Sector Report

International Shares - Emerging Markets & Asian Equities

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Executive summary

What is the difference between betting and investing? Whilst many believe investing is akin to a bet, Zenith contends that there is a stark and important distinction between the two.

Although both involve assuming risk and promise an opportunity to profit, Zenith believes the key difference between betting and investing is the probability of expected gains or losses.

With this year's edition of the Melbourne Cup fast approaching, we illustrate our contention through contrasting the difference between investing in emerging markets and a bet on the bookies' favourite horse.

We found that emerging markets provided investors with an asymmetric return profile, where the potential gains outweighed potential losses by a factor of 1.08 times. Furthermore, emerging market equities exhibited a positive expected return of 10% p.a.

Finally, we argue that investors can shift the odds even more in their favour by having a long-term investment orientation and hiring professional active managers. We demonstrate that the probability of emerging markets producing positive returns significantly increases over longer investment horizons, with Zenith's rated emerging markets funds, on average, outperforming a passive exposure over the prior 20-year period.

Over the 12 months to 30 September 2023, emerging markets (as represented by the MSCI Emerging Markets Index $A) generated a return of 11.3%, while Zenith's rated emerging markets funds outperformed, delivering an average return of 12.0% (after fees). Over the same period, Asia ex-Japan (as represented by the MSCI All Country Asia ex-Japan Index $A) generated a return of 10.5%, while Zenith's rated Asia ex-Japan funds delivered an average return of 11.2% (after fees), outperforming the index.

2. Key Themes & Issues

Investing versus Betting

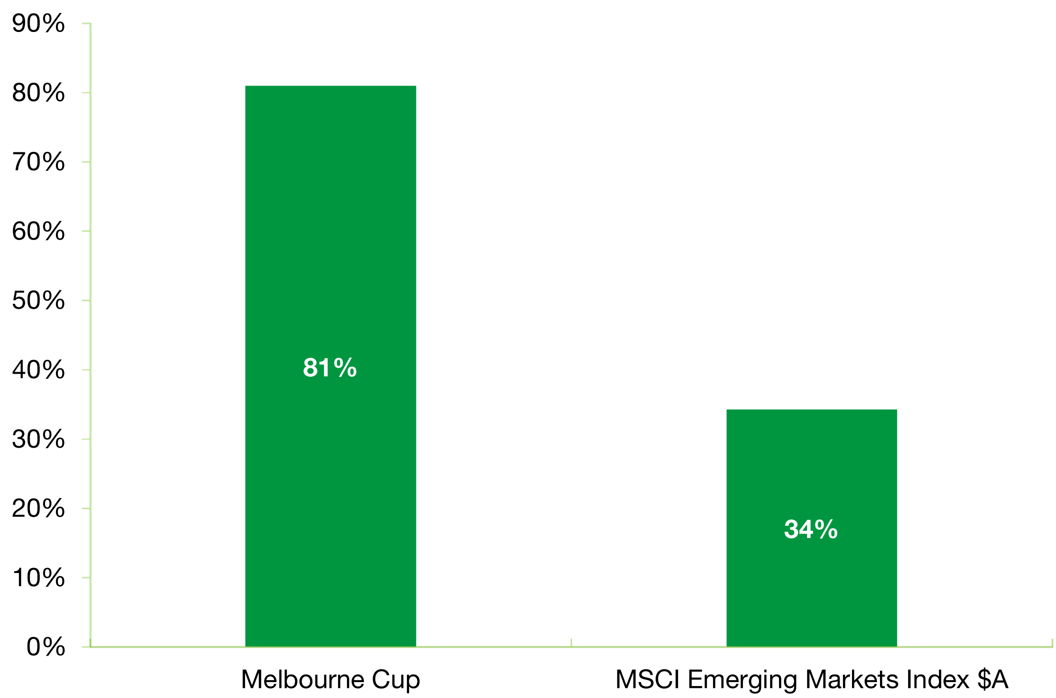
It is a common misconception that investing in emerging markets is akin to betting. However, whilst both involve assuming risk and promise an opportunity to make profit, there is a stark and important distinction between the two.

Zenith believes the key difference between betting and investing is the probability of expected gains or losses. Whilst investments offer positive expected returns, the expected outcome from betting is almost always negative. Furthermore, investing requires a longer-term horizon.

