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Buyer beware: Reasons to reconsider passive EM ETFs

Key takeaways

EM equity is one of the least efficient sectors of the market and low-cost active managers have generated superior performance relative to their ETF counterparts.

EM ETFs tend to have high exposure to SOEs (state-owned enterprises), which tend to de-emphasize shareholder value in favor of other priorities.

EM ETF expenses are higher than in many other categories.

Passive investing offers many enticing features. Most strategies focus on specific index benchmarks, and investors can seek to earn returns close to those of the index, minus expenses. Performance does not depend on a manager's active security selection relative to the benchmark. The formula works in many cases: passive strategies outperform a majority of active managers in many investment categories.

But we think the emerging markets (EM) equity category is different. We believe EM are both more dynamic and under-researched compared with developed markets, providing opportunities for managers who can do cost-effective research to outperform indexes. It's important to consider that:

- Low-cost EM active managers have outperformed exchange-traded funds (ETFs) by 190 bps annually over 10 years (as of 11/30/20).
- Passive index-aligned EM strategies generally invest in a narrower universe than active EM managers, limiting their access to attractive opportunities.
- Passive index-aligned strategies may have high exposure to state-owned enterprises (SOEs) that have underperformed non-SOE companies. (An SOE is a business in which the government or state has significant control through equity stakes.)

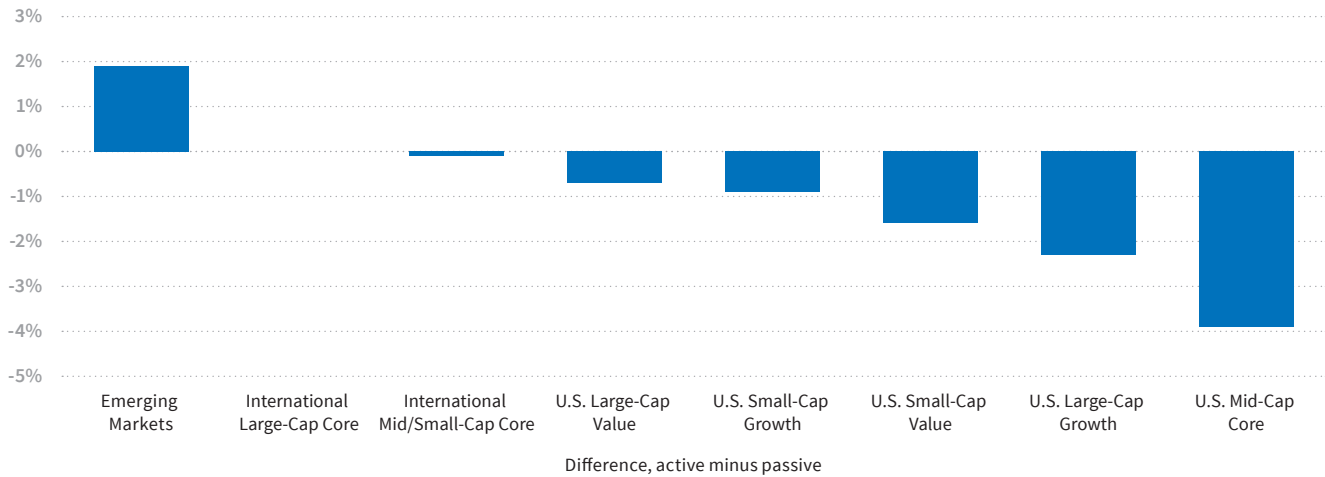
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FIGURE 1

Low-fee active EM managers outperformed the largest passive EM managers

The difference in average returns, lowest-fee quartile of active managers versus largest passive strategies for 10 years as of November 30, 2020.



