



# MILLEN CAPITAL

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## Emerging Market Equities

### Summary

It is easy to be convinced that the world's future lies in the East and other emerging economies and that investing in fast growing emerging economies is where future strong returns will come from. It is easy to forget that real risks exist, such as asset expropriation, capital controls and the lack of a developed rule of law, among many others. Reality may surprise some. This note takes a balanced view of the returns and associated risks of investing in emerging market equities.

### Client Communication 1

February 2014

‘Thirty years ago, emerging markets made up just 1% of world equity market capitalization and 18% of GDP. Today, they comprise 13% of the free float investable universe of world equities and 33% of world GDP.’

*Dimson, Marsh and Staunton, 2014.*

## Does the future really lie in the emerging markets?

The western world is in danger of getting an inferiority complex when it comes to the emerging market economies of the world. Nearly every night on the news there is a story about China’s growth (slowing to only 7%!), the latest skyscraper in Shanghai or Dubai, or the obsessive focus on education that puts emerging nations at the top of the educational charts, as we slide into the abyss. Last person in the UK, turn the lights off please! It is easy to deal in platitudes and base this positive story around population size, large land areas and abundant human and natural resources, but that is to miss the deeper and more complex reality.

This short article tries to place emerging market equity investment in perspective and to explain why high economic growth rates are not the main driver of the incremental returns that investors expect. Many emerging countries are to be saluted for their endeavour and the improvement in the structure of their economies, but all is not as rosy as some commentators make out. Many risks continue to face investors allocating capital to emerging market companies, for which they can expect to be rewarded, over time.

## What defines an economy as emerging?

Emerging economies are loosely defined as those where per capita GDP is less than US\$25,000 per annum. These include South Korea, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand and Turkey. South Korea sits on the cusp between developed and emerging markets and some market indices now consider it to be a developed market e.g. FTSE Indices. Greece has recently slipped from developed to emerging status with per capita GDP falling to \$21,000.

Due to the complex web of cross-border earnings between developed and emerging economies, it is sometimes hard to tell at a company level whether it should be classified as being a developed or emerging market investment. For example, Standard Chartered Bank, which is listed on the UK stock exchange, is, to all intents and purposes, an emerging market bank operating in the Middle East, Asia, and the Far East. Its sponsorship of Liverpool FC is aimed directly at Asian consumer markets, not at football fans in the UK. Further examples and statistics support this:

- Remarkably, around 70% of FTSE 100 companies’ earnings come from overseas: 36% from the US,<sup>1</sup> 20% from emerging markets, and the rest from other developed markets, predominantly in Europe.
- Examples of listed multi-national companies with high earnings exposure to emerging markets include: HSBC (48%), Anglo American (25%), Unilever (43%), Rolls Royce (48%), BAT (33%), and SAB Miller (38%).<sup>2</sup>
- The same situation applies in reverse. Samsung Electronics, a Korean company, is one of the largest stocks in the MSCI Emerging Markets Index and generates somewhere in the region of 40% of its revenues from Europe and the Americas.<sup>3</sup>

What constitutes ‘developed’ and what constitutes ‘emerging’ is therefore a grey area, although a quantum distinction between allocating assets to these separate pots still makes sense.

1 BNP Paribas. (2011). Quoted in The Economist (10/09/11) p 78. The Economist

2 Financial Times (FTfm). (2011). The Secrets of Investing in Emerging Markets. 5 Sept

3 Staverman, B. (2011). The Many Ways into Emerging Markets. Bloomberg

### Emerging market GDP and GDP growth

For those with longer memories, the emerging market success story is punctuated by periods of economic strife leading to currency and debt crises, such as the Mexican default (1982), the subsequent Peso crisis (1994), the Asian debt crisis (1997), the Russian default (1998), and Argentina's default (2002 and subsequent debt restructurings in 2005 and 2010). During the 2000s, having put these crises behind them, the emerging economies grew on the back of debt-fuelled consumer demand in developed economies - as later became evident - and the wave of outsourcing and relocation of entire industries from developed economies to lower wage emerging economies. Abundant natural resources supported and sustained this success.

Today their economic output is around 35% of the world's total GDP. It is sobering to think that in 1980 the GDP of China was 1.5% of global GDP, yet it is estimated that its economy will be bigger than that of the US by 2020, according to Goldman Sachs. The latest forecasts by the IMF suggest that developed economies are expected to see after-inflation growth of around 2.2% in 2014 (US 2.8%, UK 2.4%) and emerging economies growth of around 5.1% (China 7.5%, India 5.4%, Brazil 2.3%, Russia 2.0%), somewhat lower than the heady days of the mid-2000s. Things may not be so easy going forward as labour rates soar, unfavorable population demographics (particularly in China) begin to kick in, and rapidly rising debt levels potentially threaten financial stability.