With this year's edition of the Melbourne Cup fast approaching, we look at the difference between investing in emerging markets and a bet on the bookies' favourite horse, to illustrate our contention that they are completely different.

The chart below compares the probability of capital loss for emerging market equities[1] (as represented by the MSCI Emerging Markets Index $A) in any given year with a bet on the bookies' favourite horse at the Melbourne Cup.

Probability of Capital Loss



Source: Bloomberg, Australian Broadcasting Channel & Racenet

Over the history of the Melbourne Cup, the shortest odds horse lost 81% of the time. In contrast, emerging markets produced a capital loss outcome in only 34% of years.

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[1]*Since January 1988 index inception*

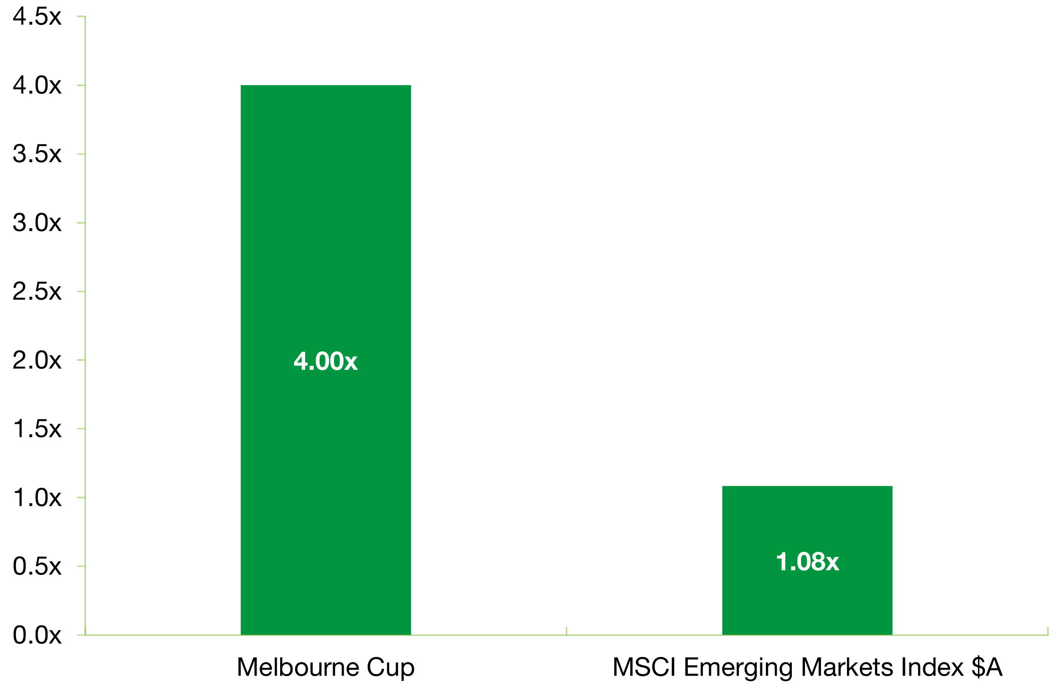
May the odds be in your favour!

When legendary investor, Warren Buffett, was asked the secret behind his investing success, he noted it was all about finding opportunities that shift the odds in your favour.

"Take the probability of loss times the amount of possible loss from the probability of gain times the amount of possible gain. That's what we are trying to do. It's imperfect but that is what it is all about."

As per Buffett's methodology, we must first determine the upside relative to the downside of emerging market equities and a bet on the bookies' favourite[2]. This is shown in the chart below. A value of 1x indicates that the upside is equal to the downside.

Upside versus Downside of Returns



Source: Bloomberg, Australian Broadcasting Channel & Racenet

Investing in emerging markets provides investors with an asymmetric return profile, where the potential gains outweigh potential losses by a factor of 1.08 times. Notwithstanding this, the potential reward for a bet on the bookies' favourite appears more enticing! However, is it sufficient to compensate for the lower chance of winning?

Continuing with Buffett's methodology, the chart below illustrates the expected return from emerging market equities compared to backing the favourite at the Melbourne Cup.

