

C A M B R I D G E A S S O C I A T E S L L C

GLOBAL MARKET COMMENT: ARE EMERGING MARKETS EQUITIES STILL CHEAP?

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Are Emerging Markets Equities Still Cheap?

Propelled by basement-low valuations, MSCI Emerging Markets Free (EMF) has returned 43.4% from last October through the end of April 2002, while select individual bourses have surged even higher: South Korea's Kospi, up 75.6%, the Budapest Index, 40.5%, and Mexico's IPC 35, 38.4%. To gauge the effect of this stunning rally on their valuations, we use four metrics—price-to-earnings, price-to-book, price-to-cash earnings, and dividend yield—to compare current valuations to historical emerging markets valuations and to developed market equity valuations. Although the end result is not unequivocal, we nevertheless find that emerging markets equities remain inexpensive. The results are subject to debate because different valuation measures provide somewhat contradictory impressions about relative valuations, and our data only go back to the end of 1995, making it difficult to cast today's valuations in a historical context.

Inexpensive—But by What Measure?

Emerging markets equities are currently about as cheap today as they have been over the last seven years (see Table A). However, given that emerging markets have been out of favor for much of the period for which we have valuation data, it is likely that valuations over this period are below "fair value." For example, the average annual compound return of emerging markets between December 31, 1995 and April 30, 2002 was only 7%—far below the nearly 90% return experienced from 1988-95. Given that valuations tend to be higher toward the end of bull markets and lower towards the end of bear markets, it is reasonable to assume the average valuations since the end of 1995 are lower than would be expected over the long term.

Just prior to the start of the current emerging markets rally, on September 30, 2001, valuations for emerging markets equities were quite low by all four metrics. In fact, both the P/E and price-to-cash earnings ratios of the MSCI EMF reached seven-year lows of 10.8 and 5.8, respectively. These valuations were even lower than those reached in August of 1998 when emerging markets, which were already in turmoil, were dealt another major blow when Russia devalued the ruble. Dividend yields and price-to-book ratios were well below their seven-year averages, but remained above the lows set in August 1998. Between September 30, 2001 and April 30, 2002 emerging markets equity prices increased 41.8%, driving valuations up a comparable level: the P/E of the MSCI EMF increased 54.7%, the price-to-cash earnings ratio increased 48.7%, the price-to-book ratio increased 40.4%, and the dividend yield decreased 31.5%. Despite this run-up, the index's P/E remains below its already low seven-year averages, while the remaining three measures remain close to their averages.

Valuations are low across all emerging markets subregions, but there are some differences. In absolute terms, equities in emerging Asia have the highest current valuations, those of Latin America generally have the lowest valuations, and those of Europe, Middle East, and Africa (EMEA) and South Africa fall in the middle. However, on average since 1995, emerging Asia and EMEA have been more expensive than the broad market (MSCI EMF), while Latin America and South Africa have been cheaper. If you consider the historical relationship of the subregions' valuations relative to those of emerging markets as a whole, EMEA is generally the least expensive, while the other subregions vary depending on the metric used (see Tables B-E.)

Most bulls on emerging markets base their case on the striking disparity in P/Es between U.S. and emerging market equities (See Table F). Despite the recent emerging markets rally, the P/E of the MSCI EMF, which has been about two-thirds that of the MSCI U.S. Index on average since 1995, stands at about half that of the MSCI U.S. Index, or one standard deviation below their seven-year mean. While the P/E of the MSCI EMF is slightly below its seven-year average, the MSCI U.S. Index carries a lofty P/E of 32.6, a level that is significantly higher than its post-1995 average of 25.7. The cheapness of emerging markets equities relative to those of the United States on the basis of P/E ratios is likely overstated as earnings in the United States are depressed following the decision by many corporations to use "big bath" accounting practices, taking charges and write-offs reflecting past and future expenses, as they saw their earnings drop as the United States entered into recession. Therefore, not surprisingly, we find that emerging markets equities are not as inexpensive relative to U.S. equities on the basis of the three other valuation metrics.

Relative price-to-cash earnings ratios and relative dividend yields are near their seven-year averages, suggesting that emerging markets still offer good value relative to the United States. Given that the average valuations over the last seven years were likely understated relative to "fair value" for emerging markets equities and are overstated for U.S. equities, it is likely that emerging markets are even more attractive relative to the United States. than they appear based on data from this short time horizon. On the basis of price-to-book ratios, emerging markets actually look quite expensive relative to U.S. equities, as the relative price-to-book ratio averaged around 0.4 over the period, and is now 0.5, or more than one standard deviation above the average. However, this has more to do with the book values of U.S. companies becoming relatively overstated in the latter half of the 1990s than with emerging markets becoming relatively more expensive. U.S. company book values ran up in the late 1990s as companies completed mergers and acquisitions at purchase prices well above the fair value of assets, requiring them to report this goodwill on their balance sheets, and bloating book values. Even with the massive write-offs many companies have taken recently, book value levels have not declined significantly from their peak in August 2001.

Overall, emerging markets equities are still quite inexpensive relative to U.S. equities. Emerging markets equities also remain attractively valued relative to other developed markets equities, but by a smaller margin (see Table F).

