eastspring investments
A member of Prudential plc (UK)

# Why it's time to diversify your Emerging Market exposure

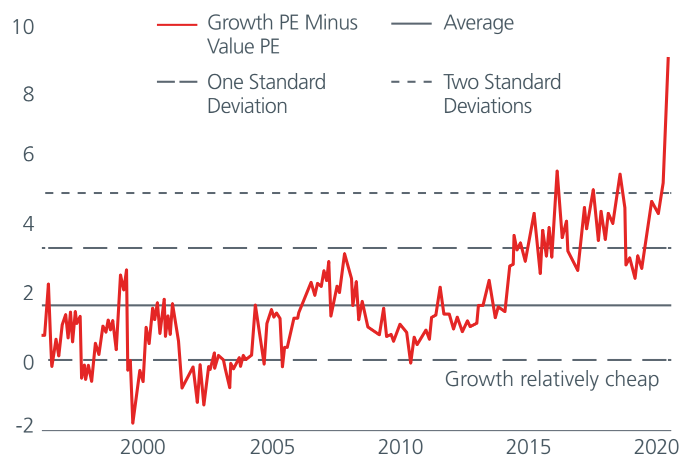
**Sam Bentley,** Client Portfolio Manager, Eastspring Investments, Singapore

**The valuation divergence between value and growth stocks in the emerging markets has reached an extreme, surpassing previous peaks seen during the technology bubble and the Global Financial Crisis. We believe that today's record valuation dispersion highlights the significant opportunities available to investors, as well as the risk to existing growth-biased emerging market portfolios.**

Much has been written about the unprecedented impact of the coronavirus pandemic – the depth of the economic contraction, the swiftness of the market correction as well as the unparalleled monetary and fiscal response of the policymakers. However, the extraordinariness of the situation does not stop there. Investor fears arising from the pandemic have exacerbated the divide between growth and value stocks within the emerging markets, creating an exceptional valuation gap. The valuation difference between growth and value stocks, on price to earnings terms, now far surpasses previous peaks seen during the technology bubble and Global Financial Crisis. See Fig. 1.

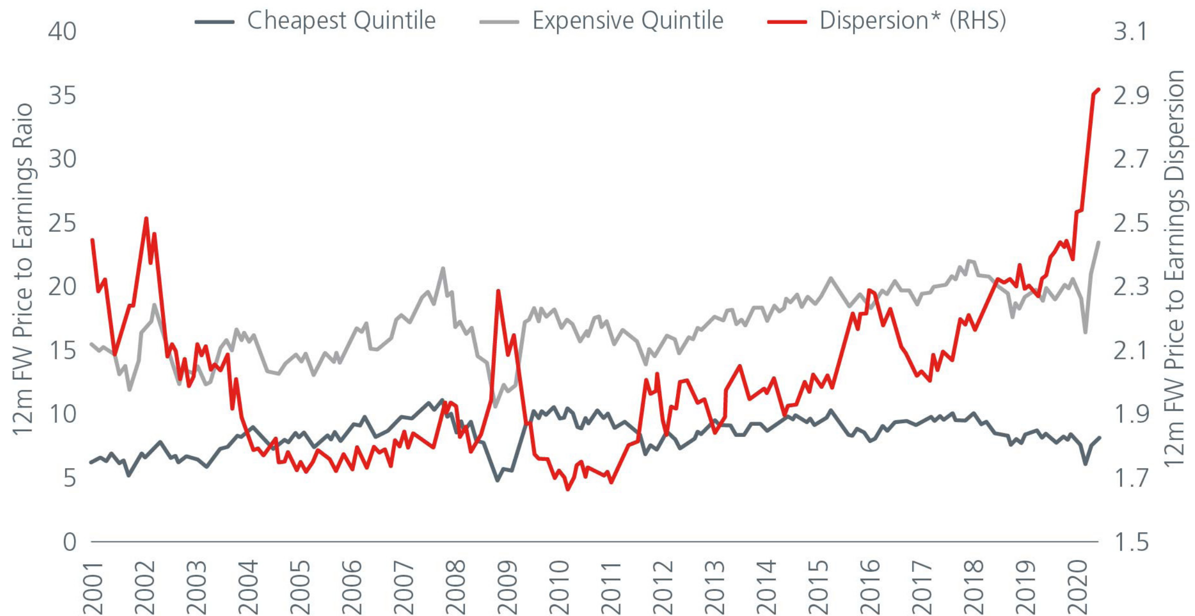
In fact, the most expensive 20% of the stocks within the MSCI Emerging Markets Index is now 3x pricier than the cheapest 20% of the stocks within the index - a valuation dispersion not seen in the last 20 years. See Fig. 2.

