Emerging Market Equities: The Case Continues

This paper will address the need for investors to consider the full potential of emerging markets within their global opportunity set.

T. ROWE PRICE
Investment *Dialogue*

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EXECUTIVE SUMMARY

- Emerging market (EM) equities account for rising shares of global gross domestic product (GDP) and market capitalization and an even larger share of expected economic growth. However, direct exposure to EM equities within many actively managed global equity portfolios implies that sentiment has not been especially bullish.
- Outside of near-term inflation and growth concerns, skeptics cite the political, exchange rate, and corporate risks associated with exposure to EM equities. But the evolution of EMs over the past decade suggests these concerns may be excessively influenced by historical attributes. Forward-looking indicators—such as EM sovereign debt spreads—reflect a much-improved risk environment.
- Short- and longer-term economic trends appear to favor EMs. Although indirect exposure to EMs can be found via developed markets, this is not a complete substitute for direct investment as it may exclude industries and stocks central to the EM growth story.
- EM valuations have converged with developed markets, in part because the latter are trading below long-term averages on growth and sovereign debt concerns. While conventional wisdom suggests EM equities should trade at a discount, our view is that convergence is consistent with relative fundamentals. Overall, EM valuations appear attractive, especially after recent weakness, although the potential for future asset bubbles should always remain a consideration.
- The structurally low EM allocations of some global equity managers may reflect a preference for benchmarking to the Morgan Stanley Capital International (MSCI) World Index, which excludes direct exposure to EM equities. We favor benchmarks that more fully reflect the global opportunity set, such as MSCI's All Country World Index (ACWI).

The strong performance of EM equities following the 2008 financial crisis attracted both record capital inflows and questions as to whether investors were herding into the next asset bubble, while 2011 saw EMs fall considerably out of favor with investors. Despite swinging sentiment and meaningful changes in valuations, relative exposures within actively managed global equity portfolios have been relatively stable and, at an aggregate underweight, have not indicated bullish

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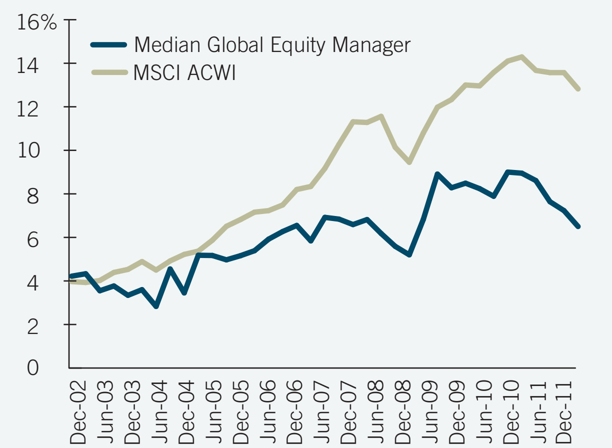
consensus. InterSec, a U.S.-based consultancy, reports that the typical global equity manager had only a 6.5% weight in EM equities at the end of 2011—up from 4.0% in 2002 but well below the 12.8% weight in the MSCI ACWI Index (Figure 1, below).

Figure 1: EM Exposure of Median Global Equity Manager vs. EM Weight in the MSCI All Country World Index



Source: InterSec Research

Such positioning may indicate a negative view of EMs—or, by implication, a more positive opinion of developed world equities. But the persistence of the trend over the past decade, through both bullish and bearish periods, perhaps suggests a more structural bias in EM equity exposure relative to index weights or global GDP shares.

We believe the underlying factors favoring EMs will persist over the medium to long term, and that the significance of the emerging world within global equity markets will continue to rise. These positives include reduced sovereign risk, faster economic and earnings growth, and structural improvements in profitability at many EM companies.

