AGF INVESTMENTS: WHITE PAPER

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BEYOND GROWTH:

Why it's time for value in emerging markets

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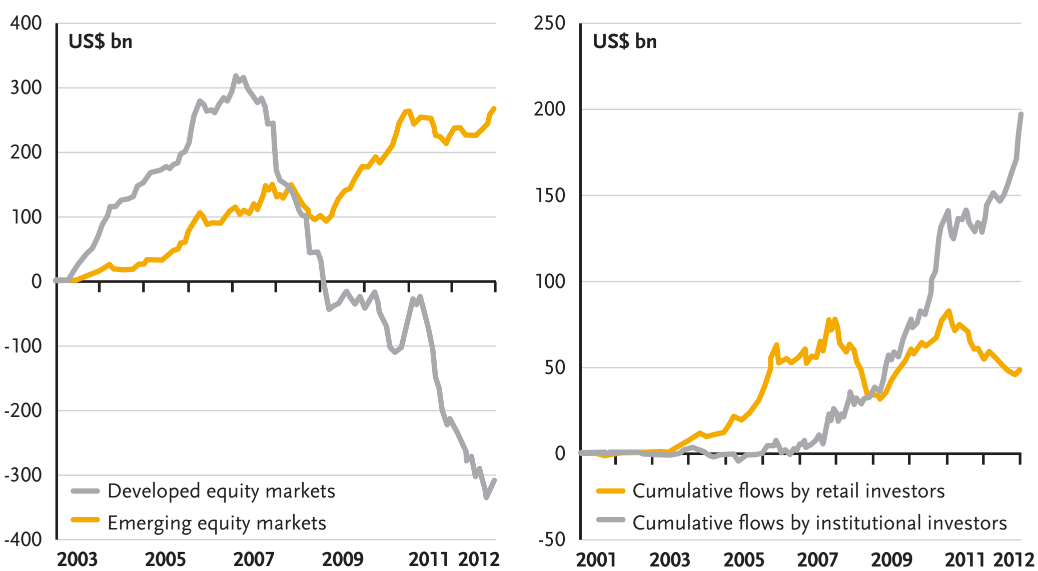
Emerging market countries have come of age. After a decade of exponential growth, these economies are now on track to claim a 55% share of global GDP in the next five years according to the International Monetary Fund (IMF). Over the last six years alone, fresh equity issuance in emerging markets has averaged US$241 billion per annum, with US$1.76 trillion in equity issued over the past decade (Source: Credit Suisse). At the same time, fund flows into emerging markets have dramatically outpaced those of developed markets, lead largely by institutional investors (Figure 1). As these markets mature, they now represent a robust and deep set of opportunities, including opportunities for every style bias: value is no exception. Although investors have traditionally seen emerging markets through a growth lens, they are in fact rife with undervalued stocks in robust industries and sectors in just about every country. Investors willing to take a value approach today have the potential to benefit from strong returns, mitigate risk and generate some of the highest dividend yields being paid out in the world today.

FIGURE 1: Fund flows in and out of emerging and developed markets



Source: Morgan Stanley, January 2013

Economic growth and stock prices

After 2008, investors lost their appetite for risk, which has taken its toll on stock prices in emerging markets. The MSCI Emerging Market Index historic price-to-earnings (P/E) ratio is 14.1X, which is not only cheap on an absolute basis, it is also trading at a 5% discount to its average P/E since 1992 and at a 17% discount to the previous decade's average (Figure 2).

PASSING THE 30/30/30 TEST

The 30/30/30 principle is a simple and effective way to manage the universe of value stocks based on three key parameters: companies must have a dividend yield 30% higher than the market yield; the stock price must exhibit a 30% drop in value in the past 18 months and a 30% discount trailing P/E relative to the market. 30/30/30 is an excellent rule of thumb for investors looking to create a well-constructed portfolio of value stocks focused on emerging markets that aims to outperform consistently over time.

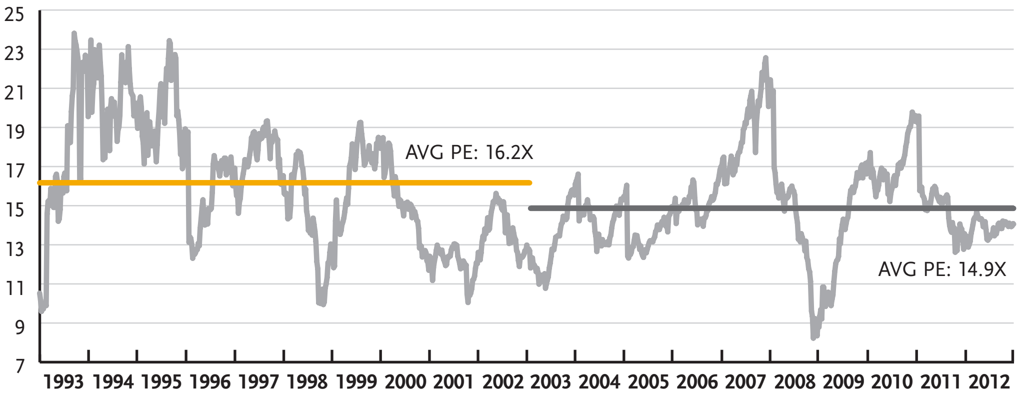
STOCK FILTER

30% OFF ITS HIGH → Current price at least 30% below the high of the past 18 months.

