

Thinking Strategically About a Value Allocation to Emerging Markets

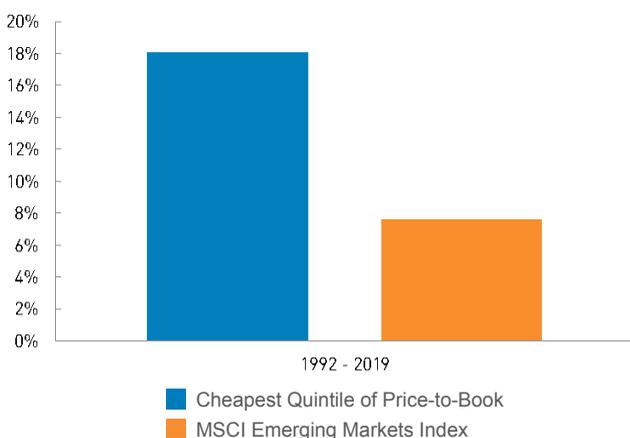
February 2020

A Value Advantage in the Emerging Markets

A hallmark of the emerging markets is growth. Some, therefore, suggest that these markets are not a natural habitat for valuation-based investing. In fact, our own research, along with that of many theoreticians, has demonstrated that using a valuation-based approach in the developing world has been a superior strategy.^[1] Research has also shown that there's no reliable correlation between GDP growth and stock performance^[2]—so the rapid economic development of the emerging markets isn't an argument for applying the growth investment style.

Figure 1 examines the return difference between low price-to-book stocks (Cheapest Quintile*) and the broad market over the period 1992 through 2019. As can be seen, we were able to confirm a significant premium for value stocks in emerging markets.

Figure 1. Returns of Cheapest Quintile and MSCI Emerging Markets Index

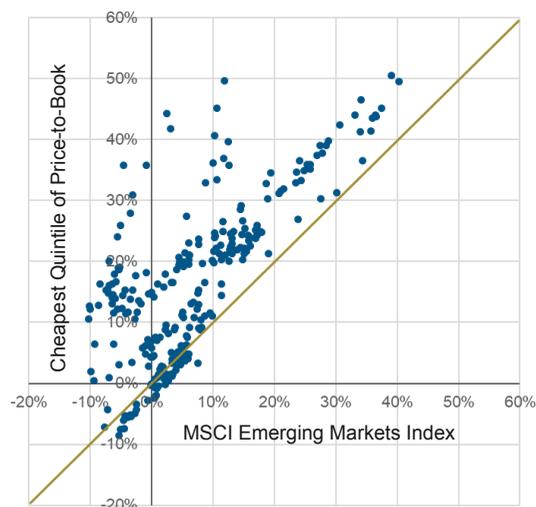


Source: FactSet, Sanford C. Bernstein & Co., Pzena analysis. Annualized returns. Past performance is not indicative of future returns. Does not represent any specific Pzena product or strategy

A Research-Driven, Long-Term Approach is Key

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, deep value stocks (the cheapest 20% of shares in the universe) beat the MSCI Emerging Markets Index 81% of the time (Figure 2—the most undervalued stocks are displayed on the y-axis, the broad index on the x-axis; dots above the line reflect value outperformance), resulting in average annual outperformance of 11.8%. Because investors are concerned about downside protection, we compared results when the emerging-market index posted negative 5-year returns. The cheapest stocks outperformed the broad index by an average of 14.7% annually. This illustration demonstrates what our data has shown more broadly—following extreme periods of market stress, deep value stocks tend to outperform by a wide margin.

Figure 2. Rolling 5-Year Returns for Cheapest Quintile and MSCI Emerging Markets Index 1997 - 2019



Source: FactSet, Sanford C. Bernstein & Co., Pzena analysis. Annualized returns. Past performance is not indicative of future returns. Does not represent any specific Pzena product or strategy

