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Value approaches to investing in emerging markets – why multiples can be deceptive

Executive summary

- The labels 'value' and 'growth' oversimplify how the art of valuation should be thought about.
- 'Value' can become confused with contrarian and what we dub 'naïve' value investing. We believe all investing must be based on intelligent and rigorous analysis.
- 'Price-to-intrinsic-value' investing is true value investing and represents a set of tools, not dissimilar to 'growth at a reasonable price' (GARP) investing, and is applicable everywhere, including in emerging markets.
- The MSCI Emerging Markets index is unlike other mainstream global and regional comparative indices in both its composition and its behaviour. It has some unusual features which we believe an active investment approach is best placed to contend with.
- Value outperformed growth for many years in emerging markets, but has given way to quality over the last six years. There are mounting calls for this to mean-revert, but we caution against this view.
- Over the long term, the aim of our fundamental process is to seek out the companies with the highest ***value-creating*** growth relative to their current share prices.
- A company with high headline multiples can, we believe, offer a better margin of safety than a stock with low headline multiples. The key is the quality and prospects of the underlying businesses.
- Companies that can grow and generate enough value to justify their multiples, whatever they may be, can at once be both growth and value businesses. These are rare, and are in our view the best companies and the only ones we seek to invest in.

Introduction

We are style-agnostic managers; indeed, we rarely pause to consider which investment 'style' or 'factor' investment in a given company's equity may be classified as. Fundamentals and trends identified by our investment themes are what drive our investments. However, we are *not* valuation agnostic: we want to buy the stocks we like, when they are out of favour, and at a substantial discount to what we believe to be their 'intrinsic value'. This, we believe, should provide the opportunity for attractive returns at acceptable risk levels over an investment time horizon of at least five years. We believe the commonly used, dualistic labels of 'value' and 'growth' oversimplify how the art of valuation should be thought about. Here we set out to tackle this issue, by looking at history, analytical theory and practical application in order to provide insight into our methods and try to dispel some myths.

As investors, we aim to maximise returns and minimise the risk taken to achieve these returns, while acknowledging that returns are never entirely risk-free. The use of style analysis is often used to break down performance and to try to understand underlying drivers of performance better. We believe that most such analysis is superficial by its very nature, given the desire to maintain simplicity of argument. In the real, highly complex world, such oversimplification can give false signals, such as the theory that what has worked in the past should work in the future.

We do not argue for a prescriptive guide to portfolio construction. What we would highlight, however, is what we believe to be the fallacy of an unsophisticated or 'naïve' value-based strategy compared to one that includes intelligent analysis to better estimate the intrinsic value of each security.

The history

Value investing as a concept was developed during the 1920s and onwards by Benjamin Graham and David Dodd. The key principle of true value investing is based upon buying stocks which thorough fundamental research suggests are trading at a discount to their intrinsic, or underlying, value with a substantial margin of safety; in fact, the term 'value' in this context is an abridged version of the original idea of 'price to intrinsic value'. The aforementioned margin of safety allows an investor to gain comfort that they will be able to 'buy low and sell high'.

What value investing is, and what it isn't - an important distinction…

From these beginnings, perhaps lazier investors, chasing an easier profit, commandeered the label 'value' to mean something slightly different. These investors might be better termed 'contrarian', in looking for securities that are out of favour, and buying them purely on the basis of low price-to-book (P/B) or price-to-earnings (P/E) valuations in the belief that these revert to their mean, rather than rising to an assessment of their intrinsic value. An ostensibly low P/E or P/B ratio (past or predicted) is, we believe, certainly no substitute for an assessment of the intrinsic value of a security. We contend that value managers who favour low P/E and low P/B on 'value' grounds are not giving due attention to intrinsic value. Unfortunately for the credibility of value investing, the performance of these managers is assimilated with value, but they are actually taking a contrarian approach.

In a mean-reverting system, buying when stocks are out of favour is synonymous with buying value. In a non-mean reverting system, that is not the case. Regime changes are commonplace as the global economy develops and changes, and hence we may see 'persistent' deterioration or improvement in prospects of different businesses, and hence in their value. Emerging markets are not mean-reverting systems. Once in a while they may offer spectacular contrarian buying opportunities, based on mean reversion (for example, after the Asian crisis), but more typically business prospects are not consistent or linear in either direction.

