TKB INVESTMENT PARTNERS

Flash note
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‘Outside view’ on asset allocation across EM

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In his book “*Thinking, Fast and Slow*”, **Nobel Prize winner Daniel Kahneman** tells a story about **a curriculum project.** The aim was to write a book that would help give high school pupils decision-making skills. After about a year, the team involved in the project, including Kahneman, made forecasts about how quickly they would finish the book. **The team members’ estimates ranged between 1.5 and 2.5 years.** Then Kahneman asked an expert in curriculum projects, who was a member of the team, **how long did it normally take to accomplish similar projects for similar teams**. The expert was surprised by his own answer: 40% failed and **none achieved it in less than seven years. This was the “outside view” –** one that was counterintuitive even for the expert who had all the data! In the end, the team took eight years to finish the project.

This ‘outside view’ concept can be used as one of the inputs when considering asset allocations across the equity markets of large emerging market (EM) countries.

If the aim is to outperform MSCI EM index over the next 12 months, the ‘outside view’ suggests:

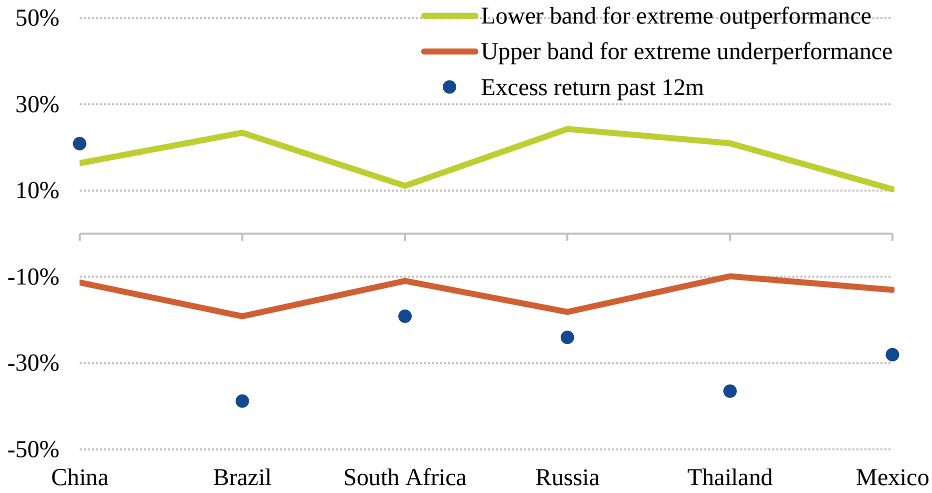
- **Overweights in Brazil, South Africa and Russia**
- **Underweights in Thailand and China.**

It is far more important to understand country specific factors then considering outside view. You can find an analysis of such factors for the Russian equity market here: Will Russia outperform EM? Focus on Russia-specific factors. **However, it is also important to have strong arguments in case of the opposite country allocation to the ‘outside view’ one.**

‘Extreme’ countries

In our ‘outside view’ analysis, we focus on countries which have demonstrated extreme outperformance/underperformance compared to the MSCI EM index over the last 12 months[1]. We do so because we believe that, in most cases, extreme performance – good or bad –is not sustainable. By extreme excess return we mean one that implies a difference of plus or minus one standard deviation from its long-term average. The countries that have recently posted extreme excess returns vs. the MSCI EM index are: China, Brazil, South Africa, Russia, Thailand and Mexico.

Graph 1. Bands for extreme outperformance or underperformance and excess return for the past 12 months