How Much Higher Can the Market Move?

While the recent rally has increased emerging markets valuations to some degree, it would not be surprising to see their prices rise significantly further, at least if history is a reliable guide. Since 1989, the 200-day moving average of MSCI EMF has been a fairly consistent indicator of the index's price momentum (see Table G). The average usually hews closely to the index, but when it breaks through—in either direction—it carries through with substantial momentum, as seen in 1998 and 1999. Comparing the pattern of the rally that began in late-1998 to the current upsurge, it would not be surprising to see emerging markets equities rise even further.

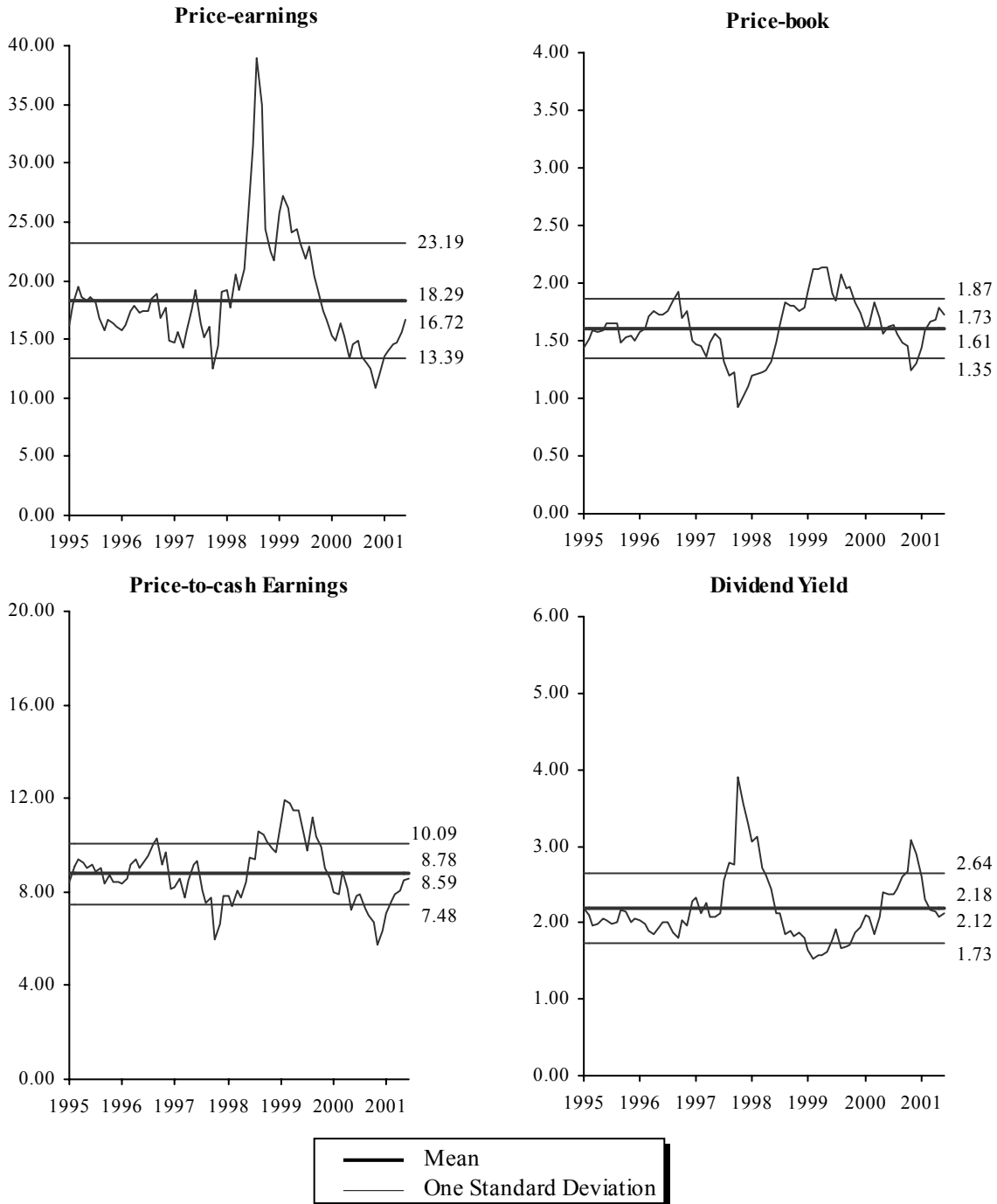
A High-Beta Bet

Given that emerging markets equities are vulnerable to investor sentiment and represent a high-beta play on global growth, investors should scale their allocation to the asset class appropriately, generally limiting exposure to 5% to 10%. While emerging markets equities remain risky, today's risk/reward ratio is very favorable. However, only investors who can tolerate the inherent volatility of this asset class should consider making commitments. Investors who have not already initiated an allocation, may want to start at this point, while those who are already committed, should consider an overweight position.