What constitutes value – defining types and misconceptions

True value investing – that is 'price to intrinsic value' investing – is a methodology more than a doctrine. Followed as such, we readily accept that this approach has merit. It is not in fact so very far away from 'growth at a reasonable price' (GARP) investing, which involves a similar workflow, including DCF (discounted cash flow) techniques to determine the value of a company. In our view, true value investing can be highly effective in all markets, including emerging markets. The proviso is that some intrinsic value investors may be thinking with a shorter-duration mindset, perhaps based on recent experience or near-term forecasts, with a holding period only as long as it takes for the asset to recover to a certain, predetermined level.

The growth investor, on the other hand, has a longer-term investment horizon. Predicated on the principle of compounding, he can buy and hold the asset for as long as the growth story remains intact and the valuation remains attractive in that context.

Neither growth nor value investors strictly adhere to the efficient market hypothesis that all 'knowable' information is in the price. Value investors look for mispricing or anomalies that indicate the market is 'getting something wrong', whereas growth investors seek to take advantage of the structural undervaluation by the market of high-growth companies which are able to compound their value creation. Investors should not be able to makes gains on the basis of growth alone, as that too should, in theory, have been efficiently 'priced in'. It is only if the growth is not adequately reflected in the starting value that anomalistic opportunities are provided for growth investors.

In keeping with our view is Charles Munger's (vice chairman of Berkshire Hathaway) quote that "All intelligent investing is value investing".[1] By 'intelligent', what is meant here is that the investment approach employs rigorous analysis, aligned with the work of Graham and Dodd. For example, an intelligent GARP manager would be taking a view on future risk-adjusted cash flows – just like an intelligent value manager. In an emerging-market universe, it is not inconceivable that the two managers could buy the same stock.

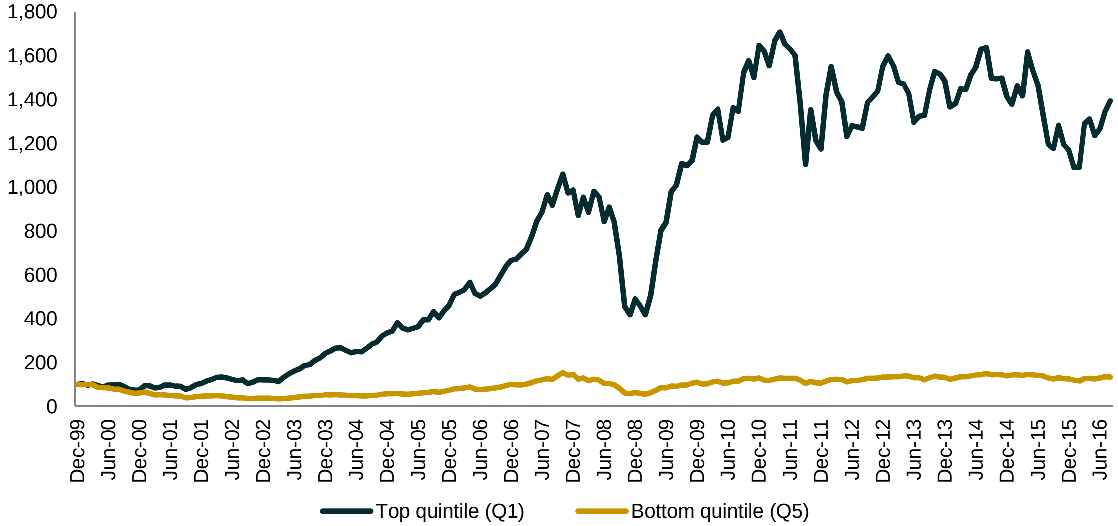
Munger goes on to say: "you must value the business in order to value the stock." We believe very strongly in investing in companies, rather than just in stocks, and certainly not in 'plays' on things. From the moment we do so, we become joint owners of that enterprise, and we take that seriously. In this regard, P/E and P/B ratios on a stand-alone basis tell us nothing about the business or the balance of future rewards or risks. Our approach, therefore, is to start by understanding the business and its prospects. We translate that into a view on the rate at which the business will compound its value over time or, in some cases, destroy value over time. From there, we arrive at an expected total return from the perspective of the equity holder. If the total return looks attractive after being tested against a range of scenarios, the stock should offer good value, regardless of P/E or P/B. By extension, a stock with high headline multiples can offer a better margin of safety than a stock with low headline multiples. The key is the quality and prospects of the underlying businesses.

