31 March 2016

OUR PERSPECTIVE ON EMERGING MARKET EQUITIES

With Emerging Market (EM) shares underperforming their Developed Market (DM) counterparts over the last five years, it can be difficult to resist joining the herd in a rush for the exits. We reflect upon the reasons commonly cited for avoiding EMs today, but ultimately conclude that now is an opportune time for investors to consider EM shares.

Summary

- Many reasons commonly cited for avoiding EMs are flawed; investors are best served treating EMs as they would any other assets: buy them when they are cheap and avoid them when they are expensive.
- After five years of relative underperformance, EM shares are now available at a substantial discount to their DM counterparts.
- The wide level of valuation dispersions both between individual EMs and within EM shares suggests the real opportunity lies in bottom-up stockpicking.

Popular opinion can be very wrong

A late 2010 survey of global fund managers by Bank of America Merrill Lynch, an approximate gauge of investor sentiment, found that managers' relative exposure to EM equities had reached historical highs. For many of those bulls, it has undoubtedly been a painful ride. 2011 marked the first year of an extended rout for EM stockmarkets, which have underperformed developed markets (DMs) by roughly 50% over the last five years. By late 2015, that same survey showed that the preference for DM over EM equities among global asset managers was the highest in the survey's ten year history. While we won't go as far to say that the survey itself is an omen of future performance, we can conclude that the crowd can certainly get it very wrong. Big swings in sentiment are precisely what cause share prices to deviate from their intrinsic value, and today, our research concludes that EMs are fertile ground for long-term investors: not *despite* being deeply out of favour, but *because* of it.

When investors herd in one direction, it's often safer to go the other way. Of course, this is often highly uncomfortable, but we believe that discomfort is the reason so few do it—and those who do may be highly rewarded. One reason for today's bearish views on EM shares is the perception that they are somehow inherently more risky than their DM peers. While EM shares do come with additional risks, often related to economic or political instability, the risk that really matters to investors is not near-term uncertainty, but the possibility of permanent loss of capital, which is most pronounced when one pays more for an asset than it is worth.

All else being equal, investors tend to put a premium on safety, and rightly so! But, when investors crowd in an area, prices rise, and so does the risk that investors will subsequently turn out to have paid too much. In 2010, investors were paying premium prices for the perceived allure of high-growth EM countries. Today, they are accepting elevated valuations as the price one must pay for the perceived "safety" of developed markets.

But are investors right to avoid EMs?

Underlying the view that EMs are particularly risky today is the widely-held belief that they underperform when the US Federal Reserve raises interest rates. The reasoning goes that higher interest rates generally cause the US dollar to strengthen, which in turn increases the burden on developing countries with significant dollar-denominated debt. Even if this were true, today's pessimism may be unwarranted, as EMs are arguably on stronger financial footing than in the past, with an emphasis on building foreign exchange reserves following the 1998 Asian Financial Crisis, and a greater number of flexible currency regimes, which help make countries more resilient to external shocks.

But is it true? Our research shows nearly **zero** correlation between changes in US interest rates (both short- and long-term) and the relative performance of EM equities (in USD terms) between 1987 and 2015, and EMs have not persistently underperformed in periods when US interest rates have increased significantly. In fact, as with many macro phenomena, including low oil prices, there are both winners and losers across EM countries and within them—at the individual company level.

Another reason cited for avoiding EMs today is that they perform poorly during DM bear markets, and that with DM shares trading at elevated valuations, EM stockmarkets stand to be major losers if/when the cycle turns. While we would not dispute the fact that DM share prices appear generally elevated by historical standards, the conventional wisdom that EMs fare worse in DM bear markets appears unsubstantiated. There have been five major US bear markets since 1900, and in each one except for 2009, EMs either outperformed DMs or fared evenly (see Figure 1). The only time that EMs underperformed was when they had outperformed in the five years prior to the bear market— quite a different backdrop to that prevailing today.

Figure 1. EMs have mostly outperformed or tied DMs in US bear markets

Date of US Market Peak	Prior 5Y performance of EMs relative to DMs	Better performer in DM bear market
1918	−	Tie
1930	−	EM
1973	Same	Tie
2000	−	EM
2008	+	DM
20??	−	?

