WaveFront Capital

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WaveFront Insights

Is Now The Time To Invest In Emerging Markets?

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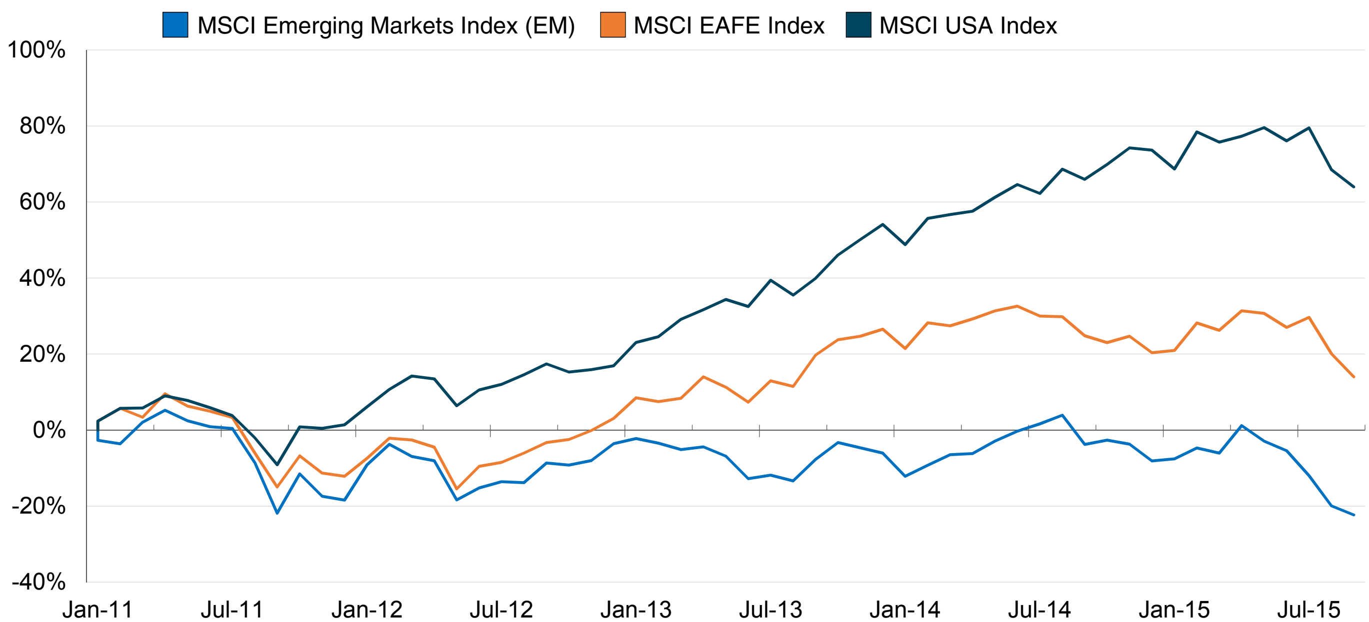
The Recent Environment

Emerging market investors have been confronted in recent quarters with troubling economic statistics and company reports. The financial media has focused on slowing GDP growth, profit shortfalls, declining commodity prices, currency wars, governmental scandals, et al, and these headwinds have weighed heavily on emerging market stock prices. In fact, emerging market stock prices have been performing poorly for several years, with their overall returns paling in comparison to equity returns in most developed markets. Exhibit 1 shows the cumulative returns using MSCI total return indexes (TR) for three major sectors of the global market: U.S., EAFE and Emerging Markets. The exhibit spans the four-year, nine-month period ending in September 2015. The MSCI U.S. Index shows a cumulative return of +64.0%, or an average annual rate of return of about 11.0%. Exhibit 1 also shows that U.S. equities sizably outgained EAFE equities, which posted a gain of +14.0% or an average annual rate of 2.8%. However, as a whole, developed markets crushed Emerging Market stocks, as this sector posted a DECLINE of -22.3% over the span, or an average annual rate of return -5.2%.

