

The robust economic growth associated with emerging markets has attracted the attention of many institutional and private clients. This heightened interest in emerging markets may be attributed to the belief that investing in the most rapidly growing economies presents the best opportunity. However, the *value* investing approach to emerging markets maintains that outperformance in this asset class can be driven by the volatility *and* mispricing of the stocks themselves. Volatility may provide an opportunity to identify stocks selling at substantial discounts to their fair or “intrinsic” values, thus the higher volatility of emerging market stocks may generate opportunities more frequently than in developed markets.

In this article we investigate the merits of the above approaches, starting with a review of research by three London Business School professors and Credit Suisse that reveals no evidence of a connection between growth in a country’s gross domestic product (GDP) and investment results. Professors Elroy Dimson, Paul Marsh, and Mike Staunton published their findings in their *Credit Suisse Global Investment Returns Yearbook 2010*. (Professor Dimson previously collaborated with the Brandes Institute in publishing the Institute’s 2004 report, “The Income Component of Long-Term Returns.”)

In addition, we examine other emerging market traits and collectively analyze what they mean specifically for investing in these markets.

METHODOLOGY

Before reviewing conclusions from the professors’ research, we address their research methods. Studying the relationship between economic growth and stock market returns, the professors ran regressions using four different definitions of real GDP:

1. GDP converted into real terms using each country’s Consumer Price Index (CPI)
2. GDP converted into real terms using each country’s GDP deflator
3. Aggregate GDP for each country
4. Per capita GDP for each country

They report findings based on GDP deflated by the CPI, but the results were “virtually identical” for all four specifications for GDP. The data for both GDP and returns comes from the professors’ extensive database.¹

To investigate any potential link between past economic growth and future returns, the professors segmented 83 countries from their database (which included developed and emerging countries) by quintiles. Countries were segmented at the start of each calendar year, based upon their real GDP growth over the preceding five years. The lowest quintile had the lowest GDP growth. Within each quintile, an equal amount was invested in the equity market of each constituent country.

These investments were held for one year, with dividend income reinvested at year-end. Countries were re-ranked each year, the portfolios rebalanced, and this process repeated through 2009. While visiting Brandes Investment Partners headquarters in San Diego in March 2005, Professor Marsh said that while he and his colleagues hadn’t segmented emerging markets in their research, “There is a strong overlap between the list of high growth countries and emerging markets, but it’s not a perfect one.”

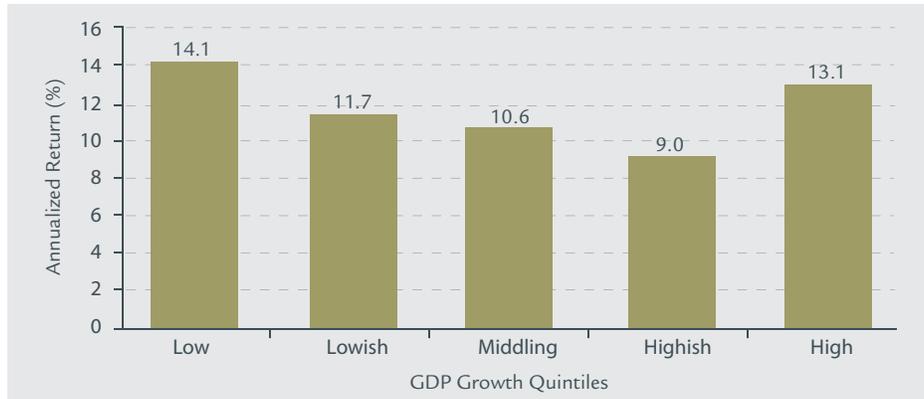
Performance results were calculated without deducting transaction costs. For some countries in the study, GDP and returns data went back to 1900.

¹ For more information, see their book, *Triumph of the Optimists: 101 Years of Global Investment Returns*, Princeton University Press, 2002.

