PERSPECTIVES

VIEWPOINTS FROM THE ACADIAN TEAM

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EMERGING MARKET EQUITIES—WHERE TO NOW?

MARCH 2016

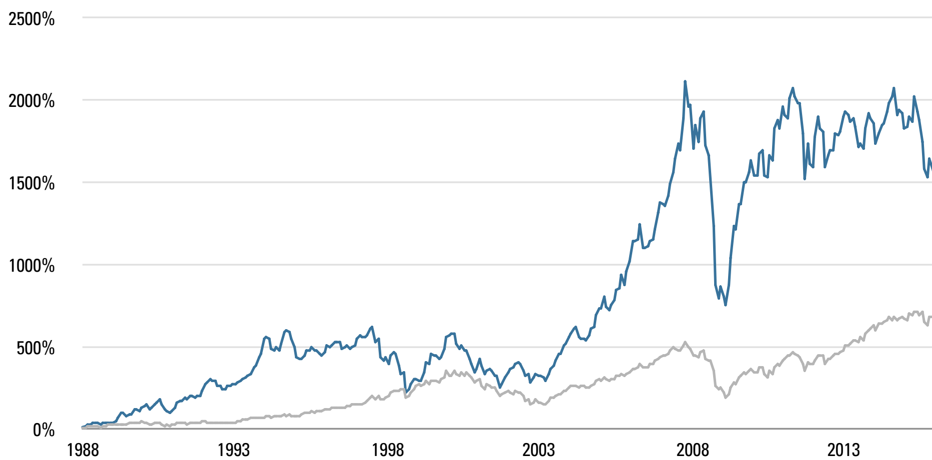
IN THE ACADIAN AUGUST 2015 PERSPECTIVES, "A TRIFECTA OF FORCES DRIVING THE EMERGING MARKETS SELLOFF," we examined factors behind the decline in emerging equities. These included slowing economic growth, the anticipated increase in U.S. interest rates, and falling commodity prices. Since reaching its 2016 low on January 21, the MSCI Emerging Markets index has gained 18%.[1] Is this a buying opportunity for emerging equities or an exit point?

EM UNDERPERFORMANCE IN CONTEXT

Since May 2008, when equity markets began their decline during the global financial crisis (GFC), the MSCI Emerging Markets equity index has returned -3.5% per year in U.S. dollar terms. In comparison, their developed World index has returned 2.9% annually, a premium of 6.4% per year. This protracted underperformance of emerging equities has understandably strained the patience of investors in the asset class. However, these lagging returns should be placed in a longer-term context. Beginning with January 1988, the inception of the MSCI Emerging Markets index, emerging equities have returned an average of 10.2% per year versus 7.3% for MSCI World (Figure 1). Despite this long-term record, emerging equities have experienced periods of extended performance shortfalls relative to developed markets. For example, from December 1994 through September 2001 there was a persistent lag in emerging markets returns brought on, in part, by economic crises in Mexico, Asia, and Russia during this period.

FIGURE 1

MSCI Emerging Markets and World indices



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[1] Index Source: MSCI Emerging Markets index. Copyright MSCI 2016. All Rights Reserved. Unpublished. PROPRIETARY TO MSCI. Return data is in U.S. dollars and includes gross dividends; date range: 1/21/2016 – 3/25/2016.

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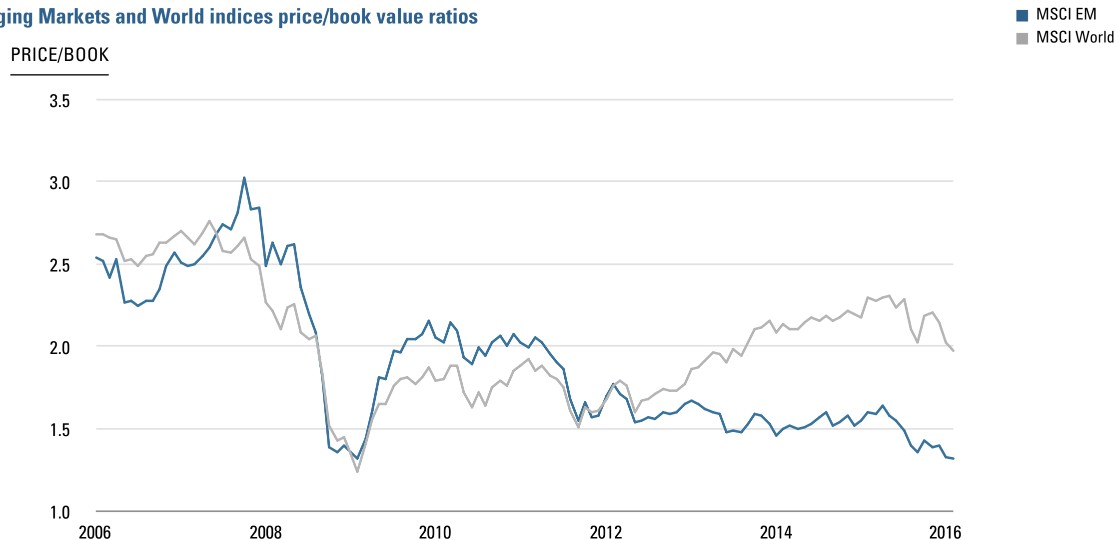
FIGURE 2

