



## Investment Perspectives

# Emerging Market Stocks: A Wealth of Opportunities

OCTOBER 2021

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### Key Takeaways

- Emerging market equities offer exposure to fast-growing economies and key drivers of global growth. Many companies in developing markets are relatively inexpensive compared to their developed market peers.
- Investing in a wide range of emerging market stocks, both household names and lesser-known small- and mid-cap securities, gives investors broad diversification and the potential to generate alpha.
- Over the past two decades, a portfolio with a blend of the MSCI Emerging Markets Index and the MSCI World Index (developed market equities) would have generated higher risk-adjusted returns than a portfolio comprised of only the MSCI World Index.
- The Dodge & Cox Worldwide Funds — Emerging Markets Stock Fund, with its valuation discipline and focus on individual companies around the globe and across the entire market cap spectrum, is well positioned to capitalise on the investment opportunities emerging markets offer.

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Over the past 40 years, investors have followed the rise of emerging market economies like China and the emergence of global leaders like Alibaba, Samsung Electronics, Taiwan Semiconductor Manufacturing, and Tencent.<sup>a</sup> While these companies have become emerging market success stories, many investors may not fully appreciate the breadth of investment opportunities across the developing world. Emerging market businesses—many of them are smaller companies that are not well known outside their home markets—are exposed to powerful economic tailwinds, creating a plethora of potential investment targets.

Our enthusiasm for these opportunities, combined with our global research and deep knowledge of companies across industries, prompted us to create the Dodge & Cox Worldwide Funds — Emerging Markets Stock Fund. We believe our time-tested, long-term, bottom-up, value-oriented approach is well suited for the challenges and opportunities presented by the emerging markets. We will talk about the new Fund later in this paper. To start, we will focus on the emerging markets themselves and what makes them so compelling to us as investors.

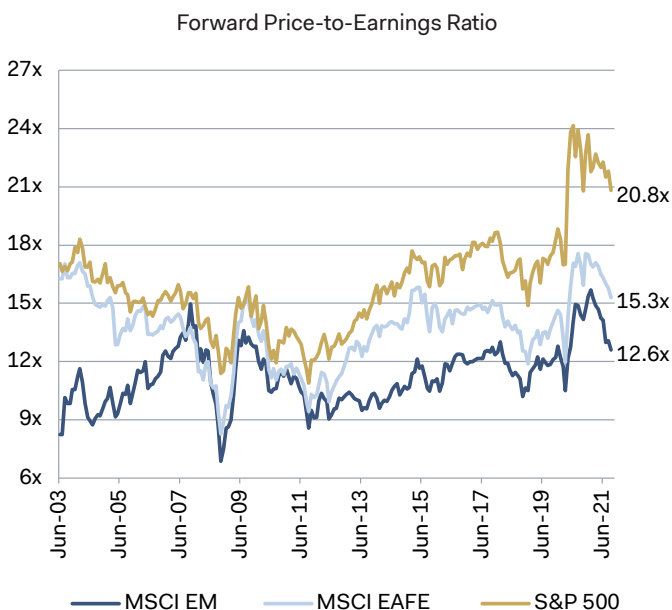
## Compelling Growth Opportunities

Emerging markets comprise over 80 percent of the world's population and are responsible for nearly 80 percent of global GDP growth. While most people know that China's economy is expanding rapidly, dozens of other emerging market countries are also showing impressive growth. Many are benefiting from advances in education and technology and the adoption of more market-friendly policies. This growth story translates into opportunities for companies located or doing business in these markets.

Compared to their developed market peers, many emerging market companies have the potential to increase earnings at a faster rate due to increasing living standards in their domestic markets and rising demand from the rest of the world. That is not to say investing in emerging market companies comes without risks. Many emerging market countries face notable challenges, such as underdeveloped and less resilient economies, greater political instability, and less well-established and predictable legal and regulatory regimes. Emerging market investors may also have less access to reliable, publicly available information about companies. Furthermore, over the past 18 months, emerging markets and emerging market companies have suffered disproportionately from the COVID-19 pandemic, and it is difficult to predict how long it may take for different markets to recover.

