

# Asset Class Review: Emerging Markets Equity

## Executive Summary

- Emerging markets handily beat developed markets in 2007. This was the seventh consecutive calendar year that emerging markets outperformed their developed counterparts.
- Emerging markets' valuations range from fairly valued to overvalued, depending upon the valuation measure used. The asset class looks particularly overvalued when we compare its current valuations to historical valuations—both in absolute terms and relative to developed markets.
- The key question is whether or not a sustainable improvement in emerging markets fundamentals means that they deserve to trade at a higher valuation than they have historically—i.e., should they be re-rated?
- Emerging-market fundamentals have improved. Many emerging-market countries have improved their balance sheets, i.e., they now run current-account surpluses and have large foreign currency reserves to meet their debt obligations. Also, several countries seem to be adopting prudent fiscal and monetary policies, though whether or not these policies last during difficult times remains a question in our minds. Still, the improvement in their macro, i.e., big-picture, fundamentals is hard to ignore and we believe it will help keep emerging-market inflation relatively low, which should provide a positive backdrop for emerging-market equities longer term. Finally, emerging markets' corporate profitability has improved significantly relative to history. We believe some of the improvements in both macro and corporate fundamentals can be sustained and, therefore, some of the re-rating in emerging markets we have seen so far is deserved, and it is possible they could be re-rated further.
- While emerging markets look expensive based on most relative historical valuation measures, they may indeed be moving to a higher relative valuation based on a sustainable improvement in their fundamentals. However, given the short history of emerging markets and their evolving fundamentals, we resist accepting the most optimistic scenarios for this asset class. Overall we continue to view emerging markets as trading within a fair-value range relative to larger-cap U.S. stocks—though we would now say they are in the upper portion of a fair-value range.
- Though we don't currently have dedicated emerging-markets exposure, we do have some exposure via the diversified foreign equity funds we hold.

## Recent Equity Market Performance

Performance Summary as of 12/31/07			
	MSCI Emerging Markets Index	MSCI World ex USA Index	S&P 500
YTD	39.8%	12.9%	5.5%

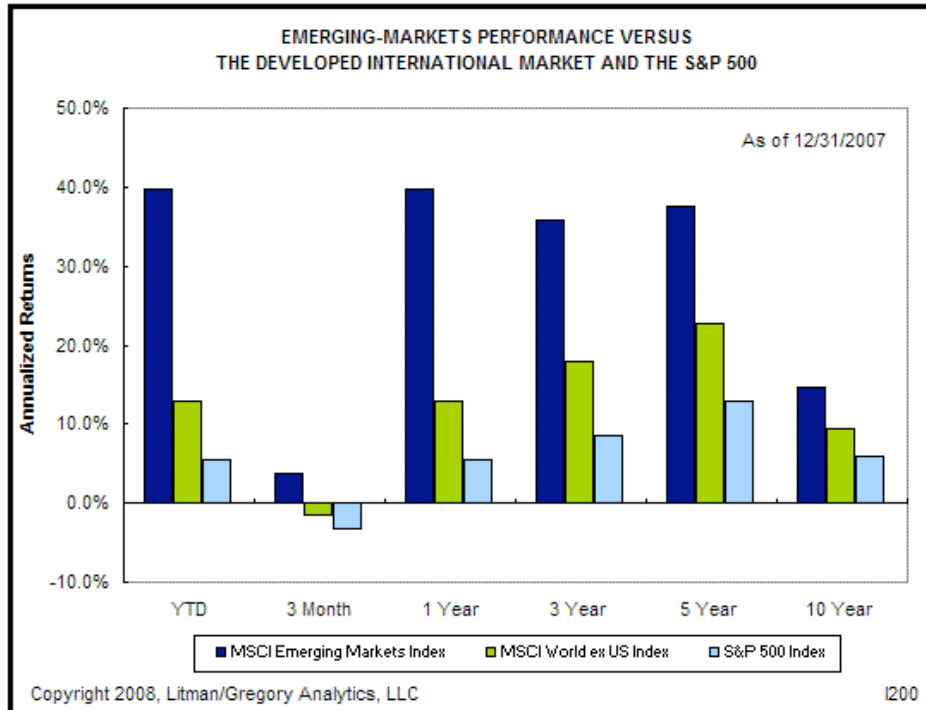
3 Month	3.7%	-1.6%	-3.3%
1 Year	39.8%	12.9%	5.5%
3 Year	35.8%	17.9%	8.6%
5 Year	37.6%	22.6%	12.8%
10 Year	14.6%	9.4%	5.9%

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In 2007, emerging-markets stocks rose 39.8% in U.S. dollar terms (USD) and 33.1% in local currency terms (LC)—the difference reflecting emerging-market currency appreciation versus the U.S. dollar. Stocks in the developed world returned 9.6% in USD for the calendar year. For the quarter ending December 31, 2007, emerging-markets stocks were up a modest 3.7% (USD) and 2.9% (LC), while stocks in the developed world declined slightly. This performance differential is notable because in the fourth quarter investor concerns about the U.S. falling into a recession and carrying the rest of the developed world with it increased. Historically, emerging-markets equities underperformed when such concerns came to the fore because of their perceived dependence on developed-world exports for their growth. The fourth quarter outperformance reflected investors' apparent willingness to take into account emerging markets' improved fundamentals and the potential for their economies to hold up better in a global growth slowdown relative to the past. However, this idea was tested in the first few weeks of January when emerging-market equities declined slightly more than their developed counterparts.