Sources: Putnam; Lipper, a Refinitiv company. Returns shown for Lipper categories: Lipper Emerging Markets Funds; Lipper International Large-Cap Core Funds; Lipper International Mid/Small-Cap Core Funds; Lipper U.S. Large-Cap Value Funds; Lipper U.S. Small-Cap Growth Funds; Lipper U.S. Small-Cap Value Funds; Lipper U.S. Large-Cap Growth Funds; Lipper U.S. Mid-Cap Core Funds. In each Lipper category, active funds include mutual funds with A shares that were open to investment and had a 10-year performance history as of November 30, 2020. Passive strategies include ETFs and mutual funds. The ranking of active funds is by prospectus net expense ratio. The ranking of passive strategies is by assets managed. The performance comparison is calculated by subtracting the average 10-year returns for the five largest passive strategies from the lowest-fee active category quartile average in each category. See the Appendix for data showing the number of funds in each category and the average performance of the comparison groups.

Active EM lower-cost managers outperformed the top-performing passive EM investments

Our analysis of mutual funds and ETFs in Lipper equity categories helps to highlight how EM is different in terms of the relative performance of active versus passive strategies. Reviewing 10-year returns through November 30, 2020, we have found that EM is one of only three categories showing an advantage for low-cost active managers relative to passive strategies. The average performance of the lowest-fee active managers in the EM category outperformed the average of passive investments.

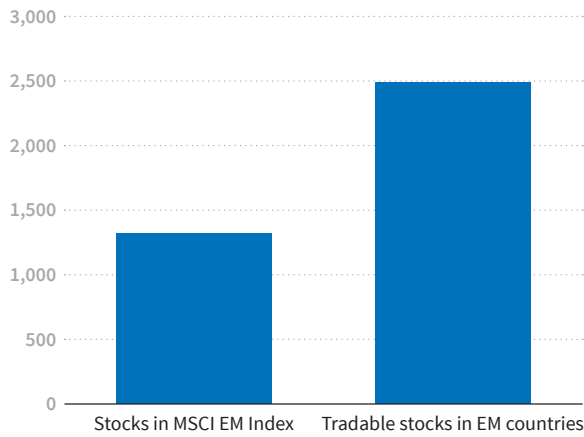
Index-aligned strategies are limited to a narrower investment universe

An investment universe is the range of securities in which a portfolio can invest, as defined by its prospectus. Passive portfolios aligned with an index are limited to invest in securities represented in the index, while active managers have the flexibility to invest in a wider opportunity set, both within and outside the index. In EM equity, this is a significant difference. Our analysis indicates that the investable EM universe is almost 100% larger than the MSCI EM Index that is the basis for many ETFs. We believe a larger investment universe generally gives active managers advantages: They can cast a wider net and balance out the variety of opportunities in emerging markets.

FIGURE 2

Indexes represent barely half of the investment opportunities in EM equity

Number of stocks in MSCI EM Index versus number of EM stocks with greater than \$3 million in trading value



Source: Putnam. Putnam calculations using MSCI Emerging Markets Index constituents and IDCPC volume data. See the Appendix for data showing data by country and aggregate data.

The MSCI EM Index has a large weighting in SOEs, which have underperformed over time

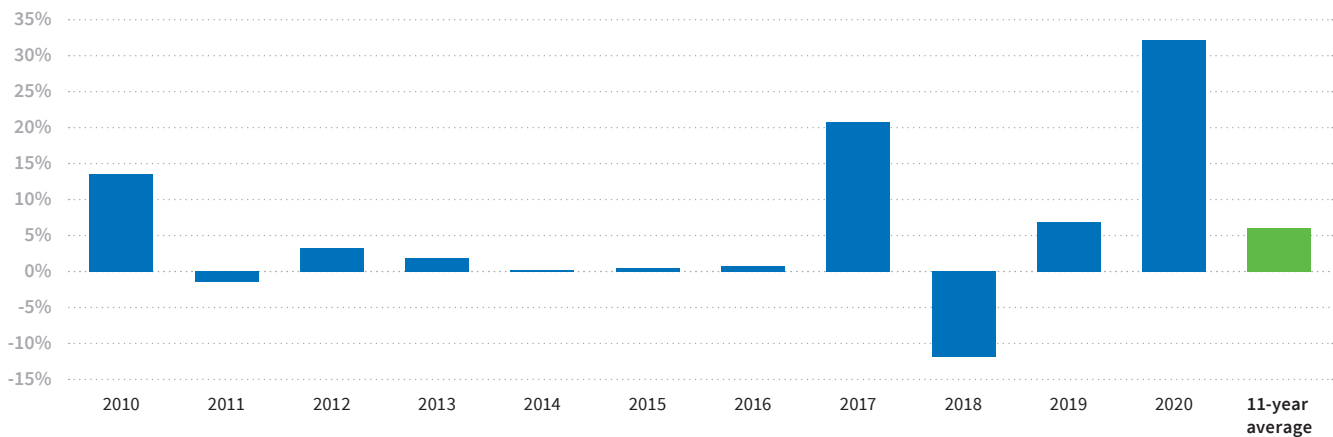
SOEs represented a 20% weighting in the MSCI Emerging Markets Index as of December 31, 2020. Sectors with large exposure to SOEs typically include financials and utilities. In our opinion, SOEs are run for employment or other government objectives, not for maximizing shareholder value. Exposure to SOEs might be a drag on performance.