Table A

MSCI EMERGING MARKETS FREE VALUATIONS

November 30, 1995 - April 30, 2002

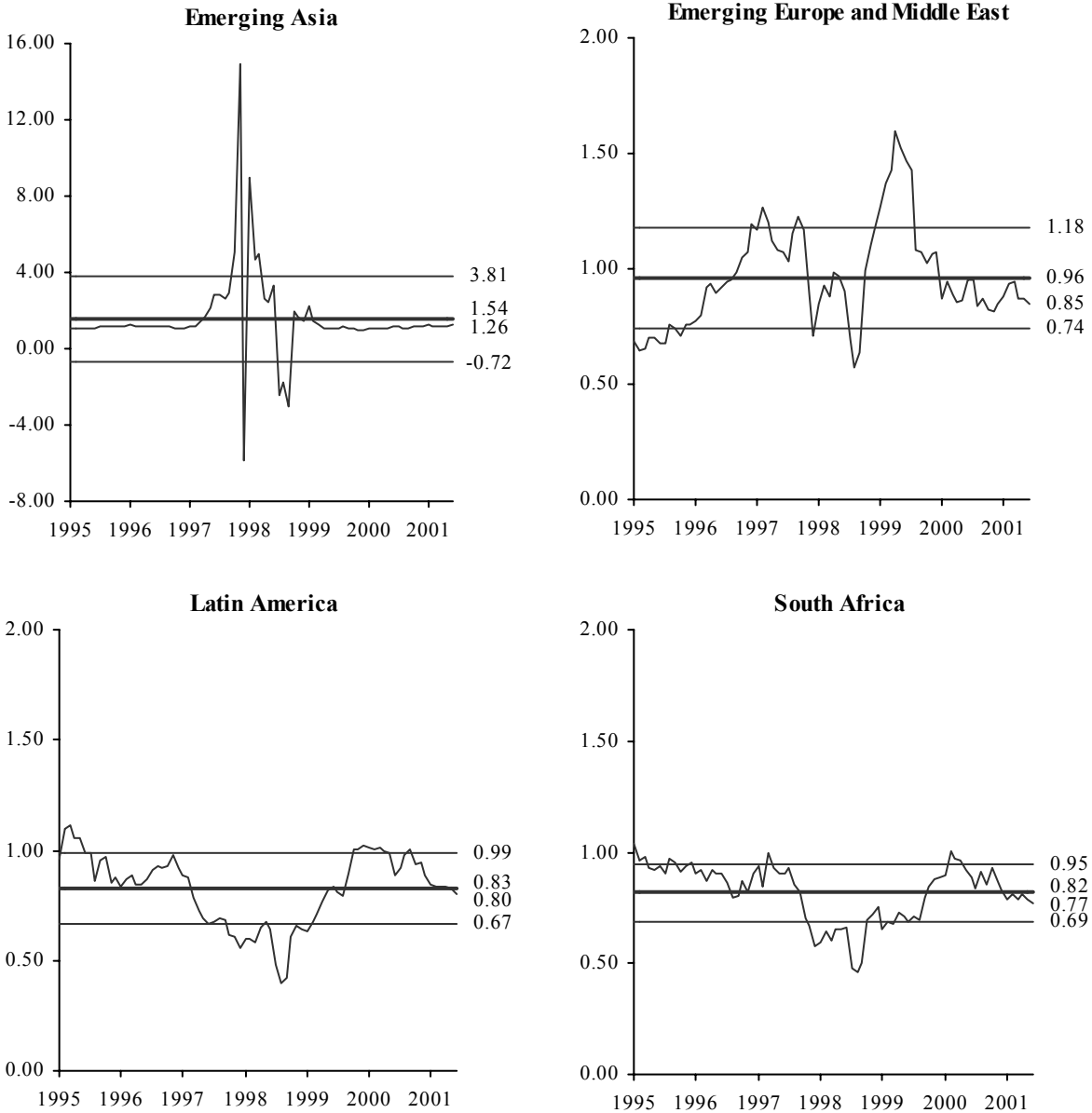


Source: Thomson Financial Datastream. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

Table B

PRICE-EARNINGS FOR EMERGING MARKETS REGIONS RELATIVE TO MSCI EMF

November 30, 1995 - April 30, 2002



— Mean
 - - - One Standard Deviation

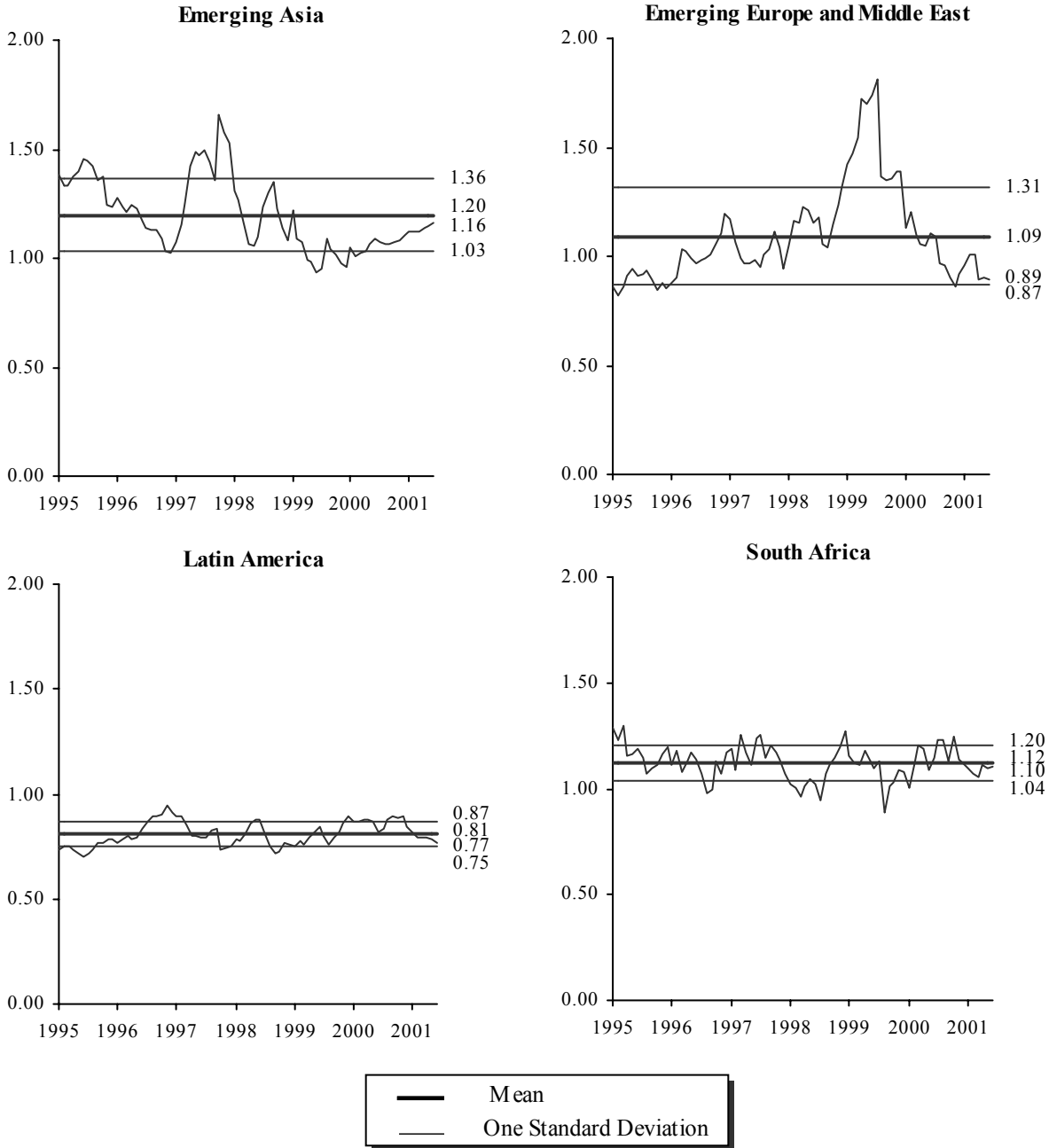
Source: Thomson Financial Datastream. MSCI data are copyrighted and proprietary to Morgan Stanley Capital International, Inc.

Note: Emerging Asia scale different due to the existence of large outliers.

Table C

**PRICE-TO-CASH EARNINGS FOR EMERGING MARKETS REGIONS
RELATIVE TO MSCI EMF**

November 30, 1995 - April 30, 2002

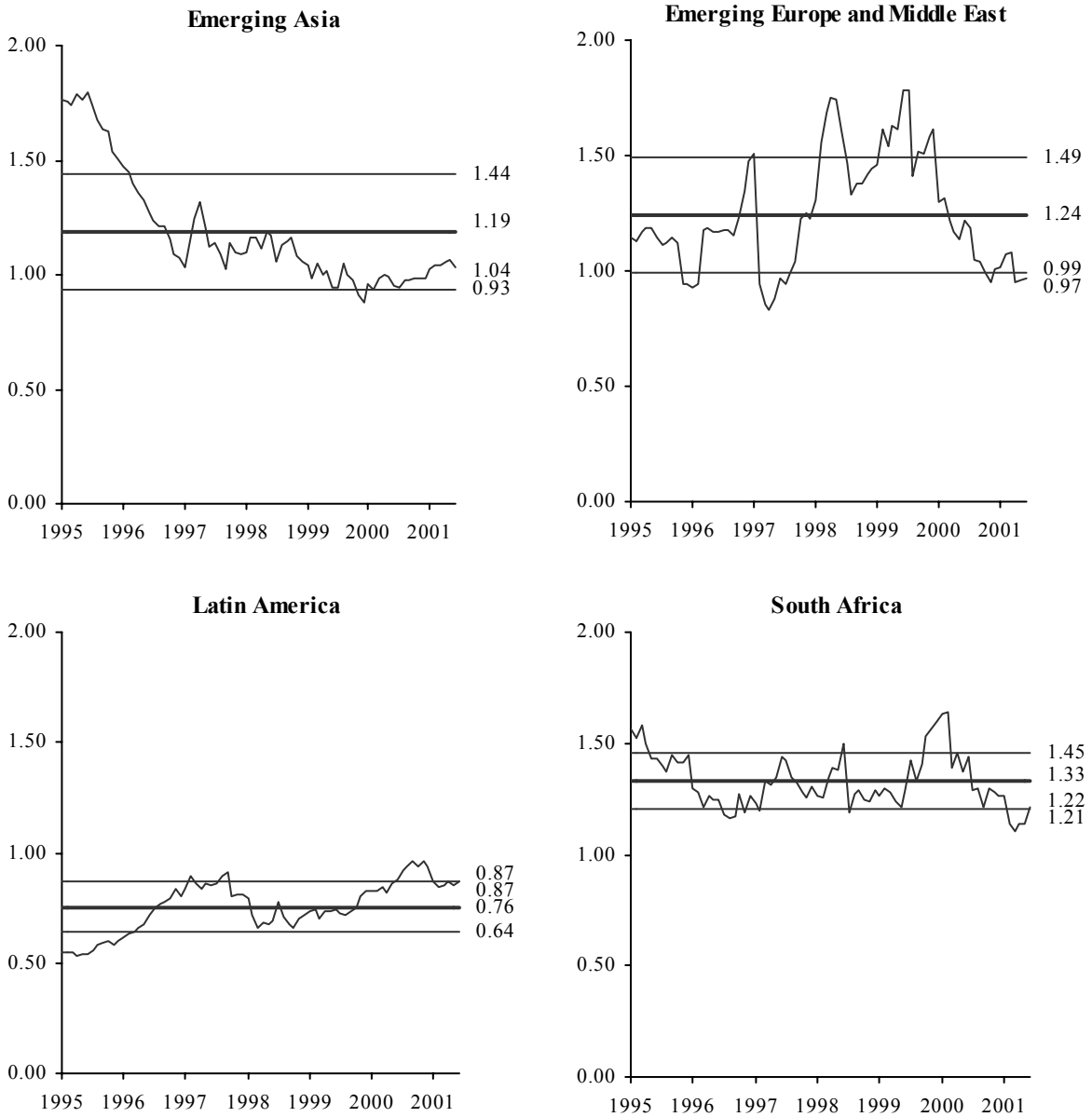


Source: Thomson Financial Datastream. MSCI data are copyrighted and proprietary to Morgan Stanley Capital International, Inc.

Table D

PRICE-BOOK FOR EMERGING MARKETS REGIONS RELATIVE TO MSCI EMF

November 30, 1995 - April 30, 2002



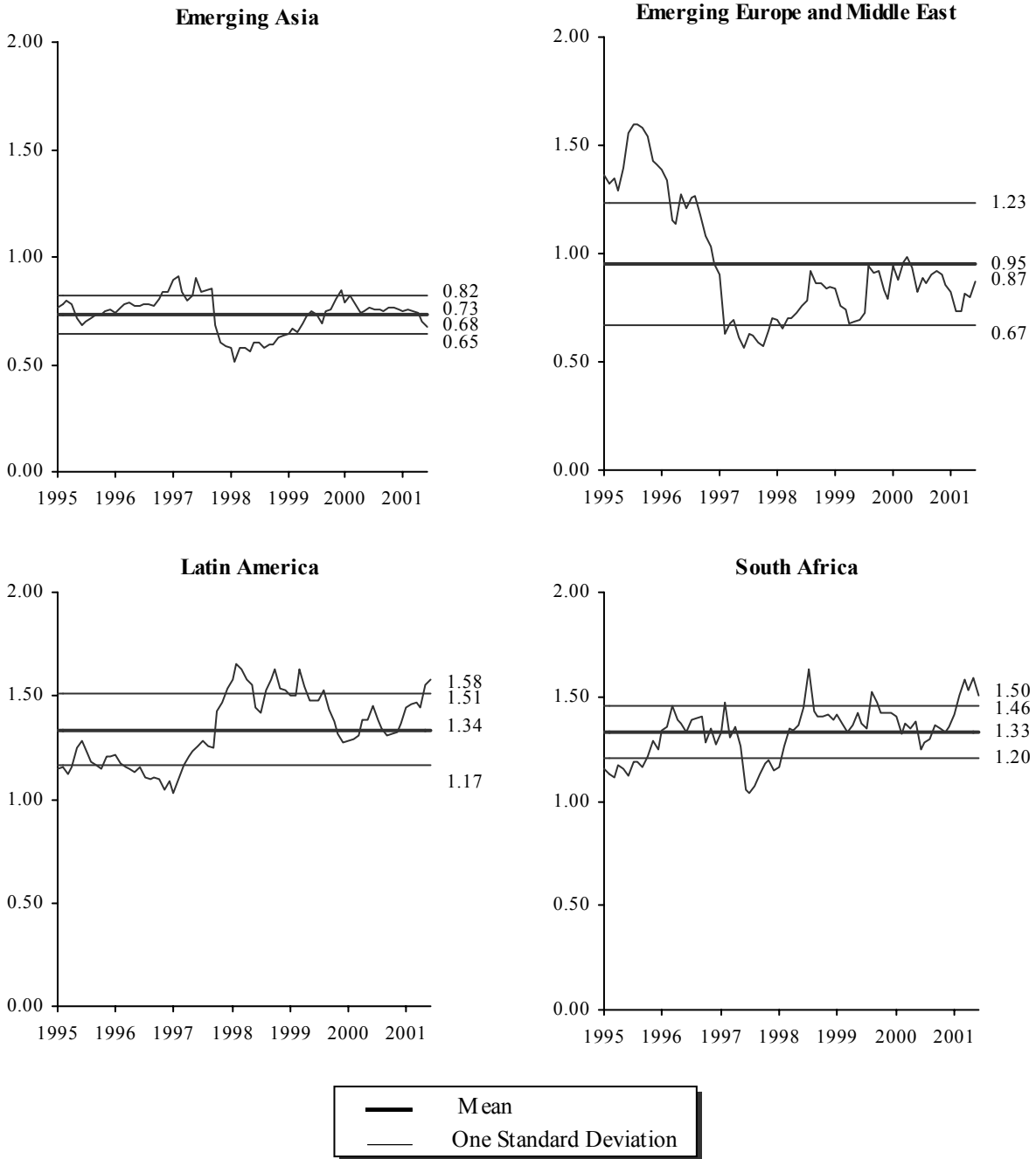
—	Mean
—	One Standard Deviation

Source: Thomson Financial Datastream. MSCI data are copyrighted and proprietary to Morgan Stanley Capital International, Inc.

Table E

DIVIDEND YIELD FOR EMERGING MARKETS REGIONS RELATIVE TO MSCI EMF

November 30, 1995 - April 30, 2002



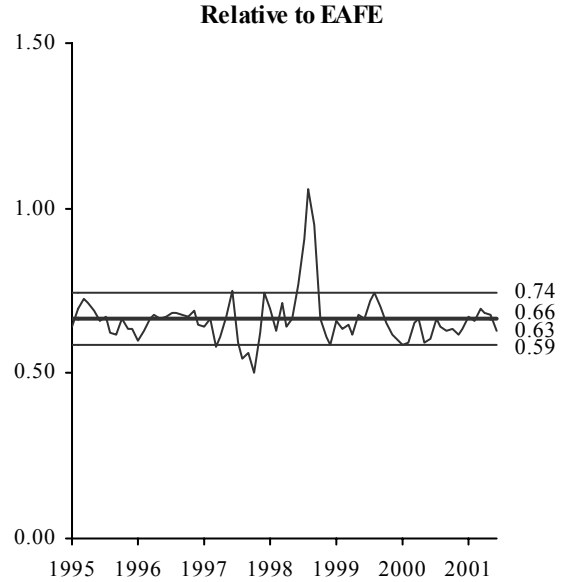
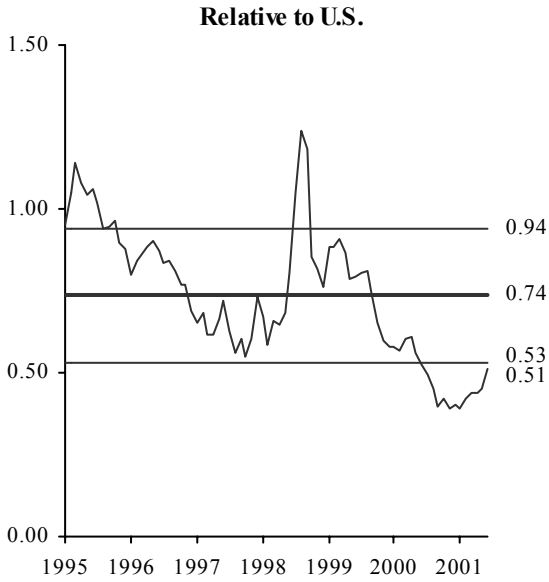
Source: Thomson Financial Datastream. MSCI data are copyrighted and proprietary to Morgan Stanley Capital International, Inc.

Table F

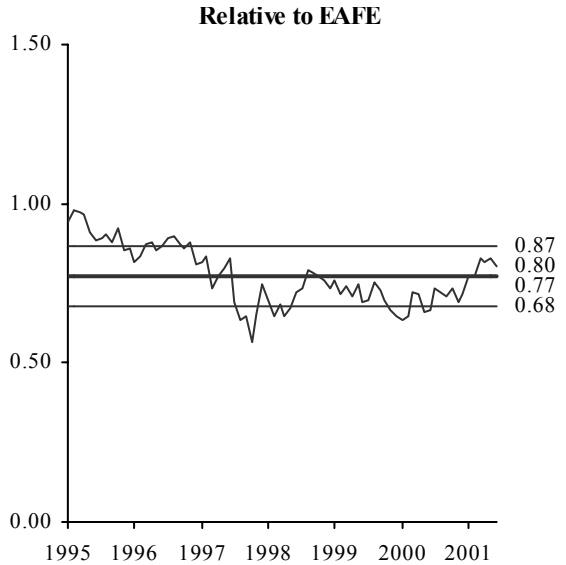
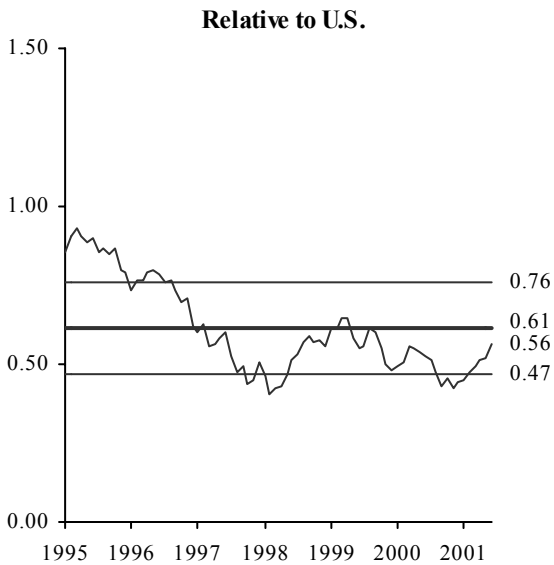
EMERGING MARKETS VALUATIONS RELATIVE TO MSCI EAFE AND MSCI U.S.

November 30, 1995 - April 30, 2002

Price-earnings



Price-cash earnings



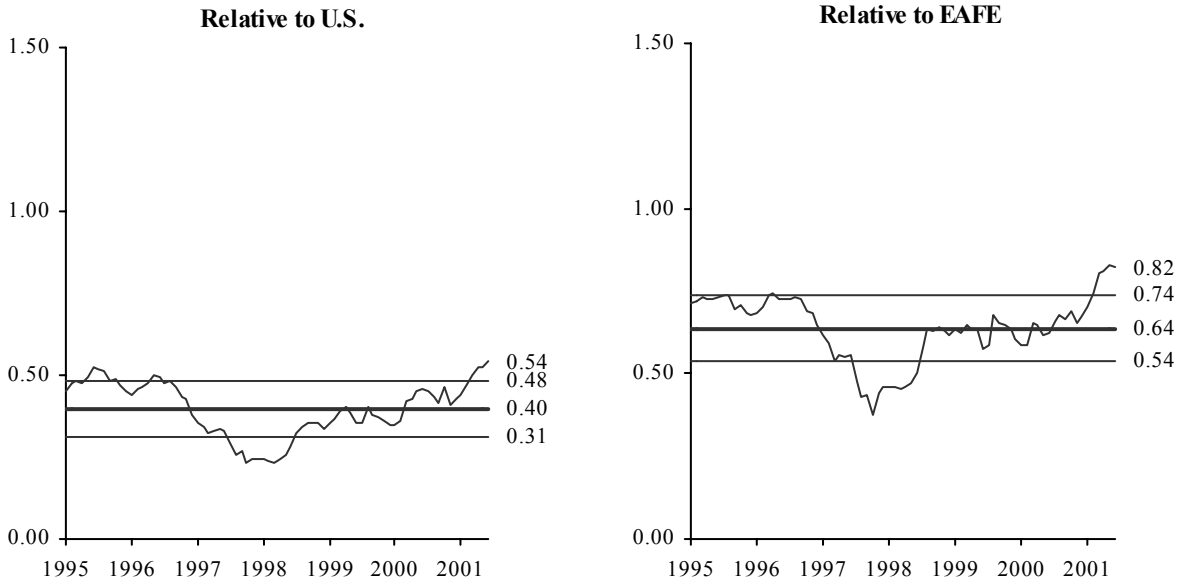
—	Mean
—	One Standard Deviation

Table F (continued)

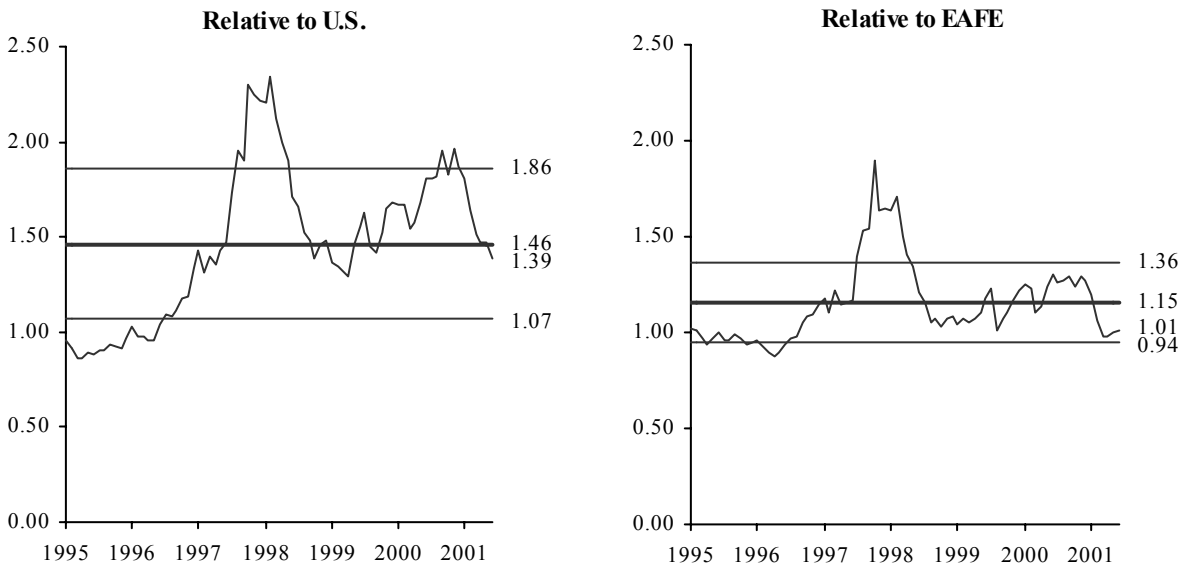
EMERGING MARKETS VALUATIONS RELATIVE TO MSCI EAFE AND MSCI U.S.

November 30, 1995 - April 30, 2002

Price-book



Dividend Yield*



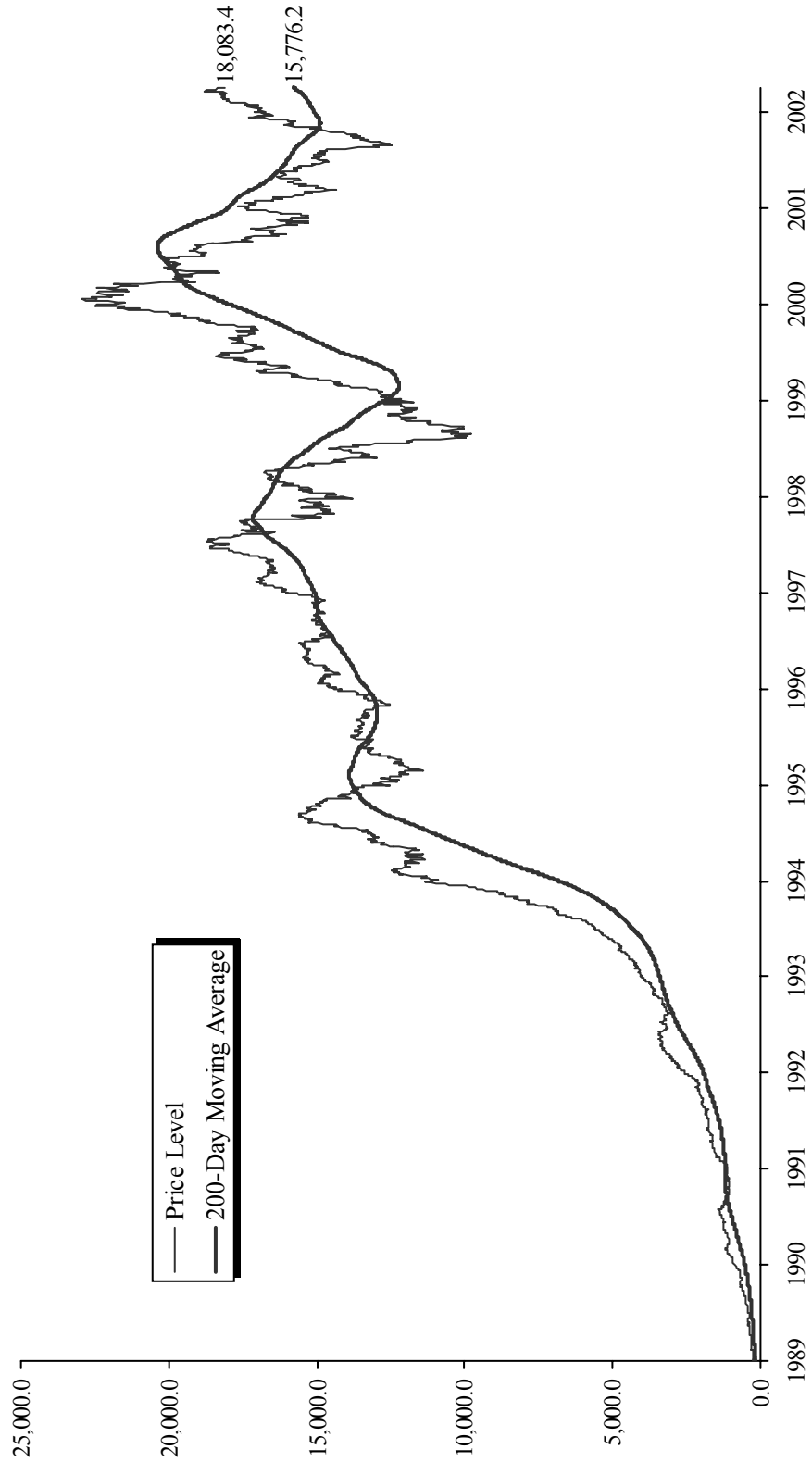
—	Mean
- - -	One Standard Deviation

Source: Thomson Financial Datastream. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

* Dividend yield scales larger to better illustrate changes.

Table G
200-DAY MOVING AVERAGE OF MSCI EMERGING MARKETS FREE INDEX IN LOCAL CURRENCY

January 1, 1989 - April 30, 2002



Source: Thomson Financial Datastream. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

Note: Data are in local currency.