RBC Global Asset Management

Rethinking Value investing in emerging markets

The RBC Emerging Markets Equity team

Is it time to revisit emerging markets Value?

In this report we highlight the extreme underperformance of Value stocks versus Growth stocks in emerging and developed markets (EM & DM) over the past decade. We summarise the key reasons for the poor performance before discussing why we believe the environment for Value should improve in coming years.

In our 2019 article, “Out of Style, why Value is due a rebound”, we identified four factors that would lead to a reversal in the long-term underperformance of Value. These were: increased competition amongst the new economy companies, heightened regulation, higher interest rates and a reset caused by a recession. Interestingly, three out of four of these factors have materialised in recent months. The question now is whether this means the Value style will perform better and claw back some of its underperformance.

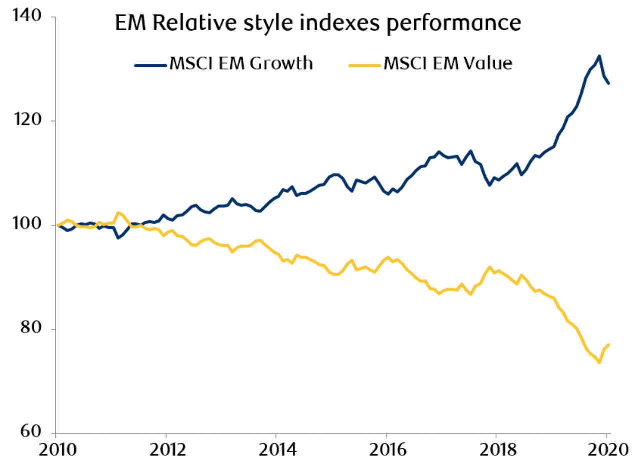
Long term underperformance of Value versus Growth

The Value style has been underperforming Growth for most of the past decade, marked by a gradual lag starting in 2012, an acceleration in 2018, and in 2020 the worst yearly underperformance of Value versus Growth since the style indexes were created.[1]

In absolute terms, the MSCI EM Value Index has actually finished broadly flat in the volatile period since the global financial crisis. Conversely, MSCI EM Growth Index has been the standout performer, gaining 120% over that same period. Exhibits 1 and 2 show the performance of the Value and Growth indexes relative to the core index in EM and the U.S. respectively.

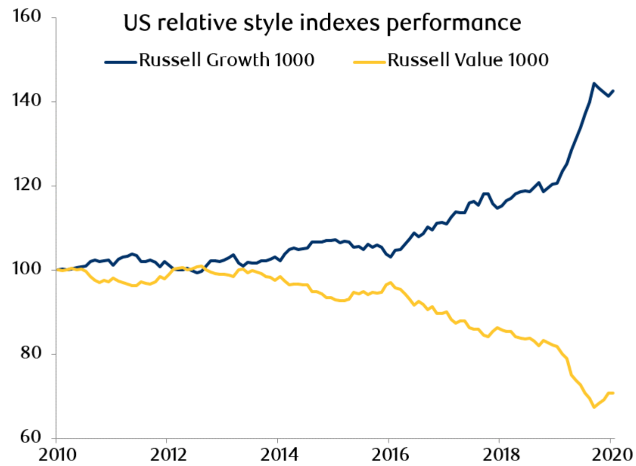
Over the 10 years to the end of December 2020, the underperformance of Value stocks compared to Growth stocks stands close to 80% and over the past two years alone at 40%. This differential is now wider than the previous era of extreme Value underperformance in 1998-1999 when the Russell Growth Index outperformed the Russell Value Index by 31%.

Exhibit 1: MSCI EM Growth and Value Index performance relative to the MSCI EM Index since 2010



Source: MSCI Emerging Markets Growth and Value Index, Bloomberg. Data as at December, 2020.

Exhibit 2: Russell Growth and Value Index performance relative to the S&P 500 Index since 2010



Source: S&P 500 Index, Russell Index, Bloomberg. Data as at December, 2020.

[1] Since 1978 for the Russell indexes and 2000 for the MSCI indexes.

The acceleration in the outperformance of Growth and underperformance of Value during the past two years has several causes:

- **An artificially prolonged economic cycle:** While the end of the economic cycle which started in 2009 after the global financial crisis has been anticipated since 2017, interventions by central banks and governments around the world have kept economic growth artificially high. In anticipation of an upcoming recession, and to protect their returns, investors have continued to favour companies with a strong growth outlook regardless of the seemingly positive top-down environment.

- **Technological revolution and index biases**: With the rise of the internet, new giants have appeared, disrupting and reshaping entire industries. Over the past two years, those companies have become so large that the top 10 stocks in the MSCI EM Growth Index are now all technology corporations. With an average market capitalisation of USD 280bn, they represent nearly 50% of the entire index, as at the end of October 2020. The huge concentration of the MSCI EM Growth Index explains why only a handful of large stocks need to perform well to have a significant impact on the performance of the Growth style.

- Indeed an analysis we conducted that removed sectorial and regional biases and equally weighted all stocks reduced the growth premium from 40% to about 10%. As noted above, in the MSCI EM Index Growth has outperformed value over the past two years by some 40%. But when we conducted an analysis that removed sectoral and regional biases and equally weighted all stocks, the Growth premium was a much more muted 10%.

