

The Need for Emerging Markets in a Global Equity Strategy

Claudio Brocado, a portfolio manager on Batterymarch's Emerging Markets team, explains why exposure to the developing equity markets is a must for long-term global investors.

One of the consequences of globalization has been a gradual decline in home-country bias among investors. This phenomenon, combined with a weakening US dollar in a low-yield global environment, has brought greater attention to non-US equity markets.

With the US market dropping to less than half of global market capitalization—and its economy to less than one-quarter—many investors are seeking to allocate assets into non-US stocks, especially in emerging markets. In many cases, these markets have proven resilient during the global downturn, with GDP continuing to rise in countries such as China and India.

Large Reserves of Domestic Capital

During the early to mid-1990s, emerging markets began trading at a premium to developed countries despite having generally weak fundamentals. In particular, many emerging countries had large current account deficits, indicating low levels of domestic savings.

Lacking enough local capital for investment, emerging markets were eventually forced to draw in foreign assets by offering relatively high interest rates. However, emerging markets companies were unable to generate sufficient returns on equity (ROE) to offset the resulting high cost of capital. A company whose ROE lags its weighted average cost of capital does not create shareholder value and, almost by definition, should not trade above its book value. During the first half of the 1990s, emerging markets companies did just that as a result of a speculative bubble.

But times have changed, and fundamentals in emerging markets are now superior to those in the developed world at the sovereign, corporate and household levels. Emerging countries have become the world's biggest savers, with years of current account surpluses, and they now hold the bulk of global foreign exchange reserves. In contrast, the US has built up a substantial current account deficit.

Emerging markets have also become savers in a different sense, having maintained enough economic activity in the recent financial crisis to keep the global economy from spiraling further downward. The developing market economies are also expected to drive the global recovery. This is an about-face for these markets, which stood at the epicenter of previous crises.

Fuel for Growth

In addition to financing the aggregate deficits of the developed world, emerging markets have been using their surplus savings to fuel their own growth, in many cases through large investments in infrastructure of every kind. As a matter of fact, the emerging world is quickly leap-frogging key developed countries in areas such as wireless telecommunications, particularly broadband, in terms of quality, reliability, coverage and market penetration. Furthermore, the transportation infrastructure, including roads and bridges, in a growing number of emerging markets cities is more developed than in many parts of the US.

The major build-out of US infrastructure that began in the 1930s and 1940s laid the foundation for many years of high, noninflationary US economic growth. Developing markets are laying similar groundwork through their enormous investments in infrastructure development. Together with the large store of domestic savings, this has created a favorable environment, a virtuous cycle of sorts, that should lead to even stronger demand for emerging markets investment opportunities from both without and within.

Superior Stock Valuations

According to most valuation metrics, emerging market equities still trade at a discount to those in more developed markets, although the gap has become increasingly smaller (Figure 1). However, in the case of price-to-book value, emerging markets now trade at what many consider a steep 2.1x, representing a premium to the developed world's 1.8x measure, although it is still in line with the 2.1x value for the S&P 500 Index. Perhaps more importantly, emerging markets have for years been generating a higher ROE than developed countries, with a lower use of leverage. While sustainably higher ROE alone would warrant a price-to-book premium for emerging markets, the declining weighted average cost of capital allows them to offer even more value to investors.

Figure 1: Relative Valuations

as of September 30, 2009

	MSCI EM Standard Index	MSCI World Standard Index	S&P 500 Index
P/E on Forward EPS	12.7x	14.0x	14.1x
Price/Book	2.1x	1.8x	2.1x
EPS Growth, 2-Year to P/E Forward	1.6x	1.1x	1.1x
Return on Equity, 1- and 5-Year Blend	19.3%	16.2%	18.4%