It's also our opinion that managers who actively research companies are likely to maintain a structural underweight to SOEs, as they typically do not represent the best opportunity for long-term fundamental growth and shareholder returns. While the difference in performance between SOEs and non-SOEs varies from year to year, non-SOEs outperformed by an average of 6.11% over the past 11 years. In 9 of the 11 years, SOE stocks lagged, and as such, typically, an underweight to SOEs has added value.

FIGURE 3

Non-SOE companies outperformed SOEs in MSCI EM Index by an average of 6.1%

Difference in performance, non-SOE companies versus SOEs in MSCI EM Index, 2010–2020



Sources: Putnam, MSCI. Putnam calculations using MSCI Emerging Markets Index constituents at the start of each calendar year. SOEs were identified from the list of EM companies currently defined by MSCI as SOEs. Returns are free-float-weighted calendar-year total returns of a buy-and-hold strategy by SOE and non-SOE groups.

EM ETF expenses are relatively high, and investment styles vary

Selecting an active mutual fund requires diligence, but finding an ETF means doing homework, too. Key criteria such as expense ratios and investment styles can vary significantly even within the category.

Investors have a choice of 58 passive investment options in the Lipper EM equity category. The number of holdings in the passive options ranges from 100 to 4,129. Many active funds, by contrast, have fewer than 100 holdings, so that each holding has more meaningful impact on performance. Investment styles also show a wide variety as measured by characteristics such as P/E ratios and return on equity. Perhaps most importantly, while some offer the low expenses associated with passive strategies, this is not the case across the board. The median expense ratio of ETFs in the category is 50 basis points, and some of the largest ETFs by assets have above-median expense ratios.

In short, many passive strategies in the EM equity category have higher expense ratios than many investors might expect. The wide range of portfolio characteristics also belies the uniformity often associated with passive strategies. It's important to research EM options and not assume that passive strategies in the EM category offer the same advantages as their counterparts in other categories.

Choosing a passive or an active approach when investing in EM

We believe this analysis makes a strong case for considering an active manager for EM equity investing.

- Active EM managers who keep their expenses low have demonstrated a high rate of success in performing better than passive strategies. They also have the flexibility to seek opportunities where and when they arise, without the index constraints of a passive approach.
- The MSCI EM Equity Index excludes many potentially attractive investment opportunities, but includes a large amount of unattractive SOEs. ETFs aligned with that index carry those disadvantages.
- EM equity ETFs have relatively high expense ratios and a large variation in portfolio characteristics.
- It's important not to assume that EM passive options are homogeneous or offer the same advantages of passive strategies in other categories.

The process of researching and selecting an EM strategy, whether active or passive, takes time, effort, and skill, and you should be rewarded for this effort with better performance. We believe active managers can win out in the long term.

FIGURE 4

Passive EM strategies show wide range of expense ratios and investment styles

Portfolio data for passive EM equity strategies as of November 30, 2020

Strategy attribute	Lowest value	Highest value
Prospectus expense ratio	0.08%	0.90%
Number of holdings	100	4,129
Price/earnings ratio	14.5	37.5
Return on equity	-26.6%	48.1%

Source: Lipper, a Refinitiv company. Data for 58 passive investment options with Emerging Markets objectives.