**Fig 1: EM Growth relative to Value**




Source: Macquarie Quantitative Research, 30 June 2020. Relative PE (price-to-earnings) of top quintile of quality (by Macquarie quality score) versus top quintile of value (by Macquarie value score) stocks and top quintile of growth (by Macquarie growth score) versus top quintile of value (by Macquarie value score) stocks in MSCI Emerging Markets.

**Fig. 2: Valuation dispersion within the Emerging Markets**




Source: Eastspring Investments, 30 June 2020. *Emerging Market equity valuation dispersion of the top quintile divided by the bottom quintile by Forward 12-month Price-to-Earnings ratio. Universe used is S&P APJ Emerging BMI index plus S&P Korea BMI Index (US$).

Any discussion on the valuation dispersion between growth and value stocks invariably leads to criticism that certain valuation metrics such as price to book value are now obsolete as the intellectual property, brand and marketing positioning of dominant technology companies do not exist on balance sheets unlike hard, tangible assets. We agree. That is why we do not rely on a single valuation method. We consider signals, both absolute and relative from a range of valuation measures including price-to-earnings (PE), price-to-book (PB) and dividend yield (DY).

## PAYING THE PRICE

We are not suggesting that many of the growth companies that have outperformed are not good businesses. Many of the sectors or sub-sectors that have led growth stocks' ascent are likely to benefit in the new normal post-covid – ecommerce, cloud, streaming to name a few. We believe that there are key technological trends that will reshape the global landscape as consumer behaviour changes for good. What we question is the premium which investors are willing to pay for such stocks. And whether the premium is based on extrapolating a continuation of these companies' outsized profits, market share and monopolistic influence into the distant future.

We are also not suggesting that every stock within the cheapest quintile of the index will eventually shine. There are companies which are cheap for a reason. Through fundamental analysis, we filter out poorly-run companies, broken business models as well as value traps and seek to identify good companies that are trading below their fair valuations. Ultimately, we invest in companies where we are highly confident that their discounted valuations are a result of temporary near-term headwinds and that these companies would deliver sustainable earnings over the long term. At the point of writing, we have found attractive opportunities in South Africa and Mexico where investors may tend to overlook given the unfavourable news headlines.

We also have broad exposure across China, just not in the overpriced sectors. Our investment philosophy takes advantage of investors' behavioural bias – the tendency for investors to over-react to both good and bad news, causing them to overpay in the former and underpay in the latter. The pandemic has compounded these tendencies.

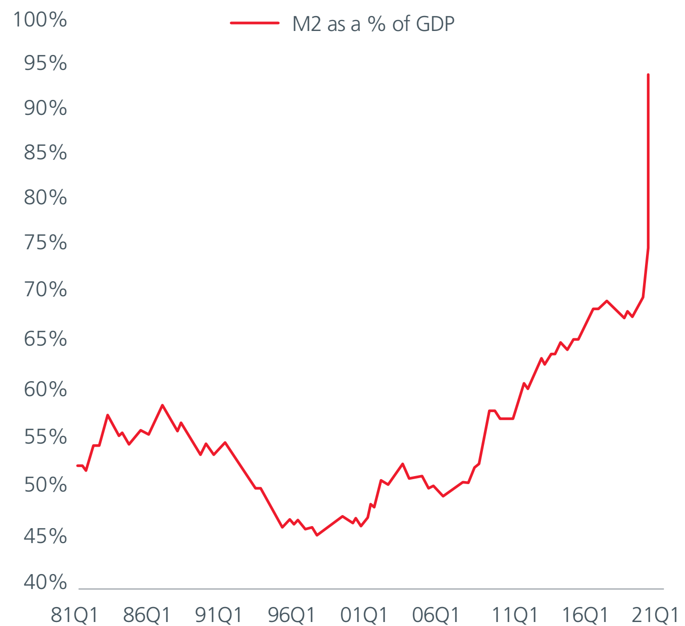
We believe that buying value stocks at this point in the cycle at such extreme valuation dispersion, increases the probability of us adding significant value (excuse the pun) to our portfolios over the medium and long term.

## WHY VALUE NOW?

Value has underperformed growth in the last ten years, testing the resolve of even the most committed value investor. So why look at value now? For one, we believe that today's record valuation dispersion highlights the significant opportunities available as well as the risk to existing growth-biased emerging market exposures. At the same time, value's decade-long underperformance has taken place against a backdrop of eroding inflation expectations and falling interest rates. Low discount rates have in turn justified the lofty valuations of many growth stocks. Today, the unprecedented fiscal and monetary stimuli aimed at offsetting the impact of COVID-19 has caused money supply to spike. Fig. 3 shows that M2, a measure of money supply which includes cash in circulation as well as in savings deposits, has hit a record high as a percentage of nominal GDP.