Exhibit 1 – MSCI EM vs. MSCI World, *Jan. 2011 to Sep. 2015*

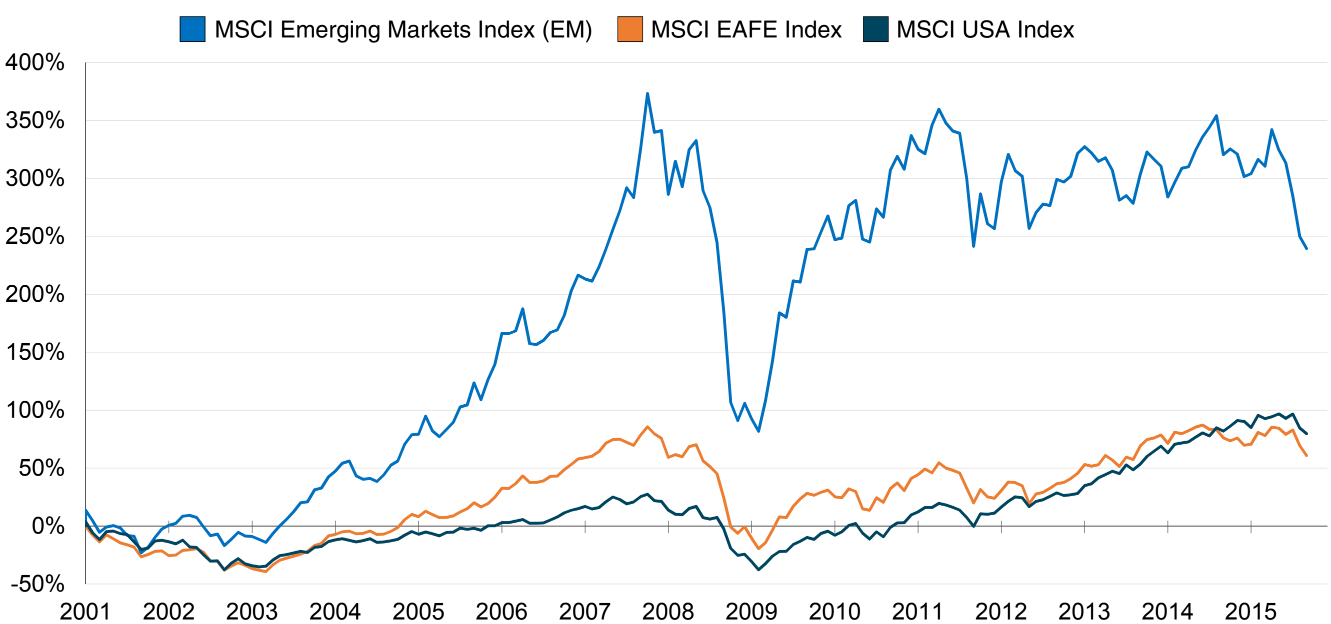


"Wait a minute," the typical global investor might ask, "isn't this supposed to be the 'Pacific Century'? When the economies of Emerging Market countries, and especially Pacific countries, grow much more quickly than Developed Market countries? What happened?"

Equity Market Indexes: A Longer View

This may yet be the "Pacific Century", but we all know that markets, especially equity markets, are fickle, and this has clearly been the case thus far in the new millennium. Exhibit 2 presents the three MSCI total return indexes from December 2000 through September 2015, and it shows a much different picture than Exhibit 1: the Emerging Markets Index has achieved the highest cumulative return, at 239.4%, or an average annual rate of return of 8.6%. However, this sizable annual EM return was achieved with relatively high volatility: an annual average of 22.9%. The MSCI U.S. Index scored a cumulative return of 79.7% (an annual average RoR of barely 4.1%), but with much lower volatility: 15.1%. Lastly the EAFE MSCI Index accumulated a gain of 60.8% (annual average of 3.3%) and average annual volatility of 17.5%. In this case, a change in perspective can certainly alter one's perception. MSCI also publishes a Developed Markets Index that is an amalgamation of equity markets in all developed market economies.