Appendix

Data for Figure 1

Lipper Classification	Number of active funds in Lipper category with A shares	Average performance of lowest-fee quartile	Asset-weighted average performance of largest 5 passive investments	Difference between low fee active managers and largest passive managers
Emerging Markets	36	5.1%	3.2%	1.9%
International Large-Cap Core	33	5.6	5.5	0.0
International Mid/Small-Cap Core	27	5.3	5.4	-0.1
U.S. Large-Cap Value	38	10.9	11.6	-0.7
U.S. Small-Cap Growth	53	12.4	13.4	-0.9
U.S. Small-Cap Value	17	8.0	9.6	-1.6
U.S. Large-Cap Growth	61	16.0	18.3	-2.3
U.S. Mid-Cap Core	28	8.8	12.7	-3.9

Sources: Putnam; Lipper, a Refinitiv company. Returns shown for Lipper categories: Lipper Emerging Markets Funds; Lipper International Large-Cap Core Funds; Lipper International Mid/Small-Cap Core Funds; Lipper U.S. Large-Cap Value Funds; Lipper U.S. Small-Cap Growth Funds; Lipper U.S. Small-Cap Value Funds; Lipper U.S. Large-Cap Growth Funds; Lipper U.S. Mid-Cap Core Funds. In each Lipper category, active funds include mutual funds with A shares that were open to investment and had a 10-year performance history as of November 30, 2020. The ranking of active funds is by prospectus net expense ratio as of November 30, 2020. Passive strategies include ETFs and mutual funds. The average performance of passive strategies is calculated using the largest five by assets managed. The performance comparison is calculated by subtracting the average 10-year returns for the five largest passive strategies from the lowest-fee active category quartile average in each category.

Data for Figure 2

MSCI Emerging Countries	Number of MSCI Emerging Markets Index constituents	Investment opportunities greater than \$3 million trading value	More opportunities vs. index
China	647	791	144
Korea	101	440	339
India	96	212	116
Taiwan	87	333	246
Brazil	51	136	85
Thailand	42	90	48
Malaysia	38	41	3
South Africa	37	49	12
Saudi Arabia	36	68	32
Mexico	25	25	0
Russia	22	36	14
Indonesia	22	60	38
Turkey	14	98	84
Poland	14	20	6
Chile	14	15	1
Remaining 10 countries	73	73	0
	1,319	2,487	1,168

Sources: Putnam, MSCI. Calculations using MSCI Emerging Markets Index constituents and IDCP volume data as of November 30, 2020.

Data for Figure 3

Year	MSCI Emerging Markets Companies			MSCI Emerging Markets Weight			MSCI Emerging Markets Return (USD)		
	State owned	Investor owned	Total	State owned	Investor owned	Total	State owned	Investor owned	Total
2010	132	620	752	28%	72%	100%	9.6%	23.2%	-13.6%
2011	147	640	787	28	72	100	-16.5	-17.9	1.4
2012	155	651	806	28	72	100	16.3	19.5	-3.2
2013	155	647	802	28	72	100	-3.8	-1.9	-1.9
2014	156	650	806	27	73	100	-1.3	-1.2	-0.2
2015	174	644	818	28	72	100	-14.4	-13.9	-0.5
2016	182	641	823	27	73	100	12.2	13.1	-0.8
2017	184	631	815	26	74	100	22.4	43.2	-20.8
2018	186	644	830	23	77	100	-4.5	-16.4	11.9
2019	298	762	1060	26	74	100	14.4	21.3	-6.9
2020	384	952	1336	26	74	100	-6.0	26.2	-32.2
Average	196	680	876	27%	73%	100%	2.6%	8.7%	-6.1%

Sources: Putnam, MSCI. Putnam calculations using MSCI Emerging Markets Index constituents at the start of each calendar-year. SOEs were identified from the list of EM companies currently defined by MSCI as SOEs. Returns are free-float-weighted calendar-year total returns of a buy-and-hold strategy by SOE and non-SOE groups.

