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GLOBAL MARKET COMMENTARY

A CLOSER LOOK AT EMERGING MARKETS EQUITY VALUATIONS

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A Closer Look at Emerging Markets Equity Valuations

"Not knowing is much more interesting than believing an answer which might be wrong."- Richard Feynman

While standard price-to-earnings (P/E) ratios (i.e., those based on trailing 12-month earnings) continue to look quite reasonable for emerging markets equities (Table A), metrics that adjust for the cyclicality of the business cycle (and, by extension, the current high level of return on equity [ROE]), paint a far different picture, indicating emerging equities are not especially cheap in absolute terms. Still, given not only the paucity of available data for the asset class, but the question of how relevant these data are to current conditions, it seems difficult if not impossible to arrive at a hard and fast definition of "fair value" for emerging markets equities, and investors should temper their expectations accordingly. On a more practical note, investors should not allow investment decisions to be driven by recent declines (and the associated increase in volatility). Rather, investors who are below their policy target should gradually (and patiently!) build positions. While prices and valuations are clearly more attractive today than they were two months ago, the current decline is a far cry from the carnage seen in emerging markets in times past.[1]

What We Don't Know

While assessing valuations is always difficult in financial markets, it is exponentially so for emerging markets due to a distinct lack of relevant data. Not only are the available data series woefully short, there are legitimate questions about how relevant they are to the current environment. (The situation reminds us of an old joke about two people eating at a restaurant. One says: "Boy, the food at this place is really terrible." The other replies: "Yeah, I know. And such small portions.") Our preferred measure for *developed* markets P/E ratios, for example, uses ten-year normalized real earnings, a metric unavailable for emerging markets due to a lack of reliable inflation data. Even using nominal earnings, however, such a series yields fewer than ten readings using annual data, and the utility of those it does provide is highly questionable. Are valuations from the early 1990s really relevant to today, for example, or have emerging markets undergone such fundamental change as to make such figures obsolete?

What We Do Know (Sort of…)

What we *can* say is that while emerging markets equities look cheap relative to those of developed markets, a comprehensive look at absolute valuations reveals a muddier picture. There is a healthy debate, for example, over just how much of the recent rise in emerging markets ROE has come from *structural*

[1] Indeed, the history of emerging markets is replete with episodes of phenomenal growth followed by gut-wrenching declines. For the 12 months ended July 31, 1997, for example, emerging markets ran up 32.2%, only to plunge 21% over the next four months. (All figures represent total returns in local currency terms.) Developed markets, by contrast, rose 40.6% over the first period, and fell only 4.9% in the subsequent period. More recently, emerging markets soared 122.3% in the 19 months ended March 31, 2000, then dropped 28.4% over the next eight months. (Developed markets rose 55.3%, and fell 11.6%.) For more details, please see our February Global Market Commentary: *What's Been Driving the Emerging Markets Equity Rally?*

changes (such as improvements in capital allocation, which should be expected to persist) and how much from *cyclical* factors (such as high commodity prices, which, even if they did persist, should be expected to draw in new competition rather than boost existing companies' bottom lines indefinitely). On balance, it seems reasonable to assume emerging markets' future ROE will be higher than its historical average, but not so high as current levels (and probably a little lower than developed markets ROE on an ongoing basis).

Thus, if we assume today's high levels of ROE (Table B) are not sustainable, we must take this into account when considering valuations, as a decline in ROE would, *ceteris paribus,* go hand in hand with a decline in earnings. We have previously stated that 12% seems a reasonable long-term level for *developed markets* ROE.[2] As such, one way to adjust P/Es for today's high ROE is simply to assume a slightly lower constant level for emerging markets (Table C assumes a constant level of 11%, halfway between the historical average of 9.9% for the IFCI and our assumed level of 12% for developed markets). On this measure, emerging markets equities appear quite overvalued, with current multiples more than one standard deviation above their long-term mean. While the methodology seems logical, however, it fails to take into account our assumption that there has been a secular shift in emerging markets ROE. In other words, while assuming a constant ROE may give us a more realistic view of *current* P/Es, it is unrealistic to assign this number to past periods, when ROE was structurally lower.

The challenge, it seems, is to find a measure that adjusts for the cyclical portion of today's high ROE, while also recognizing that emerging markets ROEs were depressed by structural factors in the past. We believe a measure that uses five-year normalized ROEs, while certainly not a panacea, does a decent job in this regard (Table D). In short, normalized ROEs smooth out cyclical fluctuations (such as the short-term plunge in ROE in the aftermath of the 1997-98 crisis), and also show the gradually rising trend of emerging markets ROE over the past few years (Table E). Thus, readings likely represent a better proxy for *sustainable* earnings—the level important to investors—than other measures. This measure shows equities to be a bit rich, but within the range we typically consider fairly valued.