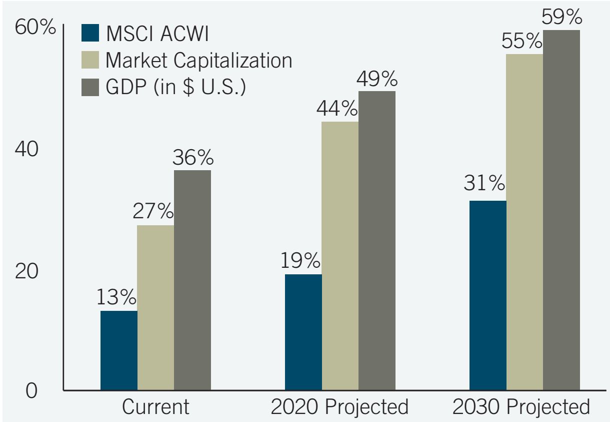
Of course, while there are downside risks to our core scenario, and short-term corrections will remain a feature of EM investing, we view an extended reversal of these trends as unlikely. Economic fundamentals remain relatively healthy, and better than most of the developed world, while valuations, corporate balance sheets, and high dividend yields provide ample reasons for continued investment. Accordingly, we continue to view these markets as highly attractive sources of stock-specific growth ideas.

EM IN CONTEXT

As of 31 Dec 2011, EMs accounted for 13% of the MSCI ACWI—a weighting that has increased 230% since 2002 on the basis of strong relative returns and a broadening of the EM investible opportunity set. However, the projected changes in the global significance of the EMs are expected to be even more dramatic over the next 10 to 20 years (Figure 2, below).

Figure 2: EM Shares of Global Totals

Current (12/31/11) and Projected



Sources: FactSet, IMF, World Bank, World Federation of Exchanges, MSCI, and Goldman Sachs

Highlights include:

- Emerging equities already account for 27% of total world market cap. This is more than double their weight in the MSCI ACWI—the difference reflecting substantial government stakes and other long-term holdings that are currently unavailable for purchase or sale.
- Estimates suggest that the EM share of total world market cap will continue its rapid rise: to 44% by 2020 and 55% by 2030.
- The gap between capitalization and free-float should shrink substantially going forward, thanks to initial public offerings (IPOs), privatizations, and the unwinding of cross-ownership arrangements.

The EM share of global GDP is expected to rise almost as rapidly. The International Monetary Fund (IMF) estimates that emerging and developing economies (a category that also includes frontier markets) will have produced 37% of world output in U.S. dollar terms in 2011 versus 25% for the European Union and 21% for the U.S. This is up from only a fifth of global GDP in

2000.[1] The EMs are projected to reach 41% of global GDP by 2016, 49% by 2020 and almost 60% by 2030. In purchasing power parity (PPP) terms, they *already* account for more than half of world GDP.

A STRUCTURALLY IMPROVED RISK ENVIRONMENT

Some investors continue to be concerned about higher volatility historically associated with direct investment in EM equities, particularly given the sharp sell-off and highly correlated nature of EM stock returns in 2008, which is still fresh in investors' minds. However, long-term historical trends may not be a reliable guide to future results. While EM equities are more volatile when compared with developed market counterparts—with this trend likely to remain so for the foreseeable future—backward-looking volatility estimates are biased upwards by the EM debt crises of the 1990s.

Forward-looking risk measures, on the other hand, appear relatively more benign—especially when compared with the developed world, which faces both the economic aftermath of the 2008 crisis and serious long-run fiscal and demographic problems:

- **Public debt:** The IMF projects that sizable fiscal deficits will push public debt in the advanced economies (in aggregate) to 105% of GDP by 2015. The average in the emerging and developing countries, on the other hand, is expected to decline to 33%, thanks to relative spending restraint and healthy economic growth.
- **External debt:** The IMF reports that EM foreign debt burdens have declined substantially since the Asian crisis from an average 160% of export revenues in 1999 to a projected 72% in 2012.
- **Currency risk:** The growth of local EM bond markets has reduced US dollar-denominated debt as a share of total external debt, leaving governments and private borrowers less vulnerable to the kind of balance sheet mismatches that proved so disastrous during the Asian crisis.
- **Foreign reserves:** EM central banks continue to accumulate hard currency assets, which reached U.S. $6.9 trillion as of 31 Oct 2011, up from U.S. $965 billion at the end of 2002, according to the IMF. While this has added to inflationary pressures in some countries, it provides considerable protection from short-term capital flight. The value of this safeguard

INFLATION AND GROWTH

Having shown considerable strength following the global financial crisis, EMs delivered significant underperformance against developed markets in 2011, causing many to question whether the EMs story was entering a new and less attractive phase of its evolution. Alongside sovereign debt and growth issues in the developed world affecting risk assets broadly, a combination of inflationary pressures early in the year and decelerating growth later in the year, also affected sentiment toward EM equities.