In more normal times, such high levels of excess cash would fund the purchases of financial assets (which we have seen) as well as goods and services. In the months ahead, optimism over a successful vaccine or treatment can cause a rise in inflationary expectations. Less uncertainty over the macro outlook and higher discount rates can compel investors to seek out the bargains found in value stocks.

**Fig. 3: Record high level of M2 to GDP**




Source: BEA, Federal Reserve, NBER, Moody's Analytics. August 2020.

## TIME TO DIVERSIFY

Our research tells us that most asset owners are likely to have a growth bias in their existing emerging market exposures since value managers currently account for only about 10% of the Global Emerging Market universe[1]. This implies that value managers are likely to offer substantial diversification benefits for long term investors with existing emerging market exposures.

Even for investors without existing growth-biased emerging market exposures, it is reasonable to assume that the extreme valuation divergence is throwing up attractive opportunities. Ironically the extended period in which value investing has not worked, sets the stage for value investing to return.

History tells us that the rotation to value tends to be hard and fast. Investors may want to get prepared.

Source: [1]eVestment Database, 30 March 2020. Eastspring Investments.

## Disclaimer

**This document is produced by Eastspring Investments (Singapore) Limited and issued in:**

**Singapore and Australia (for wholesale clients only)** by Eastspring Investments (Singapore) Limited (UEN: 199407631H), which is incorporated in Singapore, is exempt from the requirement to hold an Australian financial services licence and is licensed and regulated by the Monetary Authority of Singapore under Singapore laws which differ from Australian laws.

**Hong Kong** by Eastspring Investments (Hong Kong) Limited and has not been reviewed by the Securities and Futures Commission of Hong Kong.

**Indonesia** by PT Eastspring Investments Indonesia, an investment manager that is licensed, registered and supervised by the Indonesia Financial Services Authority (OJK).

**Malaysia** by Eastspring Investments Berhad (531241-U).

This document is produced by Eastspring Investments (Singapore) Limited and issued in Thailand by TMB Asset Management Co., Ltd. Investment contains certain risks; investors are advised to carefully study the related information before investing. The past performance of any the fund is not indicative of future performance.

**United States of America** (for institutional clients only) by Eastspring Investments (Singapore) Limited (UEN: 199407631H), which is incorporated in Singapore and is registered with the U.S Securities and Exchange Commission as a registered investment adviser.

**European Economic Area (for professional clients only) and Switzerland (for qualified investors only)** by Eastspring Investments (Luxembourg) S.A., 26, Boulevard Royal, 2449 Luxembourg, Grand-Duchy of Luxembourg, registered with the Registre de Commerce et des Sociétés (Luxembourg), Register No B 173737.

**United Kingdom (for professional clients only)** by Eastspring Investments (Luxembourg) S.A. - UK Branch, 10 Lower Thames Street, London EC3R 6AF.

**Chile (for institutional clients only)** by Eastspring Investments (Singapore) Limited (UEN: 199407631H), which is incorporated in Singapore and is licensed and regulated by the Monetary Authority of Singapore under Singapore laws which differ from Chilean laws.

The afore-mentioned entities are hereinafter collectively referred to as **Eastspring Investments**.

The views and opinions contained herein are those of the author on this page, and may not necessarily represent views expressed or reflected in other Eastspring Investments' communications. This document is solely for information purposes and does not have any regard to the specific investment objective, financial situation and/or particular needs of any specific persons who may receive this document. This document is not intended as an offer, a solicitation of offer or a recommendation, to deal in shares of securities or any financial instruments. It may not be published, circulated, reproduced or distributed without the prior written consent of Eastspring Investments. Reliance upon information in this posting is at the sole discretion of the reader. Please consult your own professional adviser before investing.

Investment involves risk. Past performance and the predictions, projections, or forecasts on the economy, securities markets or the economic trends of the markets are not necessarily indicative of the future or likely performance of Eastspring Investments or any of the funds managed by Eastspring Investments.

Information herein is believed to be reliable at time of publication. Data from third party sources may have been used in the preparation of this material and Eastspring Investments has not independently verified, validated or audited such data. Where lawfully permitted, Eastspring Investments does not warrant its completeness or accuracy and is not responsible for error of facts or opinion nor shall be liable for damages arising out of any person's reliance upon this information. Any opinion or estimate contained in this document may subject to change without notice.

Eastspring Investments (excluding JV companies) companies are ultimately wholly-owned/indirect subsidiaries/associate of Prudential plc of the United Kingdom. Eastspring Investments companies (including JV's) and Prudential plc are not affiliated in any manner with Prudential Financial, Inc., a company whose principal place of business is in the United States of America or with the Prudential Assurance Company, a subsidiary of M&G plc (a company incorporated in the United Kingdom).