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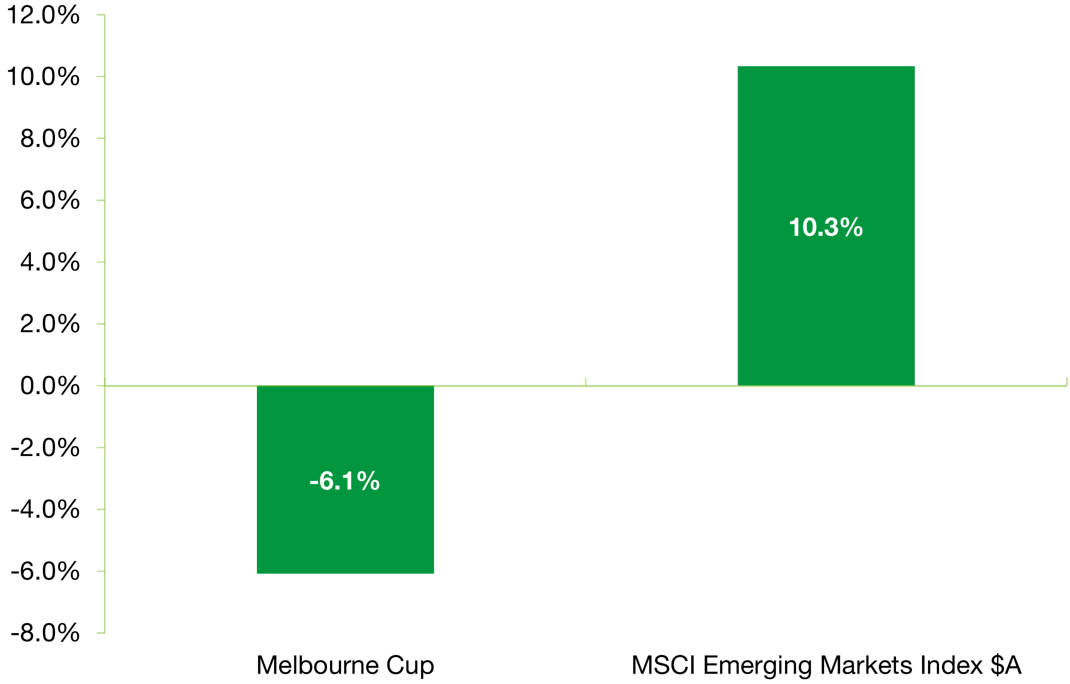
[2] *Average historical odds for the favourite*

Expected Return



Source: Bloomberg, Australian Broadcasting Channel & Racenet

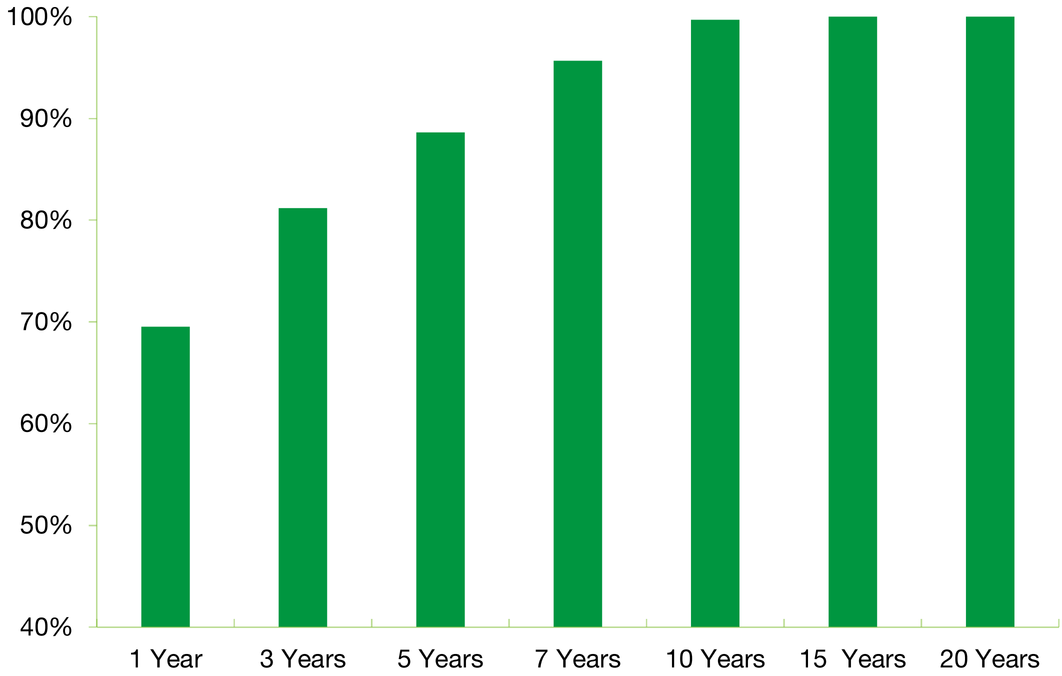
Unsurprisingly, the higher potential reward for betting on the bookies' favourite insufficiently compensated for the lower chance of winning, with an overall expected return of -6.1%. By contrast, an investment in emerging market equities exhibited a positive expected return of 10.3% p.a.