RESULTS

The professors' findings demonstrated no discernable relationship between returns and GDP growth. Exhibit 1 reflects results for all 83 countries in the study. Of these 83 countries, the majority were identified as emerging or frontier market countries by MSCI. GDP and returns data were used from the first year in which it was available for each country.

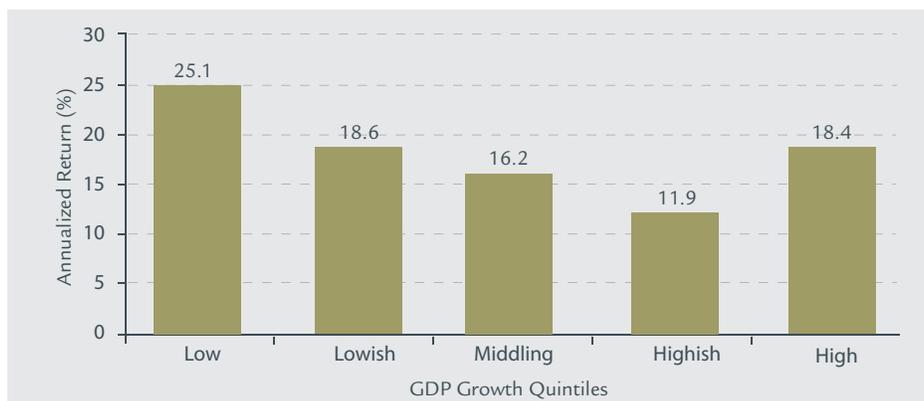
Exhibit 1: Annualized Equity Returns by GDP Growth Quintiles – All 83 Countries, 1900-2009



Source: Credit Suisse Global Investment Returns Yearbook 2010. Past performance is not a guarantee of future results.

Dimson, Marsh, and Staunton also examined the relationship between returns and GDP growth for all 83 countries between 1972-2009 (1972 was the first year where GDP was available for all countries). Surprisingly, countries with the lowest GDP growth had the highest market returns. Please see Exhibit 2.

Exhibit 2: Annualized Equity Returns by GDP Growth Quintiles – All 83 Countries, 1972-2009



Source: Credit Suisse Global Investment Returns Yearbook 2010. Past performance is not a guarantee of future results.

The professors concluded, “There is no evidence of outperformance by high-growth economies. Historically, the total return from buying stocks in the low growth countries has equaled or exceeded the return from buying stocks in the high-growth economies.”²

² Credit Suisse Global Investment Returns Yearbook 2010. Page 17.

In addition to identifying no evidence of a positive relationship between GDP growth rates and subsequent stock market returns, in their prior research³ the professors noted several countries that exhibited a negative correlation. Extending the value vs. glamour theme, the professors surmised that this dynamic may be caused by several reasons: an overreaction to good economic news reflected in higher equity prices, a declining equity risk premium in countries with improving economies, and/or shareholder dilution through initial public offerings, privatization, and equity issuance.

Separately, the researchers found that a country “That has a small capital market may have a gap between economic growth and equity performance.”⁴ In other words, privately owned businesses (which are unavailable to stock market investors) or multi-national companies (based in developed markets) doing business in emerging markets may account for a significant percentage of a country’s economic growth. This also suggests that small- or mid-cap emerging market stocks, which have low representation in the major indices for emerging markets, may better capture intra-country economic growth than their large-cap peers.

VALUE VS. GLAMOUR IN EMERGING MARKETS

The professors’ value vs. glamour analogy prompted us to compare returns for these investment styles within the world’s emerging markets. Applying the methodology used in the Brandes Institute’s research paper, “The Value Premium in Non-U.S. Markets,” we isolated emerging markets and compared historical returns.⁵

To quickly recap the methodology for this study, we used the Worldscope database and defined emerging markets as any country in the MSCI Emerging Markets (EM) Index. Consistent with our published research paper, we excluded the smallest 50% of all companies in each country to represent a more truly “investable” universe. Starting with data from June 30, 1980, we segmented this universe into value and glamour constituents by dividing the universe into deciles based on price-to-book (P/B) ratios. Stocks with the lowest P/B ratios were those in the top deciles and those with the highest P/B ratios (i.e., the glamour stocks) were in the bottom deciles. We then tracked the aggregate performance of each decile over the next five years. We repeated these steps for each of the remaining years of our study (through June 30, 2010) and averaged returns for each of these 5-year periods for comparative purposes. In Exhibit 3, we share our findings.

