ARE EMERGING MARKETS TURNING INTO THE S&P 500® INDEX?

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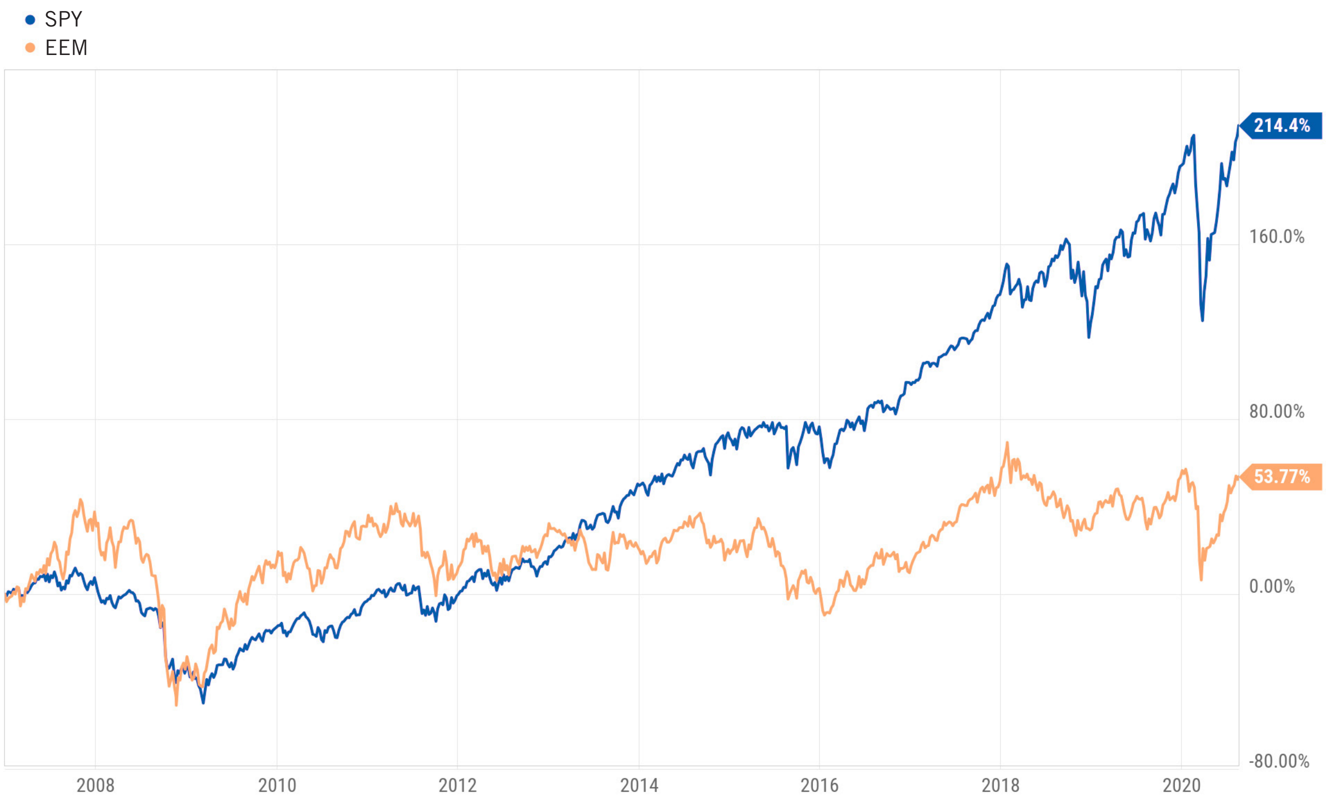
A WEALTH OF COMMON SENSE
AUGUST 17, 2020

The S&P 500® Index has crushed all competition for some time now. Small-cap stocks, value stocks, foreign stocks, emerging market stocks—none of them have been able to keep up with the mega-cap dominance of the S&P 500.

Here is the performance of the S&P 500 versus emerging market stocks since the start of 2007:



Past performance is not indicative of future results. As of 8/17/20. Source: YCharts. SPY: SPDR® S&P 500 ETF Trust Total Return Price % Change. EEM: iShares MSCI Emerging Markets ETF Total Reutrn Price % Change. SPY and EEM are used as proxies.

It's not even close.

There are many reasons for this outperformance. The dollar has strengthened mightily since the Great Recession. Emerging markets also dominated the S&P for the majority of the early 2000s.