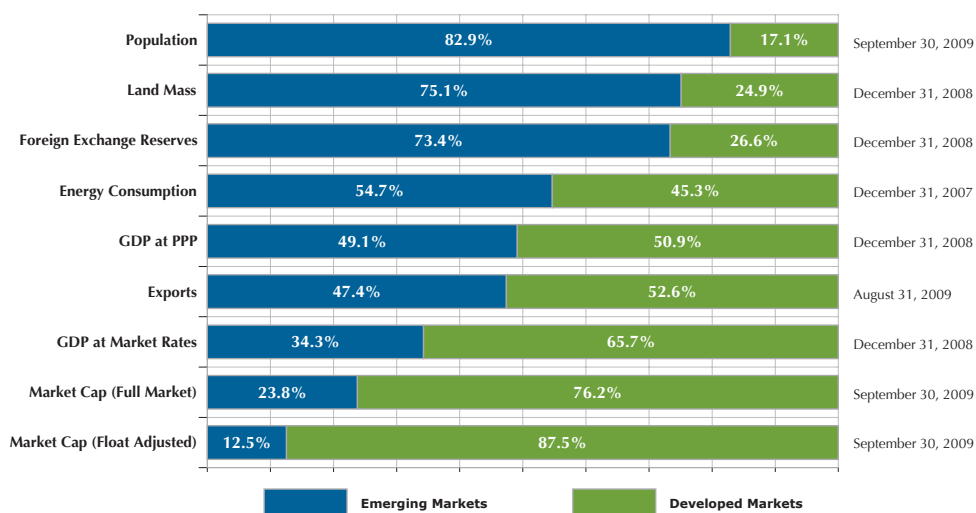
It would be worrisome if the cost of capital in emerging markets were falling due solely to foreign inflows. From our perspective, however, capital has become cheaper in these markets due primarily to the increase in domestic savings. In other words, we strongly believe that rising inflows into emerging markets are much more a consequence than a cause of the current positive balances.

The strong fundamentals in the developing markets have also contributed to a sharp rise in intra-emerging markets trade and investment, reducing their dependence on the developed world for trade and economic growth, as well as for investment sources. In fact, the US increasingly relies on the developing world, notably China, to finance its large fiscal and current account deficits.

Underrepresented Opportunities

Emerging markets remain undercapitalized, accounting on September 30, 2009 for just 12.5% of the MSCI All Country World Index, the most commonly used global equity benchmark—a very low percentage in light of emerging markets GDP (Figure 2). This suggests that most investors, whether institutions or individuals, generally have not fully deployed emerging market stocks in their global equity allocations.

Figure 2: Emerging Economies as a Percentage of Total World (Estimates)



Sources: Merrill Lynch calculations, BP, CIA World Factbook, IMF World Economic Outlook, MSCI

If full market capitalization is considered (not just free float, which includes only readily available shares), emerging markets represent nearly 24% of global market cap. Yet even this figure underrepresents the importance of developing economies, as they make up more than 34% of global GDP at currency market rates. At the same time, they represent over 49% of the global economy, based on purchasing power parity, a calculation using the theoretical fair value of exchange rates. Emerging markets are even more significant on other measures, accounting for over 70% of world foreign exchange reserves, for example.

A fresh supply of investment vehicles can be expected to emerge as start-up companies are launched and existing companies grow and diversify, resulting in IPOs and follow-on stock offerings. Over the past several months, emerging markets have become the world leaders in capital markets transactions by both size and number. This surge in activity will contribute to the ongoing expansion in emerging markets capitalization as a share of overall world market cap. We have long anticipated this trend, which should eventually close the gap between the emerging world's share of global market cap and its much greater percentage of global output.

An Imperative for Long-Term Global Investors

While ongoing strong inflows from the developed world to the developing nations will, at the margin, contribute to outperformance by emerging markets stocks, the primary source of demand will come from local investors. The large pool of domestic savings, historically underinvested even by the growing number of pension plans in these countries, will lead to an ever-greater quantity of equity opportunities. Growth in cross-border investment among emerging markets themselves is also boosting demand in this area.

Emerging countries no longer need to attract developed-market investors with high interest rates or cheap valuations. In fact, Brazil recently implemented a 2% tax on equity and fixed income inflows to help stem this year's steep appreciation of the real.

The reasons why emerging markets used to trade at a discount have ceased to exist, but the reasons to maintain exposure to them are no less compelling. In our view, the solid fundamentals and expanding growth opportunities in emerging markets make them an increasingly important part of a long-term equity strategy. Furthermore, emerging markets are an essential component of the global equity markets—as evidenced by their 12.5% floated-adjusted index weight at September 2009—which is a fact worth remembering when determining a meaningful allocation within an overall global portfolio.

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