Swedroe: Killing An Emerging Market Canard

July 24, 2017

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"To win in emerging markets, avoid the passive investing rush," proclaimed the headline of a July 2017 Bloomberg article. That sentiment happens to be one of the greatest, and hardest to kill, canards in the legion of canards espoused by proponents of active management. But let's give it a try.

A highlight of the article was the claim (citing Morningstar data) that stock pickers with funds domiciled in Europe have beaten passive funds 60% of the time in emerging markets over the last five years.

The article continues: "Picking stocks on the Standard & Poor's 500 is an entirely different animal from navigating more than two dozen emerging equity markets in countries where data can be scarce and political upheaval often takes investors unaware. Some emerging-market stocks don't even trade every day."

The article is just another in a long series based on the idea that, while U.S. markets might be too efficient for active managers to persistently outperform, emerging markets are much less efficient. With that in mind, let's see if this assertion is correct.

Testing A Claim

One simple way to test the claim is to examine the performance rankings of two of the leading providers of passively managed emerging markets funds—index funds from Vanguard and structured portfolios from Dimensional Fund Advisors (DFA). None of their funds engage in any individual stock selection or market timing, the hallmarks of active management.

The table below shows the performance ranking provided by Morningstar for the 15-year period ending July 13, 2017. (In the interest of full disclosure, my firm, Buckingham Strategic Wealth, recommends DFA funds in constructing client portfolios.)

Fund	15-Year Annualized Return (%) / Percentile Ranking
Vanguard Emerging Markets Stock Index (VEIEX)	10.1/46
DFA Emerging Markets (DFEMX)	11.4/21
DFA Emerging Markets Small Cap (DEMSX)	13.6/1
DFA Emerging Markets Value (DFEVX)	12.9/4

Before reviewing the results, it's important to understand that the data from Morningstar has a very large survivorship bias—it considers only funds that have survived the full period. This contrasts with data provided through the S&P Dow Jones Indices Versus Active (SPIVA) scorecards, which is free of survivorship bias. Its rankings consider all funds that began the period, whether they survived or not.

Because we know mutual fund sponsors don't merge or shut down successful funds, we can conclude the funds they close almost certainly had poor performance. The problem for investors selecting mutual funds today is that they are choosing from a list that excludes losing funds either shuttered or merged out of existence to make their poor performance disappear.

Understanding how survivorship bias impacts the odds of success in selecting actively managed funds that will outperform in the future is an important issue.

Passive Performance Impressive

In the case of emerging markets, using data provided by the Center for Research in Security Prices, we find that over the 15-year period ending 2016, of 77 actively managed funds that existed at the start of the period, 24 (or 31%) disappeared. This makes the relative performance of the four passive funds in the preceding table all the more impressive.

Adjusting VEIEX's 46th percentile Morningstar ranking to account for survivorship bias puts its actual ranking in the 32nd percentile. Adjusting the rankings for DFEMX, DEMSX and DFEVX for survivorship bias puts them in the 14th, first and third percentiles, respectively.

Does it not seem absurd to claim that emerging markets are inefficient when one of the DFA structured portfolios had a first-percentile ranking and another had a third-percentile ranking? Yet you hear that claim all the time.

The data also show that, because DFA's small and value funds outperformed the more marketlike portfolios of both VEIEX and DFEMX, all active managers had to do to produce a higher return than the index was to make a higher allocation to small and value stocks than the emerging markets index. Note that would not have meant they produced higher risk-adjusted (apples-to-apples) returns.

Yet on a survivorship bias-adjusted basis, we see that VEIEX still outperformed 68% of active funds and DFEMX outperformed 86% of them.

Supporting Data From SPIVA

We can look at another bit of data free from survivorship bias. The 2016 SPIVA U.S. Scorecard showed that for the 5- , 10- and 15-year periods, 75%, 86% and 90% of emerging market funds, respectively, *underperformed* their benchmark index. So here we see even the five-year results showing active management is the loser's game, and the longer the horizon, the worse the results tend to be.

On an equal-weighted (asset-weighted) basis, the actively managed funds returned 1.2% (2.0%) per year over the last five years compared to a return of 2.6% for the benchmark S&P/IFCI. Over the last 10 years, active funds returned 0.6% (1.7%) per year versus 2.7% for the index. And over the last l5 years, they returned 8.5% (9.7%) per year versus 10.7% for the index. No matter the metric or the horizon, active management was clearly a loser's game in the emerging markets.

It is also important to keep in mind that even the SPIVA figures understate the relative performance for taxable investors, because the higher turnover of actively managed funds tends to make them less tax efficient.

There are four conclusions you can draw from the data:

- Emerging markets are not the inefficient asset class active managers always seem to claim they are.
- 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.
- All that flexibility possessed by active managers in emerging markets is not the advantage they want you to believe it is. In fact, it has proven to be a disadvantage.
- Passive management is most likely to prove the winning strategy.

In short, active management remains just as much a loser's game in emerging markets as it is in developed markets. And while it's a game that's possible to win, the odds of doing so are poor indeed.

There's 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.

'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, but because it depends on the simple laws of mathematics, or what John Bogle called the "cost matters" hypothesis.

It states that, because all emerging market stocks must be owned by someone, and passive investors earn market returns less low costs, while, in aggregate, active investors must also earn the market return less high costs (especially in emerging markets), in aggregate, passive investors must earn higher net returns than active investors. And that is exactly what the evidence shows.

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