HEALTH WEALTH CAREER

VALUE IN EMERGING MARKETS

JULY 2016

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Although emerging markets have struggled in recent years, we believe the strategic case remains. In keeping with Mercer's Equity 2.0 construct,[1] we believe that value as a style continues to have merit. Furthermore, although the widening of valuation spreads has led to many value managers delivering poor relative returns, this should present some good opportunities for skilled active value investors. Correctly timing the entry into this style of investing is always likely to be challenging, but we encourage clients to consider whether their strategic mix of active managers is positioned to capture this.

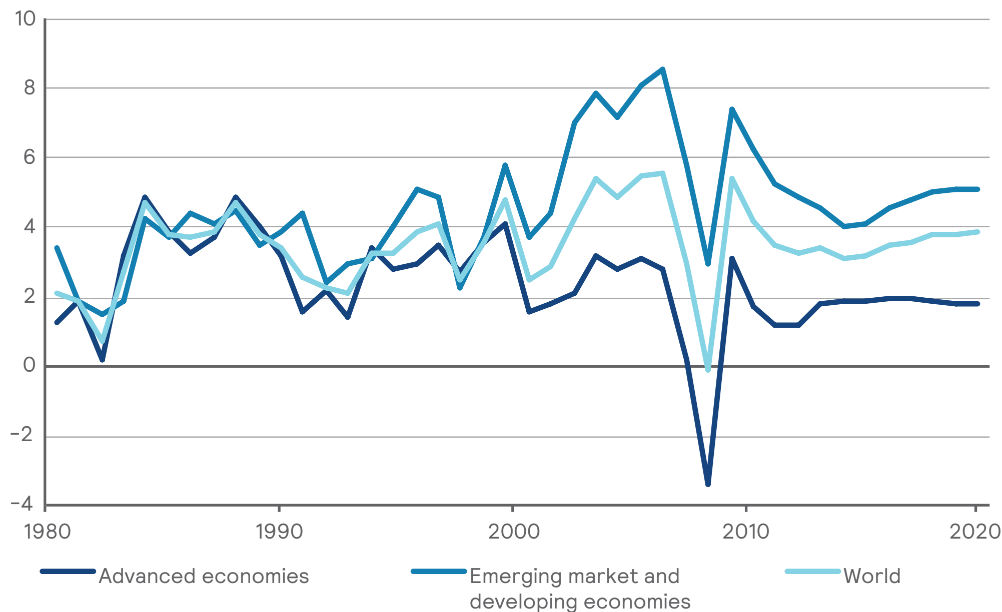
1 Since 2010 Mercer has been offering guidance on creating global equity exposure, with more recent recognition of the importance of style factors in building a well-balanced equity portfolio.

THE STRATEGIC CASE REMAINS

Mercer believes the longer-term rationale for investing in emerging markets holdsfirm: high longer-term economic growth rates, favorable demographics, relatively low government indebtedness, high secular productivity growth and diversification benefits relative to developed equities.

Figure 1 displays the International Monetary Fund's (IMF's) forecasts for real annualized GDP growth to 2020. It demonstrates that, although the divergence between developed and developing countries has been lessening the past few years, the expectation for emerging markets is still meaningfully higher.