However, as a group, emerging market companies are trading at considerably lower valuation multiples than their developed market counterparts (see Figure 1). Over the past 20 years, the aggregate market value of emerging market companies as a percentage of total global equity market capitalisation has more than doubled (see Figure 2). This

**Figure 1: Emerging Market Companies Are Relatively Inexpensive<sup>c</sup>**



Source: MSCI, S&P.

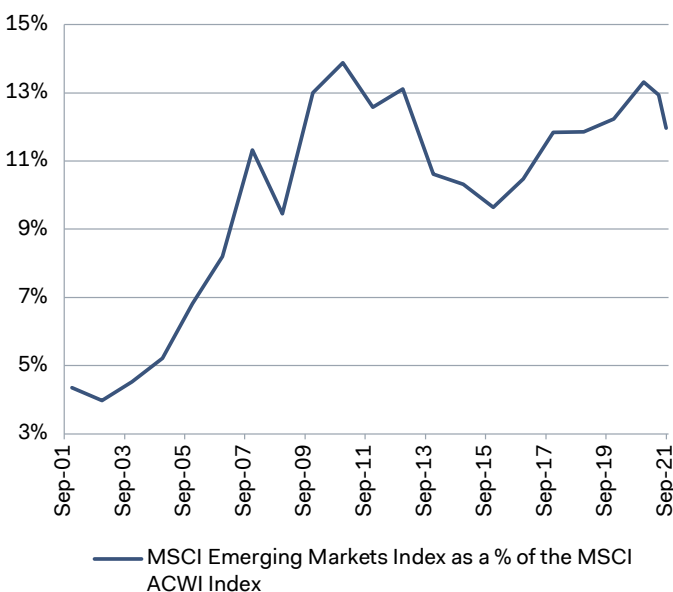
shows how quickly emerging markets are growing relative to developed markets and how much the emerging market investable universe has expanded. In 2001, the total market value of the stocks in the MSCI Emerging Markets Index was equal to about 5 percent of the market cap of the MSCI All Country World Index. Today, that number is about 12 percent.<sup>b</sup>

## Stock Selection Opportunities

We think of emerging market stocks in two broad categories: very large businesses (many of them household names) and a much longer list of small and mid-sized firms that the typical investor has never heard of (see Figure 3). By our count, there are thousands of investable companies in the emerging market universe.

