Column: Drawdown Risk in Emerging Markets

Investors in emerging markets are often being exposed to more risk than necessary. Index products like ETF's do not protect against major drawdowns. Often the risk in these markets is measured by standard deviation, but this also includes the upside risk.

Professional investors therefore mainly study the degree of downside risk by looking at the maximum percentage drop, measured from the peak to the lowest point during a specific period. Drawdowns help determine the financial risk of an investment and offer a clear insight into the actual loss.

Such big losses can have a significant impact on your assets. A 25% increase is needed to recover from a 20% decline. A 67% increase is needed to restore a 40% loss. Achieving a 10% annualized return over nine consecutive years, followed by a 57% decrease, such as during the crisis of 2008 brings you back to zero. Keeping the downside risk as small as possible is more important than getting the highest possible return in the short run.

Emerging markets in particular are vulnerable by large intra-annual declines. Every calendar year since 2001 the most familiar emerging markets index has declined by more than 10% (except 2017), nearly half of these corrections exceeded 20%. Surprisingly, these drawdowns sometimes also occurred during very positive years. For example 2004, 2006 and 2009 were all calendar years with index returns of more than 25%, but these years were also characterized by corrections of more than 20%.

If a 20% decrease points to a bear market and a 20% increase to a bull market, this means that in each of these calendar years we had a bear market in a bull market. Extreme volatility! Investors in index products are being exposed to this extreme moves, while there are opportunities to achieve the same or a better return with less risk. This requires an active approach that offers downward protection. If capital is maintained better there is more exposure on each subsequent rally and a better return is achieved.

There are several ways to do this but from own experience I know that selecting dividend stocks is a good way to limit downside risk. As an example, I made a simple screening of stocks from the emerging markets universe. The criteria: a dividend of more than 4% and a return on equity (ROE) above 12 and a market capitalization of at least one billion euro. The result of the screening has been tested on Bloomberg as an equally weighted portfolio over a period from 2008 to 2018, with a rebalance every six months. This test showed a significant higher return compared to a buy-and-hold investment in the index. The selection achieved an annualized return of 10.60% over the period compared to 2.64% for the index. The intra annual decline for the selection was less risk on an average 14.42% compared to the 20.22% for the index.

Calender year	EM Index Return % in EUR	Drawdown
2011	-15.9%	-28.0%
2012	16.1%	-12.9%
2013	-6.8%	-17.2%
2014	11.5%	-14.1%
2015	-5.3%	-31.0%
2016	14.6%	-13.9%
2017	20.4%	-4.8%
2018	-10.3%	-18.2%
Source: Bloomberg, MSCI		

Such a simulation is of course somewhat different from reality, but the above exercise indicates that investors could at least consider the degree of intra-annual declines in the choice between an active fund and an index tracker. There are solid active funds showing an outperformance with less drawdown. Meanwhile, I read the news that Emerging Market index products had an inflow of $ 22 billion in the past 15 weeks. Driven by sentiment, investors massively buy these trackers, and will get the drawdowns for free.

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