FIG 1. REGIONAL GDP GROWTH



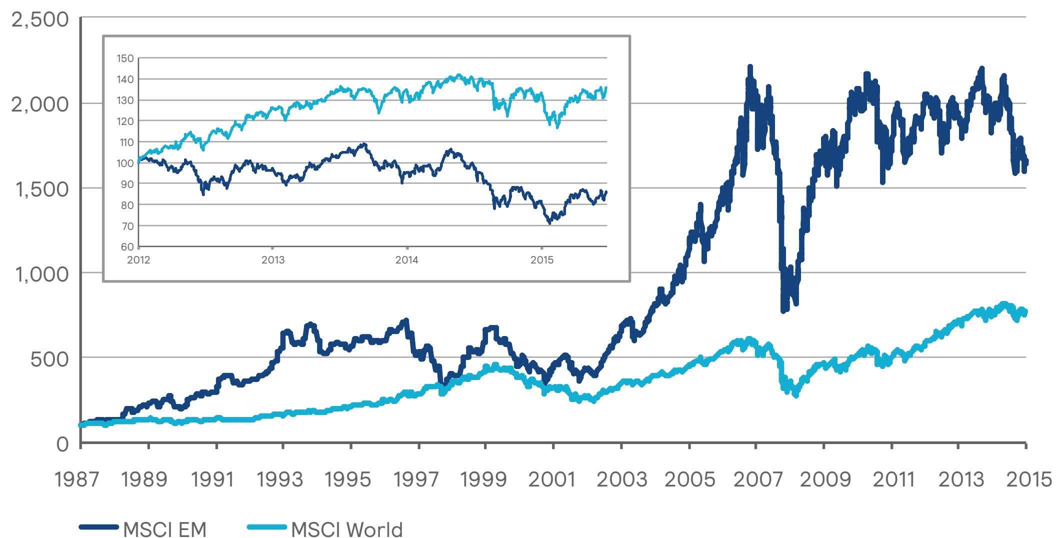
Source: IMF

RECENT EXPERIENCE HAS BEEN DISAPPOINTING

Economic growth does not, however, always translate into better investor returns. Although past returns have outpaced those of developed markets (as measured by the MSCI EM index since its inception),[2] many investors in the past three years have had an unfavorable experience. This is illustrated in Figure 2.

2 This is, of course, time dependent. It is also worth noting the composition of the MSCI EM index has materially changed since its launch, going from 10 countries in 1988 to 23 today.

FIG 2. EMERGING VS. DEVELOPED MARKET RETURNS



This disappointing period was triggered by the "taper tantrum" in 2013 and concerns around the impact a hike in Fed rates would have for capital flight from emerging markets and increased costs for those servicing dollar-denominated debt. It has since been compounded by concerns about stuttering growth in China and the spillover for commodity prices as well as geopolitical uncertainty (for example, Russia, Brazil and Syria). Add to this the recent intervention by Chinese authorities in the stock market as well as devaluations of the Chinese currency, and it is easy to see why sentiment toward emerging markets has been waning.

SOME ACTIVE MANAGERS HAVE HELD UP 'RELATIVELY' WELL

Although we cannot ignore the fact that overall market levels for emerging markets have been disappointing in recent years, certain styles of managers have been able to offset this to a degree. In particular, those with a more momentum-driven approach (often quants) as well as those with more emphasis on quality and growth have generally done quite well. However, managers in the "value" camp have struggled.

VALUE AS A STYLE HAS BEEN A HEADWIND

Taking the MSCI EM index, for example, as representative of the broader opportunity set, we can see this returned -6.4% p.a. over the three-year period ending December 2015. Comparing this to the MSCI EM Growth, Quality and Momentum versions of the same index,[3] we can see that they returned -3.9% p.a., -3.3% p.a. and -3.5% p.a., respectively. In contrast, the MSCI EM Value and FTSE RAFI EM indexes returned -9.1% p.a. and -11.3% p.a., respectively, over the same period.

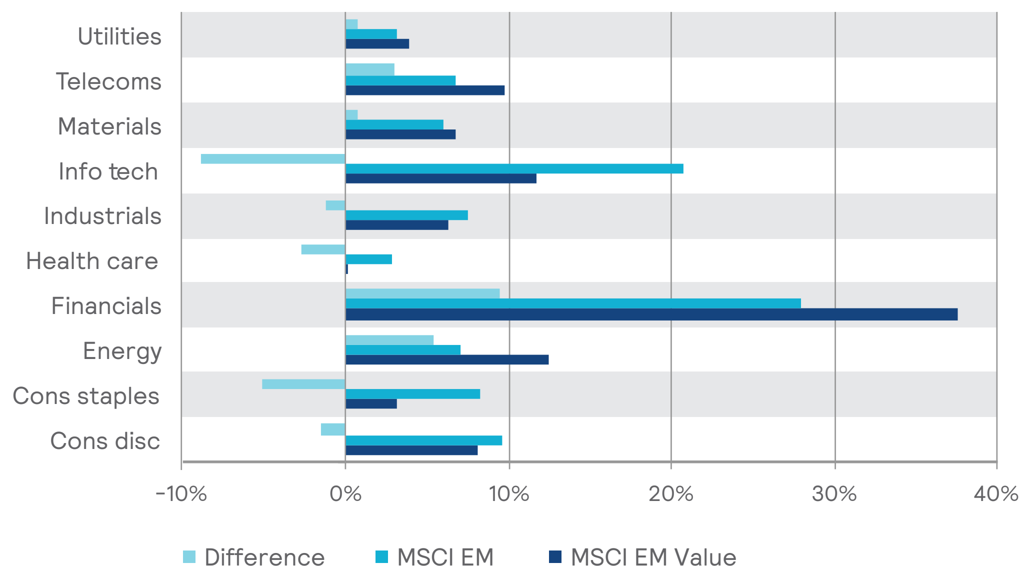
3 MSCI has constructed subsets of its parent indices to represent certain style/factor exposures. In this case, the "growth" and "value" versions referenced here utilize a market cap weighted methodology, whereas the "quality" and "momentum" versions use an alternative weighting approach.

