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Redefining EM: governance regimes are the key distinction

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The term ‘emerging markets’ should be replaced by six categories based on governance regimes

Most attempts to define emerging markets start from a macroeconomic perspective, but the results often bear little relationship to the reality of equity investing.

As equity specialists we place the interests of the minority investor firmly at the centre of our approach. We conclude that the distinction between emerging and developed markets is no longer useful for investors, and should be replaced by a more intense focus on individual countries, using the categorisation of ‘Governance Regimes’ as a starting point for analysis.

The three major intellectual underpinnings of emerging equity markets as a distinct and coherent asset class have come apart since the 2008/09 financial crisis.

- Emerging market growth rates have slowed, casting doubt on the argument that per capita incomes will converge over time.
- The slowdown in China has undermined the commodity supercycle to the detriment of many emerging economies and equity markets.
- The assumption that the major political features of emerging markets would converge towards the US/UK model is no longer valid, as most have moved towards less liberal forms of governance in the wake of the crisis.

The move away from liberal models of sovereign and corporate governance has been the key driver of both the deterioration in economic growth prospects and the poor returns from emerging equity markets.

The dominance of state-directed models of sovereign and corporate governance in China, Russia, Brazil and elsewhere, has undermined the return on invested capital across a large part of the corporate sector, thereby reducing productivity and potential GDP growth across their respective economies.

The potential impact of governance-related issues at both an economic and financial market level was apparent in the financial metrics of the listed corporate sector long before it became apparent to macroeconomic forecasters, who have consistently overestimated EM growth prospects.

Instead of the existing division between emerging and developed markets, we suggest that investors focus their analysis on the sovereign and governance characteristics of

individual countries and markets using a framework based on six types of governance regimes as a starting point.

The Ecstrat categorisation of governance regimes is based on the impact of the prevailing system of control within the listed corporate sector together with the broader balance of social, political and financial forces, on the interests of minority shareholders.

How the governance regime matrix works

Our methodology to determine the dominant governance regime in each market augments the existing academic literature on the varieties of capitalism with a detailed examination of a series of quantitative and qualitative criteria from the perspective of a minority equity investor.

We start by categorising the control of each of the 3,563 stocks in the Ecstrat database as either dispersed, state, hierarchical (family), founder, network or foreign to determine the dominant system for each market.

We then analyse the relationship between the listed corporate sector and the state, including such factors as the regulatory and fiscal environment, before bringing in other key stakeholders such as the trade unions.

Finally, we examine how these factors are reflected in the financial characteristics and operating metrics of the listed companies, in particular how control related factors determine financing and capital investment strategies.

The six governance regimes range from liberal and co-ordinated, which include most of what are currently classified as developed equity markets, to hierarchical, guided and authoritarian regimes, which are more characteristic of emerging and frontier markets.

The six regimes are as follows:

1. Liberal governance regime (LGR)

The characteristics of countries in this regime include a leading role for equity markets and the prioritisation of the rights and interests of minority shareholders. Companies in LGR regimes exhibit a separation of ownership from control, and a high proportion of them have no concentrated controlling shareholder. These countries have open economies with flexible supply sides and often overly light regulation.

Countries in this category include the US, UK, Australia, Canada, South Africa and Ireland.

2. Co-ordinated governance regime (CGR)

The characteristics of countries in this regime include a smaller role for equity markets than in LGRs and a role for stock markets that is often subordinate to banks.

Corporations in CGR countries often have financial and social stakeholders, including the state and banks, that play an important role in corporate governance. Effective corporate control is usually exercised by block holders or networks and not delegated to managers. Hostile takeovers are rare.

Countries in this category include Germany, France, Norway, Sweden, Netherlands, Switzerland, Belgium, Poland and Austria.

3. Network governance regime (NGR)

The characteristics of countries in this regime include a dominant role for a network of interlocking ownership interests within the economy. Equity markets are generally subordinate to some companies and/or individuals within the network.

Corporate control structures often appear opaque to external observers because these networks are rarely transparent. Sovereign and corporate governance structures tend to be very consensus based.
This category includes Japan and Taiwan.

4. Hierarchical governance regime (HGR)

The characteristics of countries in this regime include equity markets dominated by concentrated holdings of mainly family-controlled companies, which are not so subject to political and social constraints as in CGRs.
Equity free float as a proportion of total market capitalisation tends to be relatively low.
HGR companies tend to give a relatively low priority to the interests of minority shareholders and many are characterised by blurred boundaries between the state and private sector, resulting in moral hazard.
This category includes South Korea, India, Philippines, Greece, Turkey, Spain, Italy, Mexico, Hong Kong, Brazil (increasingly authoritarian), Portugal, Chile, Indonesia and Thailand.

5. State-guided governance regime (SGR)

The characteristics of countries in this regime include state guidance in a high proportion of financial and capital-intensive economic activity to facilitate national economic development, but the economy is also subject to market-imposed disciplines.
The currency and capital account are generally subject to controls, and equity markets tend to be dominated by state-related companies and financial institutions, but private companies also have a relatively high level of autonomy.
The category included the Asian newly industrialising economies (NIEs) in their earlier development phase. Currently included are Singapore, Malaysia and the United Arab Emirates.

6. Authoritarian governance regime (AGR)

The characteristics of countries in this regime include state dominance over the listed corporate sector, either through direct control or via a capability to intervene directly in the private sector.
The equity market is generally relatively small relative to GDP, while listed state-controlled companies will always place social and political considerations above the interests of external shareholders. The corporations typically have very low levels of external accountability and financial transparency and high levels of moral hazard.
The countries in this category include Russia, China, Vietnam, Saudi Arabia, Qatar, Argentina, Venezuela, Iran and Kazakhstan.
Governance regimes do not constitute investable asset classes, but are a framework for country-based investment analysis. Of course, we recognise that most regimes are hybrids, often of more than two regimes, but these categories make a better starting point for further analysis than the existing division between emerging and developed.

The author is founder of Ecstrat, a consultancy advising on asset allocation between global equity markets.