Data for Figure 4

Passive strategies in Lipper EM equity category as of November 30, 2020	Prospectus expense ratio	Number of holdings	Price/earnings ratio	Return on equity
Invesco Exchange-Traded Fund Trust II: Invesco DWA Emerging Markets Momentum ETF	0.90%	103	32.8	12.3%
First Trust Exchange-Traded AlphaDEX Fund II: First Trust Emerging Markets AlphaDEX Fund	0.80	164	20.7	28.9
First Trust Exchange-Traded AlphaDEX Fund II: First Trust Emerging Markets Small Cap AlphaDEX Fund	0.80	215	15.3	11.7
First Trust Exchange-Traded Fund VI: Emerging Markets Equity Select ETF	0.75	252	20.0	23.9
Pacer Funds Trust: Pacer Emerging Markets Cash Cows 100 ETF	0.74	101	18.4	16.8
iShares, Inc: iShares MSCI BRIC ETF	0.69	668	31.6	-5.4
iShares, Inc: iShares MSCI Emerging Markets Small-Cap ETF	0.69	1,361	26.0	11.0
iShares, Inc: iShares MSCI Emerging Markets ETF	0.68	1,272	29.1	3.3
DBX ETF Trust: Xtrackers MSCI Emerging Markets Hedged Equity ETF	0.66	1,242	29.1	3.3
SPDR Index Shares Funds: SPDR S&P Emerging Markets Small Cap ETF	0.65	2,191	24.2	11.2
Transamerica ETF Trust: DeltaShares S&P EM 100 & Managed Risk ETF	0.60	123	29.4	-26.4
FlexShares Trust: FlexShares Morningstar Emerging Markets Factor Tilt Index Fund	0.59	2,266	21.8	7.0
Victory Portfolios II: VictoryShares Emerging Market High Div Volatility Wtd Index ETF	0.50	100	14.5	17.9
KraneShares Trust: KraneShares MSCI Emerging Markets ex China Index ETF	0.50	307	26.6	17.5
Invesco Exchange-Traded Fund Trust II: Invesco FTSE RAFI Emerging Markets ETF	0.50	404	19.2	13.5
Victory Portfolios II: VictoryShares Emerging Market Volatility Wtd Index ETF	0.50	500	24.7	15.6
iShares, Inc: iShares MSCI Emerging Markets Asia ETF	0.50	896	28.6	-3.4
Alpha Architect ETF Trust: Freedom 100 Emerging Markets ETF	0.49	103	30.1	14.9
iShares, Inc: iShares MSCI Emerging Markets ex China ETF	0.49	569	31.1	23.5
PIMCO Equity Series: PIMCO RAFI Dynamic Multi-Factor Emerging Markets Equity ETF	0.49	582	26.4	23.1