### Emerging market equity capitalisation

Despite a 35% share of global GDP, emerging equity market capitalisation<sup>4</sup> stands at around 30% of the total non-float adjusted basis<sup>5</sup>. 'Non-float adjusted' refers to the total value of the companies listed, before taking into account shares held by governments and founding families that are not available to third party investors. Around 35% of companies in the MSCI EM Index are owned or controlled by governments and about 70% of earnings come from these companies<sup>6</sup>. The 'float', therefore, is the proportion of freely traded stock available that third party investors can own. On a float-adjusted basis emerging stock markets represented around 13% of global market capitalisation at the start of 2014, although this varies month on month. It is sobering to note that it was only 1% in 1987. Free-float levels in emerging markets stands at around 55% of market capitalisation, compared to around 95% in the US, for example<sup>7</sup>.

As their capital markets develop, market capitalisation will rise as more companies list and the proportion of shares available to investors in each company rises. The Economist recently provided data revealing that the entire free-float value of a many individual emerging stock markets is equivalent to a single developed market large cap company; the float-adjusted value of Russian equities equates to the value of Procter & Gamble; Brazil to Google; and South Africa to General Electric.

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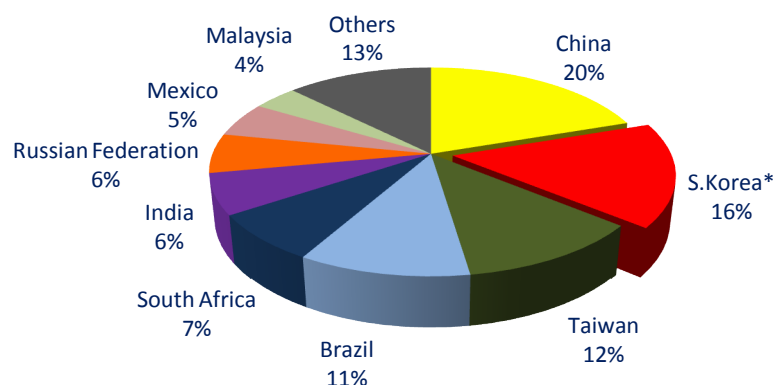
<sup>4</sup> 'Market capitalisation' is the value of all the companies listed on emerging market stock markets

<sup>5</sup> Ernst & Young (2013), Moving toward the mainstream. Found at [www.ey.com](http://www.ey.com)

<sup>6</sup> Quoted by GMO in: Boyde, E. (2012) Rise in EM passive funds raises issues about risk. FTfm P.10.

<sup>7</sup> Bekaert, Geert and Harvey, Campbell R., Emerging Equity Markets in a Globalizing World (February 10, 2014). Available at SSRN: <http://ssrn.com>

Figure 1: Emerging equity market



Data source: MSCI January 2014. All rights reserved - \* excluded in FTSE EM indices.

## Where do returns come from?

Emerging markets are expected to earn the equity risk premium derived from dividend payments and the real growth in earnings available from companies, as all equities are. Perhaps surprisingly, emerging markets dividend pay-out ratios currently stand at around 35% of earnings and dividend yields stand at around 2.5%, a level comparable to that of developed markets<sup>8</sup>.

While it is often assumed that higher expected returns are linked directly to higher rates of growth, the research evidence does not support this assumption<sup>9</sup>. In fact, a recently published paper<sup>10</sup> suggests that economies with lower growth rates and weak currencies deliver a premium over those with the opposite characteristics, which at first glance appears somewhat counter-intuitive. A number of reasons for this may exist. From an efficient markets perspective – where information is already captured in current share prices – high growth rates have already been accounted for. The authors suggest that it is a form of the value premium, where the risks of ownership are higher and thus expected returns are higher. A behavioural explanation for the value premium is that investors tend to bid up the prices of stocks with good stories (growth stocks) and overpay for them (Facebook and Twitter IPOs are possible examples).

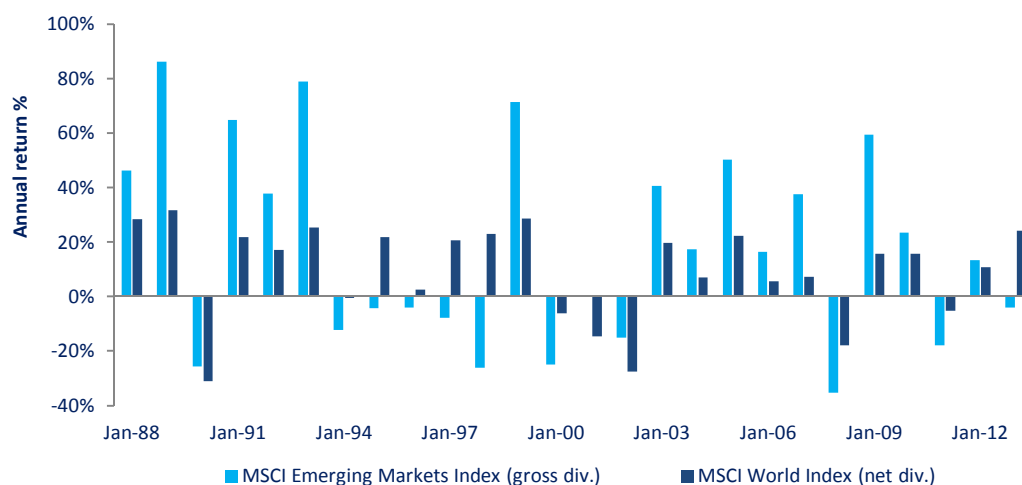
What appears evident is that emerging markets exhibit higher volatility compared to developed markets, as the figure below demonstrates. The return outcome is harder to evaluate given the short-term data series available from 1988. Over this period emerging market equities have performed well, delivering an annualised return of a little below 13% per annum, versus 8% from developed markets.

