The real benefits of emerging market equities

One of the factors driving institutional investor interest in emerging market equities has been the belief that investing in the fastest growing economies represented the best opportunity for outsized equity market returns over the long run. DENNIS MOTHONEOS[01] explores the reality.

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The quote

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Dimson, Marsh, and Staunton (2002) and Ritter (2005) reported negative cross-sectional correlations for the compounded real return on equities and the compounded real growth rate of GDP for 16 countries over the 1900–2000 period.

In fact, some studies show that developed market economies with the lowest GDP growth delivered the highest equity market returns. Similarly, a number of studies, albeit smaller in number, on emerging markets indicate a weak or negative relationship between long run equity market returns and GDP growth.

These somewhat anomalous results may have arisen for a number of reasons. Firstly, many fast growing economies have comparatively undeveloped equity markets. For example, the emerging markets hold less than 20 per cent of global market capitalisation according to Standard and Poor's but generate almost half of the global GDP according to the OECD. Therefore, a significant portion of GDP growth may be derived from newer smaller unlisted companies. This dilutes GDP growth before institutional investors in listed equities benefit via higher earnings per share growth, which help to drive equity markets returns.

Secondly, investors often overreact to positive economic and corporate news by bidding up the prices of companies in fast growing economies beyond what is reasonably justified by their earnings per share growth. As a result, overvalued growth stocks in economies with strong GDP growth, which are usually emerging market economies, often under perform unrecognised high yielding value stocks with growing earnings from economies with weaker GDP growth.

In developed markets, this is borne out by empirical evidence showing relatively unrecognised higher yielding value stocks, with growing earnings, has outperformed growth stocks over the long run. Similarly for emerging markets, the historical returns of the major indices show that higher yielding value stocks with improving earnings have outperformed the broader market by over 300 basis points per annum since 2000.

The quote

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Many institutional investors recognise that to better exploit the opportunity in emerging markets, simply investing in faster growing economies may not be the most effective strategy. Rather, many are opting for managers adhering to a bottom up strategy of selectively establishing positions in undervalued higher yielding stocks with growing earnings, in anticipation of broader market recognition of their inherent worth.

Driven by a desire to attract foreign equity capital, many relatively less well known emerging market companies, have responded positively to the demands of institutional investors by making efforts to significantly improve their strategic and financial management policies and practices. Since the Asian Crisis in 1998, many emerging market companies have shifted from market share to profitability targets and relied to a greater extent on internal cash flow to fund investment activities. They are also more focused on managing core businesses for the benefit of shareholders than creating diversified conglomerates for the aggrandisement of the founders. In addition, they are increasingly maintaining lower gearing levels; for example, according to recent data from UBS, debt to equity ratios for emerging market companies have fallen from more than 60 per cent in 1994 to less than 30 per cent in 2010.

Encouragingly, more disciplined debt management has allowed emerging market companies such as Mediatek, a Taiwanese specialist semi-conductor company and AkBank, a Turkish banking and investment management company establish higher dividend paying policies, and maintain these levels, during the recent global economic slowdown.

They are also implementing stricter corporate governance standards in relation to board performance and stricter adherence to developed market regulations – reducing the potential for insiders to misappropriate funds for personal and family gain. Again, the rising number of emerging market companies increasing their dividends is a reflection of their desire to improve corporate governance.

Investors are increasingly realising that the real benefits to be gained from emerging markets are from appointing managers who can selectively identifying undervalued usually high yielding companies with growing earnings. Compared to developed markets, the large, differentiated and rapidly changing opportunity set in emerging markets presents abundant prospects for adding value. In response, emerging market companies eager for foreign equity capital are responding with more sensible management strategies, with one of the more efficient ways to achieve this having been higher dividends. **FS**