Emerging Markets versus Developed Markets: Where We See Value

At RE:CM we have been fairly vocal about our preference for developed over emerging market stocks. This might not seem like the obvious choice: Emerging markets have outperformed developed markets for more than a decade. This outperformance has been driven by significant re-ratings and growth in earnings power.

We believe that book and price-to-book (P/B) values give a better indication of long-term value and prices than earnings-based measures. With this belief as background, in this article we explain why the fairly high P/B ratios in emerging markets are not justified by arguing that:

- the inflow of capital into emerging markets will eventually erode the superior returns on capital currently being achieved in emerging markets;
- in calculating a high level fair value for emerging markets compared to developed markets, it is not clear that a P/B premium is justified.

(Please note that we will focus on macro arguments in this article. As bottom-up stock pickers, macro issues do not typically determine how we construct portfolios. But in this instance a macro perspective best allows us to illustrate our point.)

Excerpt from the article ‘Slide fails to derail emerging market bulls’, published on the Financial Times website, 7 March 2012.

Chart 1: MSCI Emerging Markets Index vs MSCI World Index. (1987 - 2011)*

*January 2002 = 100

Sources: Thomson Reuters Datastream, RE:CM analyst
Emerging market outperformance has been a function of a material re-rating and superior book value and earnings growth. Emerging market equity indices have outperformed developed market indices by a wide margin since the turn of the century. Chart 1 shows the price performance of the MSCI Emerging Markets Index.
compared to the MSCI World Index since inception of the Emerging Markets Index. The dramatic outperformance since the late 1990s and early 2000s is clear.

This outperformance has been driven by superior growth in earnings power (whether measured by book value or earnings), and by a major re-rating of emerging market stock indices relative to developed market indices. Chart 2 shows the superior growth achieved by emerging markets. The superior earnings growth since the 2008/2009 global recession is particularly notable.

Chart 3 shows the effect of emerging markets’ re-ratings relative to developed markets, on both a price-to-book value (P/B) and price-to-earnings (P/E) ratio basis.

**Returns on equity have only been slightly higher in emerging markets than in developed markets**

Charts 2 and 3 illustrate how re-rating has been as important as earnings growth when assessing emerging markets’ superior returns from an earnings and P/E point of view. When it comes to book value and P/B value, the P/B re-rating has actually had a bigger impact than the superior book value growth.

This discrepancy is interesting because it highlights the substantial increase in returns on equity (ROE) in emerging markets since 2002. Earnings have grown relatively faster than book values in emerging markets compared to developed markets. Chart 4 shows the difference in ROE between emerging and developed markets.

Note that the ROE for emerging stock markets has on average only been about 1.0% higher than the ROE for developed markets since 1996 (where our available data starts). Since 2002, the difference has been about 1.4%, and since the onset of the 2008 recession, the gap has opened up significantly to more than 3.0%.

**In theory, there shouldn’t be a vast difference in P/B values between markets**

When we try to draw conclusions about markets, we prefer to look at matters from a book value perspective. In our experience, book values and P/B values give a better indication of long-term value and price levels for markets as a whole than earnings-based measures. Chart 3 clearly showed that since the early part of 2009, emerging markets have traded at a P/B ratio premium compared to developed markets. We believe these high ratios are not justified, for the following reasons.
1. Over the long term, risk-adjusted returns on capital between markets should not diverge widely

Theoretically there is no reason why a dollar invested in a developed market should be worth more or less than a dollar invested in an emerging market. Please note that the emerging market indices we have used for the charts in this article are all calculated in US dollars. Investors will be indifferent about where to invest if the risk-adjusted returns are the same from investments in emerging and developed markets respectively. If the risk-adjusted returns are different, capital will tend to flow to the superior destination, which will erode the superior returns over time. A clear discrepancy in prospective risk-adjusted returns should therefore not last for a very long time.

The statistics show that capital has been flowing into emerging markets at a rapid rate. This should drive down the superior returns on capital (and equity) enjoyed in emerging markets over the past decade (as was shown in Chart 4). Chart 5 shows inflation-adjusted net foreign direct investment (FDI) into Low and Middle Income Countries (as per the World Bank classifications) on the one hand, and Organisation for Economic Co-operation and Development (OECD) countries on the other hand, both since 1996.

Note the dramatic increase in FDI in low and middle income countries since 2005, which is more or less when emerging markets’ ROE started increasing meaningfully above that of developed markets.

2. P/B value should be viewed in a fair value context to determine whether a premium is justified

The mathematics also does not necessarily favour emerging markets when one does a high level fair value calculation for emerging and developed markets. The following equation can be used to calculate the fair value of an asset (or index in this case) from its book value:

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\text{Fair value} = \frac{\text{Return on equity} - \text{Growth}}{\text{Cost of equity} - \text{Growth}} \times \text{Book value}
\]

Given a constant cost of equity, it is clear that a market generating a higher return on equity and faster growth is worth a higher multiple of book value. Besides the 1.0% - 1.5% higher return on equity achieved by emerging markets over time, trend earnings growth since 1996 in emerging markets has been about 2.5% faster than in developed markets (Thomson Reuters Datastream, RE:CM analyst). But note that growth only adds value if the ROE is higher than the cost of equity. We are sceptical of the sustainability of the current historically large spread between ROE in emerging
markets compared to developed markets. The capital flows shown in Chart 5 should drive that spread down.

If we consider the longer-term 1.0%-1.5% spread to be more reflective of a sustainable level, and assume that emerging markets will continue to grow earnings about 2.5% faster than developed markets, the question that will determine empirically whether emerging markets should trade at a P/B premium to developed markets is simply whether cost of equity differences between emerging and developed markets offset the better growth and returns achieved in emerging markets. The dynamics of the fair value equation above is such that a cost of equity difference of about 2% will fully offset the growth and return advantages enjoyed by emerging markets.

There is unfortunately no definitive answer to the question of what the cost of equity differential is between developed and emerging markets. But our assessment is that a 2% equity risk premium for emerging markets above that of developed markets is easily justifiable. While political risk and matters like the security of property rights have certainly vastly improved in most emerging markets over the last decade, expropriation of assets, super-taxes and capital controls still occur more often in emerging markets than developed markets. These all increase investment risk, and hence warrant an increased required rate of ROE.

We must however mention that with the uncertain state of most developed market government finances, matters like capital controls and interference in property rights (as in the most recent alteration to the terms of Greek government debt) may well become more common in developed markets in future.

We believe the most stable, long-term value still lies in developed markets

We don’t believe the P/B premium that emerging markets currently enjoy over developed markets is justifiable. We are finding attractive value in high quality businesses in developed markets, and will not be lured into emerging markets just because (or especially because) they are currently top of mind for most investors and capital allocators globally.

Wilhelm Hertzog

References: