IN EMERGING MARKETS - IF YOU LIKE GROWTH, BUY VALUE

Emerging market equities have been enjoying a bull run since early 2016, but medium to long-term drivers remain in place – and the universe continues to offer even more value for those prepared to be selective.

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Global Emerging Markets: Rich diversity

Emerging markets are often lumped together under the acronym 'GEM', or global emerging markets. In reality, this is not a homogenous mass of similar companies trading at similar valuations. Although certain sections of the market have grown expensive, this is a richly diverse universe where it pays to be discriminating. **Value can almost always be found, and stock selection can help drive superior long-term returns.**

This is not a question of chasing short-term share price reversions or gauging whether the next earnings release will be a hit or a miss. It requires an investment process that doggedly assesses long-term corporate value – and whether the current share price offers a worthwhile discount. A company's strengths and vulnerabilities extend beyond traditional financial statements. They include corporate governance, social considerations, and the company's approach to the environment, because such ESG issues can seriously impact earnings power, assets and liabilities over the long term.

Of course, companies do not exist in a vacuum. It is vital to understand their sensitivities to their geopolitical environment or other external factors like commodity prices. From corruption sagas in Brazil to progressive reform in India, the sheer variety and interplay of political and macroeconomic dynamics require sober risk assessment – but are also to be embraced for the opportunities they create.

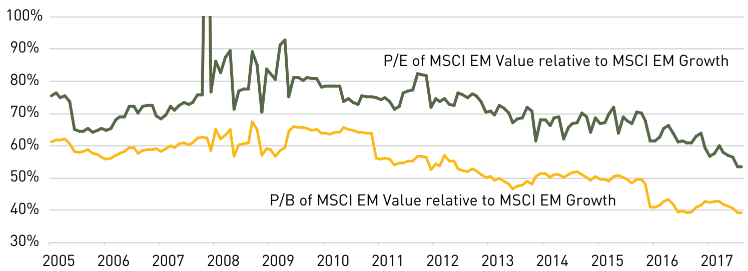
For example, in India, the reforms of Prime Minister Narendra Modi have driven sharp stock market gains in recent years. Valuations overall feel rather lofty. Yet the export-focussed pharmaceutical industry has faced concerns over a strong Indian currency and potential US border taxes. Share prices suffered over the past year to an extent that may underestimate the industry's expanding capabilities and long-term potential.

Often, though, mispricing boils down to the idiosyncrasies of the individual company. A patient search for under-appreciated potential can uncover bargains even in relatively pricey markets. Amid the low interest rate environment since the financial crisis, food stocks have been among the priciest, with valuations driven up by a reputation as stable bond proxies. However, around 2012, a close look at Mexican tortilla and corn flour maker Gruma revealed a mid-size company trading at significant discounts to sector peers, despite offering considerable potential for margin improvement through cost cutting and narrowing of its broad product line-up. In the years since, the unlocking of much of that potential has driven impressive returns for shareholders.

Price tags matter

In any case, the price you pay for an asset always matters. **Encouragingly, large swathes of emerging market equities now appear to be relatively cheap: value stocks.** There are various ways to define 'value' and 'growth'. For us, the real litmus test of value lies in qualitative analysis of each company, and above all, we look for our selection of individual equities to drive our funds' returns. Nevertheless, for simplicity's sake, if we compare the price-book or price-earnings ratios of MSCI Emerging Markets Value and MSCI Emerging Markets Growth, it suggests that value stocks are at their cheapest relative valuations in well over a decade.

EM value stocks: Lowest relative valuations in over a decade



Source: Bloomberg

Various studies point to long-term value outperformance in emerging markets (for examples, see Rouwenhorst and Fama & French).

However, from 2009 that outperformance went on pause, and since 2012, value has actually been underperforming – and getting relatively cheaper. While there will inevitably be such interim periods of value underperformance, such periods can end very quickly. **The reversion can be brutally fast for those who lack exposure to value. Indeed, late 2016 gave investors a taste of just how quickly value stocks can rally, although they have eased off again so far this year.**

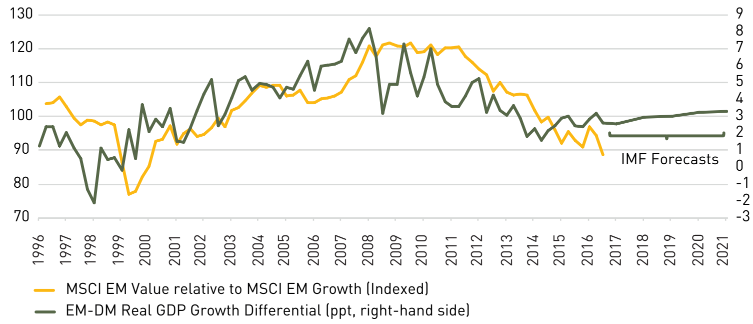
Emerging markets delivering premium growth again?

We will save for another day a full discussion of why value has underperformed in emerging markets in recent years. But we see an interesting link with the relative growth rates of emerging and developed markets. For many investors, a key motivation for allocating to emerging markets is their offer of growth rates superior to developed markets. Naturally, this varies over time. For about a decade from 1999, GDP growth accelerated sharply in emerging economies relative to developed economies. This was a key driver for the great emerging market bull run. But then growth rates eased. As emerging markets offered less of a growth premium to developed markets, money was reallocated, and from 2011 emerging equities started underperforming. The good news is emerging economy growth rates seem to have bottomed out in 2015, and indeed, their equity markets started rallying shortly after. The IMF and others expect emerging GDP growth to continue its relative recovery – and this could well serve as a tailwind for emerging market equities to offer superior returns over the medium term.

Growth drives value

So, in a sense, emerging markets are all about growth. **What might seem counterintuitive is that during periods of accelerating growth in GDP and earnings, it is often not growth stocks that benefit most – but value stocks.** There are various explanations for this, but one is simple. When economic growth slackens, companies that are able to generate higher earnings growth look relatively attractive, and benefit from a scarcity premium. So as overall growth declines, growth stocks outperform. Interest rate cycles can exacerbate this. In recent years, declining growth rates in emerging markets went hand-in-hand with low interest rates in developed markets – so yield-hungry investors herded into stocks that appeared relatively stable. This pushed many growth stocks to even higher valuations.

When EM growth accelerates, value benefits



Source: Bloomberg; 2017-21 GDP forecasts from IMF World Economic Outlook

However, as overall growth rates pick up, growth stocks command less of a scarcity premium, and value stocks can appear relatively attractive. Often, value stocks can benefit more from reflation and improved asset turnover. Meanwhile, gradual normalisation of interest rates in developed markets could be an additional tailwind. **Rising rates can spur investors to rotate out of high-multiple growth and bond proxy stocks, and reallocate towards value.** This is precisely what happened in late 2016. Although the US macro and political environment in 2017 has placed that market rotation on hold, a general outlook of improving growth rates in emerging markets, and normalising developed market interest rates, could make the coming years fairly supportive of emerging market value stocks.

Tailwinds for the asset class are always welcome – but in any case, we are convinced that global emerging markets offer a richly diverse universe, in which the patient investor can reap serious long-term rewards through investing in selective portfolios based on thorough analysis of the value in each individual holding.