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PERSPECTIVES

VIEWPOINTS FROM THE ACADIAN TEAM

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EMERGING MARKETS: STILL A BUY OR A MISSED OPPORTUNITY?

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OUR MARCH 2016 *PERSPECTIVES*, "EMERGING MARKET EQUITIES – WHERE TO NOW?" REVIEWED THE STATE OF EMERGING market equities following their rally earlier in the year. Our expectation then was that emerging equities were likely to return 7% annually over the next five years, nearly 2% above developed market equities, driven primarily by a reversion of valuations. From April through August, emerging stocks indeed outperformed, returning 8.6% versus 5.7% for MSCI World. The question now is whether emerging equities still warrant investor attention, or has the opportunity passed?

Let's start by placing the recent emerging equity rally into a slightly longer-term context: MSCI EM returned 14.8% from January through August 2016—but it had lost nearly 15% in 2015. So on a cumulative basis, emerging stocks are still trading about 2% below their January 2015 prices. In comparison, MSCI World developed market equities have gained 5% since the beginning of 2015. This extends a pattern of emerging equity underperformance since the global financial crisis in 2008.

As a result of this poor relative performance, emerging equities are trading at a considerable discount versus developed markets. Table 1 shows that the MSCI World index looks rich when comparing a selection of current value metrics to 10-year trailing averages. But for MSCI EM, earnings-based premiums are more modest, and Price/Book actually is 17% below its 10-year average. What's more, the rightmost two columns show that current EM-to-DM valuation discounts of 32%, 31%, and 26% on Price/Book, Price/Earnings, and Price/Cash Earnings, respectively, are below their 10-year averages. So although emerging markets may not look cheap based on all multiples relative to their own historical levels, they seem a bargain when compared to the developed world.

What might this relative valuation discount imply for our expectations of returns going forward? As outlined in our March *Perspectives*, we can estimate future long-term equity returns based on forecasted changes in valuations, earnings growth, and dividend yields. Table 2 shows 5-year return forecasts for DM and EM equities based on a range of period-ending P/E multiples and earnings growth rates and an assumption of stable dividend yields.

TABLE 1

MSCI index valuations as of 8/31/2016

	World			Emerging Markets			EM vs. World % Premium	
	Current	10-yr Avg	% Premium	Current	10-yr Avg	% Premium	Current	10-yr Avg
Price/Book	2.2	2.0	10%	1.5	1.8	-17%	-32%	-10%
Price/Earnings	21.3	16.8	27%	14.8	13.7	8%	-31%	-18%
Price/Cash Earnings	11.7	9.6	22%	8.7	8.4	4%	-26%	-13%
Dividend Yield	2.6	2.6	0%	2.6	2.6	0%	0%	0%

Source: MSCI Emerging Markets, MSCI World, Acadian. 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.

[1] MSCI World, Emerging Markets indices. Copyright MSCI 2016. All Rights Reserved. Unpublished. PROPRIETARY TO MSCI.
Return data is in U.S. dollars and includes gross dividends; date range: 4/1/2016 – 8/31/2016.

We've highlighted cells reflecting assumptions 1) that each equity class reverts to its own 10-year historic valuation, and 2) 4% nominal earnings growth in both DM and EM. The resulting forecasts of 2.6% annualized for DM and 5.3% for EM compare unfavorably to March projections of 5.1% and 7.0%, respectively, reflecting rallies in both equity classes without commensurate increases in underlying earnings. But because developed equities have become comparatively more expensive, the EM-over-DM expected returns spread has actually widened to 2.7% from 1.9%.

In selecting stocks for actively managed EM portfolios, average valuations aren't all that matter—we care about breadth of the opportunity set. To that end, Figure 1 shows that cross-sectional standard deviations of P/B ratios in MSCI EM and MSCI World are roughly as high as they have been over the past decade. This is especially promising for EM, given that its average P/B multiple doesn't look historically high. So on the basis of P/B, the asset class looks attractive in aggregate, and so do opportunities for active management.

TABLE 2

Five-year return projections - % annual nominal returns

MSCI World Index

Ending P/E	Annual Earnings Growth Rate 2%	3%	4%	5%	6%
16	-0.4	0.6	1.5	2.5	3.4
17	0.7	1.6	***2.6***	3.6	4.5
18	1.7	2.7	3.7	4.6	5.6
19	2.7	3.7	4.7	5.7	6.6
20	3.7	4.7	5.7	6.7	7.6
21	4.6	5.6	6.6	7.6	8.6