Emerging markets' performance in recent years has been very strong (see chart below). As a result of this performance, the ten-year annualized return (ending December 2007) for the asset class is nearly in the mid teens, having more than made up for the meltdown triggered by the Asian and Russian crises in the late 1990s, as well as the impact of the global bear market earlier this decade. In fact, this return is now more than twice that of the S&P 500, though this outperformance has come with much higher volatility.

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## Key Factors

**Emerging-market macro fundamentals have improved.** Emerging-market exports have risen strongly over the past several years, helping many emerging-market countries improve their balance sheets, i.e., their current-account balances look healthier, they have reduced their exposure to more expensive large foreign-currency reserves that easily finance their imports and serve to ward off speculative attacks on their currencies. So, relative to the past, many emerging-market countries have less of a need to borrow and, as a result, they are less dependent on foreign capital. This is a significant change because it gives these countries greater control over their monetary policies. For example, to combat inflation they can let their currencies appreciate rather than increase interest rates (to attract foreign capital) and risk an economic slowdown. In addition, emerging markets are growing faster than their developed counterparts. According to IMF estimates, emerging markets now account for 30% of the global GDP versus 21% in 1999. Emerging-market countries' improved fundamentals and superior growth rates make it more likely that their currencies will appreciate than depreciate versus developed-market currencies, such as the U.S. dollar. This makes them less vulnerable to currency-driven crisis, such as the one we witnessed in the late 1990s.

**The improvement in macro fundamentals will also benefit emerging-market companies.** Emerging-market corporate profitability is at historical highs and at levels comparable to, if not better than, those of the developed world. The question is how much of this improvement in corporate profitability is due to cyclical versus secular factors. We think cyclical improvement in the global economy since early 2003 has played a role in helping emerging markets reach high profitability levels, and we know this benefit can reverse over shorter periods. But there are several reasons why we think some of the improvement in corporate profitability stems from sustainable secular factors.

First, we hear anecdotes from some investment managers we respect that more and more emerging-market companies are focusing on maximizing profitability, though we are uncertain how widespread this discipline has become (we are somewhat skeptical given emerging markets' poor track record in that area).

Second, in general interest rates across emerging markets are historically low, and are likely to remain that way in many countries due to their improved macro fundamentals. So, on average, the cost of capital for an emerging-market company should remain low relative to history (cost of capital is directly related to interest-rate levels). This is important because when the cost of capital has exceeded profitability in the past it has contributed to emerging-markets crises. But from current high levels of profitability, it would take a significant earnings decline or a significant increase in interest rates (or some combination of both) before the gap between corporate profitability and the cost of capital becomes negative. We think this is a low-probability risk for emerging markets. Emerging-market companies are definitely benefiting from their greater integration into the global economy, and they are experiencing the same productivity benefits of technology and faster dissemination of information and learning as the rest of the world. This, combined with their improved macro fundamentals, suggest a low probability of interest rates rising significantly at a time when corporate profitability is declining.

Finally, per-capita incomes in many emerging-market countries have risen impressively over the last several years. There are indications that this rise in per-capita income is stimulating domestic consumption in some emerging-market countries. If this trend continues, it will serve as an important driver of corporate earnings in the long run.

**Financial and economic reforms are important to emerging-market countries.** The International Monetary Fund (IMF) and International Finance Corporation (IFC), the World Bank's private lending arm, have urged emerging markets to continue to make progress on financial-sector reforms so that capital is allocated more transparently and profitably. For example, they say emerging markets need to deepen local debt markets. (This will also make access to capital easier for local companies and help stimulate growth in the local economy.) Indeed, many emerging-market countries are making progress in this direction. For example, Mexico and Brazil are paying off their external (dollar-denominated) debt and turning to their local markets for their financing needs.

Monetary policies of emerging-market countries are improving. Many emerging-market countries are adopting developed-world style inflation-targeting policies, and they seem to be acting on them. For example, India and Brazil are letting their currencies appreciate in order to combat inflation. Historically, such measures were resisted because a rising currency makes the country less competitive in the export market. But now, emerging-market countries are offsetting this loss in export competitiveness with productivity gains and their still underutilized pool of low-cost labor. Another example is China. It raised domestic interest rates six times in 2007 to counter inflation.

Many emerging-market countries are also showing better fiscal discipline. For example, Russia is using its recent oil windfall to shore up its foreign reserves. It is also using conservative oil-price assumptions in its spending plans, which will hold it in good stead if its oil-related revenues come down due to a decline in oil prices.