Data for Figure 4, continued

Passive strategies in Lipper EM equity category as of November 30, 2020	Prospectus expense ratio	Number of holdings	Price/earnings ratio	Return on equity
John Hancock Exchange-Traded Fund Trust: John Hancock Multifactor Emerging Markets ETF	0.49%	649	26.5	7.2%
SPDR Index Shares Funds: SPDR S&P Emerging Asia Pacific ETF	0.49	1,257	29.5	-4.6
Fidelity Covington Trust: Fidelity Targeted Emerging Markets Factor ETF	0.45	218	25.1	13.5
Victory Portfolios II: VictoryShares USAA MSCI Emerging Markets Value Momentum ETF	0.45	235	16.5	13.9
iShares, Inc: iShares MSCI Emerging Markets Multifactor ETF	0.45	296	22.1	16.0
Franklin Templeton ETF Trust: Franklin LibertyQ Emerging Markets ETF	0.45	376	21.6	48.1
Goldman Sachs ETF Trust: Goldman Sachs ActiveBeta Emerging Markets Equity ETF	0.45	420	28.2	17.7
TIAA-CREF Funds: Emerging Markets Equity Index Fund; Retirement Class Shares	0.45	1,414	29.4	0.3
Lattice Strategies Trust: Hartford Multifactor Emerging Markets ETF	0.44	346	18.7	17.7
JP Morgan Exchange-Traded Fund Trust: JPMorgan Diversified Return Emerging Markets Equity ETF	0.44	513	22.5	25.5
FlexShares Trust: FlexShares Emerging Markets Quality Low Volatility Index Fund	0.40	171	26.8	16.2
Schwab Capital Trust: Schwab Fundamental Emerging Markets Large Company Index Fund	0.39	346	18.8	13.7
Schwab Strategic Trust: Schwab Fundamental Emerging Markets Large Company Index ETF	0.39	347	18.8	13.7
Goldman Sachs ETF Trust: Goldman Sachs MarketBeta Emerging Markets Equity ETF	0.36	1,359	29.1	3.1
Invesco Exchange-Traded Self-Indexed Fund Trust: Invesco RAFI Strategic Emerging Markets ETF	0.35	401	20.8	12.6
TIAA-CREF Funds: Emerging Markets Equity Index Fund; Advisor Class Shares	0.34	1,414	29.4	0.3
WisdomTree Trust: WisdomTree Emerging Markets ex-State-Owned Enterprises Fund	0.32	475	32.9	1.4
SPDR Index Shares Funds: SPDR MSCI Emerging Markets Fossil Fuel Reserves Free ETF	0.30	566	29.3	-0.3
SPDR Index Shares Funds: SPDR MSCI Emerging Markets StrategicFactors ETF	0.30	1,046	26.6	19.6
Invesco Exchange-Traded Fund Trust II: Invesco S&P Emerging Markets Low Volatility ETF	0.29	204	18.6	14.3
Invesco Exchange-Traded Fund Trust II: Invesco S&P Emerging Markets Momentum ETF	0.29	206	37.5	-26.6
Fidelity Salem Street Trust: Fidelity SAI Emerging Markets Low Volatility Index Fund	0.26	129	26.3	17.6
Fidelity Salem Street Trust: Fidelity SAI Emerging Markets Value Index Fund	0.25	211	20.5	13.5
iShares, Inc: iShares MSCI Emerging Markets Min Vol Factor ETF	0.25	354	27.4	34.2
iShares, Inc: iShares ESG Aware MSCI EM ETF	0.25	394	29.1	7.6
DBX ETF Trust: Xtrackers MSCI Emerging Markets ESG Leaders Equity ETF	0.20	440	31.0	-5.8
State Street Institutional Investment Trust: State Street Emerging Markets Equity Index Fund; Class K Shares	0.17	1,338	28.9	3.0
Columbia ETF Trust II: Columbia EM Core ex-China ETF	0.16	104	26.7	15.7
iShares Trust: iShares ESG Advanced MSCI EM ETF	0.16	421	29.0	-17.4
iShares Trust: iShares ESG MSCI EM Leaders ETF	0.16	504	30.1	-14.1
Invesco Exchange-Traded Fund Trust II: Invesco Pure Beta FTSE Emerging Markets ETF	0.15	901	29.7	2.5
iShares, Inc: iShares Core MSCI Emerging Markets ETF	0.13	2,617	28.8	4.1
BNY Mellon ETF Trust: BNY Mellon Emerging Markets Equity ETF	0.11	635	32.0	16.7
Schwab Strategic Trust: Schwab Emerging Markets Equity ETF	0.11	1,532	28.8	2.9
SPDR Index Shares Funds: SPDR Portfolio Emerging Markets ETF	0.11	2,486	28.9	0.2
Vanguard International Equity Index Funds: Vanguard Emerging Markets Stock Index Fund; ETF Shares	0.10	4,129	28.8	2.1
Fidelity Salem Street Trust: Fidelity SAI Emerging Markets Index Fund	0.09	1,422	28.9	3.5
Fidelity Salem Street Trust: Fidelity Emerging Markets Index Fund	0.08	1,423	28.9	3.4

Source: Lipper, data for 58 passive investment options with Emerging Markets objectives.

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