Exhibit 3: Value vs. Glamour Stock Returns In Emerging Markets



Source: Worldscope; FactSet, as of 6/30/10. Past performance is not a guarantee of future results.

Our results reveal that emerging market value stocks (in the upper deciles) tended to outperform glamour stocks over the long term. At the extremes, the average annualized return for glamour stocks in decile 1 was 4.4% vs. 20.8% for value stocks in decile 10. Consistent with the findings of Dimson, Marsh, and Staunton, we found that higher expected growth (in this case, a higher valuation) did not manifest into higher subsequent performance.

³ *Global Investment Returns Yearbook 2005.*

⁴ *Credit Suisse Global Investment Returns Yearbook 2010.* Page 15.

⁵ For the updated report “Value vs. Glamour: A Global Phenomenon,” visit the Brandes Institute website at www.brandes.com/institute.

BACKGROUND ON THE CASE FOR EMERGING MARKETS

While focusing on GDP growth and stock market returns, Professors Dimson, Marsh, and Staunton recognized that investors generally consider emerging markets for two reasons: return potential and diversification benefits. But are these reasons valid? Here, we investigate the performance of emerging markets and the correlation of their returns with the U.S. market over the last 20 years.

Emerging market indices delivered exceptional gains between 1991 and 1993, and suffered performance setbacks tied to a number of financial and currency crises in the mid to late '90s. The emerging market indices have recovered sharply over the past few years, until the global financial crises of 2008-09. As returns have tended to be volatile, Exhibit 4 illustrates the rolling 5-year returns for the MSCI EM Index, developed, non-U.S. equities, as measured by the MSCI EAFE Index, and the U.S. market, as measured by the S&P 500 Index.

Exhibit 4: Rolling 5-year Returns, 1988 to 2010



Source: FactSet, as of 09/30/10. Past performance is not a guarantee of future results.

Rolling periods represent a series of overlapping, smaller time periods within a single, longer-term time period. For example, over a 20-year period, there is one 20-year rolling period, eleven 10-year rolling periods, sixteen 5-year rolling periods, and so forth.

With respect to diversification benefits, emerging markets, again measured by the MSCI EM Index, had a correlation of .81 with the U.S. market, as measured by the S&P 500 Index, at the end of the third quarter of 2010. While this correlation is a bit lower than non-U.S. developed markets, as measured by the MSCI EAFE Index, both have risen since their lows at year-end 1996. Please see Exhibit 5 on the following page. The data in Exhibit 5 is based on monthly, gross returns (in U.S. dollars) for rolling, 60-month periods between September 1990 and September 2010.

Exhibit 5: Correlation of Returns vs. S&P 500 Index (Rolling 60-Month Periods)



Source: FactSet, as of 09/30/10. Past performance is not a guarantee of future results. Rolling periods represent a series of overlapping, smaller time periods within a single, longer-term time period. For example, over a 20-year period, there is one 20-year rolling period, eleven 10-year rolling periods, sixteen 5-year rolling periods, and so forth.

Do mixed performance results and rising correlations suggest limited benefits for emerging market investing? Not for individual stock pickers. Correlation of returns among indices may not capture the true opportunities available within these markets. Price fluctuation among index constituents may prove a better gauge of the volatility stock pickers need to identify and profit from short-term mispricings. With this in mind, we studied the standard deviations of returns for each stock in the S&P 500, MSCI EAFE, and MSCI Emerging Markets Indices. We started with all the constituents in each index as of December 31, 2009 and calculated their average, annual standard deviations, using local currencies, for the prior 1-, 5-, and 10-year periods. As shown in Exhibit 6, the standard deviations for the S&P 500 and EAFE Index are comparable in each period. However, the standard deviations within emerging markets are higher for the 5- and 10-year periods, reflecting greater price fluctuations – and thus, potentially greater opportunity.