The implication here is that, although the market in recent periods has been relatively supportive of managers with tilts toward earnings growth, low leverage, profitability and momentum, the opposite has been true for those adopting a more contrarian (that is, value) approach.

BREAKING DOWN WHY VALUE HAS STRUGGLED

Figure 3 shows the relative sector weightings at the end of 2015.

FIG 3. SECTOR BREAKDOWN



Source: MSCI

What is noticeable is that "value" has been overweight to the more cyclical areas of Energy and Financials relative to the broader index. Energy, however, was one of the worst-performing sectors in the past three years (although since year end there has been a slight recovery). At the same time, value has been markedly underweight Health Care as well as Information Technology — the two best-performing sectors — which again would have been a drag on returns.

On the basis of typical accounting measures, such as price to earnings (P/E), price to book (P/B) and dividend yield,[4] it is clear why at year end the value index was positioned this way. Energy, for example, has been trading at P/E and P/B multiples below the broader index and at the lower end of its own historic average for some time. This is also similarly the case for Financials, with "value" once again being persistently overweight. This is the opposite of Health Care, which is trading at over twice the average of the broader index as well as being higher than its own historic average.

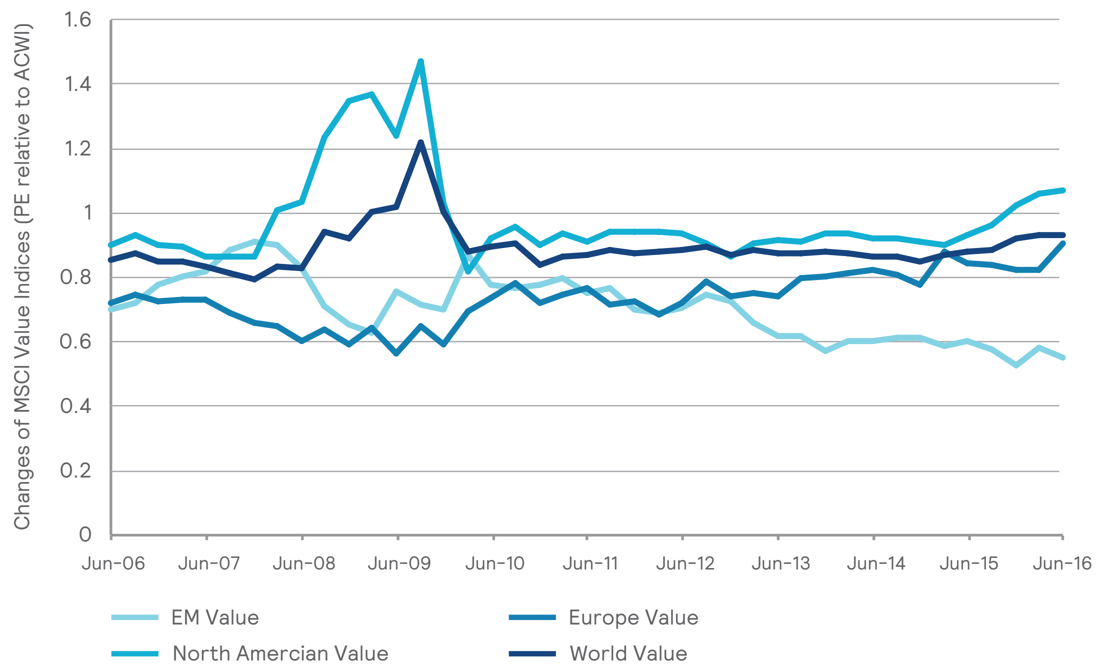
4 These are the metrics used by MSCI to construct a market cap weighted index exhibiting "value" style. Indices such as FTSE RAFI incorporate metrics such as total sales as well as free cash flow.

DOES THIS MEAN VALUE IN EMERGING MARKETS IS NOW A GOOD OPPORTUNITY?

Several measures suggest that value in emerging markets is cheap relative to other equity asset classes and to history.

Looking at Figure 4, for example, we can see that at the end of 2015 the P/E multiple for the MSCI EM value index was trading at less than half the level of its US value equivalent. Since year end, there has been a bit of a rebound in emerging markets, but as shown, valuations still remain relatively appealing.