There are, of course, other ways to adjust for earnings cyclicality. For example, we could use a five-year normalized series of "real" earnings in US$, deflated with the U.S. CPI-U (Table F). Alternatively, we could simply use normalized *nominal* earnings (Table G). Both these measures suggest emerging markets are overvalued, with current readings more than one standard deviation above their long-term averages. Any and all measures, of course, suffer from the data limitations discussed above.

Conclusion

It is extremely difficult (if not impossible) to determine "fair value" with any sort of accuracy for emerging markets. The short history of the asset class, coupled with the potential irrelevance of available data, makes any such measure an educated guess at best. The measures we look at run the gamut of valuations, with "standard" P/E measures showing equities to be attractive, those using normalized earnings and constant ROE suggesting overvaluation, and our preferred metric, which uses five-year normalized ROE,

[2] Developed markets ROE has tended to average about 12% over time.

somewhere in the middle. Indeed, to a large degree the attractiveness of emerging markets equities comes down to how much of the recent rise in ROE has been structural, and how much cyclical. While no one knows the answer, it seems safe to say both factors have made significant contributions. Thus, while ROE should be expected to moderate from current levels, it will not necessarily revert to its long-term mean. Overall, placing a valuation on emerging markets is more art than science, and more subjectivity is called for than in other asset classes for which we have better data. With this in mind, we continue to rate emerging markets equities as fairly valued, albeit approaching the high end of that range.

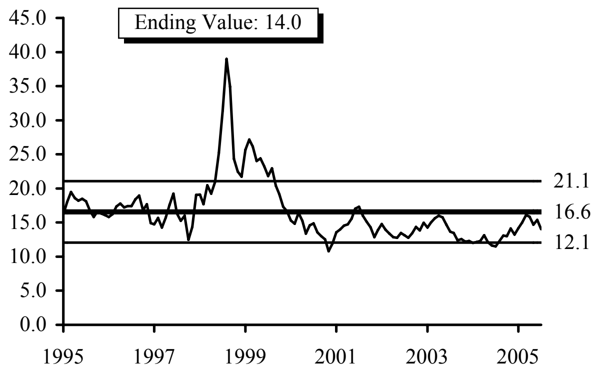
From a practical standpoint, investors should rebalance frequently to take advantage of market fluctuations, as opposed to initiating new positions in hopes of catching the bottom. Those below policy weights, meanwhile, should add to positions gradually and patiently. While we continue to believe emerging equities offer more value than developed markets, they also have the potential for more short-term downside (as evidenced over the past two months), and investors should therefore tread cautiously.