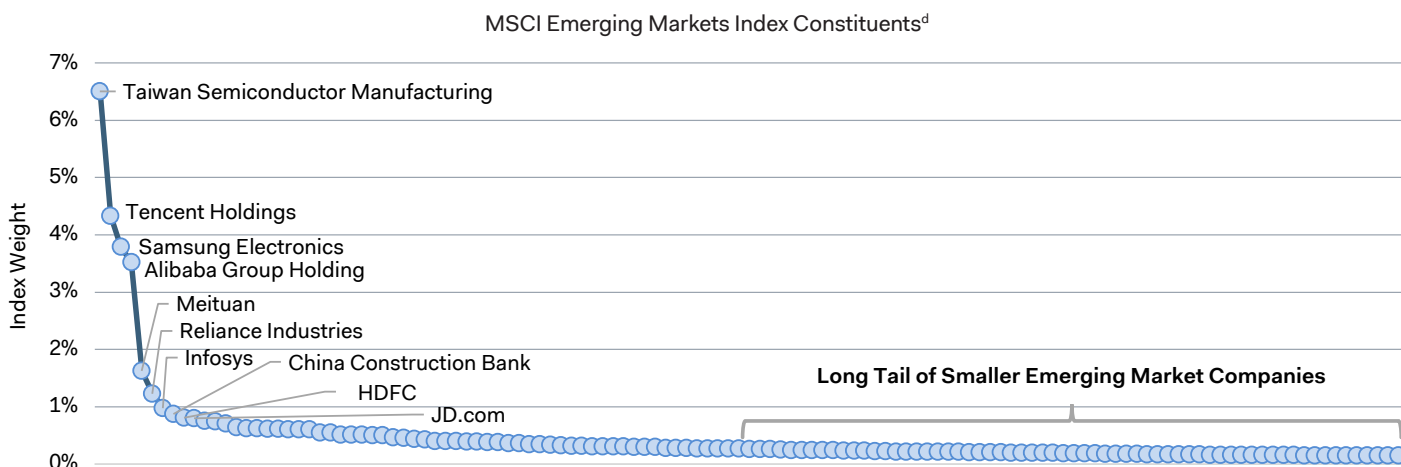
One way to think about this split is by focusing on some of the key engines of global growth. Consider the global digital supply chain that underpins our lives. At one end of the spectrum is Taiwan Semiconductor Manufacturing, one of the world's largest companies, with a market cap of more than \$540 billion. At the other end are Yageo (\$8 billion market cap), Nanya Technology (\$7 billion), and Powertech Technology (\$3 billion), other Taiwanese businesses that manufacture and distribute electronic components. This is a small sample of emerging market opportunities, but the larger point is that the growth of the global supply chain plays a role in the potential success of these smaller companies. We see the same pattern in other factors driving global economic growth—commodity production, e-commerce, and increased penetration of financial products. Emerging market companies of all sizes are providing goods and services the world demands.

**Figure 2: The Emerging Market Investable Universe Has More Than Doubled Over the Past Two Decades**



Source: MSCI.

**Figure 3. Including Smaller Companies in the Investable Universe Allows for Greater Diversification**



Source: MSCI.

Since large-cap emerging market companies are mostly concentrated in the Information Technology and Financials sectors, investors need to be willing to invest in small- and mid-cap companies to achieve broad diversification in emerging markets. Not every emerging market investment will succeed, and finding the hidden gems in the small- and mid-cap world is not simple or straightforward. It requires extensive research and a global reach. But for those with the capabilities, the potential rewards are large. Put another way, we believe the emerging markets are an ideal place for active managers to perform their craft.

**Diversification Benefits to Investors**

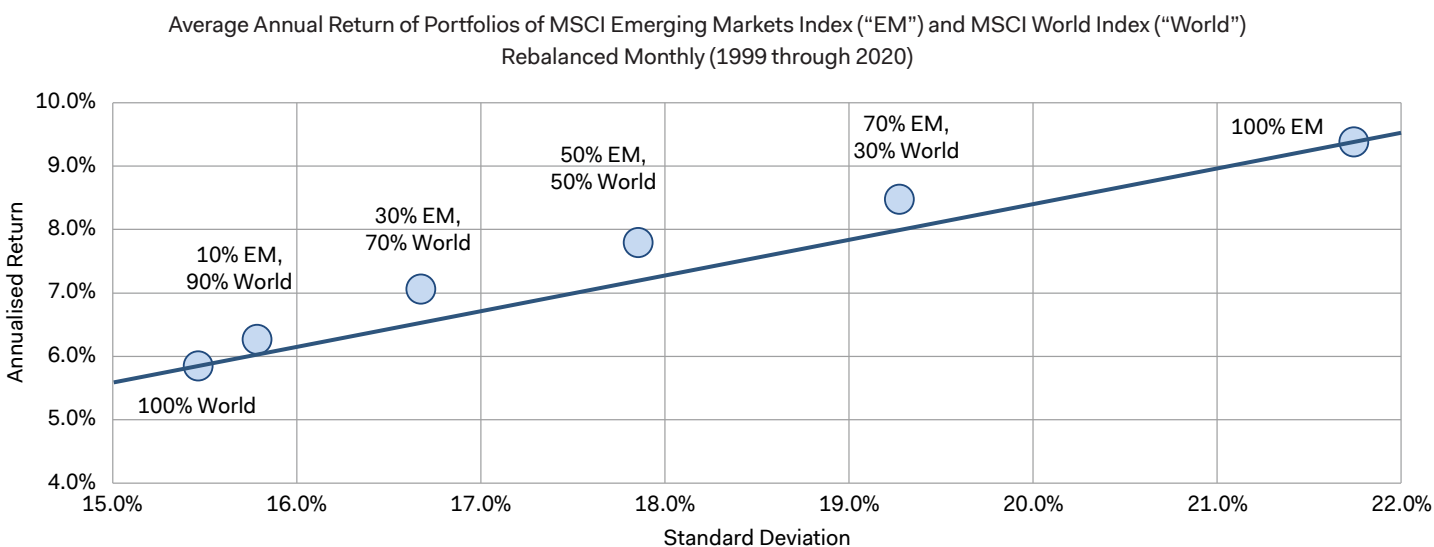
Emerging market equities offer unique risks and opportunities that may complement a diversified portfolio. Investing in emerging markets is typically considered riskier than investing in developed markets. Indeed, over the past two decades, the