30% MARKET DISCOUNT → A P/E 30% below the market – the stock is cheap, relative to the market, but the company is still reporting earnings.

30% HIGHER YIELD → A dividend yield 30% above the market – the company is still in a position to be paying dividends and has a good yield.

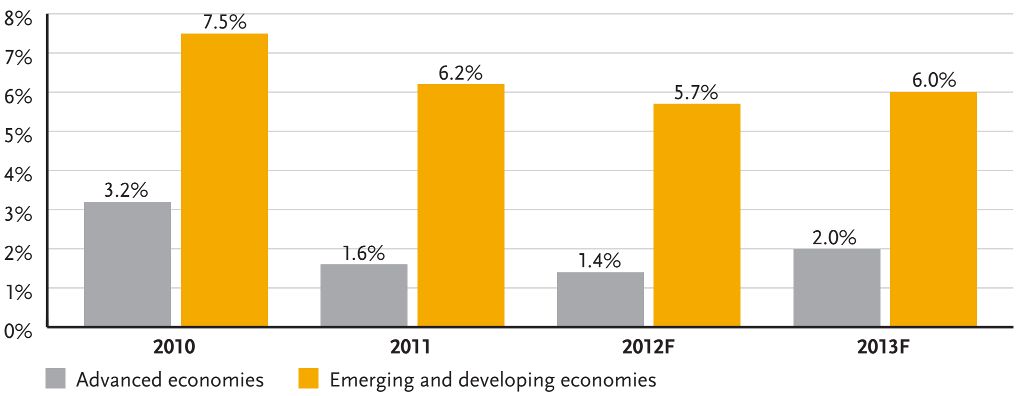
FIGURE 2: Historic P/E of the MSCI Emerging Markets Index



Source: Daiwa, December, 2012

Yet, there is much reason to be optimistic about the future of emerging market economies, especially since their GDP projections outshine those of developed economies. According to the IMF, emerging economies are expected to grow at 5.7% and 6.0% for 2012 and 2013, respectively, far outstripping the 1.4% and 2.0% projected growth for developed countries (Figure 3).

FIGURE 3: GDP growth in emerging and developed markets



Source: IMF, December 2012

However, much recent research has debunked the notion that economic growth in emerging markets is directly correlated to higher stock prices. Credit Suisse, for example, ran regressions of economic growth and stock market returns as part of its 2012 Global Investment Returns Year Book. Their data showed that higher expected economic growth did not lead to higher investment performance and used China as a key example. While that country remains one of the world's fastest growing emerging economies, its stock market returns were less than stellar. For each year between 2008 and 2011, for example, GDP growth in China was 9.6%, 9.2%, 10.4% and 9.2%, respectively. Stock returns were however highly volatile: -45%, +69%, +5% and -20% for the same four years. Although the GDP of China is 44% higher than it was at the end of 2007, the stock market is 22% lower over the same period.

THE CASE FOR ACTIVE MANAGEMENT IN EMERGING MARKETS

Many institutional investors have turned to ETFs to tap the emerging market growth story. But taking a passive approach to emerging markets isn't always the best way to build a portfolio. Here are five advantages available to active portfolio managers:

1 The market cap dilemma

ETFs are market capitalization-weighted, leading to concentration in the largest holdings. This can lead to a compounding cycle effect, where flows in and out of these names exacerbate stock movements. It also raises issues about whether or not some large-cap companies can actually provide the exposure to emerging markets investors want.

2 Buying into extremes

While investors believe that markets have become increasingly efficient, the opposite may be occurring. In his paper, *Equity Analysis Issues, Lessons, and Techniques* (2004), Fred H. Speece, Jr. argues that the growth of indexing leads investors into the extremes of the markets. As the indexing trend continues, these extremes will be exacerbated. Ultimately, because the market tends to mean revert, active managers will be presented with opportunities to add value by exploiting such extremes.

Dimson, Marsh & Staunton (2010) conducted a similar study that looked at GDP and investment results across 83 countries between 1972 and 2009. They found that those with the lowest GDP growth produced the highest returns.

