much greater -1.3%, -1.4%, -1.3% and -5.2% (although the final two cases involved just a single fund in each case). With the average underperformance being much larger than average outperformance, the risk-adjusted odds of outperforming clearly has made active management the loser’s game in this supposedly inefficient asset class.

Additional evidence showing that active managers don’t win in emerging markets comes from an October 2014 study by Vanguard. Their research team concluded that once survivorship bias was accounted for, 71% of emerging market funds underperformed the average return of low-cost index funds over the 10 years ended 2013.

The combination of SPIVA, Vanguard and Morningstar data clearly shows that active management is just as much a loser’s game in the supposedly inefficient asset class of emerging markets as it is in
U.S. large-cap stocks. While it’s certainly possible to outperform comparable passively managed funds, the odds of doing so are so poor that it’s not prudent to try.

The results shown above are on a pre-tax basis. The research shows that for taxable investors, the largest cost of active management isn’t typically the expense ratio of the fund or its trading costs. Instead, taxes are often the largest expense. Thus, for taxable investors, the odds of winning are dramatically lower than indicated in the preceding results.

Before summarizing, there is one more important point to cover. It’s related to the claim by active managers that emerging markets are inefficient and, if true, may make active management the winning strategy.

The “costs matters” hypothesis

William Sharpe demonstrated in his famous paper, “The Arithmetic of Active Management,” that passive management is the winner’s game not because of market efficiency. Instead, it depends on the simple laws of mathematics, or what John Bogle called the “cost matters” hypothesis.

In short, it states that because all emerging markets stocks must be owned by someone, and passive investors earn the market returns less low costs while in aggregate active investors must also earn the market return less high costs, then in aggregate passive investors must earn higher net returns than active investors.

The costs of operating an emerging-markets fund and the costs of trading in the less-liquid markets of these countries are together so great that once costs, including taxes, are considered, active managers are highly unlikely to add value.

Summary

The preceding analysis demonstrates that if (and this is a very big if) you had that perfectly clear crystal ball and could identify ahead of time which funds would be the largest actively managed emerging-markets funds at the end of a 15-year period, you would outperform the benchmark indexes. However, even with that clear crystal ball, you would have underperformed an equal-weighted portfolio of the three passively managed funds from DFA.

In addition, there’s little to no evidence that investors, even sophisticated institutional investors possessing far more resources than most individuals, have been able to identify the few future winners in advance. In fact, the research shows the managers that pension plans fire due to poor performance tend to go on to outperform the managers hired to replace them.

Emerging markets are not the inefficient asset class that active managers claim them to be. Indeed, the flexibility active managers tout in emerging markets is not the advantage they want you to believe. It has proven to be a disadvantage. Active management in emerging markets (like all markets) is “fraught with opportunity.”
Given the poor performance of actively managed emerging-market funds relative to passively managed funds from Vanguard and DFA, the strategy most likely to allow you to achieve your financial goals is to choose well-designed passively managed funds that provide the desired amount of exposure to the factors (such as size, value, profitability/quality and momentum) to which you want your capital allocated.

Postscript

As an interesting coda to this article, for the 15-year period ending March 1, 2016, the aforementioned Van Eck Emerging Markets Fund (GBFAX), whose CEO Jan Van Eck said that he believes there are some compelling arguments for active management in an emerging markets fund, returned 5.9% and dramatically underperformed the four passively managed funds we have discussed: VEMIX returned 7.9%, DFETX returned 8.5%, DEMSX returned 11.7% and DFEVX returned 10.4%. GBFAX’s performance provides pretty compelling reasons for using passively managed funds.

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**Disclosure:** The included data and analysis is a summary of 14 other pieces related to an ongoing series evaluating actively managed mutual fund families. For a complete list of those pieces, click to search Larry Swedroe at: www.advisorperspectives.com. The exception is the Hartford fund family analysis, which can be found at www.etf.com. The corresponding portfolios are provided for informational purposes only, were constructed specifically for this review and are not portfolios that Buckingham recommends. The returns data included is from Morningstar, and the factor analysis tool was provided by Portfolio Visualizer: www.portfoliovisualizer.com/factor-analysis. Performance is historical and does not guarantee future results. Information comes from sources deemed reliable but its accuracy cannot be guaranteed. It should not be assumed that any of the securities listed were or will prove to be profitable.