FIG 4. MSCI VALUE INDICES VS. ACWI



Source: Datastream

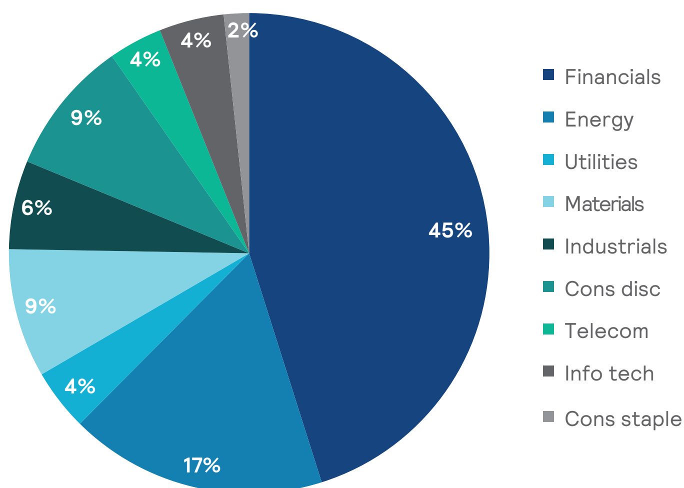
On the basis of book to price for the past five calendar years, the differential in valuations for the cheapest quartile of stocks in the MSCI EM index versus the most expensive is also toward the most stretched it has been for this period, as illustrated in Figure 5. This would suggest there is more opportunity for highly rated active managers.

FIG 5. BOOK TO PRICE FOR UPPER/LOWER QUARTILES

Source: Datastream

It is worthwhile, however, to consider further what this bottom quartile actually comprises. Figure 6 shows that, at the end of 2015, Financials and Energy and Materials represented circa 70%, with the remainder split across a number of sectors.

FIG 6. BREAKDOWN OF THE CHEAPEST QUARTILE



Source: Datastream

Digging a bit deeper into the bottom decile, at the very cheapest end Energy and Materials make up around 40% and Financials 27%.

This is not surprising, given oil prices have fallen from circa $110 per barrel the past three years to a low closer to $30 (although they are now nearer $50). Similarly, metals such as copper and iron ore have seen falls in prices of around 40% and 70%, respectively, over the same period, with corresponding reductions in return on equity (ROE) for many of those companies affected by this.

Even moving away from the very bottom, where a sizeable portion of the opportunity set is not so obviously related to commodities, presents its challenges. Within Financials, many banks, for example, have been facing the prospect of slowing loan growth and bad corporate debts — some of which is related to commodities and/or real estate. Getting full transparency on this and the implications for balance sheets and future profitability can prove problematic. Yet with dividend yields for the Financials sector as a whole at over a 30% premium to the index and ROE staying relatively stable for the past three to five years, does this present an opportunity for skilled investors to identify where asset quality might still be being mispriced?

An additional observation also worth making relates to ownership structure. Across many of the sectors within the bottom quartile, a number of these are what might be termed state-owned enterprises, or SOEs.[5] It would be fair to say that investors, as minority shareholders, have historically been wary about these in terms of government influence having the potential to impact equity returns. Although this is no doubt a prudent stance to take, it may present an opportunity for skilled investors to make an assessment of those companies that have significant state ownership but also have competitive advantages and where government policy is more aligned to generating shareholder value.

5 SOEs are entities either wholly or partially owned by a government.

FINAL THOUGHTS

If events at the start of 2016 are anything to go by, investors are wise to remain cautious and to ask what these events mean for short-term volatility in emerging markets (albeit we have seen some positive signs, with markets up by almost 7% in US dollar terms in the first half of 2016).

Tactically, it is always going to be difficult to time the bottom. This is especially true for value investors; value investing requires patience and a long-term horizon, and investors need to be able to tolerate sustained periods of underperformance. However, value has delivered positive excess returns in most markets over most long-term periods. It is worth remembering that a value approach in emerging markets does introduce increased risks, and we have seen emerging market value portfolios tend to be concentrated in more cyclical areas of the market. Equally, there are less quantifiable risks to consider, such as political uncertainty and poor governance, which can also increase the risk profile and therefore the potential volatility of these investments.

Nevertheless, despite poor recent returns, we continue to believe an active value approach has merit in emerging markets, and the current environment may present some attractive opportunities for such an investor.

We suggest clients consider whether their balance of active managers in emerging markets is positioned to capture this.

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