This emphasizes the benefits of a value approach to country selection. By overweighting cheaper countries in the emerging markets space, investors can potentially generate additional returns. A key example of this is Thailand, where the stock market was sold off heavily following a period of political unrest in 2007 and again during the global financial crisis, reaching mid-single digit P/E multiples (Figure 4). The stock market performance (Figure 5) after each of these periods was very strong, rising over 50% from the 2007 lows and 200% from the 2008 lows.

FIGURE 4: Thailand market P/E

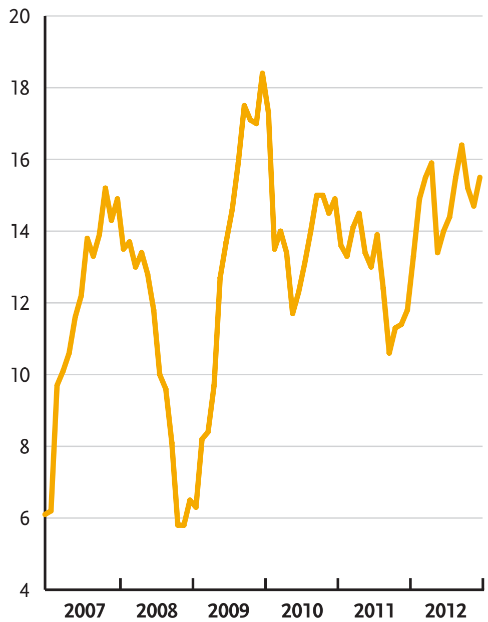
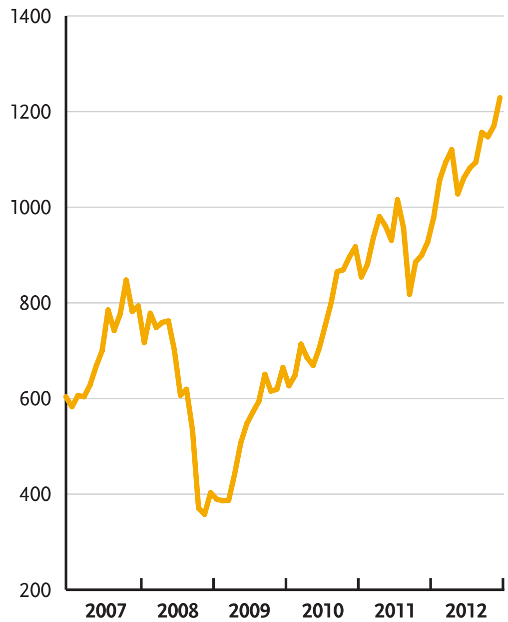


FIGURE 5: Thailand price index



Source: Datastream, December 2012

This bottom-up approach is advantageous in emerging markets where the pace and sophistication of governance, political and regulatory reforms vary from country to country. The ability to assess risks related to these factors is central to any value-based analysis for emerging market companies and is an excellent way to understand and control portfolio risk.

3 The concentration effect

As the money management community consolidates and ETFs rise in popularity, liquidity is becoming a major obstacle. As a fund manager's assets under management increase they can be forced into buying larger capitalization companies. This can create opportunities in the small and mid-cap segments of the market.

4 Hedge funds

Hedge funds with high-specific risk strategies (increasingly the norm in the market), also create opportunities. Strategies pursued by these funds exacerbate trends and increase volatility, creating opportunities for stock pickers who can look beyond the short-term impact of hedge fund activities. Hedge funds tend to have a significantly shorter time horizon, causing analysts to adjust their horizon and perspectives. This gives rise to more inefficiencies and opportunities for managers and analysts who can see through the short-term noise and take a longer-term view.

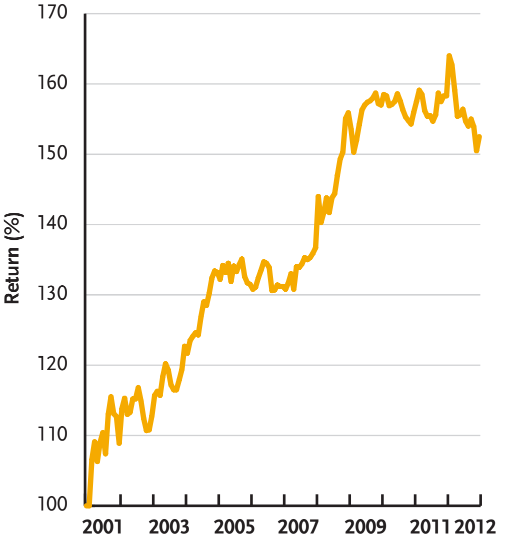
5 Stock picking still the better way

The high standard deviations evident in the different emerging market countries and indexes provide volatility. This in turn creates mispricing opportunities and gives good stock pickers the ability to outperform over the long run.