Another reason many investors harp on is sector differences between the United States and foreign stock markets. They say these differences help explain the large valuation gap between these markets:

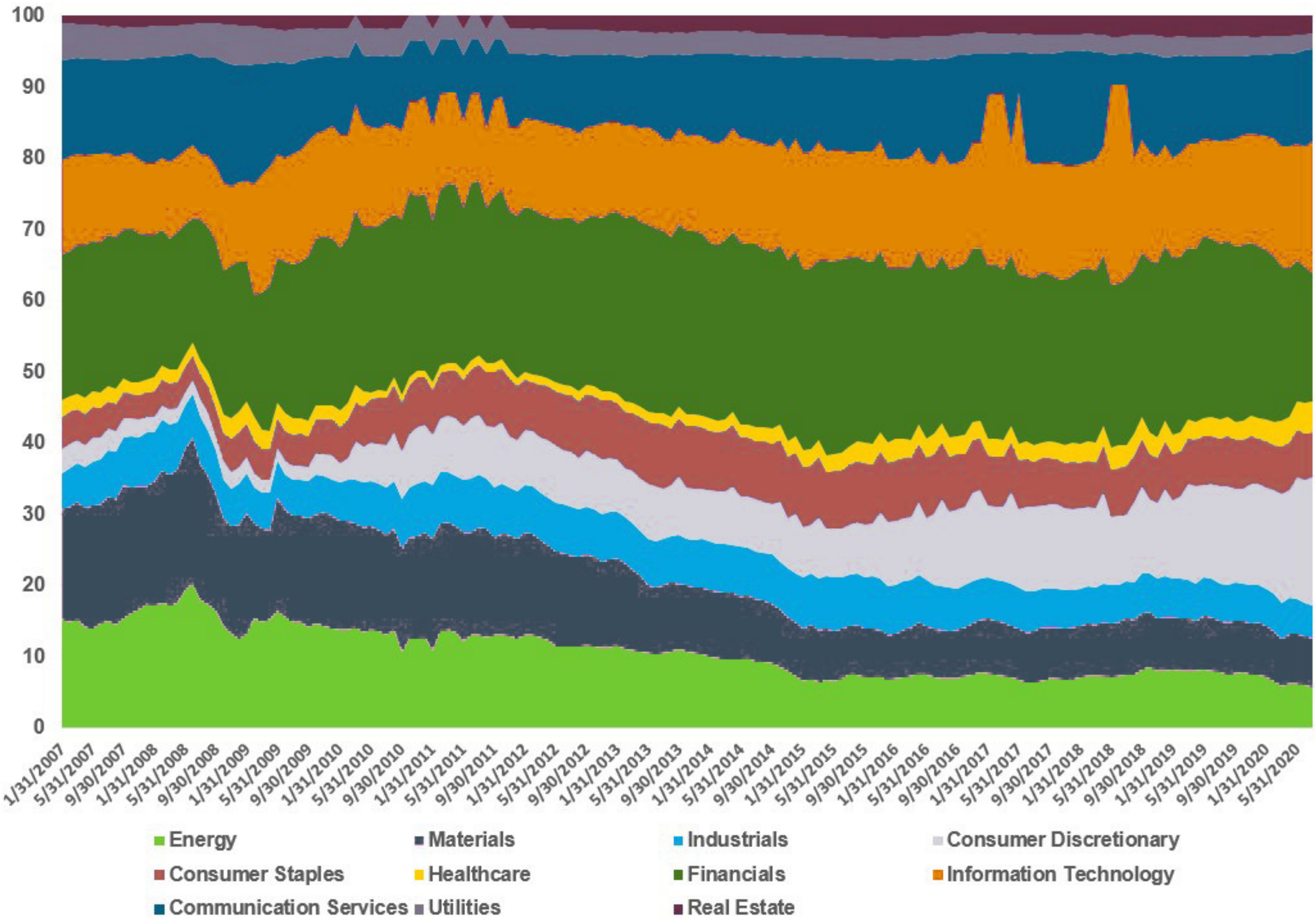
Valuation	Emerging Markets	S&P 500
Price/Earnings	15.7	25.0
Price/Book	1.7	3.4
Price/Sales	1.4	2.4
Price/Cash Flow	9.3	14.4
Dividend Yield	2.7%	1.8%

Past performance is not indicative of future results. Source: Vanguard. Data as of 7/31/20. Proxies: EEM and SPY.

Emerging markets are cheaper on every metric. Many investors say this makes sense, considering emerging markets are full of energy, materials, and financials, while the U.S. is more driven by technology and consumer stocks.

This was a good argument in 2007, or even 2015, but not so in 2020.

The make-up of emerging market equities has changed dramatically in recent years. The chart below reflects the sector changes of the iShares Emerging Markets ETF (EEM) since 2007:



As of 8/17/20. Source: Blackrock. Sector weightings are subject to change.

Here are some notable changes since the start of 2007:

- Energy has gone from more than 15% to less than 6%
- Materials were closer to 16% and now sit at 7%
- Financials have gone from more than 20% to 18% (and are down from a high of 27% in 2015)
- Consumer discretionary stocks have gone from roughly 3% to 18%
- Technology is now the biggest sector, having risen from 13% in 2007 to more than 18% now

Financials still have a large weighting, but it's a dwindling market share compared to the past. Energy and materials companies combined are now less than either of those categories were individually in 2007. And, technology stocks now make up the largest sector in the fund.