Source: Credit Suisse Global Investment Returns Yearbook 2014, Elroy Dimson, Paul Marsh, and Mike Staunton using data from the DMS database, MSCI Barra and S&P/IFCP. Orbis.

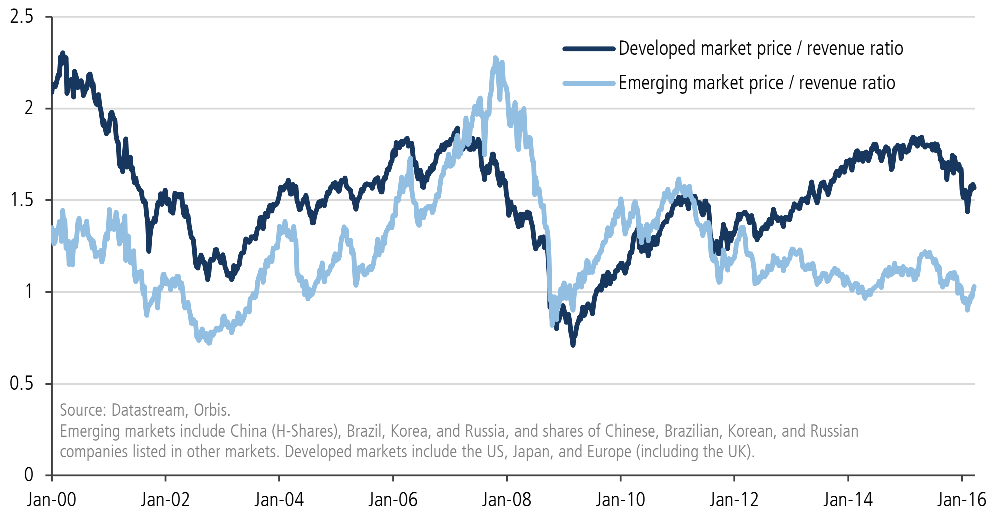
As the main reasons cited for avoiding EMs don't seem to withstand scrutiny, investors are best served treating EM investing in the same way they would treat any other asset class: buy when assets are cheap and avoid them when they are expensive.

The good news in this regard is that it is starting to feel like EMs might be a real bargain. Data from EPFR shows that between 2011 and 2015 investors took more than $100 billion out of EM equities, while pouring over $500 billion into DM equities. EM valuations have languished as a result.

While there are many ways to think about valuation, with historically-high profit margins in the West, price-to-earnings valuation comparisons may understate valuation differences between regions. On a price-to-revenue basis, the gap between DM and EM shares is nearly the widest it has been in the past 15 years (see Figure 2), while on a price-to-book basis, EM shares trade at an approximate 30% discount to DM peers (see Figure 3).

Figure 2. EM shares trade at a substantial discount to those in DMs

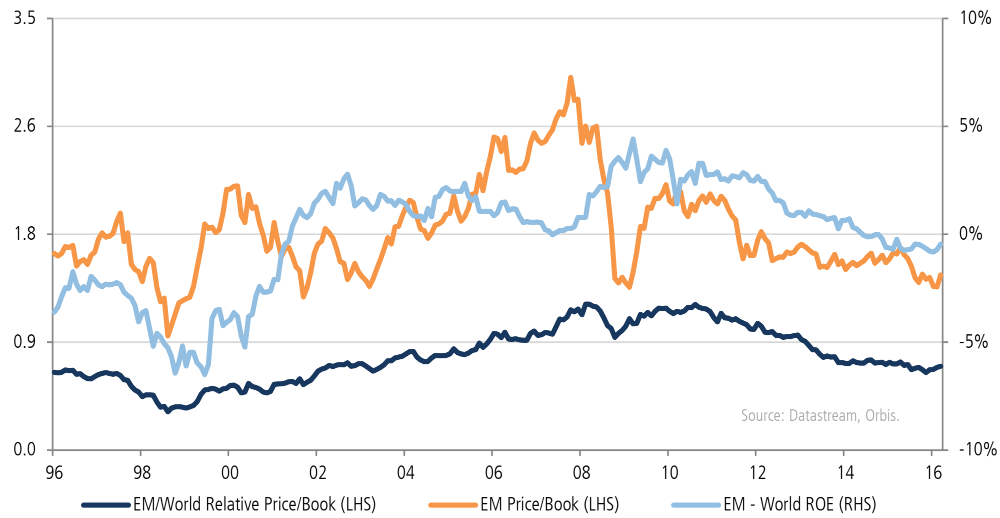
Price-to-revenue ratio of selected DM and EM stocks, Jan 2000 through Mar 2016