Table A

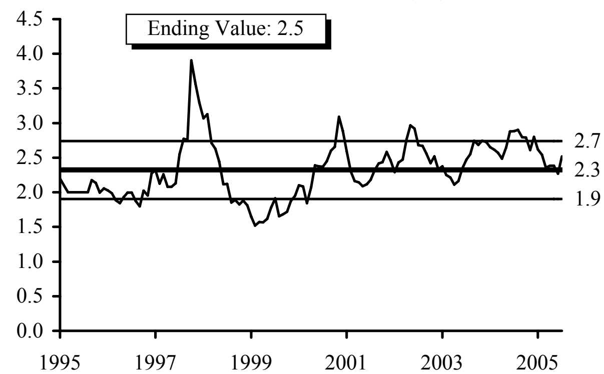
MSCI Emerging Markets Index

November 30, 1995 - May 31, 2006

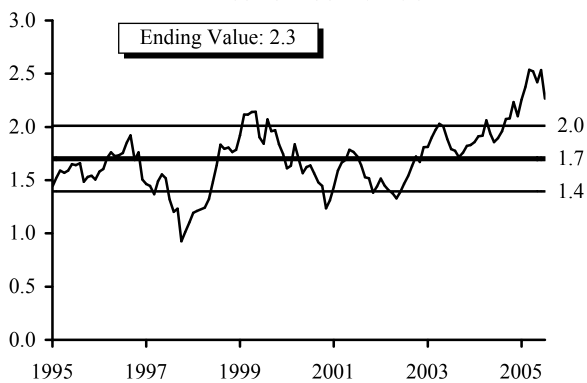
Price-Earnings



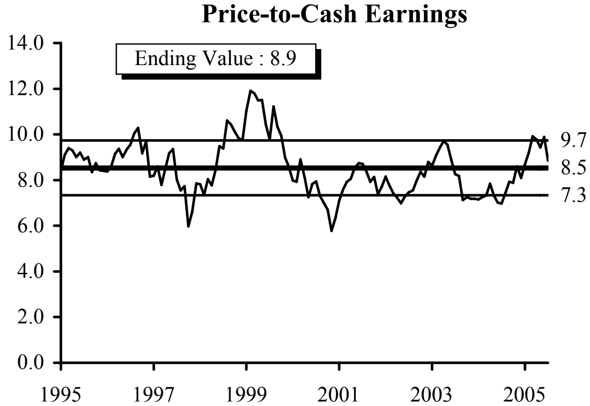
Dividend Yield (%)



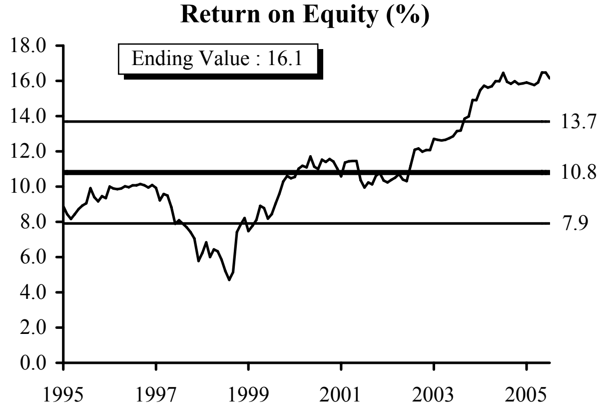
Price-to-Book Value



Price-to-Cash Earnings



Return on Equity (%)



Mean
One Standard Deviation

Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Note: Return on equity is calculated by dividing the index's price-book ratio by its price-earnings ratio.
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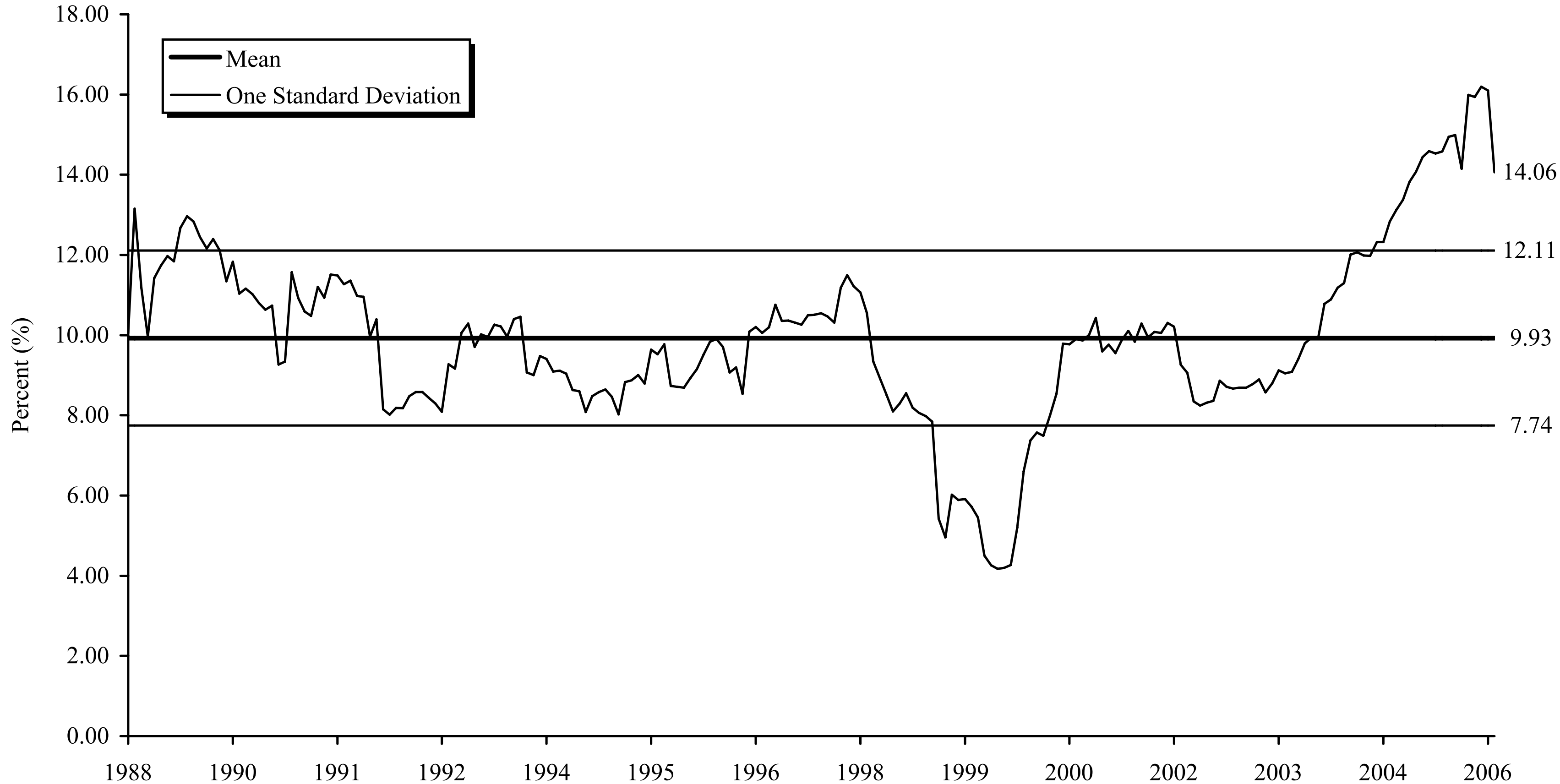
Table B

