



WHY VALUE INVESTING WORKS IN EMERGING MARKETS



Allison Fisch, Pzena Investment Management

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%



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.

This article appeared in Viewpoint, the official journal of the Pensions and Lifetime Savings Association, Issue 1 2019.

These presentation materials are intended for the exclusive purpose of evaluating the investment advisory services of Pzena Investment Management, LLC ("PIM"), which is located at 320 Park Avenue, 8th Floor, New York, NY 10022. Any other use is strictly prohibited.

PIM is a US-registered investment adviser with the United States Securities and Exchange Commission. PIM follows a classic value investment approach.

Past performance is no guarantee of future results, and the past performance of any account or commingled fund managed by PIM should not be considered indicative of the future performance of any account or commingled fund managed by PIM. Investment return and principal value of an investment will fluctuate over time, may go down as well as up, and you may not receive upon redemption the full amount of your original investment. The performance information provided is historical in nature. The investment strategy performance information presented represents composite performance of separately-managed accounts. The views and statements contained herein are those of Pzena Investment Management, LLC and are based on internal research.

This document does not constitute an offer to sell, or a solicitation of an offer to buy, securities or investment advisory services in any jurisdiction where such an offer or solicitation is against the law, or to anyone to whom it is unlawful to make such an offer or solicitation, or if the person making the offer or solicitation is not qualified to do so. The information contained herein is general in nature and does not constitute legal, tax, or investment advice. Prospective investors are encouraged to consult their own professional advisers as to the implications of making an investment in any securities or investment advisory services.

The MSCI information may only be used for your internal use, may not be reproduced or disseminated in any form and may not be used as a basis for or a component of any financial instruments or products or indices. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each other person involved in or related to compiling, computing or creating any MSCI information (collectively, the MSCI Parties) expressly disclaims all warranties (including, without limitation, any warranties of originality, accuracy, completeness, timeliness, non-infringement, merchantability and fitness for a particular purpose) with respect to this information. Without limiting any of the fore-going, in no event shall any MSCI party have any liability for any direct, indirect, special, incidental, punitive, consequential (including, without limitation, lost profits) or any other damages.

© Pzena Investment Management, LLC, 2019. All rights reserved.