Exhibit 2 – MSCI EM vs. MSCI World, *Jan. 2001 to Sep 2015*

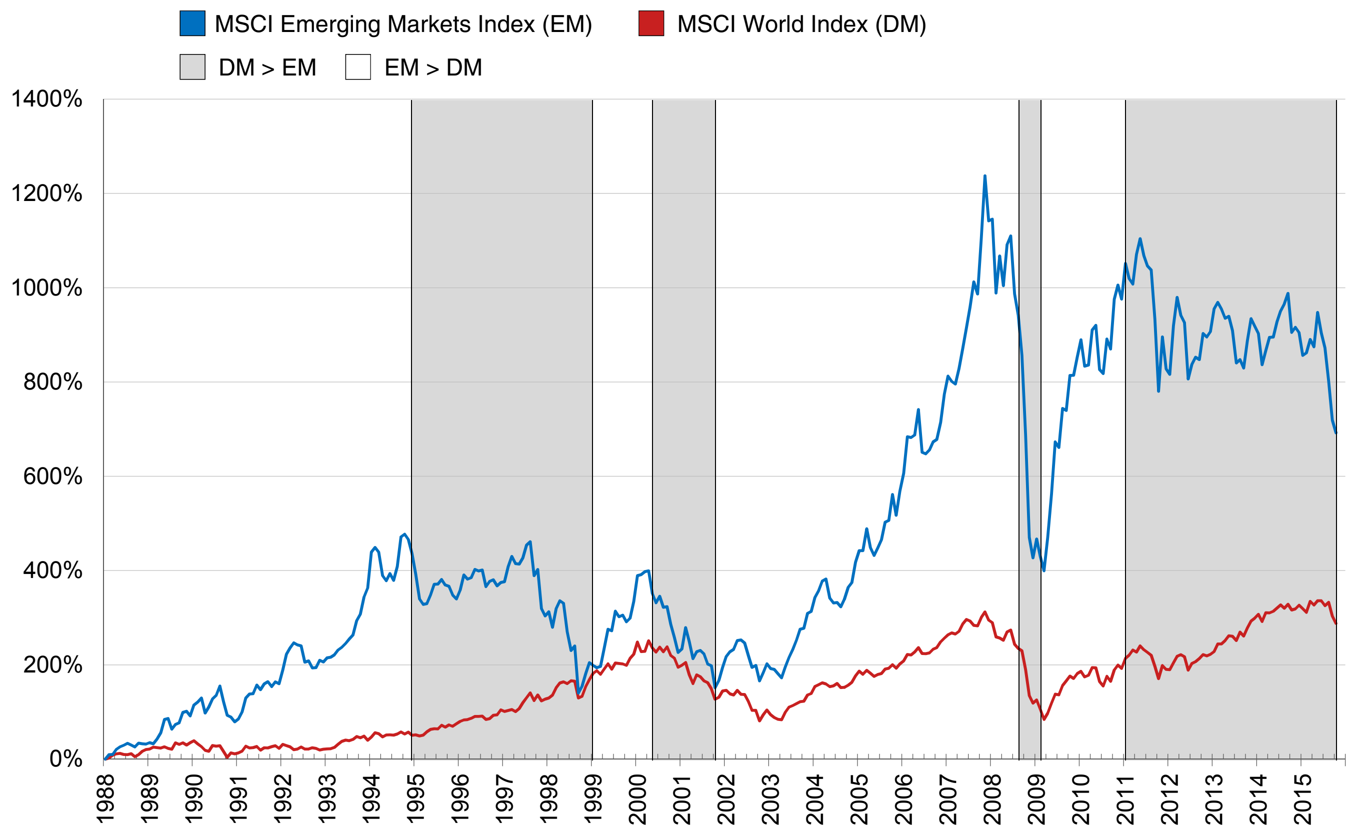


Emerging Markets (EM) versus Developed Markets (DM)

Unfortunately, the MSCI Emerging Markets (TR) Index began being published only on 12/31/2000, but the MSCI Emerging Markets (Price Only) Index is available back to December 31, 1987. Using this series, on a monthly average basis, and its equivalent for Developed Markets, we can calculate the monthly price returns on the MSCI EM Index that were greater than the monthly price returns on the DM Index and vice versa. In all, 179 out of 333 the months had EM>DM, or 54% of the monthly observations. Of course, this result is not surprising, since the average return and volatility of the EM Index is greater than the return and volatility of the DM Index. To offset this, our analysis divided the entire segment into 8 periods of various length when, firstly, the cumulative EM return was greater than the DM return, and, secondly, the cumulative DM return was greater than the cumulative EM return for a minimum of six consecutive months.

Exhibit 3 shows that the initial period had the EM return greater than the DM return, lasting for 79 months ending in July 1990. This was followed by a 49-month span when the cumulative return for the DM Index was greater than the cumulative return of the EM index. Exhibit 3 shows the entire 333-month period as well as the eight sub-periods that alternate between EM>DM (Unshaded) and then DM>EM (Shaded).

Exhibit 3 – MSCI EM vs. MSCI World, *Jan. 1988 to Sep 2015*



One striking feature of Exhibit 3 is that the current 56-month period is now the longest running span when DM>EM since the EM Index (price only) was initiated by MSCI. Does this mean that EM equities are now going to outperform DM equities? Not necessarily. It does suggest, however, that from a relative return perspective, EM equities are undervalued relative to DM equities, and that asset allocators should probably be increasing the proportion of their portfolios to EM equities rather than DM equities.

Why Invest in Emerging Markets?

The case for investing in Emerging Markets remains compelling. Listed below are eight points that underscore why investing in EM is currently an attractive proposition:

- The population in non-DM countries currently constitutes 85% of the world population.
- Nevertheless, EM countries currently only account for only 40% of global GDP.
- EM countries are projected to grow more than twice as fast as DM countries in 2016, and longer-term projections suggest that this gap will remain for some time.

- EM countries (and Frontier Market countries) have a much lower average age than DM countries, and their population's growth rate is, on average, well above that in DM countries.
- EM countries are urbanizing at a faster rate than DM countries.
- EM countries, as a group, have expanding middle classes, and these individuals are becoming richer and spending more despite being, on average, high savers with a goal of improving their living standards.
- With some exceptions, the debt burdens of EM countries are lower than the debt burdens of DM countries.
- Company valuations measures are more attractive for EM equities than for DM equities. Most valuation measures (P/E, P/B, P/cash flow, dividend yield, etc.) currently favor EM equities.

We began with a reference to the media's current focus on various trends and situations that are, and will likely remain, issues for investors in emerging market equity. However, the intermediate- to longer-run case for EM is a strong one, and most investors in developed markets currently are underweight EM equities, generally by a sizable amount. Is now the time to begin increasing one's allocation to EM? Remember Warren Buffett's quotation about when to invest:

"Be fearful when others are greedy and greedy when others are fearful"

We at WaveFront capital believe that now is the time for asset allocators and other investors of all types to either initiate or increase their exposures to emerging markets in their portfolios.

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