MSCI Emerging Markets Index has been more volatile than the MSCI World Index of developed market stocks, using the standard deviation of monthly returns as a proxy for volatility. Over the same period, the MSCI Emerging Markets Index generated higher returns than the MSCI World Index. That is not surprising. However, investors might be surprised to learn that, over the past two decades, a portfolio reflecting a blend of emerging and developed markets indices would have generated higher returns than a developed markets-only portfolio, with only a modest increase in volatility (see Figure 4, tracking the performance of various blends of the MSCI Emerging Markets and MSCI World Indices).

**Our Fund**

We launched the Dodge & Cox Worldwide Funds – Emerging Markets Stock Fund in May 2021 to offer investors a portfolio that includes the most compelling emerging

**Figure 4: Exposure to Emerging Markets Has Historically Improved Risk-Adjusted Returns<sup>e</sup>**



Source: Bloomberg, MSCI. Past performance is no guarantee of future results. Index returns include dividends, but unlike Fund returns, do not reflect fees or expenses.

market investment ideas identified by our global research team. We study a broad research universe of roughly 4,300 emerging market stocks across 70 countries, including many emerging market companies that are not part of the Fund's benchmark, the MSCI Emerging Markets Index. We consider companies across the market capitalisation spectrum. Fund holdings include companies based in emerging markets *and* companies based in developed markets with significant economic exposure to emerging markets.

Casting a wide net means we consider more companies, countries, and sectors than a typical emerging markets fund. Our portfolio includes many stocks that are not household names in the United States. While dozens of Wall Street analysts follow every Fortune 500 company, few analysts cover more than the largest of these emerging market companies. As of September 2021, the Fund had 37 percent of its net assets in small- and mid-cap stocks.<sup>f</sup> Many of these smaller-cap holdings have exposure to attractive growth drivers, such as increasing consumption patterns, demand for wealth management services, expanding telecommunications and internet coverage, and real estate development, to name a few. In some cases, there are no large-cap investment alternatives providing exposure to particular growth drivers. By expanding the universe of potential emerging market stocks to include smaller companies, the Fund's shareholders get two benefits: 1) greater diversification through exposure to companies, sectors, and regions, and 2) additional opportunities to generate alpha through investment in companies not included in commonly tracked indices.

Like other Dodge & Cox-managed funds, this Fund has below-average fees and expenses compared to its peers. This Fund's net expense ratio is currently capped at 70 basis points<sup>9</sup> versus an average of approximately 100 basis points for actively managed funds within the Morningstar EAA Fund Global Emerging Markets Equity category.<sup>h</sup> That difference winds up in the pockets of our shareholders and makes a difference to performance over time.

