Pzena Investment Management

First Quarter 2015 Commentary

Return on equity has been the main driver of returns in emerging markets. With ROE's declining, today's environment favors stock selection where pessimism is already reflected in valuations.

Introduction

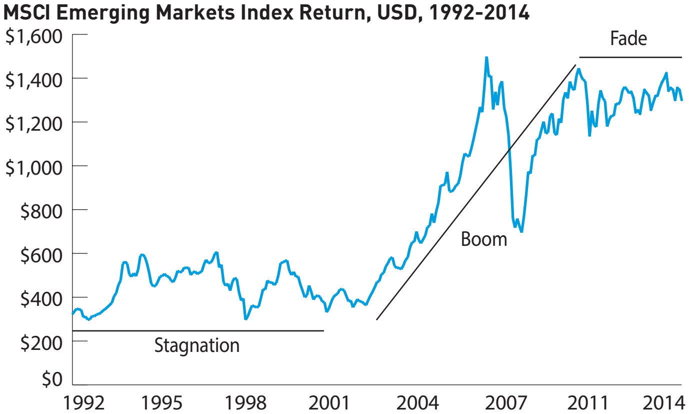
Investor interest in emerging markets remains extremely high today, even following a period of weak performance now in its fourth year. Without doubt, this interest owes much to the fact that the preceding period constituted a near-decade-long boom that still looms large in investors' minds. In this Commentary we take a look at a longer period of history and to try to put the current opportunity in perspective. Our examination of historical total returns will reveal the central importance of relative currency moves, returns on equity, and investors' estimates of growth and risk as drivers of variability in returns. From the levels these drivers sit at today, a resumption of the returns achieved during the 2000's seems unlikely. On the other hand, valuations are constructive enough to make attractive prospective returns possible, and the crucial requirement for achieving those returns will be to construct a portfolio priced for modest, rather than peak, profitability.

Decomposition of Emerging Markets Returns

From January 1, 1992 through December 31, 2014, the annualized total return of the MSCI Emerging Markets Index was 6.3%, a not particularly impressive figure. This performance was far from evenly distributed, however. A look at Figure 1 (index total price in USD, with dividends reinvested) suggests a rough division into three historical periods:

1. "Long stagnation" – this comprises the period from January 1, 1992 through March 31, 2003, the tail end of the Asian-led currency and commodity crisis. Over this period of more than 11 years, the annualized return on the index was a mere 1.1%, a level in sharp contrast to performance achieved in developed market indices during the same period.
2. "Boom" – Over the 8+ year period from March 31, 2003 through April 30, 2011, the annualized return was a whopping +18.6%, achieved via a sharp rise to late 2007, a GFC-induced crash through 2008 and early 2009, and finally a massive rally from March 2009 to April 2011 (outdistancing other major indices' rallies in the recovery). This period was born out of the Asian recovery and continued into the "China boom" era.
3. "Fade" – from April 2011 through December 2014, the index delivered an annualized return of -2.8%, i.e., a loss.

Figure 1: Emerging Markets Returns Over Three Distinct Periods
MSCI Emerging Markets Index Return, USD, 1992-2014



Source: MSCI, Pzena Analysis

Table 1 looks in detail at the composition of returns during the three periods. The (dollar-based) returns are decomposed into dollar-growth of book value, change in the P/B ratio, and dividend yield. The following can be clearly observed from the data:

1. Not surprisingly, dividend yield has been a relatively steady component, contributing 2.4% on average with a relatively narrow range of variation.
2. Changes in valuation – as captured by the P/B ratio – have contributed precisely zero over the entire period. However, valuation changes have contributed significantly to variability in returns across time. In particular, valuations expanded during the boom period and have collapsed in the recent fade.
3. Book value growth has been the largest individual contributor to returns over the period at 4.8% and has also varied significantly across the three periods, with small contributions in the first and third periods and outsized growth in the boom.