Value vs. growth

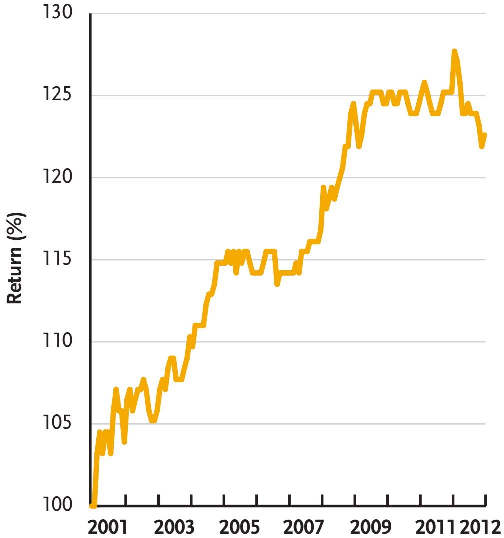
Value investing in emerging markets is not new. In fact, since 2001, the MSCI Emerging Markets Value Total Return Index has outperformed the MSCI Emerging Markets Growth Total Return Index by 50% (Figure 6) and also outperformed the MSCI Emerging Market Total Return Index by over 20% (Figure 7).

FIGURE 6: MSCI EM Value relative to MSCI EM Growth



>100 = Outperformance of the MSCI Emerging Markets Value Total Return (TR) Index vs. MSCI Emerging Markets Growth TR Index

FIGURE 7: MSCI Value relative to MSCI EM



>100 = Outperformance of the MSCI Value Total Return (TR) Index vs. the MSCI Emerging Markets TR Index

Source: Datastream, December 2012

Why is this the case? One reason is the “glamour” factor, meaning investors tend to pour into high demand, big name stocks, which in turn pushes stock prices up. The tendency for investors to view emerging markets primarily as a growth opportunity simply exacerbates this trend and, as a result, emerging markets investors can easily find themselves overpaying for stocks the market believes are poised for growth. This can be seen by looking at the individual stock valuations of the Thomson Reuters Datastream Emerging Market and Developed Market Indexes. As at May 2012, they showed markedly different results. The bottom quartile of stocks trade at an average Price to Book Value (PTBV) of 0.6X, similar for both indexes. This suggests that value is value either in emerging or developed markets. However the top quartile of emerging market stocks trade at an average valuation of 8X PTBV, compared to 6X for their developed-market peers.

This preference for glamour stocks is good news for value investors willing to take the time to identify cheaper, better-priced stocks with long-term prospects. Such opportunities abound in emerging markets, especially today. Take China’s banking sector for example. Risk averse investors have largely turned away from Chinese banks due to weaknesses in the country’s real estate sector. However, some of China’s largest banks (i.e., Industrial and Commercial Bank of China, Bank of China and China Construction Bank) offer exposure to strong economic and consumption growth and have taken prudent steps to boost their provisions and capital ratios. The Chinese banks index is trading at a PE multiple of 6.7X and offers a dividend yield of 4.3% (Source: Datastream, December 2012). This makes them solid value stocks.

The dividend advantage

Another key advantage of a value approach to emerging markets is the ability of value stocks to deliver dividend returns effectively and consistently. Growth stocks on average tend to have lower dividend yields as cash flow is reinvested in the business. On the other hand, as the theory goes, value stocks tend to distribute their earnings to shareholders in the form of dividends. Dividend payments also show that the company generates cash earnings and are a signal from management that they feel the company can continue to generate these earnings in the future.

Over the last few years, dividend growth rates in emerging markets have been higher since companies are carrying low debt levels on their balance sheets and, as a result, have more cash on hand for sustainable dividend payouts (UBS: 2012). Over the past 10 years, emerging market companies have delivered stable and impressive dividend payout ratios of 30% to 40% (Source: Datastream, December 2012). Such dividends are very competitive compared to global equities; the average dividend yield offered by emerging markets companies over the last 15 years was 2.4%, compared to 2.2% for global equities. Currently, emerging markets firms offer a dividend yield of 3% on average, higher than that offered by global equity markets (Source: Datastream, December 2012).

Going forward, dividend growth in emerging markets is set to outpace that of developed markets. Companies in some emerging market countries, such as Taiwan, Thailand and Malaysia, have always had a strong commitment to paying dividends to shareholders. Brazilian companies are required to payout a minimum of 25% of their net earnings as dividends. In Russia, the large oil companies have been increasing their pay-out ratios to present a more investor-friendly image. All this leads to a highly positive dividend landscape for investors.

Rethinking emerging markets

As emerging markets continue their stunning evolution, growing their economies and their capital markets, investors can't afford to be complacent. They must constantly rethink and reassess how they approach these burgeoning markets and which styles work best. A value approach to investing in emerging markets can offer investors the potential to generate strong returns, mitigate risk and benefit from higher dividend yields. It can ensure their portfolios continue to evolve and reflect the changing reality of global markets.

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