Of course, low valuations alone are not necessarily enough to make an investment case. If fundamentals are diminished, then you would simply be paying less for a lower quality company, but this doesn't appear to be the case in EMs today. As shown in Figure 3, the difference between the returns on equity of EM and DM shares is close to its 20-year average of zero, suggesting that there are no major differences in the quality of the two groups of stocks.

Figure 3. EMs trade at historically low valuations relative to DMs despite similar ROEs

Relative price-to-book valuation and return-on-equity difference between shares in the MSCI EM and MSCI World (Developed) Indices, Jan 1996 through Mar 2016



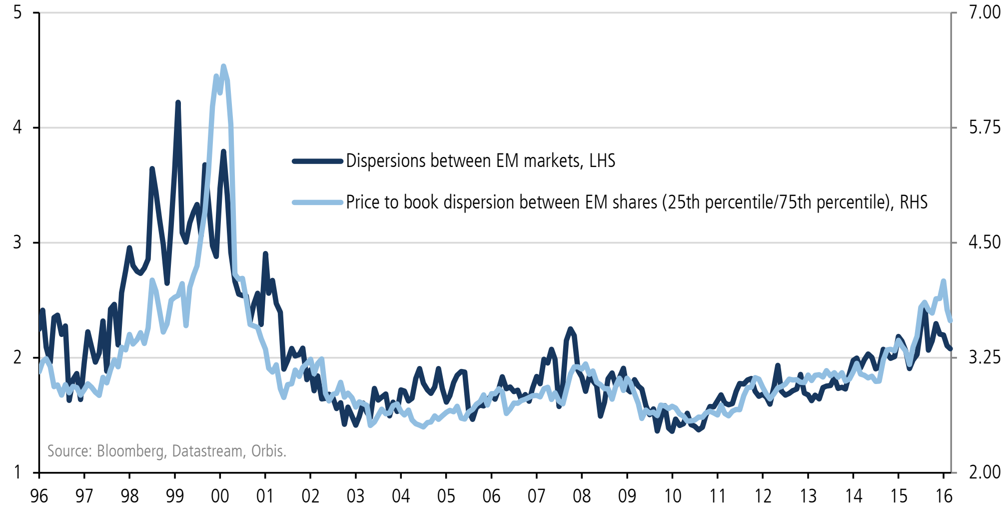
Despite comparable fundamentals, the price-to-book ratio of the stocks in the MSCI EM Index is close to the lows reached during the Global Financial Crisis and during the Asian Crisis of the late 1990s, which proved to be fantastic buying opportunities for Asian shares.

While EMs look attractive on several broad measures, investors should be wary of piling into the market blindly. Instead, they can choose to invest in selected parts of the market—and the wide level of dispersions both *between* individual EMs and *within* EM equities suggests there may be ripe opportunities for bottom-up stockpickers. As opposed to homogenous stockpicking environments, we believe wide dispersions improve the chances that fundamental investors can benefit from successfully identifying shares at a discount to their intrinsic value.

As shown below, dispersions in price-to-book valuations between individual EM markets, and between individual EM shares, are currently both close to the highest they have been since the Asian Crisis.