Not all created equal

For every 'cheap', 'mispriced' stock that 'recovers' there will be many others that continue to perform poorly. So there is significant skill required to be successful in 'intelligent' value investing on a sustained basis. Stocks trading at low multiples usually do so for good reasons.

[1] http://bit.ly/2e2DFgM

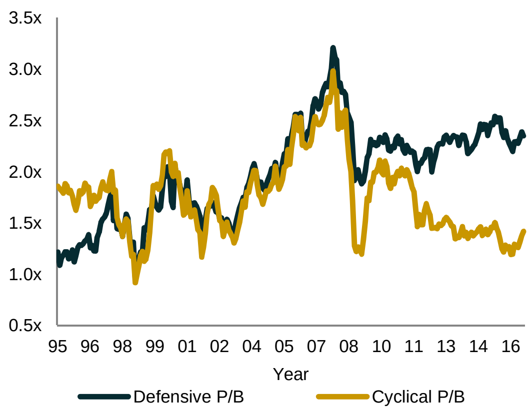
Exhibit 1: MSCI Emerging Markets: value performance (since 2000) – top and bottom quintile (Index)



Source: CLSA, September, 2016

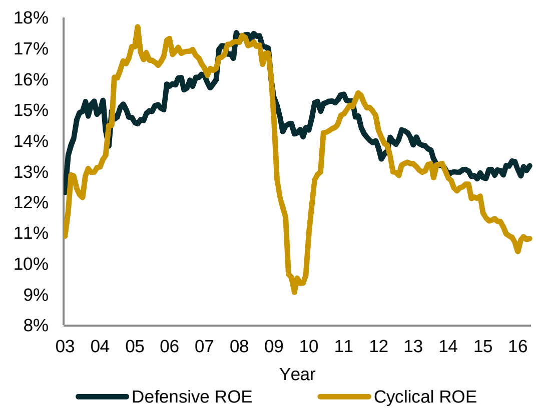
What needs to be analysed is whether the market has been efficient in estimating the value of those ‘good reasons’ over a longer investment horizon, and therefore whether the prospects of the company’s value have been correctly assessed, or whether there may be an opportunity owing to other factors such as an overreaction of sentiment, or less stock-specific issues such as nearer-term sector or macroeconomic headwinds. Low P/E stocks in cyclical sectors, where earnings are highly correlated with the economic cycle, can also create an optical illusion. Their valuations look low when the environment is favourable, but can move very quickly, hollowing out their profits and margins. In these cases we need to look firstly at a range of different measures, but most importantly at through-the-cycle performance.

Exhibit 2: Defensives vs cyclicals: price/book



Source: IBES, MSCI, UBS, September 2016

Exhibit 3: Defensives vs cyclicals: return on equity (ROE)



Source: MSCI, UBS, September 2016

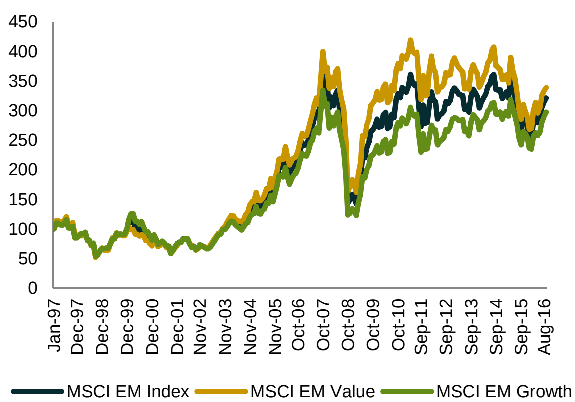
A simplistic approach to value investing, whereby investors seek purely to identify optically low multiples, assuming these will be mean-reverting and that this gives them an assumed margin of safety, we dub ‘naïve’ value investing. It is our contention that this approach asks too few qualitative questions, which is where our investment themes come in. Consider the example of the South Korean market, ostensibly, in our opinion, a natural hunting ground for 'naïve' value investors owing to its low P/Es and P/Bs. The 'naïve' value investor would consider these to be an indication of a favourable margin of safety in valuations. But a more sophisticated and fundamental 'price to intrinsic value' investor would ask more questions. For instance, given demographics (as highlighted by our *population dynamics* theme), the outlook for many constituents of the South Korean market would appear to be as sclerotic as for developed markets. Moreover, we think many Korean companies are poor fiduciaries of shareholders' capital, and hence destroy value when they recycle capital or attempt to grow. Factoring these two points into a proper assessment of intrinsic value would tell the value investor that many South Korean equities deserve to trade on their low multiples, and they would therefore be avoided by an 'intelligent value' investor not wishing to be caught in the value trap.