S&P/IFC INVESTABLE COMPOSITE RETURN ON EQUITY

December 31, 1988 - May 31, 2006



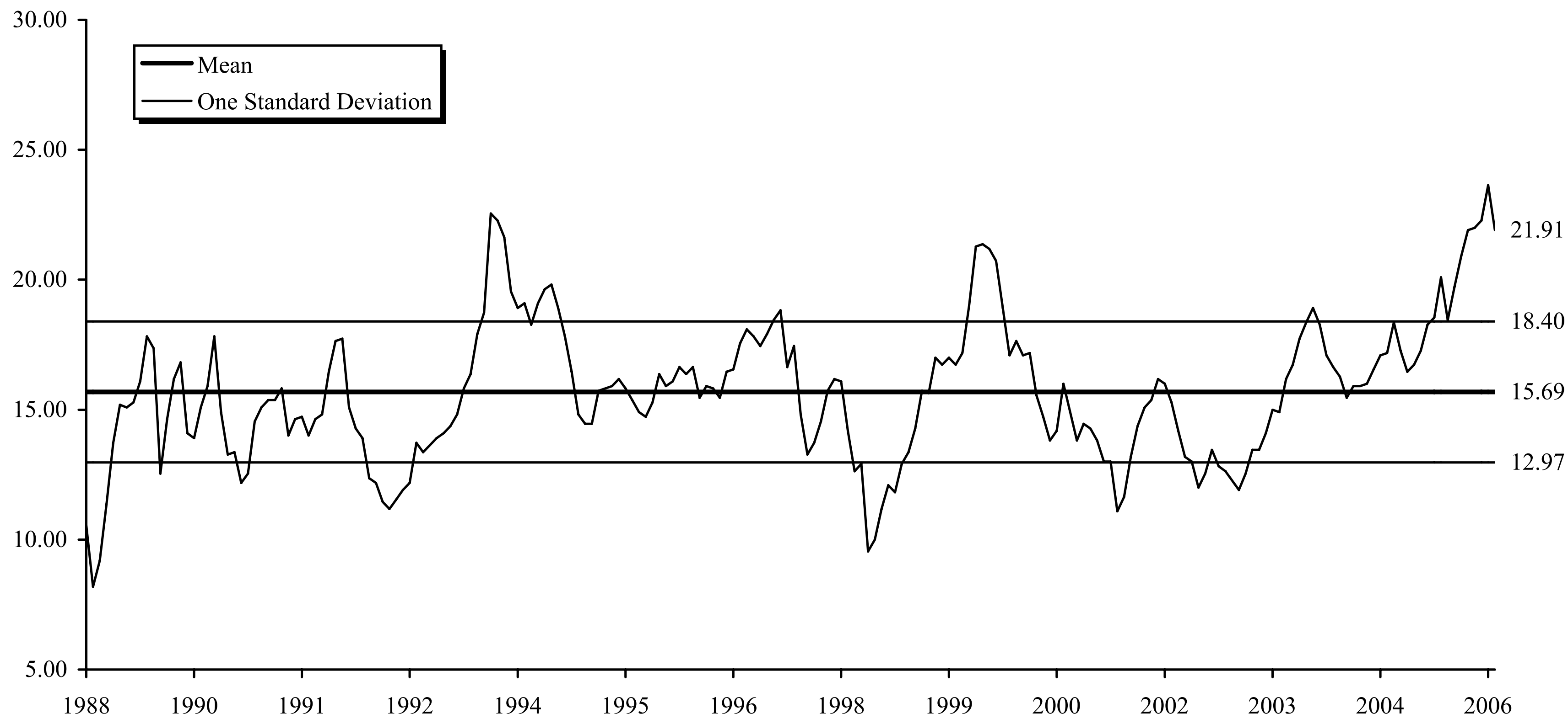
Sources: Calculated from data provided by Standard & Poor's and Thomson Datastream.