Having risen to near cyclical peaks in the first half of 2011, inflation rates in the emerging world began to fall during the latter half of 2011, indicating that monetary tightening measures have yielded the desired effect. Unfortunately, this improvement in the inflation backdrop was overlooked in light of concerns that the accompanying near-term economic slowdown resulting from higher interest rates might be harsher than policymakers intended. Such concerns were compounded in light of the slowdown in import demand from the eurozone.

We continue to believe that policymakers have reacted appropriately by targeting a stable long-term inflationary environment—even at the expense of near-term economic growth. While fears of a "hard landing" in China remain a threat, inflation control is needed to preserve the strong foundations that many emerging countries have worked hard to build over the past decade. Moreover, we believe a hard landing scenario in China is unlikely. China's policymakers have demonstrated the willingness to prioritize long-term economic growth in a sustainable fashion and, with inflation abating, have already begun to enact accommodative policy measures. With economic growth across the emerging world expected to grow at around 6% p.a. over the next two years, we continue to see EMs as a global engine of growth—albeit near-term risks will continue to create volatility and, hence, attractive entry points for investors.

[1] IMF, World Economic Outlook database, September 2011.

was demonstrated in 2008, when EMs as a whole were able to weather a U.S. $1 trillion decline in private inflows with relatively minimal financial disruption.

These structural gains have led to a steady tightening of spreads on EM sovereign debt (Figure 3, right). It seems reasonable to believe that the reduced risk premiums visible in these spreads should also be reflected in EM equity valuations.

Improvements in macroeconomic stability over the past decade have been mirrored in the corporate sector, which has managed to improve return on equity (ROE). Between 2003 and 2011, ROE has climbed from 10.4% to 14.7% in the emerging world while developed world companies have seen little structural change.

As opposed to being a purely cyclical trend, EM profitability appears to be on a structural upward trend: ROE has been higher for the MSCI EM Index than for the MSCI World Index in every year since 2001 (Figure 4)—implying that strong EM returns over the past decade (the MSCI EM Index has returned +14.2% p.a. between 1 Jan 2002 and 31 Dec 2011 versus +7.2% p.a. for the MSCI World Index for the same period) have been solidly underpinned by improving fundamentals.

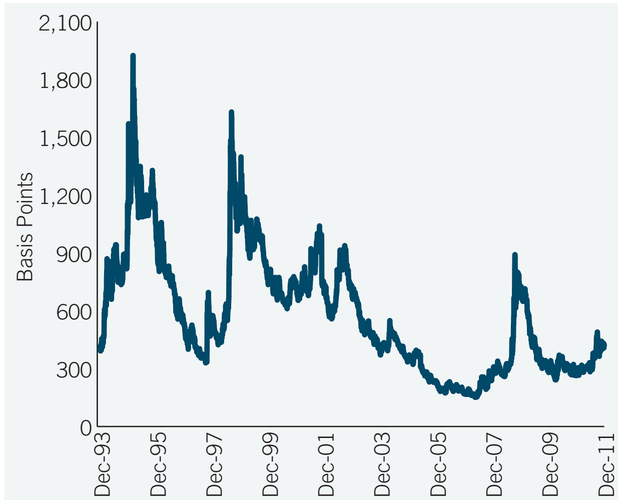
SHORT-TERM AND LONG-TERM GROWTH DYNAMICS FAVOR EMs

While EM economies account for a high and rising percentage of global GDP, they are generating an even larger share of global economic growth.