'Value' performance in the recent past

Emerging markets are often considered synonymous with growth: they have recently been contributing c.60% of global GDP growth, and account for 90% of the world's population under 30, an age group whose purchasing power is broadly rising.[2] However, 'value'-style investing (as measured using the MSCI Emerging Markets Value index) significantly outperformed growth (as measured using the MSCI Emerging Markets Growth index) in the region, with little interruption, throughout the period from 2000 to 2010.

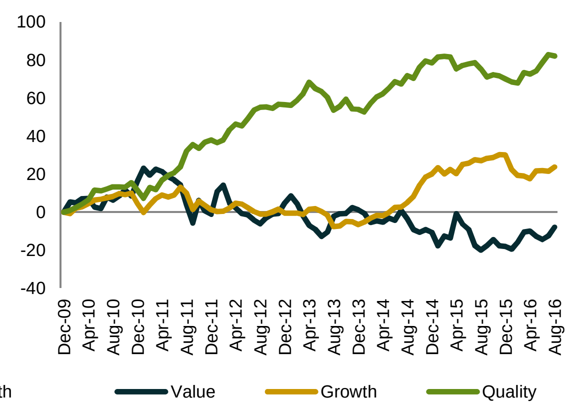
Over the last six years, the performance of 'value' in emerging markets has given way to growth, and more particularly to quality. A number of investors, perhaps of a contrarian bent and with a belief in mean reversion, have been questioning whether this will indeed reverse. However, emerging markets, as an asset class distinct from developed markets, have unusual features which lead us to caution against a 'naïve value' approach to investment and instead advocate defining these terms very carefully and being prepared to look a little deeper than a seemingly 'cheap' or 'expensive' headline multiple.

Exhibit 4: Long-term MSCI EM Growth and Value total-return indices



Source: Thomson Reuters Datastream, Newton, 29 September 2016

Exhibit 5: MSCI EM: Style premiums (since 2010) – value vs growth vs quality
(OPF Index, Q1–Q5)



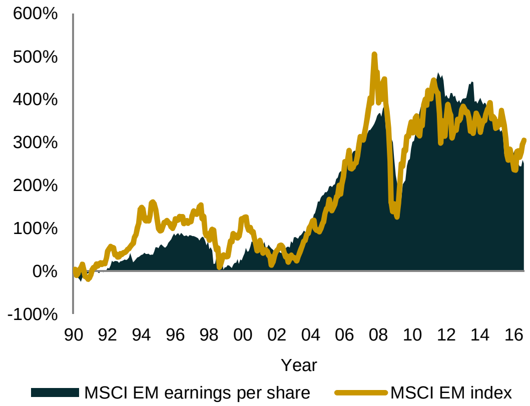
Source: FactSet, CLSA, September 2016

Over the long term, the aggregate valuation of the stock market should oscillate around intrinsic value, itself set by the long-term trend profitability of its constituents and the cost of capital. There will be shorter periods during which Warren Buffett's 'Mr Market' can cause wilder swings, especially in emerging markets, given political risks, economic crises, China fears, and commodity and currency

[2] http://monitor.icef.com/2014/03/the-role-of-emerging-markets-in-shaping-global-demand

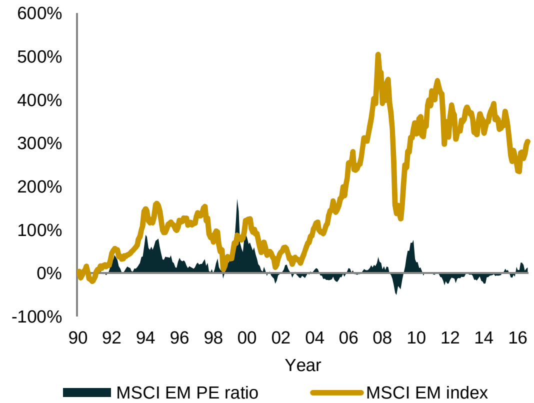
risks to name but a few. However, we believe the benefit of the long term cannot be reiterated enough, and it is here where we see very clearly that what matters for returns is earnings in US-dollar terms.