Note: Return on equity is calculated by dividing the index's price/book ratio by its price/earnings ratio.

Table C

S&P/IFC INVESTABLE COMPOSITE RETURN ON EQUITY ADJUSTED PRICE-EARNINGS RATIOS

December 31, 1988 - May 31, 2006



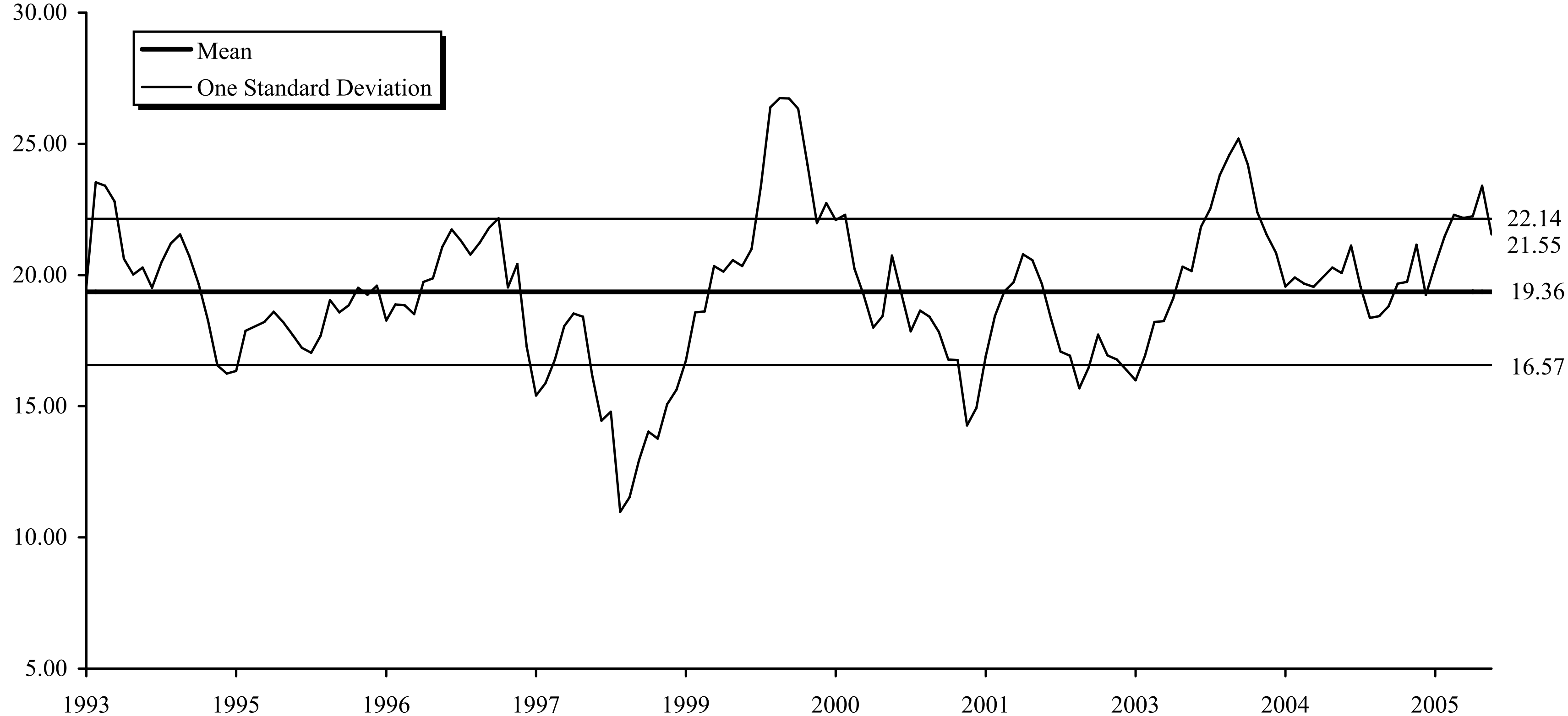
Sources: Calculated from data provided by Standard & Poor's and Thomson Datastream.