In the short run, this trend is being exaggerated by sluggish recoveries in developed countries. Current IMF figures show the emerging and developing countries averaging 6.4% real GDP growth in 2011 and 6.0% in 2012 versus 1.6% and 1.9% for the advanced economies, respectively. Growth rates in excess of 5% are projected across much of emerging Asia, Latin America, and the Middle East and Africa (Figure 5). These forecasts imply that EM economies are expected to account for more than 70% of global GDP growth over the next three years, in PPP terms. Longer-term trends also suggest that future earnings growth in many global industries will be driven primarily by the emerging world:

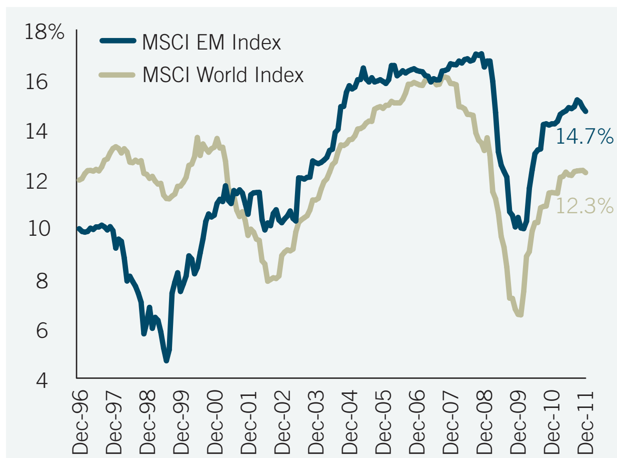
- **Demographics:** The populations of nearly every developed country—with the significant exception of the U.S.—will begin to shrink before mid-century. While some EM countries (China, in particular) face similar futures, on average they are not nearly as far along the aging trajectory, and still have large, young, rural populations looking to enter their urban labor markets.

Figure 3: EM Sovereign Spreads Over U.S. Treasuries
MSCI EM Bond Index Global as of 31 Dec 2011



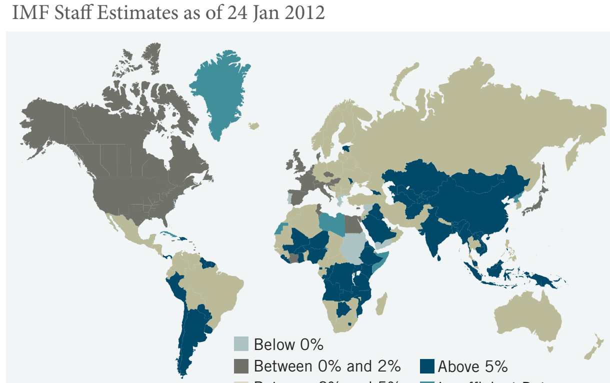
Source: FactSet

Figure 4: Return on Equity
As of 31 Dec 2011



Source: MSCI

Figure 5: Projected 2011 GDP Growth Rates
IMF Staff Estimates as of 24 Jan 2012



Source: IMF

- **Productivity:** Even more advanced EM countries are still far behind the developed world. GDP per worker in South Korea, for example, is still only 58% of the U.S. levels, while in China it is 18% and in India 8%.[2] As a study by the New York Federal Reserve notes, this creates "ample high-return investment opportunities and scope for technological advance" in the emerging economies.[3]
- **Consumption demand:** Analysts have long predicted that rising EM incomes would propel a shift from export-led to consumption-led growth. This shift is well under way. The BRIC (Brazil, Russia, India, and China) countries accounted for a larger share of global consumption growth than the U.S. in 2007, 2008, 2009, and 2010.[4]

DIRECT AND INDIRECT EM EXPOSURE

EMs are a significant source of earnings growth for many developed world companies—large-cap industrial and consumer multinationals in particular. This raises a natural question: Why do investors need to hold EM equities (and the higher volatilities associated with them) when indirect exposure to EM growth can be obtained via the developed markets?

The answer, of course, is that one can find EM growth opportunities in the developed markets—and there will be times when these opportunities appear more attractive, due to relative valuations or other factors. However, indirect exposure is often an incomplete substitute for direct EM investment and may not allow the portfolio manager to capture the intended risk and return thesis—this is particularly true when targeting stock fundamentals with leverage to micro themes, as opposed to targeting prospective returns with greater links to top-down or macro-based emerging world trends.

