INVESTMENT FOCUS: Emerging Markets

Value or Value Trap?

There is always much debate around the topic of investing in Emerging Markets (EM) vs. Developed Markets (DM). As South African investors, and therefore EM based, we assess whether increasing exposure to EM's will create value or turn out to be a value trap.

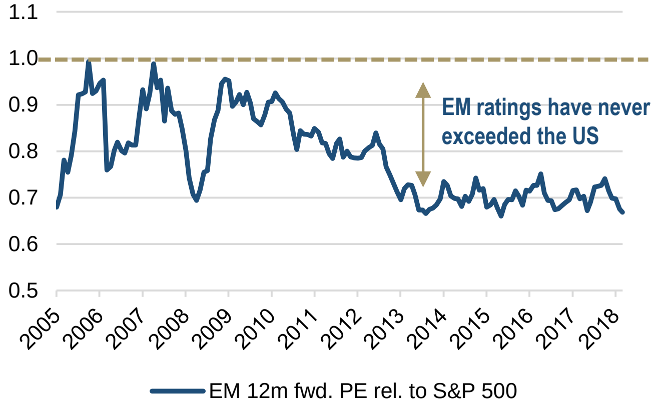
Before assessing whether EM's can create value for investors in a general sense, it is worthwhile remembering that as SA investors, we are an Emerging Market, which contributes 5.9% of the total MSCI Emerging Market Index. Therefore, we are already heavily exposed to the asset class. EM is also actually only a small proportion of the global universe of potential investments – it makes up only 11.3% of the MSCI All Country World Index. To put this in context, Info Tech alone makes up 15.5%. Therefore, investors looking for value creating investments have many other options to choose from.

EM's look cheap, right?

The argument for EM exposure is often made based on low relative valuations – implying that EM's have the potential to provide value once ratings return "to fair value". However, as seen in figure 1 below, for more than 10 years, EM's have always been relatively cheaper on a Price to Earnings basis vs. the US market. Without a major catalyst, there is little to suggest that we could see significant re-rating. This begs the question – are EM's "cheap" for a reason? We think so, but why?

There are three main reasons why a company's PE is higher than another's: 1.) earnings stability / quality (as proxied by ROE), 2.) strong cash flow conversion (i.e. do earnings closely represent cash flow), and finally 3.) growth. In all three areas, EM's score poorly relative to the US. Therefore, their lower rating is justified.

Figure 1: EM 12m fwd. PE relative to the S&P 500



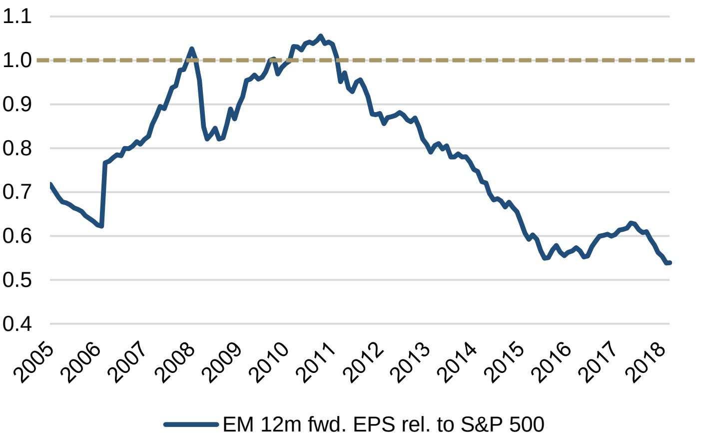
Source: Bloomberg

Cheap, but why?

It is important to assess why EM valuations appear persistently undervalued. To answer this question, we look first to earnings.

In figure 2, the chart shows that EM earnings have been relatively lower than US earnings since the end of 2010. In fact, on an absolute basis, EM earnings have also been in decline. Given the make-up of the EM industries, their capex & working capital intensity is higher than US, which implies that cash flow conversion will also be worse.

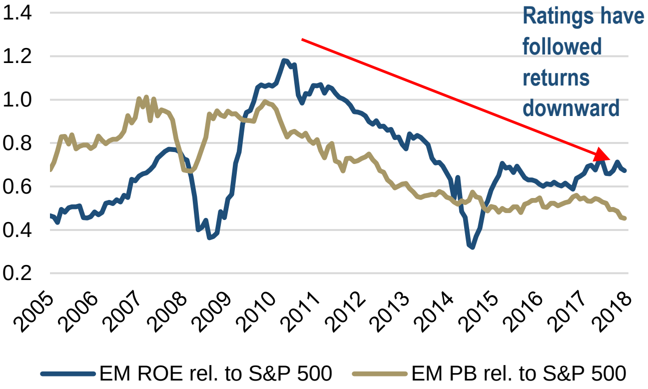
Figure 2: EM Consensus EPS relative to the S&P 500



Source: Bloomberg

Next, we assess returns. In figure 3 below, EM returns have been below those of the US. We use ROE as a proxy, as it speaks to reinvesting earnings (RE) in order to grow (RE is the missing 6% of earnings yield after paying out dividends). In this case, lower EM growth drove lower relative returns.

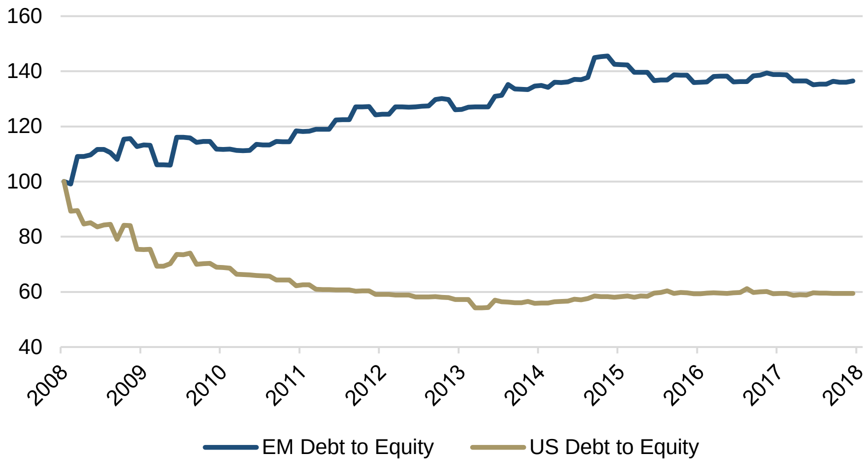
Figure 3: EM Price to Book Value & Return on Equity relative to the S&P 500



Source: Bloomberg

The last factor to consider is leverage. As in figure 4 below, EM's have been increasing leverage, whereas US corporates de-leveraged in the wake of the Global Financial Crisis. Since then, leverage has remained roughly neutral since 2011.

Figure 4: EM vs. US Leverage



Source: Bloomberg

With the US continuing on a rate hiking cycle and EM's increasing gearing, often denominated in USD, that means that USD strength and increasing rates will result in even higher EM leverage. In other words, risks for EM's are to the downside.

An imminent turnaround? Probably not…

For EM to create value for investors, there would have to be a considerable re-rating relative to the US and developed markets in general. For that to happen, they need improving earnings, with cash flow a strong representation of reported earnings; and increasing returns, driven by growth. However, as we have seen, earnings are both declining and of lower quality than developed market peers, in addition to having lower growth, despite increasing leverage. This combination has driven valuations lower – suggesting that they are actually "cheap" for a reason.