Initial P/E	21
Current Yield	2.6%

MSCI Emerging Markets Index

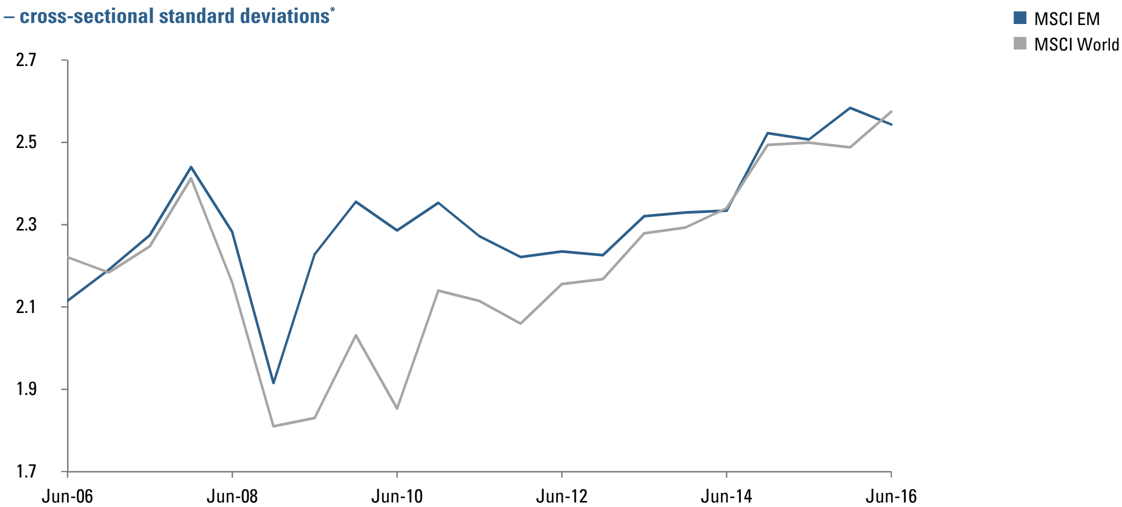
Ending P/E	Annual Earnings Growth Rate 2%	3%	4%	5%	6%
13	1.9	2.9	3.9	4.8	5.8
14	3.3	4.3	***5.3***	6.3	7.2
15	4.6	5.6	6.6	7.6	8.6
16	5.8	6.9	7.9	8.9	9.9
17	7.0	8.1	9.1	10.1	11.1
18	8.2	9.2	10.3	11.3	12.3

Initial P/E	15
Current Yield	2.6%

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.

FIGURE 1

Price/Book – cross-sectional standard deviations*



*P/B ratios calculated semi-annually. Cross-sectional standard deviations calculated among MSCI World and EM constituents excluding P/B ratios above 15 (98th percentile) and below 0. Source: MSCI World, Emerging Markets indices. Copyright MSCI 2016. All Rights Reserved. Unpublished. PROPRIETARY TO MSCI. 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.

How has the risk environment changed since we published the original piece at the end of March? Revisiting a few aspects that we touched on then:

- **Growth Forecasts**: The IMF's July 2016 update of its World Economic Outlook left growth forecasts for EM unchanged vs. April at 4.1% for 2016 and 4.6% for 2017. For advanced economies, growth forecasts were reduced to 1.8% for both years, however, reflecting Brexit as a threat to European GDP.
- **Commodity Prices**: Commodities have generally remained above the lows many experienced early in 2016. Copper, oil, and gold as examples are all above their January levels and the latter two above their March prices – albeit with some recent volatility. For particular emerging countries dependent on extractive industries, those rebounds might pose increased downside risk. But we'd reiterate that contrary to conventional wisdom, emerging equities in aggregate are only modestly more heavily weighted in energy and materials companies than the World index. As of August 31, 13.7% of MSCI EM represented energy and materials companies versus 11.4% for MSCI World.
- **Interest Rates**: While there is a fairly widespread perception that emerging equities broadly share negative exposure to global interest rates, we see heterogeneity in sensitivities. The possibility of rate increases does pose a threat to some emerging countries, such as Brazil and Turkey, but key markets including China, South Korea, and Taiwan, which total over 50% of the MSCI EM index, enjoy current account surpluses. As well, despite recent speculation about acceleration of U.S. rate hikes, on balance we believe that global interest rates will remain accommodative for the foreseeable future. Furthermore, if the basis for material rate increases were a substantial improvement in the growth outlook, the net effect for equities globally might be positive.
- **China**: The second largest economy globally and the largest market in the MSCI EM index at 27%, China has significant influence on developing and advanced economies. For example, it is the largest export destination for South Korea and Taiwan, so its growth has an impact on many key emerging economies. The latest IMF growth forecasts for China are 6.7% for 2016 and 6.2% for 2017, modestly above their growth forecasts in April and still significantly above expectation for emerging and advanced markets in aggregate.

CONCLUSION

Our return forecasts for emerging equities have come down since our March *Perspectives*, but they remain significantly above those of developed markets. And although market crises by nature are challenging to predict, most of the more obvious risks to emerging equities don't appear especially heightened in the near term and/or are largely not unique to these markets. In an environment of diminished returns expectations for most asset classes, we believe emerging equities currently represent one of the more appealing options to global investors.

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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