Exhibit 5: Price vs. earnings performance
Cumulative change since 1990 (pp, USD)



Source: Emerging Advisors Group, September 2016

Exhibit 6: Price vs. valuation performance
Cumulative change since 1990 (pp, USD)



Source: Emerging Advisors Group, September 2016

In exhibits 5 and 6, we see stock-market returns at the index level decomposed into their definition of the cumulative change in earnings per share and the cumulative change in share valuation as defined by P/E. Earnings are by far and away the more important of the two, and it is our assessment of future earnings streams in real hard-currency terms, rather than a ride on multiples, that guides our understanding of intrinsic value and, by extension, future returns.

A word on the index and emerging-market idiosyncrasies

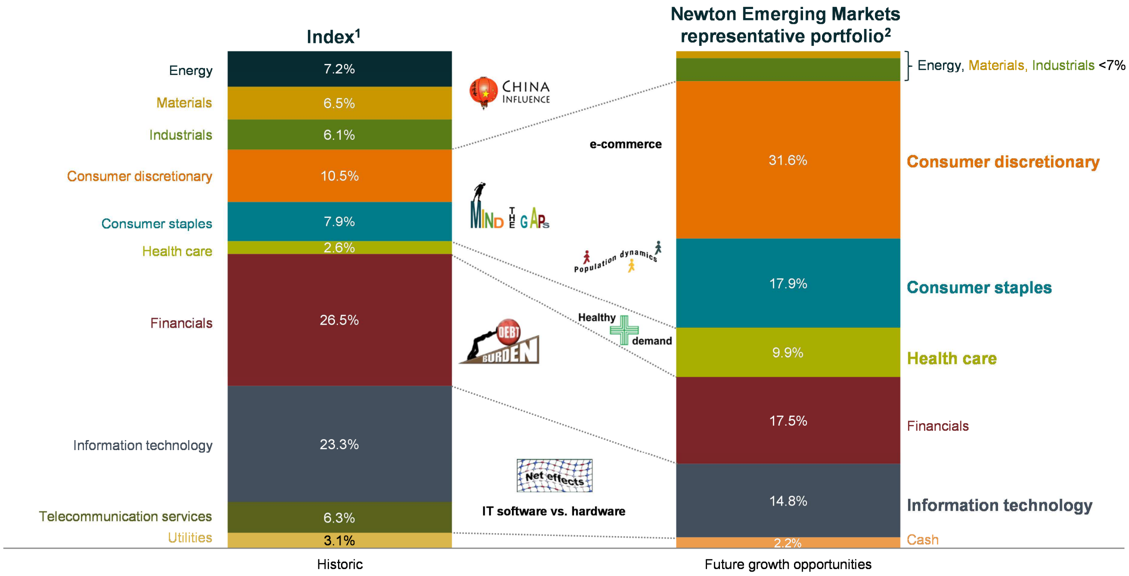
The MSCI Emerging Markets index is dissimilar to other mainstream global and regional comparative indices in both its composition and its behaviour. It has some unusual features for investors to contend with, such as greater volatility, higher returns and lower correlations across its constituent markets. This last characteristic should mean that volatility is reduced when exposure to markets is combined and diversified across a portfolio. As for the profile of emerging-market returns, empirical evidence shows them to be ‘fat-tailed’ and ‘left-skewed’.[3] Simply speaking, this means a greater number of outliers (particularly to the downside), a higher level of risk, a model not suitable for use with standard deviation (which assumes a normal distribution), and an investment approach which is not mean-reverting and where value investing is challenging.

[3] https://www.jpmorgan.com/cm/BlobServer/AM_Non-normality_of_market_returns.pdf?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1158543264199&blobheader=application%2Fpd

Sectoral composition

Exhibit 7: Sectoral composition of MSCI Emerging Markets index vs Newton Global Emerging Markets strategy

The sectoral composition of the index is heavily weighted to more traditional ‘value’ sectors:



Notes:

1 The MSCI Emerging Markets Index is used as a comparative index for this strategy. The strategy does not aim to replicate either the composition or the performance of the comparative index.