Even in a globalized economy, most companies in most industries still generate the bulk of their revenues in home markets. A "virtual" EM portfolio of developed multinationals inevitably will be biased towards some sectors (technology, industrials) and away from others (utilities, financials, telecommunications) where local companies are dominant.

In contrast to the consumption booms seen in many developed countries (most notably the U.S.) over the past decade, EM consumer demand is being fueled by broadening wealth gains, not debt. With net national savings rates averaging more than 34% of GDP in the emerging world versus 19% in Europe and 13% in the U.S., household leverage remains low, according to the IMF.

Fiscal prudence, combined with investment rates that average more than 30% of GDP across the EM world, according to the IMF, has created the conditions for the self-financing growth cycle we see now.

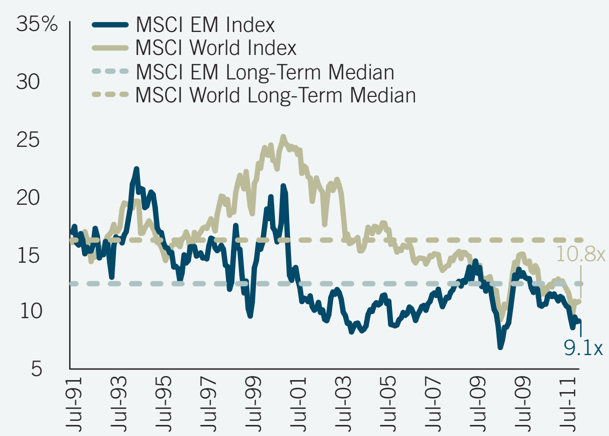
EM VALUATIONS APPEAR REASONABLE

In addition to the strength seen year-to-date, EM equities have performed strongly over the medium and long term, and have attracted large fund flows since the bottom of the 2008-2009 bear market. Given this backdrop, there have been concerns voiced that EM investors have pushed valuations to unsustainable levels—a view endorsed by some commentators, who warn of an EM bubble.

Evidence of a broad-based bubble is hard to find in the data, however. While clearly not cheap when compared with the 2008 market trough, we believe EM equities appear reasonably priced—especially considering their superior growth prospects. At the end of December 2011, the price/earnings (P/E) ratio for the MSCI EM Index was 9.1 versus a 20-year median of 12.3 (Figure 6). At 1.6, the index's price/book ratio was below the long-term (20-year) median of 1.8 but still well below the 2007 high of 3.0.

Figure 6: P/E Ratio

Based on IBES 12-Month Forward Earnings as of 31 December 2011



Sources: IBES, FactSet, and MSCI

[2] Data as of 2009 via the Center for International Comparisons of Production, Income, and Prices, University of Pennsylvania.
[3] "Is the United States Losing Its Productivity Advantage?," *Current Issues in Economics and Finance*, New York Federal Reserve, September 2007.
[4] Data provided by Morgan Stanley Global Research.

Although top-down valuations remain reasonable, there will always be areas within an attractive asset class that appear expensive at any given time. Today's environment is no different. However, the breadth of the EM equity opportunity set, compared with 10 years ago, should give active managers the scope to accommodate relative valuations within EMs while also balancing the growth and valuation potentials of EM and developed world companies.

Valuation differentials between developed and emerging markets have narrowed substantially over the past decade as seen via the P/E ratios in Figure 6. In the case of price/book, they have essentially reversed, with the MSCI EM Index valued in line with the MSCI World Index at the end of 2011. But relative valuations have shifted very little over the past three years—the period in which the alleged EM bubble is said to have formed. Moreover, there is a case that narrower discounts relative to the developed markets—or even an EM valuation premium—may be justified, both by the improved risk factors cited above and their relative growth prospects.[5]

Recent research from Goldman Sachs appears to support the case that EMs have yet to peak, given still reasonable valuations and above-average growth prospects.[6] Goldman analysts examined the 10-year correlations between valuation, earnings per share growth, and equity returns (Figure 7). Not surprisingly, the analysis shows that, over the long run, valuations matter—and in the developed markets they matter a great deal, with 10-year equity returns having a -0.92 correlation with initial valuations (the implication being that inexpensive valuations are central to positive future returns). But earnings growth also matters, and in EMs it appears to matter more: 10-year returns show a 0.89 positive correlation with forecast EPS, a stronger statistical relationship than between EM returns and EM valuations. In other words, EM equity returns historically have been driven by robust growth rather than cheap valuations. If growth remains strong in the emerging world over the long term, as we expect it will, this should bode well for EM equity returns.

