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Emerging outperformance?

by Tom Delic

An investor in Emerging Market (EM) equities over the last 12 years has had a torrid time. The asset class has not only suffered poor returns in both absolute terms since 2010, but also relative to Developed Market (DM) equities, with the latter being driven by the strength of the US equity market.

At the beginning of 2010, EM equities were valued at a premium to both its own historical average valuation, but also versus DM equity valuations. DM equities on the other hand, looked attractive relative to their own history. Starting valuations matter and EM's 4.6% annualised returns from 2010 to 2021 have significantly lagged the 11.6% annualised return of DM equities over the same period.

Today's investor is faced with a different proposition. Since the end of 2021, EM valuations are standing at their biggest discount to DM equities since the late 1990s. What followed in the 2000s was effectively zero returns for DM equities, while EM equities returned 10% annualised. It is early days yet but excluding the effect of Russia which made up around 4% of EM indices[1] at the beginning of the year, EM equities have outperformed DM equities year-to-date.

While relative valuation can be instructive, a more important consideration however is absolute valuation. Part of today's dispersion in valuation between EM and DM can be explained by the elevated absolute valuation of DM equities. After reaching a price-to-book ratio of 3.3 times at the end of 2021, DM equities almost reached bear market territory in May[2], before rallying over the last few weeks. At today's valuation of 2.8 times, the asset class still trades above its long-term average of 2.4 times.

EM equities however trade at 1.4 times price-to-book, below their long-term average of 1.6 times and around a 50% discount to DM equity valuations. This is a much more reasonable starting valuation, and while there is never any guarantee that markets cannot fall further (as we have seen so far this year), we believe a larger margin of safety exists in EM given both absolute and relative valuations.

It is worth repeating that starting valuations matter, but only with a strong emphasis on future long-term returns.

Anything can happen in the intervening period, not least attractive valuations becoming even more attractive, which is a kind way of saying 'a period of poor performance can last even longer'. If you are willing to stay the course however, investing at low starting valuations puts the odds of a good outcome on your side. When EM equities have traded at a price-to-book ratio of 1.4 times or lower, 12-year annualised returns have at least been 10% and have averaged over 15% per annum. For DM equities, the picture is less rosy, with a premium starting valuation producing maximum 12-year returns of 6.9% per annum historically, but an average of just 3.4%. However, this year's weakness has already improved the return outlook for DM equities.

We are big believers in active investment strategies, more so in regions where considerable inefficiencies remain, like EM equities. Using a bottom-up universe of companies to analyse the attractiveness of equity markets, we calculate around one fifth of EM equity stocks trade below a price-to-earnings ratio of 10 times. This compares to just 6% of our North American universe.

Therefore there is plenty of opportunity for an active EM manager to deliver attractive returns, despite what occurs in the mainstream indices, over the next decade or more.

1 Russia's weight In MSCI Emerging Markets Index (%), MSCI
2 Bear market defined as a 20% fall from its prior peak
All return and valuation figures sourced from Bloomberg Finance, L.P

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