MSCI Emerging Markets and World indices price/book value ratios



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CURRENT VALUATIONS AND PROSPECTS FOR FUTURE RETURNS

Despite the long-term outperformance of emerging equities, they have typically traded at a discount to developed markets. Relative to the MSCI World index over the past decade, emerging equities have traded at an average discount of 18% on price/earnings, 12% on price/cash earnings, and 7% on price/book. In part due to the underperformance of recent years, these discounts currently stand at 25%, 22%, and 30%, respectively. Figure 2 highlights the pattern in price/book value. Emerging markets traded at a premium to developed markets both in the lead-up to the GFC in late 2007 - early 2008, as well as in its immediate aftermath from 2009 - 2011, due at least in part to their higher expected growth rates at the time. Valuations narrowed toward parity by early 2012, and EMs began trading at a discount to developed markets thereafter with the gap widening in recent years. This valuation gap extends to other ratios such as price/earnings and price/cash earnings as well. What might current valuation levels reasonably imply about future EM returns?

One approach to forecasting long-term returns to equities relies on three inputs: dividend yield, expected earnings growth, and changes in valuation. We can use this methodology to gauge the impact of varied assumptions regarding fundamentals and valuations on expected EM and DM returns. Holding dividend yields at current levels, we can derive the following matrices of five-year returns projections for the MSCI World and Emerging Markets indices:

Assuming 1) nominal 4% earnings growth for both developed and emerging markets, and 2) that valuations will converge to their 10-year averages, these matrices project a 5.1% annual return for developed equities and 7.0% for emerging markets over the next five years. This 1.9% EM premium is due primarily to valuation reversion, and is, coincidentally, in line with the 28-year historical premium. This is just one scenario—the matrices support other growth and price/earnings assumptions.

Bottom line—we believe that EM equities are inexpensive on a fundamental basis, and these results demonstrate that a modest valuation reversion alone, not heroic earnings growth assumptions, could potentially generate materially higher returns than developed markets over the medium term.

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FIGURE 3

Five-Year Return Projections - % Annual Nominal Returns

MSCI World Index

		Annual Earnings Growth Rate				
		2%	3%	4%	5%	6%
Ending P/E	15	0.8	1.8	2.7	3.7	4.7
	16	2.0	3.0	3.9	4.9	5.9
	17	3.1	4.1	***5.1***	6.1	7.0
	18	4.2	5.2	6.2	7.2	8.2
	19	5.2	6.2	7.2	8.2	9.2
	20	6.2	7.2	8.2	9.3	10.3

Current P/E	18.5
Current Yield	2.7
10-Year Average P/E	16.6

MSCI Emerging Markets Index

		Annual Earnings Growth Rate				
		2%	3%	4%	5%	6%
Ending P/E	10	-1.2	-0.2	0.7	1.7	2.6
	11	0.5	1.5	2.4	3.4	4.3
	12	2.1	3.1	4.0	5.0	6.0
	13	3.6	4.6	5.6	6.5	7.5
	14	5.0	6.0	***7.0***	8.0	9.0
	15	6.3	7.3	8.3	9.4	10.4

Current P/E	13.8
Current Yield	2.7
10-Year Average P/E	13.7

Source: MSCI Emerging Markets, MSCI World, Acadian. Returns are calculated using a proprietary methodology based on the concepts introduced in: Bogle, John C., “Investing in the 1990s,” *Journal of Portfolio Management*, Vol. 17, No. 3, (Spring 1991): 5-14. For illustrative purposes only. Past performance is no guarantee of future results. Investors have the opportunity for loss as well as profits. It is not possible to invest directly in any index. Index Source: MSCI Copyright MSCI 2016. All Rights Reserved. Unpublished. PROPRIETARY TO MSCI.

