ACADIAN

PERSPECTIVES

VIEWPOINTS FROM THE ACADIAN TEAM

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EMERGING MARKETS—CHEAP FOR A REASON?

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- **Emerging markets equities continue to trade below the long-term average discount to developed markets.**
- **MSCI's EM index sector composition has shifted significantly over the long-term.**
- **We find that sector composition contributes only minimally to EM's current discounted valuation relative to developed markets.**

In our September 2016 Perspectives, "Emerging Markets: Still a Buy of a Missed Opportunity?", we made the case that emerging equity markets, even after their rally of early last year, were trading at deep discounts on most valuation measures relative to U.S. and other developed market equities. Since then, emerging markets have continued to outperform most other equity regions—yet still trade at considerable discounts, as shown in Table 1. For example, since 1995, the discount between emerging and developed market stocks has averaged 16%. Today that discount averages closer to 21%. Although there are many reasons why one equity class may trade at a discount, this paper will focus on whether differences in sector weights between emerging and developed markets justify these discounts or whether this may be an opportunity for investors.

JUST HOW CHEAP?

To highlight the extent of the discounts on emerging equities, Table 1 shows some common valuation measures for the MSCI Emerging Markets (EM) and World indices, the latter being based on developed equity markets. In addition, current and historic discounts for the emerging markets are shown. On average, emerging equities are currently trading below their long-term historic discounts, at -21% versus -16%. It is worth noting that this is near twice the -11% discount seen over the last 10 years.

TABLE 1

MSCI valuations and discounts

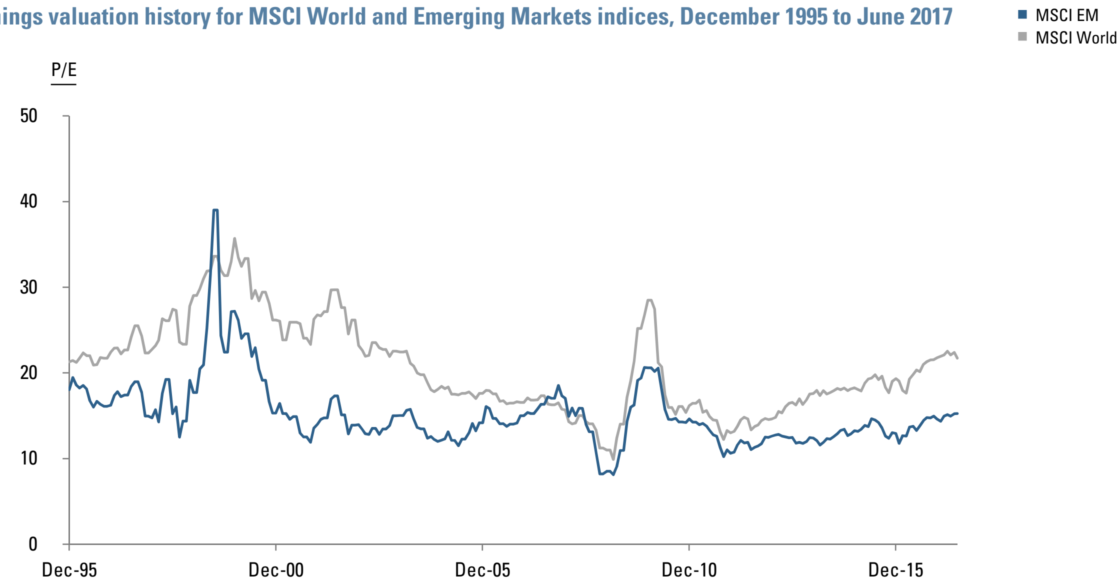
	Price / Earnings	Price / Book	Price / Cash Earnings	Dividend Yield	Average
June 2017					
Emerging Markets	15.2	1.7	9.3	2.4	--
World	21.7	2.3	12.3	2.4	--
EM Valuation Discounts					
Current	-30%	-28%	-25%	-1%	-21%
10- Year Average	-21%	-10%	-14%	0%	-11%
Long-term Average	-26%	-27%	-22%	10%	-16%

Sources: MSCI Emerging Markets Index, MSCI World Index. For illustrative purposes only. Past results are not indicative of future results. Investors have the opportunity for loss as well as profits. Index Source: MSCI.