**Foreign investor flows have historically played an important role in emerging markets, though this is changing.** Developments in a number of emerging markets are providing incentives for further development of local capital markets which in turn promote an equity culture. For example, in some countries such as Mexico, Thailand, China, and India,

we're seeing a rise in consumer lending in the form of auto loans, credit cards, mortgages, etc. In Brazil, Mexico, and Poland we are seeing pension reform, which is broadening the local investor base there.

## Risks

**Emerging markets look expensive** on several valuation metrics. This is a key risk.

**Another key risk is that emerging-markets companies' profitability suffers if the developed world slows significantly.** While that has been largely true in the past due to many emerging-market countries' heavy reliance on exports, emerging markets may now be able to hold up better. As mentioned above, because many emerging-market countries are less reliant on foreign capital they have less of a need to attract it by raising interest rates. Historically, this need made it difficult to lower interest rates to stimulate growth in their domestic economies in times of economic weakness. This lower dependence on foreign capital doesn't eliminate risks from a slowdown in the developed world's growth, but it is a mitigating factor relative to the past. Second, domestic consumption in some emerging-market countries is improving, which reduces their dependence on exports. Finally, the rise of China as an economic power is a mitigating factor. In 2006, China replaced the U.S. as emerging markets' largest export destination. So a developed-world slowdown would likely have less of an impact on emerging markets than in the past, although China's dependence on the developed world for its exports could slow it down, which could have a trickle-down effect on emerging markets.

**A rise in protectionism (policies such as imposition of high tariffs and quotas that restrict trade among nations) is a low-probability, though material, risk for emerging markets.** Because many emerging-market countries rely on exports for their growth, any protectionism-induced friction in global trade could negatively impact their growth prospects. In general, emerging markets' domestic economies have not yet evolved to a level where they can offset a material slowdown in exports, although, as stated earlier, there is evidence that domestic demand in a number of emerging countries is improving.

**Rising interest rates in the developed world is a minor risk** for emerging-markets equity. Low interest rates across the globe have created high levels of liquidity, generating strong flows into riskier asset classes such as emerging-market equities. Higher rates could reduce or eliminate the liquidity benefit that emerging markets have experienced in recent years, although increased local participation in emerging markets, such as by local pension funds, mitigates this risk.

**Inflation, particularly in food, is rearing its head in many emerging-market countries.** *The Economist* Commodity Price Index rose in the high teens in 2007, with food commodity prices rising over 40%. Because food is a relatively large expenditure for an average emerging-market consumer, rising food prices may depress consumption and, as a result, slow company-level earnings more than expected.

## Valuations

Emerging markets valuations do not look excessive on some earnings-based metrics, but do appear overvalued on most other measures, especially when we look at how emerging markets have traded relative to developed markets in the past.

Emerging-markets equities, like their developed counterparts, have seen a rough start to the year. As of this writing, they trade at a trailing P/E of 17x, which compares to their historical average of over 16x. Furthermore, on this valuation metric, emerging markets trade at an 8% premium to developed markets. Historically, they have traded at a median discount of over 16% and an average discount of 8%. Emerging markets traded at a premium to developed markets in the early to mid 1990s, though this asset class was still very young at that time and we think investors did not fully understand the risks associated with investing in emerging markets. At the time, investors were enamored, somewhat like today, by the growth prospects of emerging markets. Since around the mid 1990s, emerging markets have, for the most part, traded at a trailing P/E multiple lower than their developed counterparts. While emerging markets' relatively high growth prospects have always been an attractive feature, they have traded at a discount to the developed world because of their political uncertainty (which can lead to changes in macro policies that are not conducive for growth), susceptibility to macro shocks (this risk has diminished as macro fundamentals of emerging markets have improved), and relatively less-liquid markets. Looking at trailing price to book, which has been a more stable valuation measure than trailing P/E, a similar observation can be made. Emerging markets trade at 2.8x price to book, which is at the high end of their history and a 12% premium to developed world.

According to IBES Consensus estimates, emerging markets are selling at a forward (2008) P/E of 13x, a similar valuation multiple as developed world. Investors, on average, expect emerging-market earnings to grow in the mid teens, versus low double digits for the developed world, so emerging markets do not seem expensive when one takes their superior earnings growth prospects into account. However, emerging markets have traded at a discount to developed world on a forward P/E basis in the past despite their superior growth prospects for reasons we state above.

Finally, emerging markets look overvalued when we compare their cash-flow yield relative to that of developed markets over time (see chart below).

While emerging markets look expensive based on most relative historical valuation measures, they may indeed be moving to a higher relative valuation based on a sustainable improvement in their fundamentals. Given the short history of emerging markets and their evolving fundamentals, however, we resist accepting the most optimistic scenarios for this asset class. Overall we continue to view emerging markets as trading within a fair-value range relative to larger-cap U.S. stocks—though we would now say they are in the upper portion of a fair value range. The very strong returns delivered by emerging markets over the last five years, along with loftier valuations, make lower returns highly likely going forward. Relative to developed markets, it is difficult to say whether emerging markets are likely to outperform over the next few years. The key will be whether emerging markets' higher valuations are fully justified given their strong fundamentals and whether these fundamentals continue to improve.

#### RELATED CHART

[Emerging Market/Developed Markets relative valuation \(pdf\)](#)