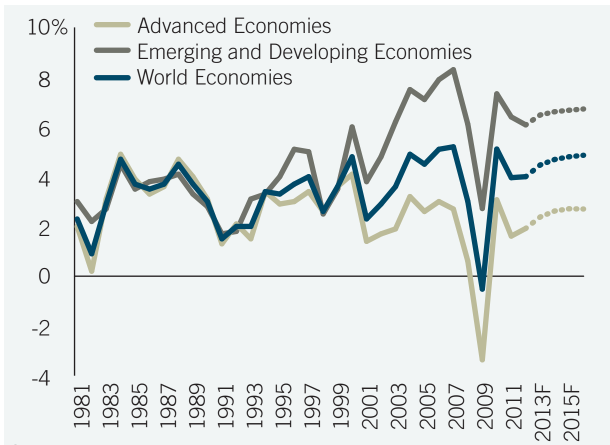
Figure 7: Equity Return Correlations
1987 Through 2011

10-YEAR RETURNS VS:	STARTING VALUATION	EPS CAGR
Developed Markets	-0.92	-0.15
Emerging Markets	-0.53	0.89
Global Markets	-0.67	0.67

Source: Goldman Sachs Global ECS Research

Clearly, EM equities are no longer the standout undervalued asset class they were at the depths of the financial crisis. On the other hand, their growth prospects—both absolute and relative—have continued to improve since that time. This is in marked contrast to the bubbles of the 1990s, when the superior (relative to the developed world) growth potential of EMs was widely hailed, but not realized on a global basis (Figure 8).

Figure 8: Real GDP Growth, Annual % Change
2012 Through 2016 Based on IMF Forecasts as of 20 Sep 2011



Source: IMF

EM FUND INFLOWS ARE BEING MET WITH NEW SUPPLY

Another pillar put forward in the case against EM equities is the scale of capital inflows into EMs. According to EPFR Global, a U.S. research firm, these reached U.S. $95.8 billion in 2010, following a then record U.S. $83 billion in 2009 (but a record outflow of U.S. $49.5 billion in 2008). Skeptics argue that these are classic signs of irrational exuberance and this appears to have driven some of the sharp unwinding of EM positions in 2011 (when dedicated EM funds reported outflows of $48.2 billion USD). However, despite these inflows, we

[5] See "Do Emerging Equity Markets Deserve a Valuation Premium?," T. Rowe Price Investment Dialogue, August 2008.
[6] Goldman Sachs Global ECS Research, *EM Equity in Two Decades: A Changing Landscape*, September 8, 2010.

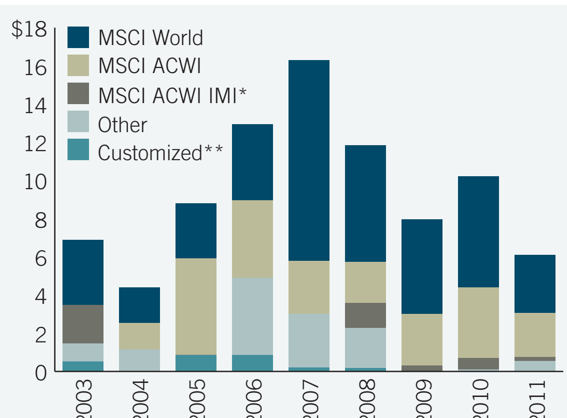
have not seen evidence of broad-based multiple expansion one would expect in an irrational market. (Compare this with the technology bubble in the late 1990s and the subsequent multiple contraction that led to the lost decade for developed market equity returns in the 2000s. From 1 Jan 2000 through 31 Dec 2009, the MSCI World Index returned -18% cumulatively. The MSCI Emerging Markets Index returned +162% cumulatively, however, in part due to an attractive valuation start point.)