There is one further point to make here. Since book value growth is in dollar terms, the growth rates pick up both nominal book value growth in local currency and movements in the dollar relative to the local currency (Table 2 on page 3). Currency changes have worked against MSCI dollar returns (i.e., the dollar strengthened relative to the local

Table 1: MSCI EM Index: Composition Of Historical Total Return, 1992 - 2014*

	Dividend	Book Value Growth in US$	Valuation	Total Return*
Stagnation	2.1%	-0.3%	-1.2%	1.1%
Boom	2.5%	14.1%	5.3%	18.6%
Fade	2.8%	1.5%	-7.5%	-2.8%
All years	**2.4%**	**4.8%**	**0.0%**	**6.3%**

Source: MSCI, Pzena Analysis
*Nominal price return in US $ plus dividends.

currency over the entire sample period). Only during the boom period was there significant dollar weakening, a tailwind to the return figures picked up in book value growth. These differences partly reflect dollar fundamentals and partly reflect higher/lower inflation periods in EM history.

Table 2: Currency Can Play A Signifiant Role
MSCI EM Index 1992 - 2014

	Local Currency Book Value Growth	Change in Currency	U.S. $ Book Value Growth
Stagnation	16.7%	-14.6%	-0.3%
Boom	10.9%	2.9%	14.1%
Fade	8.0%	-6.0%	1.5%
All years	**13.2%**	**-7.4%**	**4.8%**

Source: MSCI, Pzena Analysis

With this point in mind, we can characterize the three return periods as follows:

- Stagnation – no book value growth in U.S. $ terms, modest total return completely accounted for by dividends.
- Boom – huge book value growth was accompanied by expansion of P/B multiple and relative currency strength.
- Fade – large decline in P/B was offset partly by dividends and book value growth modestly above currency depreciation.

A Closer Look at Key Drivers

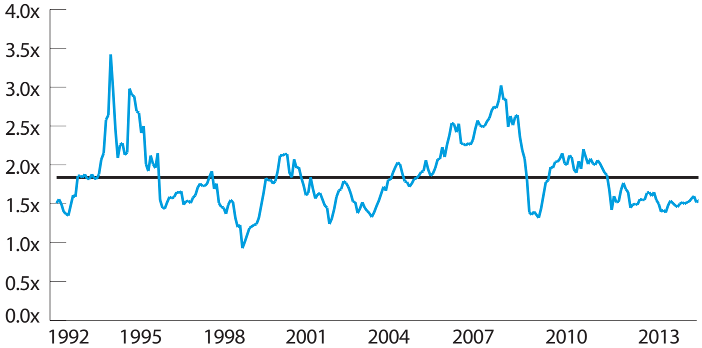
It is clear from the preceding discussion that the principal drivers of the variability in total return across the three periods have been dollar-based book value growth and changes in the P/B multiple. Interestingly, the latter has contributed exactly zero over the historical period, though it has been a major driver of differences across periods. As can be seen in Figure 2, multiple-expansion reinforced positive fundamentals during the boom period and then completely reversed its gains during the recent fade period. Today, the P/B ratio sits slightly below its long-term average.

With the valuation factor neutral over the history, book value growth has been the principal determinant of total returns. As noted above, during the Stagnation and Fade eras, book value growth was largely offset by currency depreciation, while during Boom, growth was significant. Underlying this variation has been the varying profile of corporate profitability (return on equity, or ROE). This is not surprising, since ROE is one of the principal drivers of book value growth. Figure 3 illustrates what has gone on, tracing historical ROE along with lines for the average and ±1 standard deviation. The relationship to the three return time periods is hard to miss: mediocre and mostly declining returns for the long stagnation; a rapid ascent during the boom, culminating in a 5-year period more than one standard deviation above the long-term average; and a fade back toward the average recently.

Further insight on profitability can be derived from Figure 4 (on page 20), which considers ROE's for the energy and materials sectors separately from the rest of the index. Three time periods are shown: stagnation, boom, and the most recent observation (December 2014). The final set of bars shows ROE ex-energy and materials; here, the variability across the three time periods for is far more muted than for those two sectors, which are depicted in the middle set of bars. Said another way, a meaningful part of the boom-era rise in ROE's in emerging markets was led by improvement in just these two sectors.