Exhibit 6: Standard Deviation of Index Constituents
(Annualized Averages as of 09/30/10)

STANDARD DEVIATION SUMMARY			
	1 Year	5 Year	10 Year
S&P 500	30.7	35.4	36.6
EAFE	29.3	33.9	33.4
EM	32.0	43.5	45.1

Source: FactSet. Past performance is not a guarantee of future results.

Given this data on emerging markets' performance history, correlations, and constituent-level volatility, as well as the London Business School professors' recent findings regarding GDP growth and investment market returns, what conclusions can emerging market investors draw?

WHAT DOES THIS MEAN FOR EMERGING MARKET INVESTORS?

After debunking the notion that powerful stock market returns generally are found in countries with robust economic growth, the professors answer the question of whether investors should avoid emerging markets. They assert, "That is not an implication that should be drawn from our research." Instead, they emphasize diversification as the primary reason for allocating assets to developing markets, suggesting investors maintain "a strategic exposure." Please note that diversification does not assure a profit or protect against a loss in declining market. The findings in this report underscore key considerations for investors in the world's emerging markets:

Emerging market stocks with low valuations have tended to outperform those with high valuations. While emerging market equities often attract attention for high expectations of growth, the value vs. glamour research demonstrated that undervalued securities historically provided investors with more robust subsequent return.

Low correlations can help mitigate volatility. For investors who have trouble being patient during inevitable market downturns, mixing asset classes with low correlations can help mitigate the effects of short-term declines. Like developed markets, emerging markets show lower correlations with the United States, offering diversification benefits for U.S.-based investors. For long-term investors, however, short-term fluctuations should be a minimal concern.

Volatility isn't necessarily bad. With conviction about companies' intrinsic values, fluctuating stock prices aren't synonymous with concerns – they can create opportunities. When prices fall significantly below an estimate of a company's underlying value, it creates an opportunity for purchase. Conversely, as prices rise toward these intrinsic values, holdings may be sold with the proceeds redeployed in other, undervalued stocks. The high standard deviations among the EM Index constituents reveal greater opportunities for short-term mispricings within these markets. To value investors, this academic research reveals even more clearly the real opportunities in emerging market investing. By avoiding the “herd mentality” that follows the siren call of the fastest-growing economies, it is possible to focus on the opportunities caused by stock price volatility and market inefficiency, and identify companies selling at prices well below intrinsic values.

The economic growth experienced by emerging market countries may be best captured by investing in small- or mid-sized companies. The major indices for emerging markets are dominated by large-cap companies. Many of these emerging market large companies have global operations, and their performance is not closely linked with domestic development and growth. Conversely, smaller companies in emerging markets may be better positioned to capitalize on rising prosperity and the consumer needs of the growing middle class.

The foregoing reflects the thoughts and opinions of the Brandes Institute.

MSCI Emerging Markets (MSCI EM) Index: The MSCI Emerging Markets Index with gross dividends is an unmanaged, free float-adjusted market capitalization weighted index designed to measure equity market performance in emerging markets throughout the world. This index includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

MSCI EAFE Index: The MSCI EAFE (Europe, Australasia, Far East) Index with net dividends is an unmanaged, free float-adjusted market capitalization weighted index designed to measure equity market performance of developed markets, excluding the United States and Canada. This index often is used as a benchmark for international equity portfolios and includes dividends and distributions net of withholding taxes, but does not reflect fees, brokerage commissions, or other expenses of investing.

S&P 500: The S&P 500 Index with gross dividends is an unmanaged, market capitalization weighted index that measures the equity performance of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it can also be a suitable proxy for the total market. This index includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

Price/Book: Price per share divided by book value per share.

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