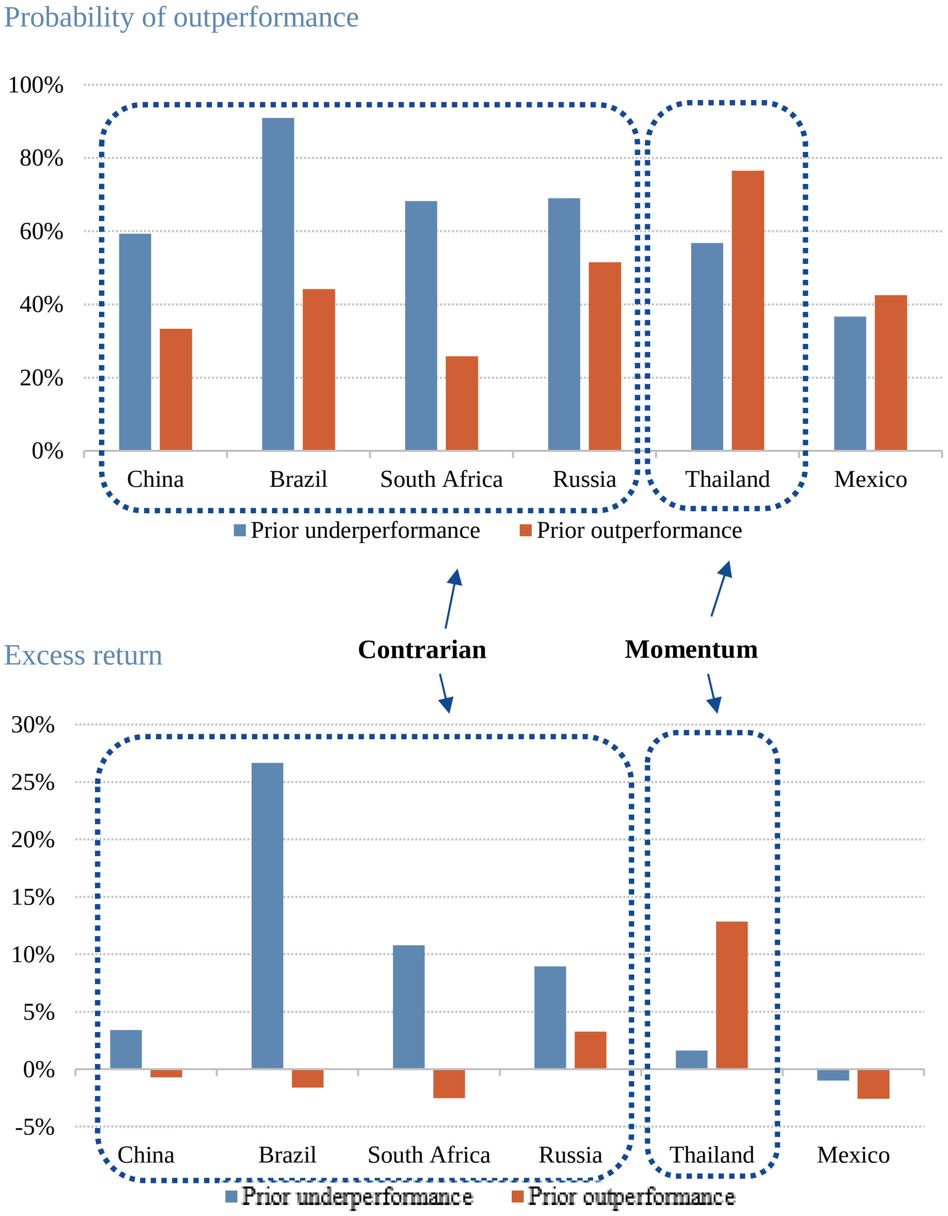
Note: We took a sample of excess returns for MSCI country indices vs. the MSCI EM index over 12-month periods from end 2000 to end September 2020 in one-month steps, e.g. from end 2000 to end 2001, from end January 2001 to end January 2002, etc. All figures are in USD terms and on a total return basis. We calculated the excess return for each period using geometric formula. We calculated the average excess return and standard deviation of excess return for each country on the basis of the whole sample. Lower band for extreme outperformance is equal to average excess return plus standard deviation. Upper band for extreme underperformance is equal to the average excesses turn minus standard deviation. Past performance is not indicative of future performance. Source: Bloomberg, TKB Investment Partners; October 2020

‘Outside view’ analysis

In the past two decades, the excess returns of China, Brazil, South Africa and Russia have followed a distinct contrarian pattern. Extreme past-12-months underperformance for these markets normally improved the odds and size of the outperformance in the following 12 months and vice versa. Thailand followed a momentum pattern. Extreme underperformance in the past 12 months for this market usually reduced the odds and size of the outperformance in the following 12 months and vice versa. We did not find it possible to come to a conclusion about the pattern type for Mexico.

