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For Investors, Emerging Markets May Have Fizzled

By The Moscow Times

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If the popping of the dot-com bubble in 2000 spelled the demise of growth-at-any price investment strategies in the West, 2013 may be the year for this to happen in emerging markets, as rip-roaring growth rates, particularly in Russia, fizzle.

Emerging market investors, just like their dot-com predecessors of the 1990s, are learning the hard way the risks of paying higher and higher prices for assets in the hope that turbo-charged future growth will deliver the payoff.

Now an emerging equity collapse, coming amid a steep growth decline, may have put paid to the so-called growth investing model that has for years blinded fans of the sector.

Counting from end-2010, emerging equity returns stand a thumping 50 percent below U.S. markets. And this year may be the final straw: As a growth slowdown gathers pace in the developing world, share prices are lagging developed peers by more than 20 percent and U.S.

stocks by a third.

Time, many say, for a shift to value-based investing: buying shares which are deemed to be trading at a discount to their fundamental worth. In other words, eschewing some of those Indian or Russian retail stocks that trade at 50 times forward earnings on the premise of explosive future consumption growth.

"We are injecting elements of value investing in our emerging market portfolios," said Giordano Lombardo, CIO of Pioneer Investments in Milan.

"Investors are in a conundrum, on one hand they need to factor in worsening fundamentals, and on the other valuations are looking more attractive," he said. "A good strategy at such a time could be to play more on the value side and avoid some of the stories in countries and stocks that still look expensive."

Most emerging shares indeed seem very cheap. Average valuations are down more than 25 percent from 2009, Deutsche Bank says, while U.S. and European markets are mostly unchanged.

And a comparison with 2007 peaks makes their case even more compelling. The sector has de-rated by 50 percent, Deutsche data show. Developed valuations meanwhile are 28 percent off peaks.

On a book-value basis, almost every emerging market looks vastly cheaper than its history. Brazil, Poland and India for instance show a 30 percent discount to their own 10-year history, and South Korea is a quarter under its historical average.

The vaunted link between fast economic growth and stock market returns has been discredited by many a study, most notably by a 2005 report by London Business School academics Elroy Dimson, Paul Marsh and Mike Staunton.

A more recent Lombard Odier study applied this to China, finding that despite 15 percent annual growth between 1993 to 2005, compounded stock market returns languished at minus 3.3 percent.

Indeed, double-digit returns on emerging stocks before 2008 stemmed not from fast growth but from the market's cheapness back in 2000 when the developing world was just recovering from crisis, Societe Generale analyst Albert Edwards says.

"Valuation is what matters for investing in emerging markets, not their superior growth story," Edwards told clients.

Growth and value are, of course, not mutually exclusive: A company's growth prospects are part of its value. The problem arises when those valuations run far ahead of future growth, often exaggerated by new players keen to join the party.

That is what happened to the dot-coms in the late 1990s and possibly to emerging markets in the years after 2007.

Edwards is notorious for his gloom-ridden investment outlook, but emerging equity prices are looking so beaten down that even he reckons a valuation gap is opening up. The sector trades at less than 10 times forward earnings or 30 percent below developed stocks. Edwards describes this as "very reasonable."

Another example of the relative valuation gap, two U.S. Banks — Wells Fargo and JPMorgan — with a joint market cap of $440 billion, now have a higher value than the entire energy and materials sector in Brazil, Russia, India and China.

Less than three years ago these banks were worth half the BRICs' commodity sectors, Bank of America/Merrill Lynch notes.

Deutsche Bank analyst John-Paul Smith, long bearish on emerging stocks, says only his conviction of a looming financial crisis in China keeps him from advising clients to buy.

"Were it not for the China factor, for a long-term value investor, emerging equities could be tempting," he said.

It could prove hard to immediately apply the concept to emerging equities, however. In a relatively young sector, value investors could find that long-term historical data on valuations, debt or normalized earnings are elusive.

And many shares will be cheap for a reason: weak profit growth, poor corporate governance or excessive state meddling are all issues that dog companies in the developing world.

It can be tough, therefore, to find stocks that have both cheap valuations and strong fundamentals.

"Value is a good strategy for emerging markets, provided you don't make the mistake of falling into value traps," says Pioneer's Lombardo, who is still invested in some expensive stocks such as consumer goods because of long-term potential.