2 The representative portfolio adheres to the same investment approach as Newton’s Global Emerging Markets strategy.

Source: Newton, 31 August 2016

The traditional value sectors are what we see as ‘old economy’, low-growth industries, and they comprise a large proportion of the comparative index. As can be seen from exhibit 7 above, our Global Emerging Markets strategy is underweight these areas, driven by our themes.[4] We see these sectors as the profit pools of the past, with valuations telling us something about the low growth (or even shrinkage) of these parts of the global economy. We believe that the divergence between these ‘haves’ and ‘have nots’ at both the country and industry levels are widening, and we capture this thinking through our *mind the gaps* investment theme, which helps us to identify what we think are the best areas in which to invest.

State-owned enterprises

Another factor peculiar to the emerging-markets universe is the scale of state-owned enterprises (SOEs), which account for c.25% of the overall market capitalisation.[5] In aggregate, they are cheaper and less profitable than their non-state-owned counterparts, and thus could be determined to be ‘value’ stocks. The P/E differential between SOE and non-SOE companies has opened up in recent years, in line with investors’ preference for quality.

[4] Compared to more established economies, the value of investments in emerging markets may be subject to greater volatility due to differences in generally accepted accounting principles or from economic, political instability or less developed market practices. A fall in the global emerging markets may have a significant impact on the value of the strategy because it primarily invests in this market.

[5] Source: Newton, CLSA, 31 July 2016

Exhibit 8: SOEs vs non-SOEs: forward P/E

Source: Datastream, IBES, MSCI, UBS, September 2016

SOE weightings are highest in the utilities, telecommunications, energy and financials sectors – those in which our Global Emerging Markets strategy has the largest underweights. Our strategy currently has zero direct exposure to any SOE. This is not on account of any negative screening, but as a result of our bottom-up process, which looks for companies generating returns on capital well above their cost of capital and reinvesting cash flows in high-return activities and for the benefits of all shareholders. Until the SOEs close their return-on-equity gap to non-SOEs, and institute the necessary reforms, we see them as less likely to be attractive investments. Having said that, there are many structural impediments which may apply to any company, including corruption, ease of doing business, degree of democratisation, market efficiency and the rule of law.

Market inefficiency

Many emerging markets have limitations in terms of market depth and liquidity, features which are also associated with low institutional and high retail ownership in a number of cases. For value investing to work, a rational investor base must be present to some extent, so that the 'price discovery' process by which spot values converge on intrinsic values can take place. These characteristics of emerging markets mean that periods of seemingly irrational price extension in either direction can last longer than expected (hence the fat tails). The silver lining to these periods is that they allow active investors opportunistic long-term entry points into attractive assets. Emerging markets tend to be fickle, volatile and short-term focused, which we believe presents long-term investors, who invest sensibly, with highly attractive opportunities.

Commodities

We believe the commodities bull market of the 2000s, which followed a bear market that had lasted since the 1980s, is notable. It led to substantial operating leverage improvement in previously quite unprofitable businesses, and boosted a number of economies along the way. This is not likely to be repeated in the near future; in fact, the longevity and capital misallocation of the most recent boom is still likely to take a long time to work through. Many 'value' stocks in emerging markets have apparently been created by the unwinding of the commodity super-cycle as share prices have fallen faster than earnings. The key point here is that the adjustment for many is not yet over. This is not something we see as mean-reverting, and it has huge ramifications for countries, industries and companies globally. In our view, we are going through a reset period, not a cyclical trough. While emerging markets in aggregate may have historically had a high positive correlation to commodity prices, the best companies should perform according to their own operations, and active managers can seek to identify and select these opportunities.

Equity risk premiums

Equity risk premiums in emerging markets can, and should, be different from those in developed markets, and these need to be factored into valuations too. For example, the implied equity risk premium in Brazil has become distorted and is currently negative, so any intrinsic valuation work needs to adjust for this. To our mind, the capital asset pricing model (CAPM) is very bad at capturing many of the more idiosyncratic stock-specific risks that we must allow for when estimating the cost of capital.