Turn patience into profit

Timeframe provides investors with another key advantage. By the end of the Melbourne Cup, you know if you have either won or lost. On the other hand, an investment is made over many years and the outcomes compound over time.

The chart below illustrates the percentage of periods where emerging market equities (as represented by the MSCI Emerging Markets Index $A) produced positive returns over different investment horizons.

Percentage of Periods with Positive Returns over Different Holding Periods



Source: Bloomberg

As shown above, the probability of emerging markets producing positive returns significantly increased over longer investment horizons. Effectively, investors can increase the odds in their favour by having a long-term investment orientation. Unlike gambling, where the more you play the more you lose, in emerging markets and investing in general, the longer you stay invested, the more likely you will experience positive results.

In the words of Seth Klarman, Founder of The Baupost Group, L.L.C.

> *"The single greatest edge an investor can have is a long-term orientation."*

Does active management improve the odds?

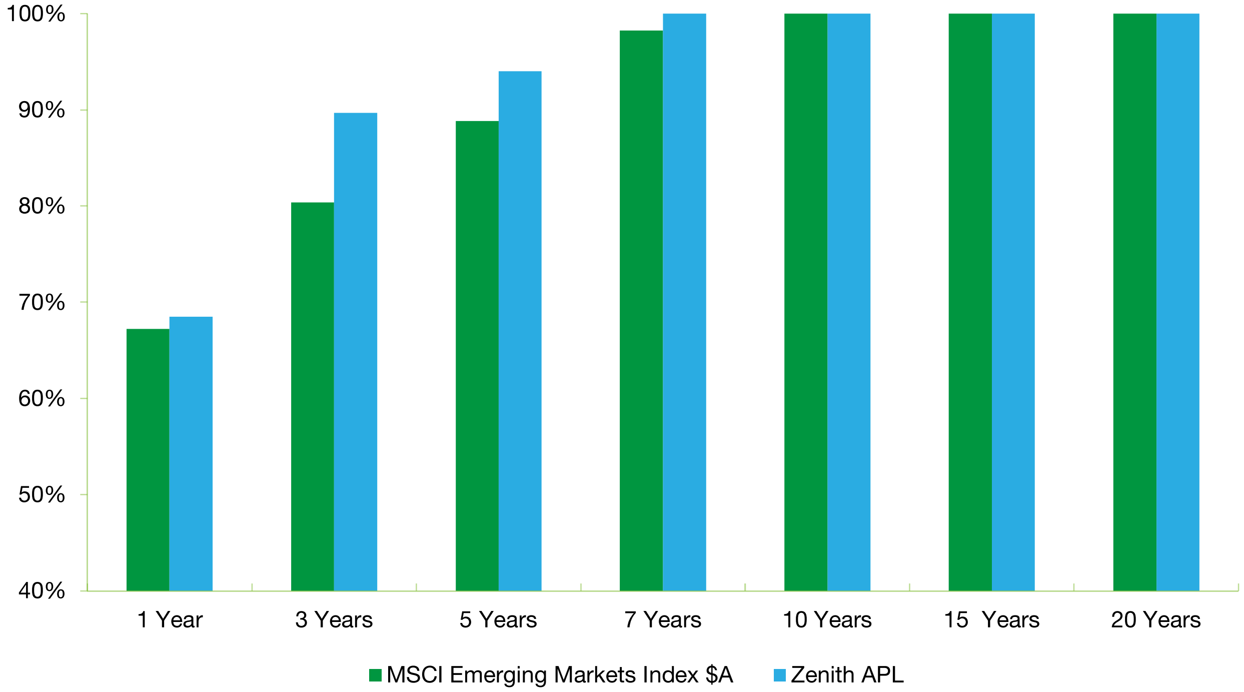
So far, we have only considered passive exposures to emerging markets. Zenith believes professional investors can exploit the inefficiencies inherent in the asset class to deliver superior outcomes. By hiring professional active managers, investors can move the odds even more in their favour.