FACTORS INFLUENCING THE EM VS. DM OUTLOOK

Is the economic and financial environment supportive of scenarios that would favor EM returns? On balance, we believe that several factors suggest it is.

GROWTH PROJECTIONS

For 2016 and 2017, the IMF forecasts that emerging economies will grow 4.3% and 4.7%, respectively.[2] These projections are quite a bit lower than the 7% annual growth posted in the mid-2000s but materially above the growth estimate for advanced economies of 2.1% over each of the next two years. So despite headlines proclaiming falling growth for emerging markets, they are still expected to realize a 2-2.5% growth premium over developing economies. Although past growth has a limited impact on forward equity prices, there is evidence that future aggregate real GDP growth does have a positive influence on equity returns.[3] Recall too, that the promising relative EM returns forecast from the simple valuation model was premised on 4% growth in both DM and EM economies.

STABILIZATION OF COMMODITY PRICES

Energy and materials companies comprise 14% of the MSCI EM index versus 11% of the World index, meaning that emerging markets are modestly more exposed to commodities. Many investors are well aware that commodity exports contribute significantly to several large emerging economies including Russia, Brazil, and South Africa. It’s less well appreciated, though, that the largest markets by equity capitalization, China, South Korea, Taiwan, and India, are commodity importers and generally benefit from declines in input prices. In sum, commodity price changes have a heterogeneous impact across emerging markets. We believe that more stable commodity prices, as seen in recent weeks, should benefit emerging equities as a whole.

U.S. INTEREST RATES AND THE DOLLAR

Following the U.S. Federal Reserve’s decision to raise its funds target rate last December, other major central banks have implemented or extended negative interest rates on deposit accounts. Even the U.S. 10-year Treasury yield has dropped from 2.3% to 1.9% since mid-December. These developments, along with recent commentary from the Federal Reserve, suggest that further rate increases

[2] “IMF World Economic Outlook (WEO) Update, January 2016,” International Monetary Fund, 2016, Web, 21 Mar. 2016.

[3] Dimson, Elroy, Paul Marsh, and Mike Staunton. “The Growth Puzzle,” *Credit Suisse Global Investment Yearbook 2014*, (Feb 2014): 17-29.

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in the U.S. are likely to be measured. Tempered rate hike expectations may not necessarily be a reassuring sign for equities to the extent that they reflect concern about global growth. But a potential benefit for U.S. domiciled EM investors would be a slowing or reversal of the dollar's appreciation. Since January 2015, EM stocks have lost 15% in U.S. dollar terms vs. only 5% locally, meaning that the majority of the USD loss is attributable to currency effects. Softening of the U.S. rate outlook may help to minimize currency losses going forward.

CHINA

As the world's second largest economy—and the largest emerging one—both in terms of equity market capitalization and GDP, China has a significant impact on other emerging as well as developed markets. Economic growth in China has slowed from 14% in 2007 to an estimated 6.7% in 2016, which is a more significant decline than experienced in most emerging or developed economies.[4] This decline is due in part to slowing growth in China's export markets, such as Europe and the U.S. However, China's growth expectations are still considerably higher than those of any other major global economy.

CONCLUSION

We believe emerging market equities are inexpensive on key valuation measures. While valuations are not precise timing signals and the gap could persist, we believe that EM stocks' current relative discount provides a sound basis for investment given the current economic and financial environment. Emerging markets may offer greater economic growth and should benefit from the stabilization of commodity prices and the U.S. dollar. Surprise deterioration in these facets of the economic and financial outlook would, of course, pose risk to EM stocks. But we believe that a reasonable range of expectations supports the view that EM equities offer greater promise than DM markets over the next several years.

[4] "Global Outlook Summary: January 2016 Forecasts," The World Bank, 2016, Web, 21 Mar. 2016.

BIOGRAPHY

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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, he worked in the Systems Planning Group at Bank of New England and as a Senior Systems Analyst at Mars Incorporated. He is a CFA charterholder and a member of the Boston Security Analysts Society. Education: B.S., Accounting, Lehigh University; M.S., Management, MIT.

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