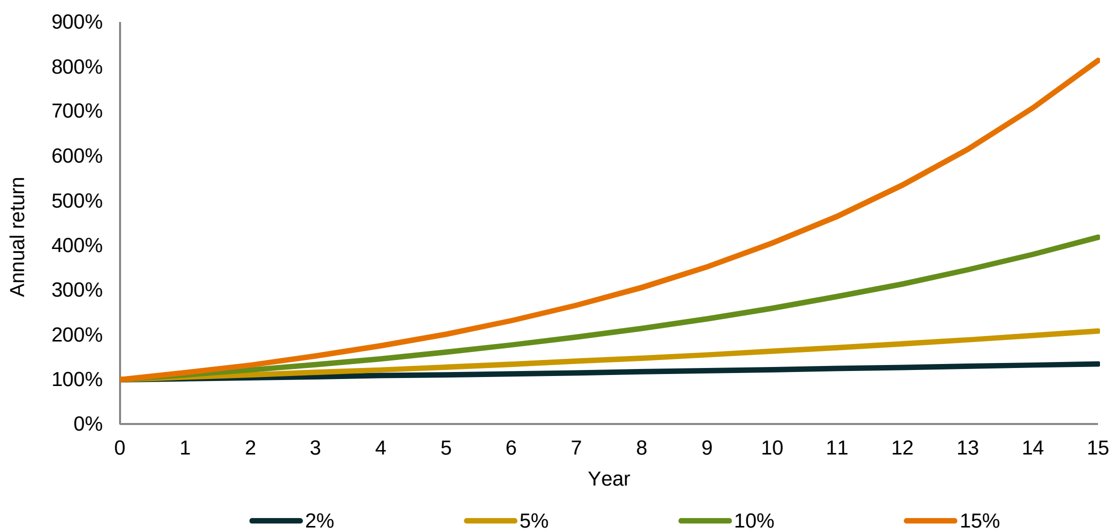
The power of compounding

'Margin of safety' is a key tenet of value investing and a powerful psychological buffer. Some investors would simply equate high P/E with an insufficient safety margin, and this may lead to missed opportunities, especially in an emerging-market context where compounders with high growth and high return on capital employed can actually justify disproportionately high multiples. In some cases, a stock trading on a very high current-year multiple may, optically, provide a wider valuation buffer than a low-P/E stock with unsound credentials (as long as it has good fundamentals). There is no guarantee that low headline multiples offer any cushion.

Einstein referred to compounding as the 'eighth wonder of the world'!

A stock which can grow at 5% for 20 years will deliver 165% capital appreciation, if it is able to maintain its P/E rating. If that growth rate is instead 10%, the return would be 570%. If this second, higher-growth company was rated at 30x P/E, and fell by two thirds to 10x, it would still outperform the company growing at 5% over a 20-year holding period. Key, then, are earnings growth and a long-term horizon. We look for companies that have deep competitive 'moats', which should enable them to sustain high earnings growth and compound that over many years.

Exhibit 9: Returns compounded at different rates over 15 years
(% of initial investment)



Source: Newton, August 2016

Conclusion

Most human beings are naturally risk-averse. We'd like the greatest return for the lowest level of risk. Given this, it follows that we are also disposed to pay a premium for safety. But does that safety come in the 'margin of safety' thinking of the traditional value style, or have we perhaps seen a shift to paying a premium for safety in the form of quality?

For a company to be able to improve its value creation, it needs to be able to show a genuine improvement in returns. This means being forward-looking when analysing a stock, rather than assessing it against its own history or former glory, meaning that *marginal* returns are key. Such forward-looking analysis does involve risk, but so does relying on the profitability and growth experience of the recent past.

Perhaps part of the attraction of some 'value' investments is the predictability of the typically higher dividend payments (unless they are cut!), versus the hopefully higher, but less predictable, capital gains for the growth investor. We cannot stress enough our conviction that impatience does not have a place in investment: we contend that there are no substitutes for thorough analysis and a long time horizon.

Over the long term, the aim of our fundamental process is to seek out the companies with the highest ***value-creating*** growth relative to their current share prices. We are not interested in growth for the sake of growth, or in companies that do not create value through their growth. Our process favours stronger and more scalable business models that allow growth at higher incremental returns, which, hence, we expect to generate more value and more cash to return to shareholders as they grow.

We are stock-pickers, looking to achieve sustainable performance: to buy and hold our investments rather than swiftly buy low and sell high. Companies that can grow and generate enough value to justify their multiples, whatever they may be, can at once be both growth and value businesses. These are rare and are, in our view, the best companies. They are the only ones in which we seek to invest.

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Important information