Here are the sector comparisons versus the S&P 500 ETF (SPY) as of the end of July:

Sector	SPY	EEM
Energy	2.6%	5.6%
Materials	2.3%	7.0%
Industrials	8.6%	4.5%
Consumer Discretionary	11.0%	18.0%
Consumer Staples	7.4%	6.4%
Healthcare	14.4%	4.3%
Financials	13.1%	18.1%
Technology	24.1%	18.4%
Communication	10.9%	13.0%
Utilities	3.0%	2.2%
Real Estate	2.7%	2.5%

Sector weightings are subject to change. Sources: iShares and Vanguard.

There are still differences here (mainly in healthcare), and of course the individual companies themselves are not the same, but this looks a lot closer than things did in the past. And, by far, the biggest changes are in the tech and consumer sectors.

One of the main reasons the overall U.S. stock market has done so well is the monstrous performance of the giant tech stocks. Amazon, Apple, Microsoft, Facebook, and Google currently make up around 23% of the S&P 500.

Emerging markets now have a similar tech concentration at the top. These are the top 10 holdings in EEM:

Name/Currency	Assets	Type	Sector	Country
Alibaba Group Holding Ltd ADR (USD)	7.35%	ST	Consumer Cyclicals	China
Tencent Holdings Ltd (HKD)	6.05%	ST	Communication Services	China
Taiwan Semiconductor Manufacturing Co Ltd (TWD)	5.63%	ST	Technology	Taiwan, Republic Of China
Samsung Electronics Co Ltd (KRW)	3.59%	ST	Technology	Republic Of Korea
Meituan Dianping (HKD)	1.59%	ST	Consumer Cyclicals	China
Reliance Industries Ltd (INR)	1.27%	ST	Energy	India
Naspers Ltd Class N (ZAR)	1.21%	ST	Communication Services	South Africa
China Construction BanK Corp Class H (HKD)	1.09%	ST	Financial Services	China
Ping An Insurance (Group) Co. of China Ltd Class H (HKD)	0.97%	ST	Financial Services	China
JD.com Inc ADR (USD)	0.82%	ST	Consumer Cyclicals	China

Holdings and sector weightings are subject to change. Source: Vanguard. Data as of 7/31/20.

The sector labels can be confusing because the lines are now blurred between the consumer, communication, and technology segments of the market, but the top four holdings are all basically tech stocks in EEM, and they make up 23% of the MSCI Emerging Markets Index.[1]

In many ways, Alibaba, Tencent, Taiwan Semiconductor, and Samsung are to emerging markets what Apple, Amazon, Microsoft, Facebook, and Google are to the U.S.

Now, I'm not saying emerging market stocks deserve a similar multiple to the S&P 500. There are other factors at play here including rule of law, the maturity of the financial markets, trust in the financial system, the autonomy of corporations in various countries, and how shareholders are treated by regulators and government officials.

But, things have drastically changed over the years in emerging markets, and many investors may not know this because their shares have lagged so badly.

It's also worth noting the cyclical nature of the relationship between these markets over time:

Time Frame	Emerging Markets	S&P 500® Index
1988-1993	545%	130%
1994-1998	-39%	194%
1999-2007	420%	38%
2008-2020	23%	191%

Past performance is not indicative of future results. Source: Returns 2.0. Data as of 7/31/20 (total returns).

These start and end dates are selected for illustrative purposes. And, despite the vast differences in performance depending on the cycle, the returns in the overall period are nearly identical—10.7% per year for the S&P 500 and 10.4% for the MSCI EM Index since 1988.

So maybe investors don't care as much about the sectors as the other factors involved when investing in developing markets. But, emerging markets are starting to look more like the S&P 500 over time. Eventually, that should be a good thing for investors in these volatile markets.

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[1]For example, Amazon is considered a consumer discretionary company. Facebook is classified as a communication services company. Apple is tech, but could easily be consumer discretionary.

Dividend Yield: Annual rate at which dividends are paid, including extra dividends. It is the indicated annual dividend for each stock divided by the price of the stock. **Price-to-Book Value:** A ratio used to compare a stock's market value to its book value. **Price-to-Cash Flow:** Per-share stock price divided by the per-share operating cash flow. **Price-to-Earnings Ratio:** A ratio calculated by dividing the company's stock price by its earnings per share. The higher the P/E ratio, the more an investor pays for the company's earnings. **Price-to-Sales Ratio:** The price-to-sales (P/S) ratio is a valuation ratio that compares a company's stock price to its revenues. It is an indicator of the value placed on each dollar of a company's sales or revenues.

The **S&P 500® Index** is a free-float market-capitalization weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The **MSCI Emerging Markets Index (net)** is a free float-adjusted market capitalization-weighted index designed to measure equity market performance in the global emerging markets. The index is calculated on a total return basis with net dividends reinvested. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.