Figure 4. Valuation dispersions between and within EMs have risen in recent years

Price-to-book of third most expensive market / price-to-book of third cheapest market, using the 12 largest country constituents of the MSCI Emerging Markets, and price-to-book dispersion between 25th percentile (most expensive) and 75th percentile EM shares, Jan 1996 through Mar 2016

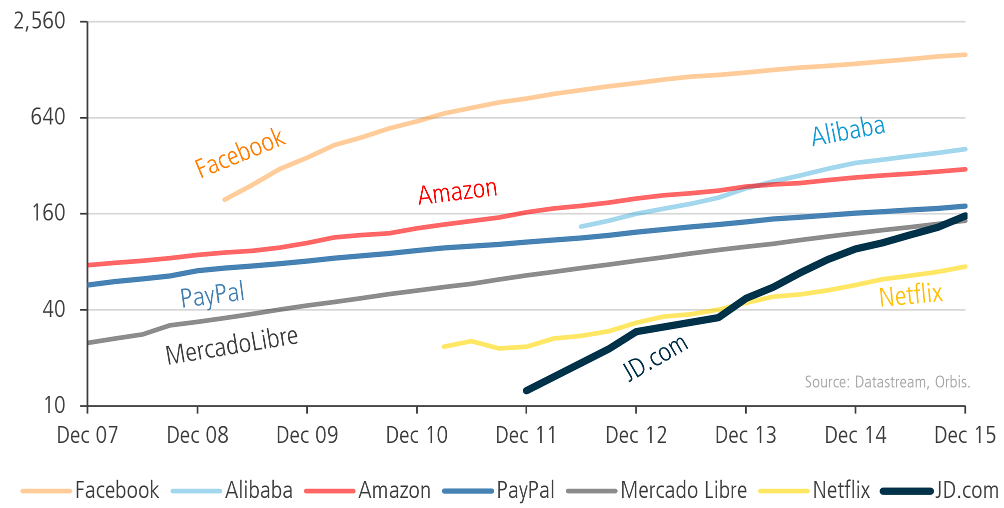


Of course, many EM shares are deservedly cheap—low quality companies that may not survive—and it is important not to be contrarian for the sake of it. But, contrary to popular belief, we believe you don't have to sacrifice quality when investing in EMs. Instead, if you look to parts of the market facing near-term uncertainty or a dip in sentiment, you may find quality shares with stellar growth prospects trading at reasonable prices.

A good example is JD.com, China's second largest e-commerce player and its largest retailer. Its operations are comparable to Amazon's, with self-managed logistics, services and infrastructure (e.g. warehouses) supporting the sale and delivery of goods directly to consumers. JD currently has a 20% market share and, as shown in Figure 5, has grown the number of monthly active users faster than any of the other quality, high-growth companies shown in the chart in the past four years.

Figure 5. JD.com is growing its user base rapidly

Number of active users (mn), 2007 through 2015



Since the earnings gestation period for internet businesses can be prolonged, we generally find that valuation multiples based on earnings are less useful. For e-commerce retailers, we believe Gross Merchandise Value (GMV)—the total value of goods sold through a site—is a helpful measure in assessing long-term fundamental value. JD's shares are available at a price equal to half its GMV, while Amazon has hardly ever traded at less than 1x GMV, only dipping below 0.5x GMV during the worst of the Global Financial Crisis. Of course, many obstacles can arise on a company's growth path, such as competitive risks, but if JD can indeed deliver on our expectations of 40% annual GMV growth through 2019, it may become a significantly more valuable company than it is today.

Another type of attractive opportunity on offer in EMs today is in prominent, mature companies that are available at a discount to their historical mean valuations on account of transient headwinds. These are proven businesses that face near-term hurdles, or challenging operating environments, but may provide attractive long-term returns if the environment eventually normalises.

An example is KB Financial, Korea's largest retail bank. Sentiment has been muted amidst weak profitability, resulting from a low interest rate environment, KB's semi-rigid cost base, and its conservative balance sheet. At KB's present valuation, which is less than 50% of its tangible net asset value, an improvement in its return on equity, supported by what we believe will be successful cost-cutting and capital management initiatives, may drive meaningful shareholder returns over time.

Back in 2010, many were predicting EMs would maintain premium valuations, as rapid growth would drive ever-greater allocations on the part of developed world investors. Today's valuation gap certainly shows the limitations of forecasting: not only do investors pay no premium for EM equities today, they get a substantial discount.

The combination of low aggregate valuations and high dispersions indicates the potential for bottom-up stockpicking in EMs to deliver attractive long-term returns. As Baron Rothschild famously said: "Buy when there is blood in the streets, even if the blood is your own". If there is blood in the streets, valuations in the gutter, and fundamentals above-water it is often the time for discerning long-term investors to pounce. We believe that is the case in EMs today.