Examining valuations through time, Chart 1 plots the price/earnings for emerging and developed equity indices from December 1995 through the current period. During the early years, emerging equities traded at considerable discounts except during the Asian crisis in the late 1990s when earnings for many emerging companies fell relative to their price, temporarily inflating valuations. Since that time, the valuation gap gradually closed until 2009, when emerging equities traded near par with developed markets. However, in the most recent years, the discount gap has again widened.

CHART 1

Price/Earnings valuation history for MSCI World and Emerging Markets indices, December 1995 to June 2017



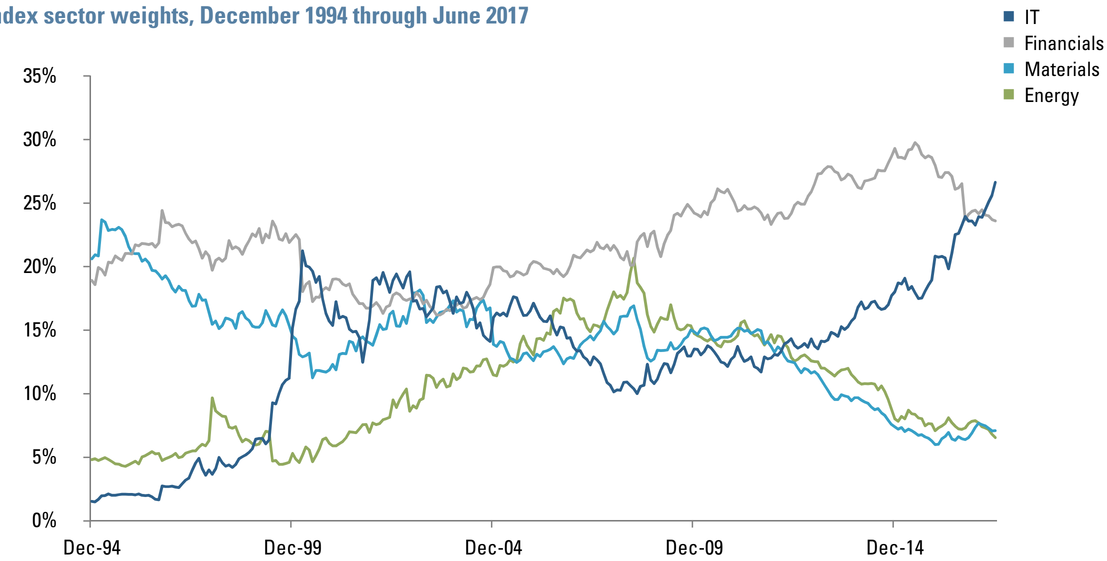
Sources: MSCI Emerging Markets Index, MSCI World Index. For illustrative purposes only. Past results are not indicative of future results. Investors have the opportunity for loss as well as profits. Index Source: MSCI. Copyright MSCI 2017. All Rights Reserved. Unpublished. PROPRIETARY TO MSCI.

WHICH SECTORS DOMINATE EMERGING MARKETS?

Many investors view emerging economies as primarily commodity oriented. Commodity stocks, such as energy and materials, typically trade at lower valuation multiples so emerging markets should justifiably be cheaper. Although this may be a compelling argument, it has little empirical support, at least in recent years. Chart 2 shows the changing composition of key sectors for the MSCI EM index since 1994. Although materials was the largest sector within the index in 1994 and again briefly so in late 2002, it has since been eclipsed by financials and more recently information technology (IT). The weight of energy has generally tracked oil prices, peaking in 2008 and declining since. Today financials and information technology dominate, totaling more than half of the index. In 1994, IT was less than 2% of the index.

CHART 2

MSCI EM index sector weights, December 1994 through June 2017



Sources: MSCI Emerging Markets Index. For illustrative purposes only. Past results are not indicative of future results. Investors have the opportunity for loss as well as profits. Index Source: MSCI. Copyright MSCI 2017. All Rights Reserved. Unpublished. PROPRIETARY TO MSCI.

SECTOR DIFFERENCES AND DO THEY MATTER?