Dimson, Marsh and Staunton, academics who undertook the recent research referenced, compiled a long-term data history of emerging market returns and found that from 1900 to the present, developed markets delivered around 1% higher returns than emerging market equities. That is perhaps not that surprising given the closure of the Russian and Chinese stock markets after the communists took over in 1917 and 1949 respectively, along with the 98% loss on the Japanese market after the Second World War. Since 1950, however, emerging markets have delivered a premium of around 2% a year, on average, above developed markets.

<sup>8</sup> Rao, S., (2012) Emerging markets join the dividend race. [www.reuters.com](http://www.reuters.com)

<sup>9</sup> Ernst & Young (2013) Moving toward the mainstream. Found at [www.ey.com](http://www.ey.com)

<sup>10</sup> Dimson, Marsh & Staunton, Credit Suisse Global Investment Returns Yearbook, 2014. Emerging Markets Revisited p.5-15

**Figure 2: MSCI Emerging Markets Index vs. MSCI World Index 1/1988 to 12/2013**


Data source: Morningstar Encorr, 2014. All rights reserved.

### Emerging markets are a cost of capital play

The risks of investing in emerging markets have again been evident in the news during 2013 and the start of 2014: there is an ongoing political crisis and civil unrest in Egypt; Turkey has seen large street protests against corruption which has embroiled its Prime Minister; ditto Brazil, where violent protest has become more common. China has seen its own problems as the communist party tries to curb the cronyism and corruption of the political and commercial elite, such as in the prosecution of Bo Xilai. It has also been flexing its growing military muscle imposing security zones around disputed islands, raising tensions with Japan and the West. Worries are also rising about badly allocated capital and a growing level of potentially bad debt. South and North Korea have been on a heightened state of alert on account of the latter's sabre rattling and nuclear threats. The Sochi Winter Olympics were not without allegations of cronyism and corruption; and the detention of Greenpeace activists on piracy charges illustrated, starkly, the differences between different legal systems.

Broader risks include: political instability, currency risk, a lack of open and free markets, higher costs to invest, insufficient legal protection for owners, limited liquidity, poor corporate governance, and misaligned interests between shareholders and management. It is fair to say that the cost of capital of similar investment projects in developed markets and emerging markets differ as the risks in the latter are perceived to be materially higher. With higher risk comes a higher expected return. As these markets develop they will become more integrated with developed markets and costs of capital differences will narrow, although this may be some years, or even decades, away.

### Emerging markets as part of a diversified portfolio

A few years back, emerging market equities were seen as providing the opportunity for both higher returns and strong diversification benefits. This was noted by many institutional and private investors and considerable funds have flowed into these markets. However, because investors tend to make allocations at the emerging market/developed market level, not at a specific country level, this has accounted for rising correlation between emerging markets and also between emerging markets as a whole and developed markets over the past few years. In an ideal world, different assets would have return series that are unrelated, as returns in one series should be smoothed by the other.

Despite this rise in correlation, there is still merit from owning emerging market stocks from a diversification perspective; that of diversification across time. A good example of this in practice was following the Credit Crisis when all risky assets fell; emerging market equities lead the way out of the crash, helping to restore, in part, the value of investors' portfolios. Between 2/2009 - being the bottom of the equity market crash - and the end of 2012, emerging markets more than doubled in value, gaining back their losses.

## Conclusion

Investors may be forgiven for perhaps questioning whether these risks are worth it. For most investors holding equities as part of a well-diversified, balanced portfolio, an allocation made across a broad range of emerging markets and individual companies – such as via an emerging markets equity fund – provides scope to capture these valuable incremental returns above developed market equity returns. Allocations to emerging markets should be moderate – perhaps between 10% and 20% of the equity-oriented risk assets that an investor owns – on account of the very real risks that this entails. An incremental expected return in the region of 1% to 2% is not unreasonable, and very welcome if captured over time.

## Other notes and risk warnings

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