The Fund is constructed based on Dodge & Cox's strict valuation discipline and fundamental approach to stock selection, with a portfolio built on the expertise of our global industry analysts. In the years we have spent investing in emerging market companies for other Dodge & Cox mutual funds, we have built tools to enhance our analysts' ability to identify risks and opportunities in emerging markets. In managing the portfolio, the Emerging Markets Equity Investment Committee also relies upon the breadth of our equity and fixed income research teams. This includes our global macroeconomic analysts who identify the geopolitical and institutional risks that disproportionately affect emerging market currencies and capital markets.

## In Closing

As an active manager, the Dodge & Cox Worldwide Funds – Emerging Markets Stock Fund gives us the flexibility to pursue the opportunities we see as most compelling across emerging markets. Investors who share Dodge & Cox's long-term investment horizon and are seeking active, value-oriented exposure to developing economies and companies in markets that are difficult to access should consider our Emerging Markets Stock Fund. We look forward to discussing this new investment opportunity with you.

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### Emerging Markets Equity Investment Committee Members



**Charles Pohl, CFA**  
Chairman and  
Chief Investment Officer



**Diana Strandberg, CFA**  
Senior Vice President  
and Director of  
International Equity



**Mario DiPrisco, CFA**  
Vice President and  
Research Analyst



**Rameez Dossa, CFA**  
Vice President and  
Research Analyst



**Robert Turley, Ph.D., CFA**  
Vice President and  
Research Analyst



**Sophie Chen, CFA**  
Vice President and  
Research Analyst

## Extending Our Global Reach

The creation of our Emerging Markets Stock Fund is the latest stop on our journey to offer our investors access to opportunities around the globe. By the 1980s, it was apparent that more industries were becoming globally competitive, so it no longer made sense to confine our research efforts to American companies. As our analysts evaluated non-U.S. companies, they found a number of strong businesses selling at attractive prices. As a result, we have expanded significantly the range of opportunities available to our clients, first in the United States through the Dodge & Cox International Stock Fund to U.S. investors in 2001, and later to non-U.S. investors through the Dodge & Cox Worldwide Funds — Global Stock Fund (launched in 2009) and Dodge & Cox Worldwide Funds — Global Bond Fund (launched in 2014), and this newly launched Emerging Markets Stock Fund.

All our Funds benefit from other additions to our tool kit, including macroeconomic analysis, environmental, social, and governance (ESG) research, and quantitative modeling that enable us to measure risk more accurately. Together, these tools have made us stronger global investors.

Since 1930, Dodge & Cox has adhered to a consistent approach to investing grounded in our conviction that a combination of fundamental research and a valuation discipline will produce the best results over time. That has not changed. What has changed is the scope of our work. We have pursued a multi-decade quest to expand the scope of our research coverage and analytical skill set in response to the growing global universe of investment opportunities.

### Global Research Expertise

Strengthened global research and investment capabilities as U.S. companies became multinationals

### Emerging Market Expertise

Launched International and Global Stock Funds to U.S. investors in 2001 and 2008, respectively; further honed emerging market research capabilities

### FX/Macroeconomic Expertise

Executed first FX hedge in 2007, expanded fixed income research to cover sovereign bonds in 2010, and formed the Global Macro Committee in 2012

### Quantitative Expertise

Established teams analysing portfolio risk and asset allocation using quantitative methods

### 1980's & 90s

- Invested in select multinational companies based outside the U.S.
- Integrated global research efforts with management and company visits outside the U.S.

