INVESTMENT ADVENTURES IN EMERGING MARKETS

PERSPECTIVE

Are EM Small-Cap Stocks Due for a Rebound?

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While investor interest in emerging markets picked up in the first quarter of 2019, many seemed to overlook small-cap stocks in the space. Here, the Franklin Templeton Emerging Markets Equity team suggests some reasons why investors might want to consider select EM small-cap stocks.

Almost all major asset classes experienced declines in 2018—it was clearly a challenging year. EM small-cap stocks (as defined by the MSCI EM Small Cap Index) were not immune, suffering double-digit declines. However, the asset class saw a rebound in the first quarter of this year, as the index delivered a gain of 7.8%.[1]

Yet, in a continuation from last year, EM small caps didn't keep pace with their EM large-cap counterparts in the first quarter.[2] In our view, part of this underperformance can be attributed to some investor misconceptions about EM small caps. As we mentioned in this article, these misconceptions, such as a view that EM small caps are more volatile than larger-cap EM stocks, conceal key strengths that an active manager could potentially benefit from.

Opportunities in EM Small-Cap Stocks

The EM small-cap space remains attractive to us, partly because many of the headwinds in 2018 have already been priced into valuations or are likely to abate this year. The US Federal Reserve (Fed) has taken a more dovish tone this year. At its March 2019 meeting, the Fed confirmed the patient tone on interest rates it already adopted in January.

Also, in terms of US-China trade relations, signs are pointed more optimistically that there will be a near-term agreement, although the possibility that a trade agreement is not reached is a major tail risk.

In addition, the market's general expectation is that oil prices will remain relatively range-bound, given continued growth in supply and weakened demand with a global economic slowdown. In our view, stable oil prices should support consumption and ease inflation for certain Asian economies, such as India, that are net importers of oil.

We think for many investors the current market environment provides a particularly attractive entry point. In particular, we like select companies in the health care sector, as well as companies that stand to benefit from long-term secular trends relating to consumption and innovation.

Health Care

Demographic shifts and aging populations in many emerging-market countries are intensifying pressures on health care systems. In our view, these factors will continue to be a boon for hospitals, dietary supplements, medical devices and pharmaceuticals.

The health care landscape is also changing, with growing consumer awareness fueling medical and wellness needs. We are seeing more consumers embrace preventive health care out of a desire to look and feel better.

For example, we like the long-term prospects for a South Korean company that produces products using botulinum toxin type A for both therapeutic purposes and aesthetic purposes. This company has entered the global botulinum toxin market and we think it is well-positioned to benefit from the growing global demand for anti-aging products, particularly in fast-growing economies such as China where this segment is forecast to grow fast in the decades ahead.

Consumption

Rising domestic consumption remains a long-term secular driver for emerging markets. We believe the demand for goods and services in emerging markets is set to accelerate on the back of a burgeoning young and working population, coupled with rising household incomes.

In our view, this growing demand will create opportunities for businesses that tap into the growing consumer market. In particular, we like select companies that stand to benefit from the rising trend of premiumization of consumer goods and services. We also see rising incomes driving demand for more sophisticated financial products and services such as wealth management and asset management.

Innovation

Emerging-market companies have not only embraced the use of technology but have become global market innovators in many areas. As we mentioned in this article, emerging markets are now at the forefront of the latest technological developments, from mobile banking and shopping to robotics, autonomous vehicles, health care and more.

We expect technology to continue to reshape emerging markets, as technology disruptors become the norm by transforming industry landscapes, and companies continue to embrace technology and innovation.

Technology is changing the automobile industry, introducing new trends such as electric vehicles and automated driving systems. In addition, e-commerce is still very much a penetration story, resonating in several markets as consumers increasingly use multiple devices for online transactions.

Investment Implications

Perhaps what is most important to recognize is that there are numerous EM small-cap companies that will likely remain small, whether due to corporate governance issues, poor quality of management, lack of market growth or other factors. The role of an active manager is to seek out companies which will succeed over the long term, while striving to reduce downside risk and thus enhance risk-adjusted returns.

At Franklin Templeton Emerging Markets Equity, we believe active managers who can focus on risk management and long-term growth drivers for the asset class are best equipped to uncover opportunities in this space. Our EM small-cap research is driven by an extensive on-the-ground team of over 80 portfolio managers and analysts in 16 countries, which allows us to have regular face-to-face meetings.

Overall, with our bottom-up, high-conviction, long-term investment approach we look to invest in companies with good management teams, where we have conviction that they can make the right strategic choices.

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What Are the Risks?

All investments involve risks, including the possible loss of principal. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. The technology industry can be significantly affected by obsolescence of existing technology, short product cycles, falling prices and profits, competition from new market entrants as well as general economic conditions. Smaller and newer companies can be particularly sensitive to changing economic conditions. Their growth prospects are less certain than those of larger, more established companies, and they can be volatile.

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1. Source: MSCI, as of March 29, 2019. The MSCI EM Small Cap Index is a free float-adjusted, market capitalization-weighted index designed to measure performance of small cap equities in emerging markets. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. Past performance is not an indicator or guarantee of future results.

2. Ibid. The MSCI Emerging Markets Index captures large- and mid-cap representation across 24 emerging-market countries. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. Past performance is not an indicator or guarantee of future results.