To illustrate the benefits of active management, we repeat our analysis with Zenith's International Shares – Emerging Markets peer group.

The chart below illustrates the percentage of periods where emerging markets and Zenith's average rated emerging markets fund produced positive returns over different investment horizons.[3]

[3] *Since 1998, which is aligned with the inception of Zenith's APL. All returns are on an after-fee basis.*

Percentage of Periods with Positive Returns over Different Holding Periods

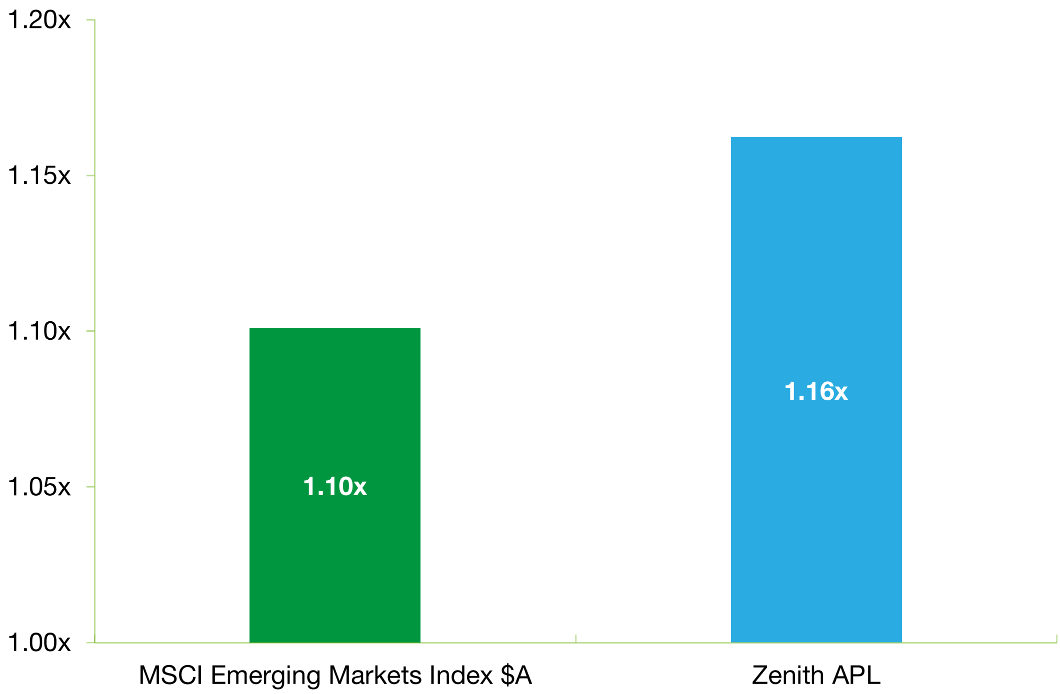


Source: Bloomberg & Fund Managers

Pleasingly, over all applicable investment horizons, active management increased the probability of positive returns.

The upside relative to the downside for active management compared to a passive exposure are shown in the chart below.

Upside versus Downside of Returns



Source: Bloomberg & Fund Managers

In line with our expectations, active management meaningfully increased payoff outcomes compared to a passive exposure.

The table below displays the benefits of active management from a risk/return perspective over the last 20 years.

Zenith's Average Rated Manager versus the Benchmark

	MSCI Emerging Markets Index $A	Average Rated Manager
Returns (% p.a.)	6.2% p.a.	6.6% p.a.
Standard Deviation (% p.a.)	10.9% p.a.	10.1% p.a.
Return/Risk	0.57	0.65

Source: Bloomberg & Fund Managers

Zenith's average rated emerging markets Funds outperformed the Index by 0.4% p.a. (after fees) over the period with less volatility, as measured by Standard Deviation. As such, the differential between the risk-adjusted outcomes is even more meaningful.

Place your bets!

Armed with our analysis, we believe that the Australian public would be better off investing in active emerging market strategies for the long term rather than placing a bet on the upcoming race.

However, for those who do decide to have a bet at this year's edition of the Melbourne Cup, the bookies' favourite would still be our pick. With the lowest odds horse not having won since 2013, is a win long overdue?

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Fund Reports

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