Emerging value in emerging

Over the past year equities markets around the world have continued to rally. Panic over the state of the European union has slowly subsided and the US economy continues to grind its way out of the GFC-inspired mire.

Increased optimism among investors has driven valuations in many developed markets to multi-year highs. For example, the one year forward Price to Earnings (PE) ratio on the S&P500 is around 15.5 times - its highest in close to four years.

Similarly, the one-year forward PE on the Euro Stoxx 50 index recently reached around 12.5 times. This is up from a low of arouond 8 times in late 2010, and the highest the measure has been since the end of 2009.

In contrast to the bullish price action in developed markets, emerging market equities indices have slid from recent highs as money has flowed back into the developed markets. The chart below compares the one-year forward PE of world developed markets (represented by the MSCI World index) with that of emerging markets (represented by the MSCI Emerging Markets index).

Divergence emerging as valuation differentials between EM and DM widen

The most recent wobble in the MSCI Emerging Markets index occurred after US Federal Reserve chairman Ben Bernanke indicated the quantatative easing program that has been in place for several years could begin to be tapered sooner rather than later. This talk of less-loose monetary policy in the US caused a minor panic and a rush for the exits from investors in emerging markets stocks. Why? The justification was that QE had bouyed growth assets like emerging markets equities as investors took advantage of US cheap money.

This wobble may have created an opportunity for Australian investors looking to diversify their portfolios into high growth overseas markets.

Emerging Markets defined

First coined in the 1980s by a World Bank economist, the term Emerging Markets has come to represent a broad array of less developed economies. These days the constituents of the Emerging Markets are defined by the index provider MSCI, whose Emerging Markets index is the global standard for investors in this space.

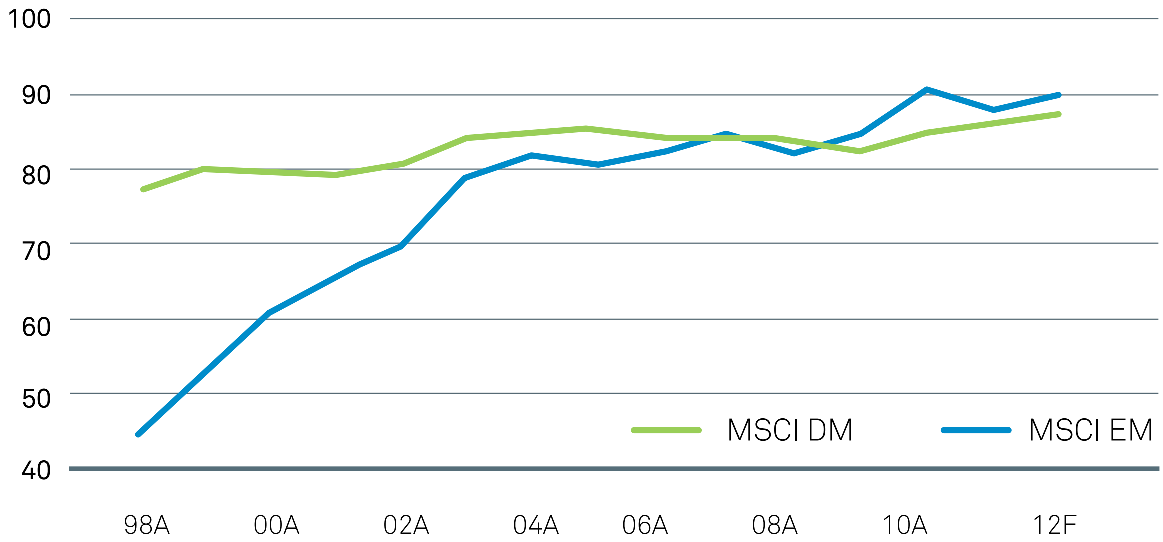
When MSCI first launched its emerging markets index in 1988 there were just 10 countries in the index, representing less than 1% of global equity market cap. Today the MSCI Emerging Markets Index covers over 800 securities across 21 markets and represents approximately 13% of global equity market cap.

From growth to value; from capital gain to (some) income

Much has been written about the opportunities that exist for investors in economies racing to catch up to the living standards of the developed nations of Europe and North America. In the past, much of the talk around emerging markets was centered on the growth prospects of the countries in question.

What may be interesting to investors is that emerging markets equities are now trading at what appear to be compelling valuations. We think that shying away from emerging markets due to concerns around continued growth may be missing an opportunity. When compared to historical averages, and to developed markets, emerging markets equities appear inexpensive. Further evidence of this shift from a focus on growth to value in emerging markets equities can be seen in the chart below. It shows the percentage of emerging markets equities which pay dividends has risen steadily in recent years.

(% OF STOCKS PAYING DIVIDENDS)



Source: CLSA, Factset. March 2013

Recognition of new investment opportunities such as Emerging Markets equities is one thing, but gaining access to offshore investments may have previously been difficult or expensive. Thankfully those concerns are largely a thing of the past. iShares provides a range of ETFs trading on the ASX which investors can use to gain exposure to 19 overseas equity market indices.

For investors who do see value in emerging markets, the iShares MSCI Emerging Markets fund trades on the ASX under the ticker IEM.

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