PZENA Investment Management

WHY VALUE INVESTING WORKS IN EMERGING MARKETS

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AGAINST A DECADE-LONG ANTI-VALUE BIAS, GLOBAL EQUITIES HAVE FAVORED HIGH-FLYING GROWTH STOCKS. BUT THE SELLOFF AT THE END OF 2018, WHICH HAPPENED EARLIER AND WAS MORE PRONOUNCED IN EMERGING MARKETS, REFLECTED INVESTORS' INCREASING RISK AVERSION AND A COOLING PREFERENCE TOWARD GROWTH SHARES. HIGHER BETA EMERGING MARKETS ENDURE MORE FREQUENT BOUTS OF VOLATILITY BUT OFFER AMPLIFIED RETURN POTENTIAL FOR VALUE INVESTORS:

1) It's psychology:

Investors tend to exaggerate the significance of near-term problems and discount the potential for business, industry, or management improvements over time. The emotional response is more pronounced in emerging markets, adding to valuation dispersions that offer opportunities when deeper discounts are ascribed to out-of-favor companies.

2) It's about earnings power:

Despite a lack of empirical evidence, investors often conflate GDP growth with higher equity returns. When growth-seeking investors don't achieve the quick gains they're looking for, their reaction to disappointment can be amplified. Healthy, sustainable businesses should be based on competitive positioning, industry dynamics, and managements' ability to generate earnings.

3) The style is underexploited:

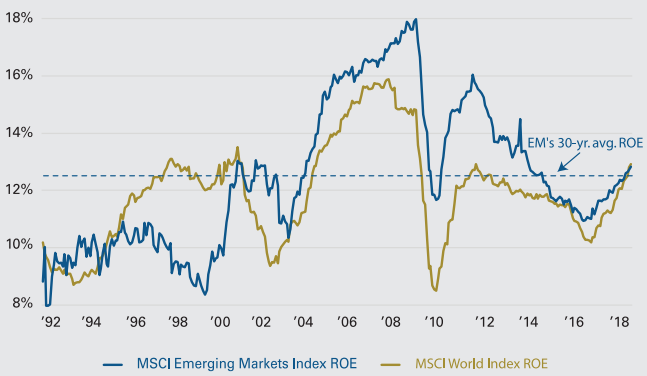
Most investment managers tend to favor macroeconomic or quantitative approaches to emerging markets, leading to crowded trades and wider market swings. There are few managers with an unwavering commitment to value investing.

VALUATIONS ARE LOWER, BUT PROFITABILITY IS ON PAR WITH DEVELOPED MARKETS

The events last year demonstrate why emerging markets are a fantastic hunting ground for value investors. In 2018, these markets fell harder and faster (-14.2%) than developed (-8.7%). A notable portion of the losses came from investors' shifting preference from growth stocks toward capital preservation. After the run-up in global technology stocks, the MSCI Emerging Markets Index became highly concentrated. (The top-five positions composed nearly 20% of the index.) Based on MSCI growth and value index results, an allocation to growth would have led to losses of 18.0%, while value shares would have fallen by a less painful 10.4%. According to MSCI, value ended the year trading at a remarkable 60% discount to growth, while the broad Emerging Markets Index already traded at a 22% discount to the World Index. When valuations reach such extremes, it's often a sign that investors expect the worst, and bad news is already priced into the market.

Based on return on equity (ROE), companies in emerging markets are more profitable than they were before the recent correction and remain on par with their developed market counterparts. After enduring broad swings in the past, ROEs have stabilized, reflecting better growth prospects, improved fundamentals, and greater competitive positioning than in the past.

Figure 1: Return on Equity (ROE) Is Slightly Higher in Emerging than in Developed Markets



Source: MSCI, Sanford C. Bernstein & Co., Pzena analysis

Past performance is not indicative of future returns

PENSION FUNDS MAY CONSIDER VALUE INVESTING IN EMERGING MARKETS AS A PRUDENT APPROACH TO THESE HIGHER BETA MARKETS

VALUE STOCKS HAVE BEATEN THE BROAD MARKETS OVER TIME:

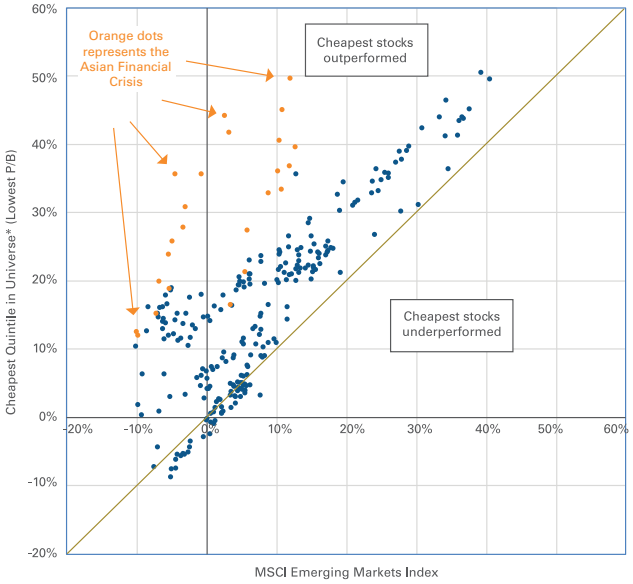
Picking from the cheapest stocks within an investment universe, we rely on detailed research to distinguish companies facing near-term distress that's reparable from those that may subject investors to the permanent impairment of capital. While poor short-term earnings visibility can continue to weigh on these companies' stock prices, the longer the holding period, the greater the prospect of earnings improvement and subsequent returns for a stock.

Over five-year rolling periods, classic value stocks (the cheapest 20% of shares in the universe) beat the MSCI Emerging Markets Index 85% of the time, resulting in absolute, average annual outperformance of 9.8%. Because pension funds are concerned about downside protection, we compared results going back to 1997 to see what happened when the emerging-market index posted negative returns over 5-year rolling periods. On an absolute basis, the cheapest stocks outperformed the broad index by an average of 14.0%, annually. But what about more extreme scenarios? In Figure 2, the orange dots represent monthly (5-year rolling) returns for the Asian Financial Crisis, sparked by the Thai baht devaluation in July 1997. During this period, the most undervalued stocks (displayed on the y-axis) beat the broad index (on the x-axis) by an absolute 28.4% on average. This illustration demonstrates what our data has shown more broadly – following extreme periods of market stress, classic value stocks tend to outperform by a wide margin.

IN DOWN MARKETS, THE CHEAPEST STOCKS' AGGREGATE, ANNUAL OUTPERFORMANCE OVER THE BROAD INDEX WAS

14%

Figure 2: Classic Value Stocks Outperform by a Wide Margin over Time



Source: MSCI, Sanford C. Bernstein & Co., Pzena analysis
Returns are measured on a 5-year rolling basis between December 1996 - December 2018. Does not represent any specific Pzena product or service. **Cheapest Quintile of Universe* is based on the price-to-book values of the approximately 1,100 of the largest companies in emerging markets on an equal-weighted basis.

Past performance is not indicative of future returns.

THE BOTTOM LINE:

The treacherous fourth quarter marked a painful end to 2018 for global equities. The selloff in growth stocks ensued after a rolling chorus of negative headlines surrounding tariffs, protectionism, and political instability unsettled investors throughout the year. Emerging markets were disproportionately hurt by these forces. Because investors are more prone to respond emotionally to events in the emerging world, value is a prudent way to invest in these dynamic markets. This measured approach to stock picking offers downside protection and more positively skewed outcomes over time.

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