One reason may be that inflows are being absorbed by new supply. Ernst & Young reports that EM initial offerings raised more than $195 billion USD in 2010, accounting for 69% of global IPO volume. This included almost $82 billion USD from the privatization of state-owned EM enterprises. China accounted for the vast majority of these privatization deals, although India, Poland, and Indonesia also made substantial offerings. While the terms of some offerings have been criticized as unfair to investors (and thus, evidence of an overheated market), to us they simply reflect the realities of the situation: Growth is at a premium globally.

As with any strong investment case, investors ultimately may push prices to unsustainable levels—especially if newcomers rush into the asset class late in the cycle, at a point when valuations may no longer be as reasonable. However, we see little evidence now that EM returns have outstripped the fundamentals, particularly after the relative weakness seen in 2011. On the contrary, we believe there are many attractive opportunities to be found via bottom-up stock selection.

Figure 9: Global Equity Initial Fundings by Benchmark

In U.S. $ Billions, as of 31 Dec 2011



*Investable Market Index

**Primarily combinations of U.S. domestic and international benchmarks

Source: Intersec Research

BENCHMARK CHOICE MAY CONSTRAIN EM EXPOSURE

EM weights within many global equity strategies may be well below index and market cap levels because managers are benchmarked to indexes that do not include direct exposure to EM equities.

The eVestment Alliance, a U.S.-based research firm, reports that 75% of the global equity managers in its database (356 out of the 475) are tied to the developed-only MSCI World Index, which also accounts for the bulk of newly awarded global mandates in its universe (Figure 9, as of 31 Dec 2011). If not balanced by dedicated EM allocations, benchmarking global equity allocations to the MSCI World Index may cause portfolios to lag the evolution of the EMs within global markets.

To the extent benchmark choice significantly affects decisions regarding EM versus developed market exposure, it may dilute one of the advantages of a global equity mandate: the ability of global managers to leverage their skills across the broadest possible opportunity set in order to create high-conviction portfolios within defined risk and return tolerances. Including EM exposure in the benchmark serves this purpose in three ways:

- **Stock selection:** The MSCI ACWI contained 2,435 stocks to the MSCI World Index's 1,615 as of 31 Dec 2011 —a 51% increase in the bottom-up opportunity set.
- **Top-down sector and/or country bets:** Adding the 21 EM countries to the 24 developed markets more than doubles the possible country/industry pairs from 990 to over 2,300 (based on the MSCI ACWI).
- **Tactical allocation:** Less constrained managers have greater ability to make global stock comparisons and shift from EM holdings to indirect exposure via the developed markets based on valuation or other factors.

CONCLUSIONS

Projected trends in global economic growth and new equity issuance suggest that EM shares of world market cap and public float will continue to rise. However, the data show that many global equity managers retain a persistent underweight position to EM equities, perhaps in part reflecting the widespread use of the MSCI World Index as a performance benchmark.

In our view, the trends that have driven EMs to meaningfully outperform the developed world over the past decade—decreased sovereign risk, structurally higher profitability, and better relative growth prospects—are likely to persist over the medium and long term. While there are downside risks, such as the potential for higher inflation and higher interest rates, these risks are more than offset by the bottom-up opportunities available in these markets.

Current relative valuations will certainly favor indirect exposure to the EM economies via developed market companies at certain stages of the cycle. However, we believe direct and indirect exposure are both necessary to capture the full potential of EM growth. A case can be made that the convergence in valuations seen over the past decade has been underpinned by changes in relative risk and growth fundamentals. In absolute terms, EM valuations still appear reasonable relative to historical averages.

Investors should recognize that EM equities have different risk and return profiles when compared with developed markets. They remain more segmented, with greater dispersion of returns. Liquidity is more likely to be an issue, as are gaps in sell-side coverage. At times, these factors will lead to higher volatility. However, we believe they also create the potential for active managers (whether dedicated EM, international, or global) to add value where they have the research capabilities to identify opportunities in this dynamic asset class.

T. ROWE PRICE AT A GLANCE

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