Notes: Return on equity is calculated by dividing the index's price/book ratio by its price/earnings ratio. The ROE-adjusted P/E ratio is the current P/E based on trailing 12-month earnings multiplied by the ratio of the current ROE to a constant level of 11.0. Graph represents monthly data through May 31, 2006.

Table D

S&P/IFC INVESTABLE COMPOSITE PRICE-EARNINGS RATIOS USING FIVE-YEAR NORMALIZED RETURN ON EQUITY

December 31, 1988 - May 31, 2006



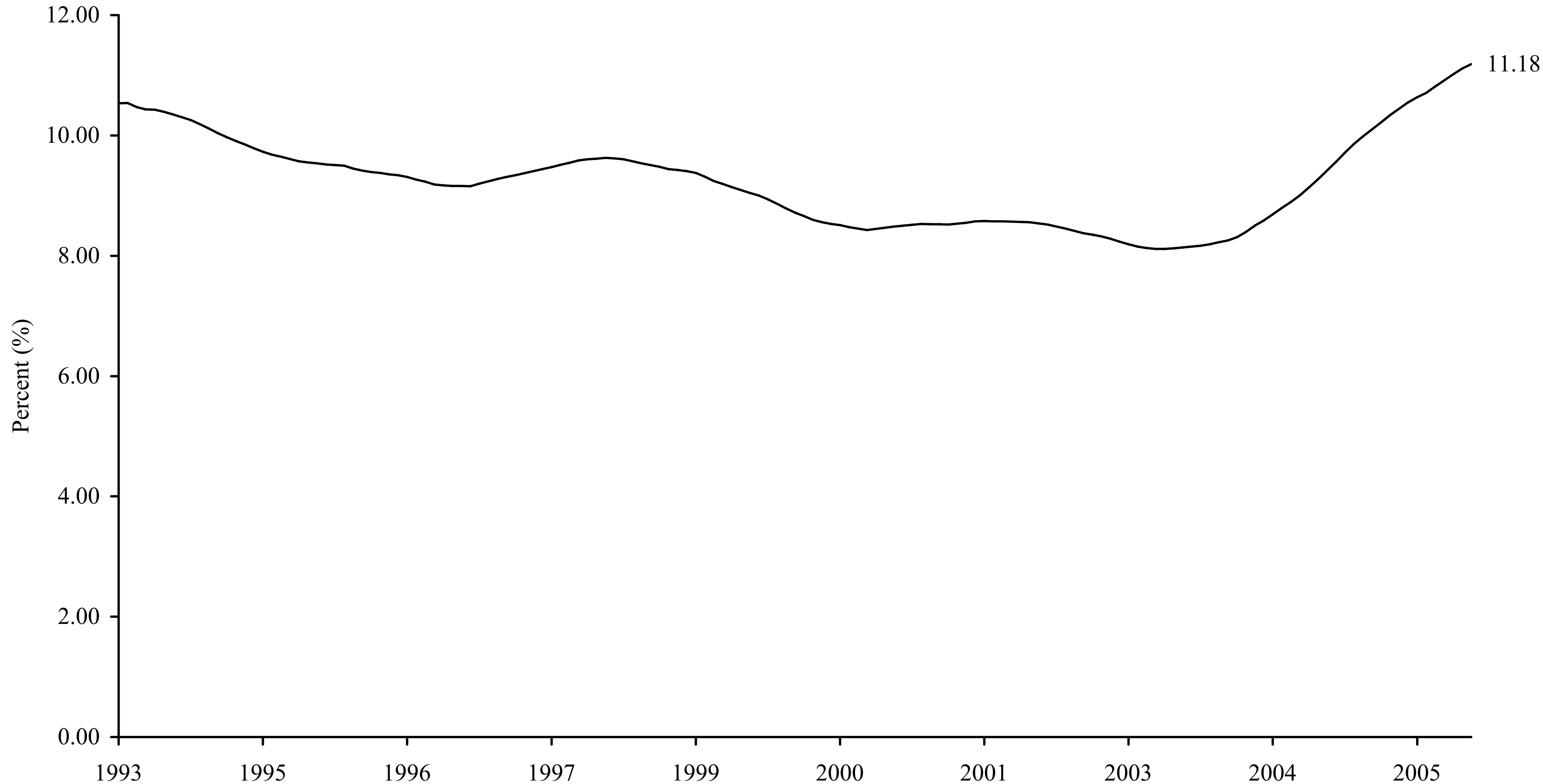
Sources: Calculated from data provided by Standard & Poor's and Thomson Datastream.