[1] From end of September 2019 to end of September 2020; top-10 largest countries within MSCI EM which country specific indices are available for the period 2001-2020

Graph 2. 'Outside view' on a country's equity market ability to outperform the MSCI EM index over the next 12 months following an extreme excess return during the preceding 12 months (2001-2020)

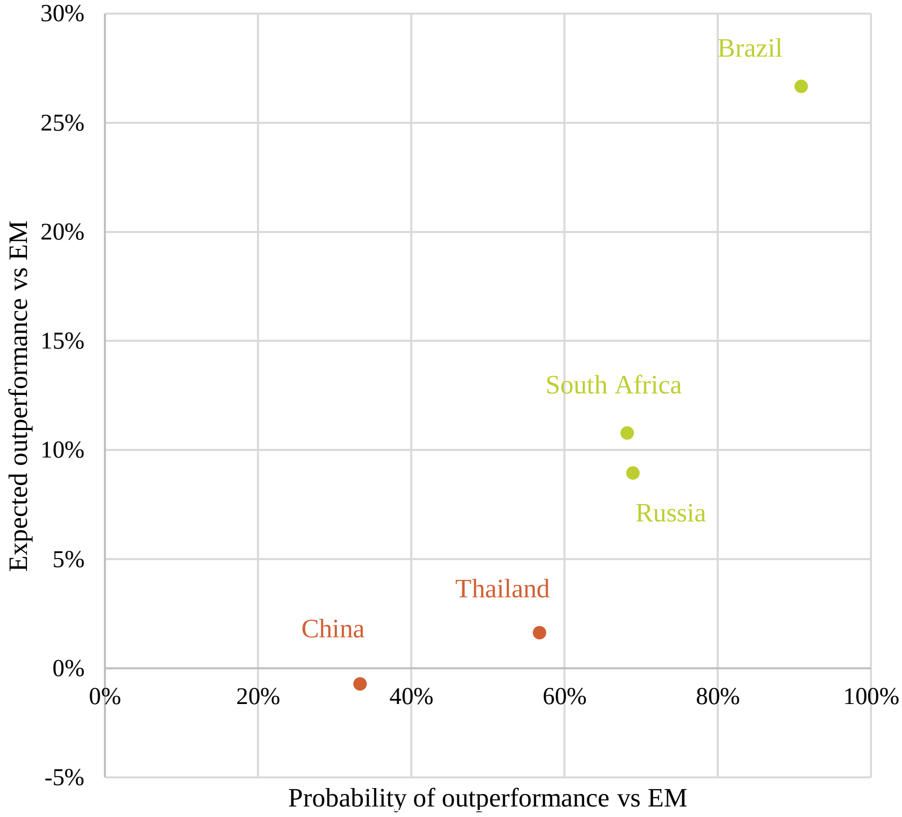


Note: On the sample of countries' excess returns we used for Graph 2, we analysed the interdependence between extreme cases for excess return and excess return over the next 12 months. The probability of outperformance is the share of the 12-month period after an extreme performance over the past 12-month period when there was an outperformance, i.e. in the past when China extremely outperformed EM over a 12-month period this resulted in the outperformance over the next 12 months in 33% cases and the average underperformance vs. EM was 0.7%. Past performance is not indicative of future performance. Source: Bloomberg, TKB Investment Partners; October 2020

To get the 'outside view' on the ability of individual equity markets to outperform the broad EM index over the next 12 months, we combine their performance over the last 12 months with their contrarian or momentum characteristics over the last two decades. For example, China equities over the last 12 months outperformed the EM index by 21%. This is more than 16.4%, which is the lower band for extreme outperformance. This band is equal to the country average annual outperformance over the last 20 years of

2.5% plus 13.8%, which is a standard deviation of the excess return of China vs. EM in the 12-month periods sample. In the past, when China extremely outperformed EM over 12-month periods, it resulted in the outperformance over the next 12 months in 33% cases and the average underperformance vs. EM was 0.7%.

Graph 3. 'Outside view' on the ability of the equity markets of various EM countries to outperform the MSCI EM index over the next 12 months



Note: We combined the results of the analysis we did to arrive at the data for Graphs 1 and 2.
Past performance is not indicative of future performance. Source: Bloomberg, TKB Investment Partners; October 2020

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