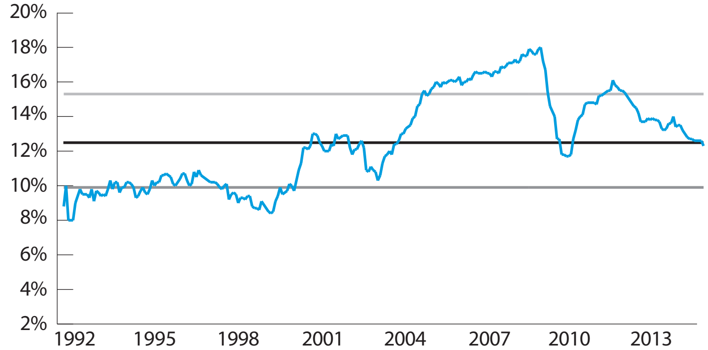
The overall prognosis for ROE, based on this history, is somewhat inconclusive. With return levels near "normal" today, one would expect the corresponding future performance contribution from dollar-based book value growth to be near its long-term average. However, for sectors which experienced the largest uplifts in profitability during the boom, prospective book value growth and returns are likely to be subdued, given their unsustainable investment-driven nature.

Figure 2: MSCI Emerging Markets Index Historical Price-to-Book Ratio, 1992 - 2014



Source: MSCI, Pzena Analysis

Figure 3: MSCI Emerging Markets Index Return on Equity, 1992 - 2014

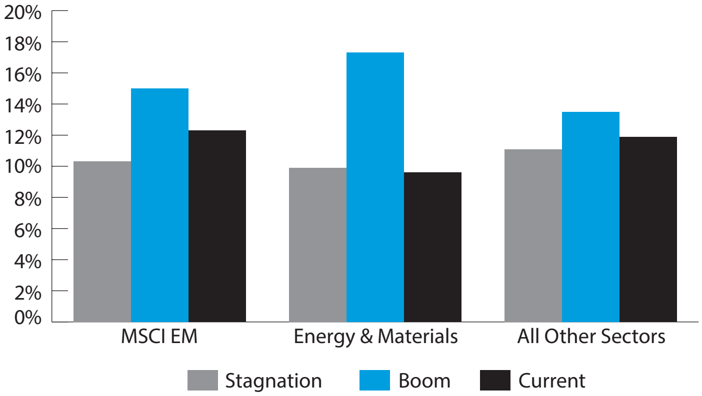


Source: Sanford C. Bernstein & Co., Pzena Analysis

Conclusion

Putting all the findings together, we emerge with what is perhaps a deflating conclusion: the environment today for emerging markets investing is unlikely to present investors with returns either markedly above or markedly below long-term averages. On the positive side, price/book valuations today sit below long-term history. More cautiously, though, the index's collective return on equity straddles its long-term mean but with a current downward trajectory that is likely to persist in the near-term, particularly for sectors heavily exposed to the prior boom in capital spending and commodity strength. As ROE has historically been the most important driver of the index's returns, it is difficult to be wildly bullish about a simple buy-the-index strategy today.

Figure 4: Emerging Markets Return On Equity by Sector, 1992-2014



Source: Sanford C. Bernstein & Co., Pzena Analysis

Prospects for stock selection in this environment appear more interesting. The uncertain macroeconomic environment has clearly created a strong investor preference for yield and defense – with sectors like consumer staples and healthcare dramatically out-performing more cyclical parts of the economy. Within the latter group, valuations reflect the very difficult environment inherent in a post-boom period, in particular the challenges for profitability following a period of high growth and investment. The key question for stock selection will be to find companies pricing in a high degree of pessimism in spite of prospects for adequate profitability and mean reversion, perhaps through some measure of self-help. Such investments – the staple of any value investing portfolio – stand the best chance of beating the tape over the next five years. ■