Tables 2A and 2B address two questions: How different are sector weights between the EM and World indices and how much do they contribute to their valuation differences? As Table 2A shows, the sector composition of the MSCI EM index is not all that different than that of the World index. The two most notable differences are in health care and information technology, with the former being relatively under-developed within emerging markets and the latter being its largest single sector, containing some of the world's biggest companies such as Samsung and Alibaba.

TABLE 2A

MSCI sector weights, June 2017

	World	EM	EM - World Active Weight
Information Technology	15.6%	26.6%	11.0%
Energy	6.0%	6.5%	0.5%
Consumer Discretionary	12.3%	10.6%	-1.7%
Utilities	3.2%	2.6%	-0.6%
Real Estate	3.2%	2.7%	-0.5%
Industrials	11.5%	5.7%	-5.8%
Materials	4.9%	7.1%	2.2%
Consumer Staples	9.7%	6.8%	-2.9%
Telecom Service	3.0%	5.4%	2.4%
Health Care	12.6%	2.4%	-10.2%
Financials	18.0%	23.6%	5.6%

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TABLE 2B

MSCI sector weights, June 2017

	EM - World Weight	World P/E	Marginal Contribution to EM Index P/E
Information Technology	11.0%	24.2	0.25
Energy	0.5%	90.3*	0.08
Consumer Discretionary	-1.7%	19.2	0.05
Utilities	-0.6%	19.0	0.02
Real Estate	-0.5%	21.0	0.00
Industrials	-5.8%	22.0	-0.02
Materials	2.2%	20.5	-0.03
Consumer Staples	-2.9%	24.1	-0.06
Telecom Service	2.4%	17.1	-0.14
Health Care	-10.2%	25.8	-0.35
Financials	5.6%	15.5	-0.48
Total Impact on EM Index P/E			-0.67

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*The price/earnings on the MSCI World energy sector is quite elevated due to low current earnings. Since prices have not been driven commensurately lower, the expectation appears to be for better earnings in the future. The difference in the energy sector weights between the EM and World indices is very small, so this high P/E will have minimal impact on this analysis.

Table 2B again shows sector weight differences but adds the price/earnings ratios of the companies in the World index for that sector. The final column on the right shows the marginal contributions that differences in sector weights should have on the final P/E of the MSCI EM index relative to the MSCI World index (see appendix for marginal contribution calculation). On the top line for example, because IT has a greater weight in EM versus the World index and because this is a relatively high P/E sector, the EM index should have a total P/E that is 0.25 greater than the World index. For a negative example, the higher exposure of EM to financials, which have a low P/E, should contribute a 0.48 discount to the total P/E of the emerging index versus World. The total of contributions from sector differences suggest that the EM index should have a P/E that is only 0.67 lower than the World index. But as seen in Table 1 earlier, the EM index currently has a P/E multiple that is 6.5 less (15.2 vs. 21.7) than the World index – far more than sector composition justifies! So if emerging markets are cheap, it is not because of differences in sector exposures.

CONCLUSION

The argument that sector differences between emerging and developed markets contribute lower valuation multiples for the former appears true, but only marginally and not nearly to the extent of current discount levels. Our analysis shows that sector differences account for less than 0.7 of the 6.5 price/earnings multiple discount now on emerging equities. Clearly sector differences do not explain the deep valuation discounts currently seen on emerging equity markets.

APPENDIX:

The marginal contribution that a sector difference has on the price/earnings ratios between the World and Emerging Market indices is calculated as:

= 1 / (World E/P + (EM Sector Wgt – World Sector Wgt) * (Sector E/P – World E/P)) – World P/E

The sum of these contributions is the impact that sector weight differences should have on the aggregate price/earnings ratio of the Emerging Markets index relative to the World index.

BIOGRAPHY

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SENIOR VICE PRESIDENT, SENIOR PORTFOLIO MANAGER

Brian joined Acadian in 1990. Prior to his current role as Senior Portfolio Manager, he served as director of Portfolio Management, overseeing portfolio management policy as well as co-director of Research, responsible for developing and applying investment techniques to evaluate markets and securities. Before joining Acadian, Brian worked in systems planning at Bank of New England and as a senior systems analyst at Mars Incorporated. Brian obtained an M.S. in management from MIT and a B.S. in accounting from Lehigh University. He is a CFA charterholder and a member of CFA Society Boston.

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