

Research shows that value investing works in the emerging markets, and can provide access to a potentially higher growth universe at valuations similar to developed markets.

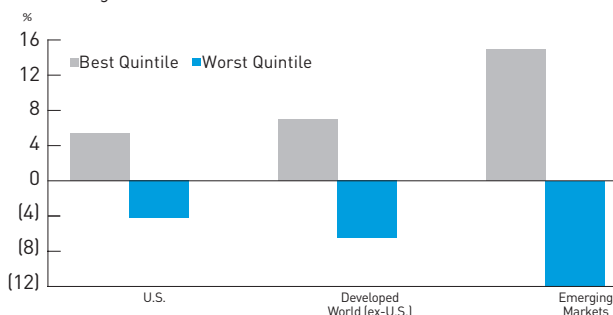
The Emerging Markets Value Advantage

The investment community has shown increasing interest in emerging markets on the premise that they are the world's future growth opportunity. From a value investor's perspective, we need to know that what we buy will outperform the average. The value effect—that of cheap stocks outperforming those of more expensive valuations—is well understood both in the US stock market and in developed international markets. With the launch of our Emerging Markets portfolio, we examined the value effect in developing countries.

Academic researchers have shown that low price-to-book and low price-to-earnings stocks have beaten high price-to-book and high price-to-earnings stocks in emerging markets over long time periods. In their 1998 study¹, Fama and French found a value premium in emerging markets, as did Barry, Goldreyer, Lockwood and Rodriguez in their 2001 work². Our investment performance for 2008 and 2009, although covering a relatively short period, has given us additional evidence of the value advantage, having outpaced the MSCI Emerging Markets index by 710 basis points per annum. Similar to the findings in US and developed markets, the best-supported academic explanation for value's outperformance is investors' incorrect estimation of earnings growth—in short, overestimating the future for "glamour" stocks and underestimating value stocks' outlook.

More recent work reveals that not only does the value

Figure 1: Developed and Emerging Markets
Relative USD Returns to the Best and Worst Quintiles of Valuation
Measured Over One-Year Holding Periods
1987 Through Mid-December 2009



Source: Empirical Research Partners Analysis
¹Returns are USD-hedged

advantage exist in emerging markets, the advantage is actually greater there than in the developed world. In fact, excess returns based on low valuation in emerging markets are more than double those in developed markets over the last 22 years, as can be seen in Figure 1, below. In addition to the academic studies on returns, work has also been done with respect to risk in emerging market value investing. Among other studies, a study by Tinbergen Institute in the Netherlands (Jaap van der Hart, et.al.³) concluded there is "no evidence of higher market risk or lower liquidity for value strategies."

We set out to investigate why the value advantage has been greater in emerging markets. Back testing has proven that valuation metrics lead to greater outperformance when valuation spreads are wide, both within developed and developing markets. We postulated that broader spreads in emerging markets may be the source of the more substantial value effect in emerging markets.

Spreads Converge But Still Attractive

To explore our hypothesis, we accessed historical price-to-book data for both an emerging markets regional index and a developed world index. Each index's price-to-book metrics were divided into five quintiles, from cheapest to most expensive. For each point in time, we compared the price-to-book of the cheapest quintile to that of the midpoint of the stock universe in order to examine just how cheap the cheapest stocks were versus the market average.

As shown in Figure 2, emerging markets historically displayed a wider spread in valuation between the cheapest stocks and the midpoint of the universe compared to developed markets. This spread, however, has been narrowing over time, to the point where today emerging market valuation spreads have converged with those of the developed markets. Based on

Figure 2: Spreads Have Converged Over Time
Cheapest Quintile as a % of Regional Index Price-to-Book



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

these observations, one might conclude that the wider spreads once enjoyed by the emerging markets may well have led to the greater value effects illustrated in Figure 1. Although this relative spread advantage between emerging and developed markets has been eliminated, the value investor is still able to access a pool of investment opportunities at the same relative valuations as those enjoyed in the developed markets. Today that represents a 55% discount to broad market valuations, which, as history shows, still represents good value opportunity.

The Opportunity Today

What about emerging markets as a whole? Much speculation exists that, given the MSCI Emerging Markets 79% rise in 2009, the markets may now be overvalued. We examined the absolute price-to-book value of the cheapest quintile of the emerging markets regional index, as well as valuation of the emerging markets universe. At approximately 1x price-to-book, the cheapest quintile's absolute valuation is similar to that of the developed markets today. We then valued the emerging markets universe using a dividend discount model similar to those we use domestically and in developed international markets. As shown in Figure 3, the MSCI Emerging Markets index, although off its lows, continues to be in the normal range of valuation vis-à-vis bonds, which is still a good environment for the value investor.

Conclusion

In summary, we found evidence that the value advantage in the emerging markets is still intact based on today's valuation spreads, which show a 55% discount of the cheapest quintile to the average for the emerging markets regional index. Our expectations for value outperformance in emerging markets going forward should be more in line with that experienced in

developed markets, as opposed to twice the advantage realized historically, due to the spread convergence we discussed earlier. An added advantage, however, is the ability to access a universe of potentially higher growth companies in the emerging markets for valuations similar to those of developed markets. ■

¹Fama, Eugene F., and French, Kenneth R., Value versus Growth: The International Evidence, *Journal of Finance*, December 1998

²Barry, C. B., Goldreyer, E., Lockwood, L. and Rodriguez, M., Robustness of Size and Value Effects in Emerging Equity Markets, 1985 – 2000, Texas Christian University, May 2001 (subsequently published in *Emerging Markets Review* 3 (2002), 1-30)

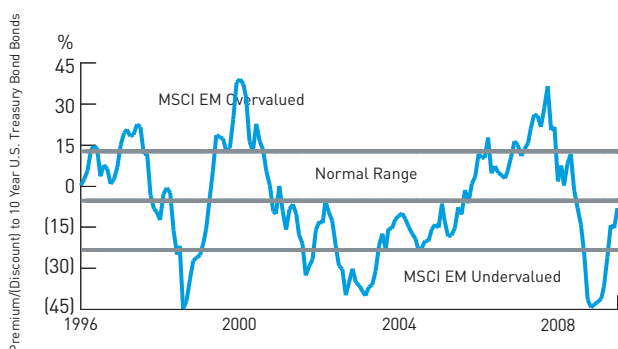
³van der Hart, Jaap, de Zwart, Gerben, van Dijk, Dick, The Success of Stock Selection Strategies in Emerging Markets: Is it Risk or Behavioral Bias?, *Emerging Markets Review* 6 (2005), 238-262.

DISCLOSURES

Past performance is no guarantee of future results. The historical returns of the specific portfolio securities mentioned in this commentary are not necessarily indicative of their future performance or the performance of any of our current or future investment strategies. The investment return and principal value of an investment will fluctuate over time.

The specific portfolio securities discussed in this commentary were selected for inclusion based on their ability to help you understand our investment process. They do not represent all of the securities purchased, sold or recommended for our client accounts during any particular period, and it should not be assumed that investments in such securities were, or will be, profitable.

Figure 3: MSCI EM Valuation Relative to Bond Market: Assuming Normal Equity Risk Premium



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