Why Value Works

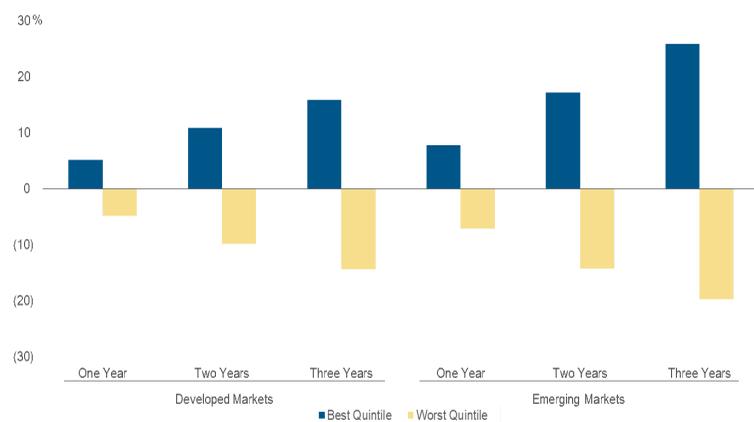
The psychological underpinnings. The history of investing is that valuation distortions are common, observable, and exploitable. A value investment style works in the emerging markets for precisely the same reasons that it works everywhere else: Human beings are emotional creatures who tend to

- overreact to near-term events,
- misjudge the likelihood of a future event, and
- have an overconfidence in their ability to predict outcomes.

Emerging markets—less well understood and mature than their developed world counterparts—are even more susceptible to the cycles of fear and euphoria (i.e., overreaction). Therefore, it should come as little

surprise that a valuation-based approach has actually worked better in the emerging markets than the developed world. Figure 3 (on the spreads in relative returns between the cheapest and the most expensive stocks worldwide) makes a clear case for value in the emerging markets. Over the 33-year period shown, the cheapest stocks globally have outperformed their respective markets by a meaningful amount, just as the most expensive stocks underperformed—and to a far greater degree in the developing world.

Figure 3. Developed and Emerging Markets Returns Cheapest and Most Expensive Quintiles Based on Price/Book 1987 - 2019



Source: Empirical Research Partners. Developed markets is a proxy for MSCI World universe; returns USD-hedged. Emerging markets is a proxy for MSCI Emerging Markets universe; USD returns. Equally-weighted data. Past performance is not indicative of future results.

Reversion to the mean. Reversion to the mean exists in two key factors that contribute to stock returns—valuation and company performance. We see reversion to the mean in valuations precisely

because cognitive biases cause investors to overweight information such as recent news and underweight salient fundamental data about long-term prospects, causing prices to temporarily swing away from their fundamental values. This leads investors to undervalue companies that are experiencing some form of distress.

As for company performance, we believe that very high levels of profitability or earnings growth usually are not sustainable, and tend to be overvalued. The odds are against the sustainability of perfection, but the price of the stock often is set by investors whose confidence that their company will beat the odds is too high.

We also believe that very poor profitability can be temporary. Over time, cycles turn, management takes actions, costs are cut, and excess industry capacity diminishes. The odds favor improvement, but the stock prices of companies in pain are often set by investors who cannot look past the near-term problems.

With fewer than 20% of emerging markets strategies identifying as value, chances are you are underexposed to this compelling opportunity set. Pzena has adhered to a classic value, research-driven approach rigorously applied since its inception more than 20 years ago.

PZENA INVESTMENT MANAGEMENT: EXPLOITING THE VALUE ADVANTAGE

Data through December 2019. Returns are calculated in US dollars. Past performance is not indicative of future returns. The information is provided for equity returns including dividends gross of withholding tax rates.

[1]See, for example; Eugene F. Fama and Kenneth R. French, “Value versus Growth: The International Evidence,” *The Journal of Finance*, Vol. 53, No. 6 (1998), pp. 1975-99; Vladislav Kargin, “Value Investing in Emerging Markets: Risks and Benefits,” *Emerging Markets Review*, Vol. 3, No. 3 (2002), pp. 233-44; Christopher B. Barry, Elizabeth Goldreyer, Larry Lockwood, and Mauricio Rodriguez, “Robustness of Size and Value Effects in Emerging Equity Markets, 1985-2000,” *Emerging Markets Review*, Vol. 3, Issue 1 (2002), pp. 1-30. Although much of this research was published some time ago, the conclusions favorable to Value strategies in the emerging markets still apply. [2]See, for example, Jay R. Ritter, “Economic Growth and Equity Returns,” *Pacific-Basin Finance Journal*, Vol. 13, Issue 5 (2005), pp. 489-503.

*The “cheapest quintile” includes the cheapest 20% of stocks based on Pzena’s estimates of their price-to-normal valuations, measured on an equally weighted basis within the universe (~1,500 largest emerging markets companies).

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