### 2000s

- Assigned country coverage to Research Analysts
- Established global track records

### 2010s

- Developed currency hedging expertise

- Broadened fixed income research of sovereign bonds

- Formed Global Macro Committee
- Expanded detailed coverage to 35+ countries

- Integrated work on risk modeling, portfolio analytics, and ESG data
- Improved decision-making processes to reduce behavioral biases

### 2020s

- Established ESG Research Steering Committee
- Opened Shanghai, China research office

### Fund Launches

2001

International Stock Fund for U.S. investors

2008

Global Stock Fund for U.S. investors

2009

UCITS Funds for non-U.S. investors

2014

Global Bond Fund for U.S. investors and UCITS

2021

Emerging Markets Stock Fund for U.S. investors and UCITS

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The MSCI Emerging Markets Index is a broad-based, unmanaged equity market index of large- and mid-cap securities aggregated from 27 emerging market country indices. The MSCI EAFE (Europe, Australasia, Far East) Index is a broad-based, unmanaged equity market index aggregated from 21 developed market country indices, excluding the United States and Canada. The MSCI World Index is a broad-based, unmanaged equity market index aggregated from 23 developed market country indices, including the United States and Canada. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This publication is not approved, reviewed, or produced by MSCI. The S&P 500 Index is a market capitalisation-weighted index of 500 large-capitalisation stocks commonly used to represent the U.S. equity market. The S&P 500 Index is a product of S&P Dow Jones Indices LLC and/or its affiliates and has been licensed for use by Dodge & Cox. Copyright 2021 S&P Dow Jones Indices LLC, a division of S&P Global, Inc. and/or its affiliates.

The Dodge & Cox Worldwide Funds — Emerging Markets Stock Fund is subject to equity risk and market risk, meaning investments in a Fund can be volatile and may decline in value because of changes in the actual or perceived financial condition of their issuers or other events affecting their issuers. Investment prices may increase or decrease, sometimes suddenly and unpredictably, due to general market conditions. Local, regional, or global events such as war, acts of terrorism, the spread of infectious illness or other public health issues, recessions, or other events could also have a significant impact on a Fund and its investments. In addition, investing in non-U.S. securities may entail risk due to foreign economic and political developments; this risk may be higher when investing in emerging markets.

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- a The use of specific examples does not imply that they are more or less attractive investments than the portfolio's other holdings. As of 30 September 2021, Taiwan Semiconductor Manufacturing, Tencent Holdings, Samsung Electronics, and Alibaba Group Holding were the largest companies in the MSCI Emerging Markets Index. The Dodge & Cox Worldwide Funds — Emerging Markets Stock Fund's top 10 holdings were Samsung Electronics (5.2% of the Fund's market value), Prosus (5.0%), Alibaba Group Holding (4.6%), ICICI Bank (3.9%), Taiwan Semiconductor Manufacturing (3.2%), JD.com (3.2%), Baidu (3.0%), Itau Unibanco Holding (2.9%), Glencore (2.9%), and Magnit (2.5%).
- b Unless otherwise specified, weightings and characteristics are as of 30 September 2021.
- c MSCI's official forward price-to-earnings ratio data is available since 30 June 2003.
- d The chart shows the top-ten constituents in the MSCI Emerging Markets Index as of 30 September 2021.
- e Performance data for the MSCI Emerging Markets Net Total Return USD Index is first available in Bloomberg starting on 31 December 1998. As a result, the first annual period of performance begins on 31 December 1999.
- f Defined as under \$10 billion in market cap.
- g One basis point is equal to 1/100th of 1%. Dodge & Cox has contractually agreed to reimburse the Dodge & Cox Worldwide Funds — Emerging Markets Stock Fund for all ordinary expenses to the extent necessary to limit aggregate annual ordinary expenses to 0.70% of the average daily net assets of each share class. Dodge & Cox may terminate or modify this agreement upon 30 days' notice to shareholders.
- h Equal weighted average of the lowest cost share class Prospectus net expense ratio for U.S. domiciled funds within the Morningstar EAA Fund Global Emerging Markets Equity category (excluding index, enhanced index, and fund of funds). Source: Morningstar Direct (data was downloaded on 13 October 2021). © 2021 Morningstar.