Notes: Return on equity is calculated by dividing the index's price/book ratio by its price/earnings ratio. The five-year normalized ROE-adjusted P/E ratio is the current P/E based on trailing 12-month earnings multiplied by the ratio of the current ROE to the average ROE of the previous five-year period.

Table E

S&P/IFC INVESTABLE COMPOSITE FIVE-YEAR ADJUSTED RETURN ON EQUITY

December 31, 1988 - May 31, 2006



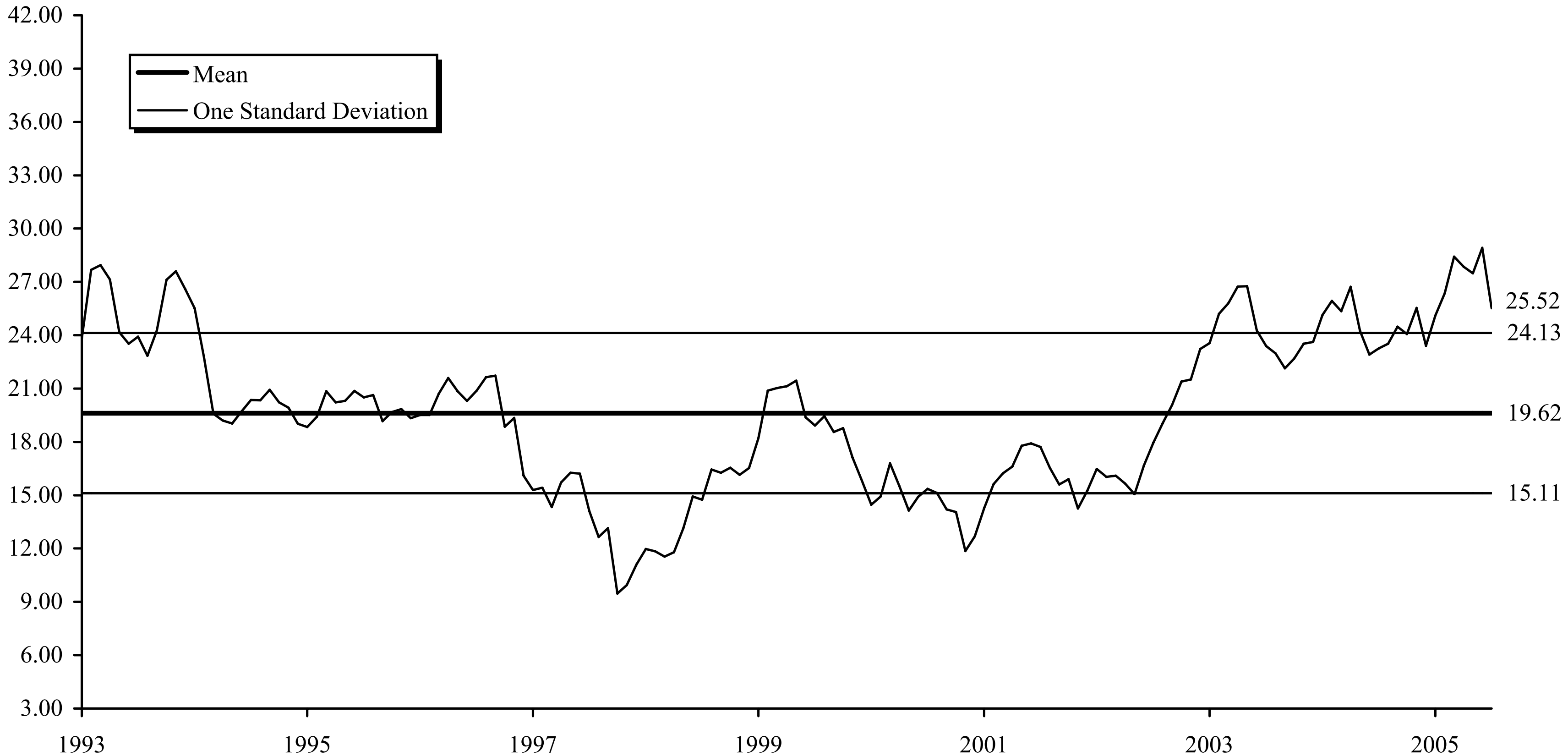
Sources: Calculated from data provided by Standard & Poor's and Thomson Datastream.

Note: The five-year adjusted return on equity is calculated by taking the average ROE of the previous five-year period.

Table F

S&P/IFC INVESTABLE COMPOSITE REAL NORMALIZED PRICE-EARNINGS RATIOS

December 31, 1988 - May 31, 2006



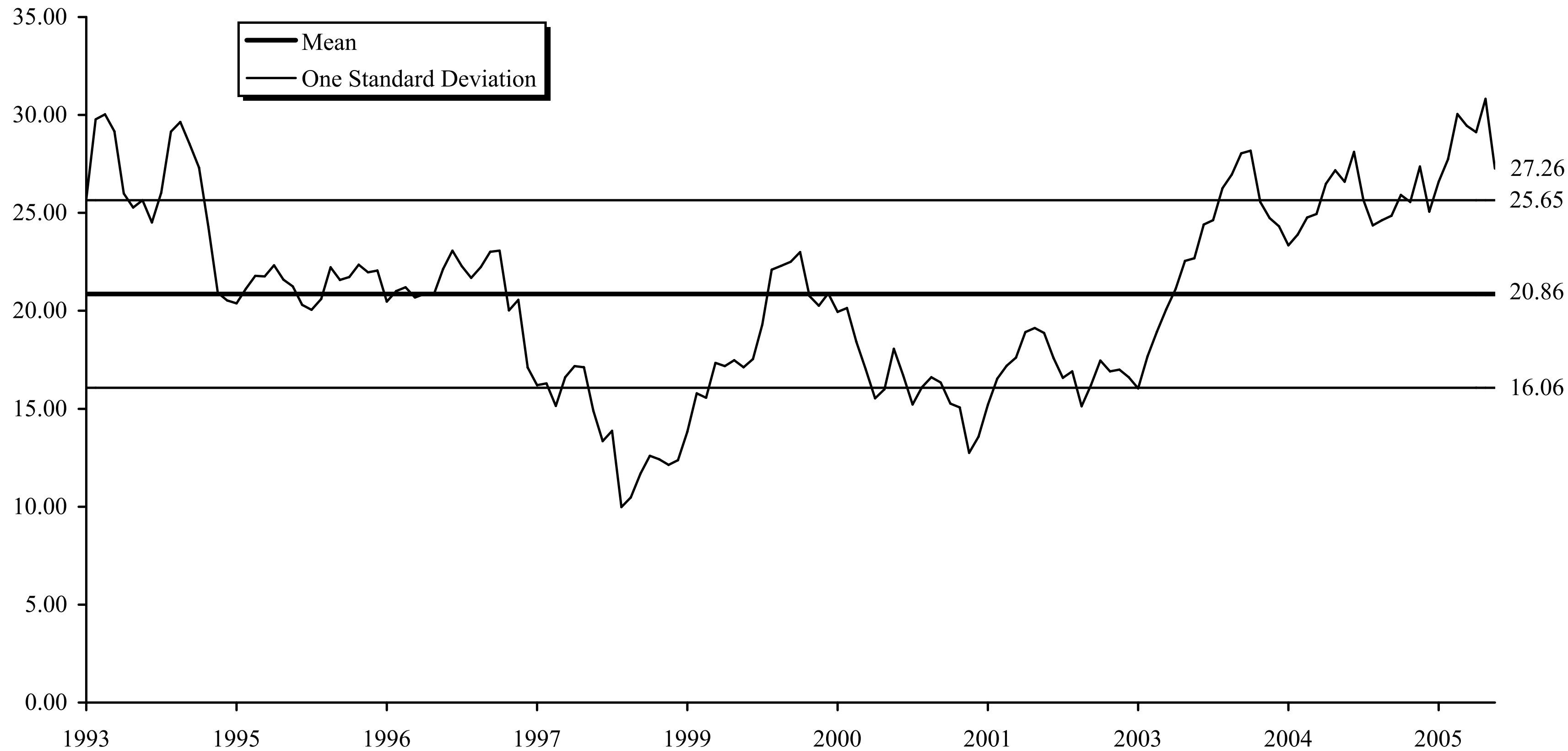
Sources: Calculated from data provided by Standard & Poor's and Thomson Datastream.

Notes: Normalized real price-earnings ratios for the S&P/IFC Investable Composite are calculated by dividing the current real price index value, in U.S. dollars, by the annualized average real earnings for the trailing five years. The index is deflated using the CPI-U. The graph represents monthly data through May 31, 2006.

Table G

S&P/IFC INVESTABLE COMPOSITE FIVE-YEAR NORMALIZED PRICE-EARNINGS RATIOS

December 31, 1988 - May 31, 2006



Sources: Calculated from data provided by Standard & Poor's and Thomson Datastream.

Notes: Normalized price-earnings ratios for the S&P/IFC Investable Composite are calculated by dividing the current nominal price index value, in U.S. dollars, by the annualized average nominal earnings for the trailing five years. The graph represents monthly data through May 31, 2006.