- We also find that the entire outperformance of the Growth style comes from China. Over the past few years, China has rapidly evolved from being an out-of-favour stock market, characterised by large state-owned enterprises, to a market that appeals to foreign investors. This is thanks to the emergence of successful, innovative privately run companies and means the weight of China in the MSCI EM Index grew from 22% to 43% in just six years. The largest four stocks in the MSCI China Index are now new economy companies that operate in the areas of e-commerce and e-gaming. Overall, these four stocks represented 33% of the MSCI EM Growth Index.

- **The COVID-19 pandemic** in 2020 further accelerated the digital revolution, leading to a surge in the adoption of online services such as e-commerce, gaming and working-from-home technology. This further benefited Growth stocks.

- **Low interest rates** globally has pushed investors into the equity asset class, in the pursuit of returns. Money which might once have been invested in fixed income, is now invested in Quality and Growth stocks as they are as perceived to be safer than Value ones.

  - Finally, the **rise of retail investors** has been remarkable over the past few years and, in 2020, was accelerated by the younger generation. In the U.S., retail stock trading increased from 9% of total shares traded in 2019 to 20% currently, while in China, overall trading volumes have increased by 60% in the past five years.[2/3] Not only have the new zero-commission online apps made trading more accessible and fun, but the millennial generation has emboldened by strong returns from equity markets in recent years. These new investors have probably helped push the handful of stocks highlighted above even higher.

While the performance of the Value style has worsened in recent years, cheaper names have actually been underperforming since 2010. This is mainly because:

- The global economy struggled to recover after the **global financial crisis** in 2008. While there was no global recession in the ensuing decade, many countries have faced challenges and below par economic growth. Furthermore, the failure of some countries to implement much-needed reforms and the rise of populist governments have led to weaker currencies, poor equity performance and the derating of riskier countries such as Mexico, Indonesia, Turkey and South Africa.

- A prolonged period of **low interest rates** has negatively impacted Financials stocks with the majority never fully recovering from the global financial crisis. Financials make up a large portion of the MSCI EM Value Index.

- **Shale gas expansion** in the U.S. coupled with sluggish economic growth in EM countries has hurt the Energy sector, which is a traditional Value sector.

- **Reduced spending on physical capex and infrastructure projects** over the past decade, following the exceptional growth of the prior decade when China was building its infrastructure at record speed, has hurt the Materials sector, another traditional Value play.

[2] Citadel Securities, December 2020. [3] Goldman Sachs, December 2020.

- As the new economy stocks outperformed and became increasingly expensive, the majority left the MSCI EM Value Index. As a result, the MSCI EM Value Index is now mainly composed of old economy areas, notably Financials, Materials and Energy, which together comprise 48% of the MSCI EM Value Index compared to 15% for the MSCI EM Growth Index as of end of November 2020 (Exhibit 3).

Was the strong performance of Growth versus Value justified in 2020?

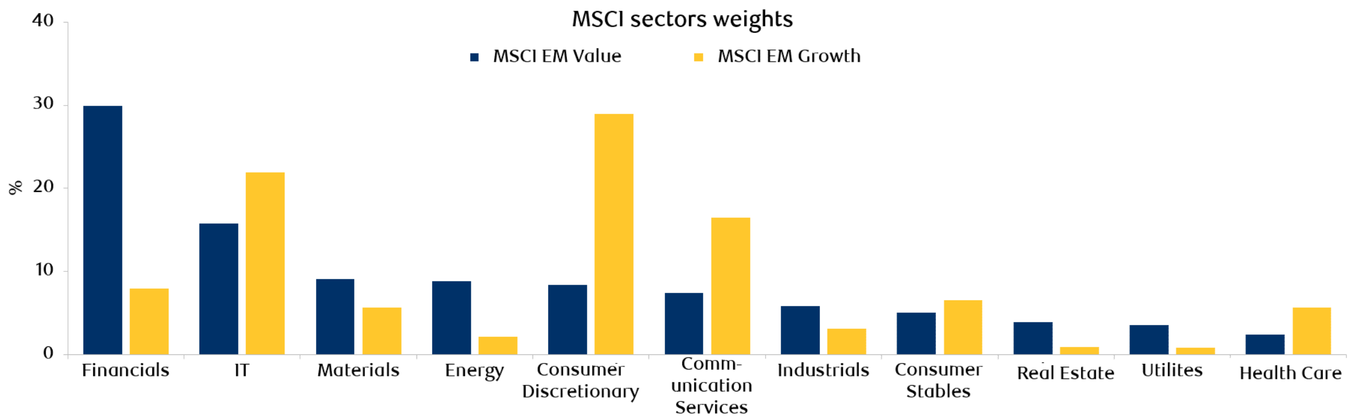
2020 was a challenging year as Covid-19 led to a global recession. Typically in a risk-off environment, it would be expected that Growth would outperform Value. Breaking down the 2020 returns of Value and Growth shows that re-rating (P/E expansion) explains part of the performance, but fundamentals (change in earnings) also played an important role (Exhibit 4).

The rapid recovery in global equity markets is an important factor in style indexes not being de-rated despite poor fundamentals in what was – at least for a time - the worst global recession in 100 years. The main reasons for this are, the extremely low interest rate environment, which favour equities, and the nature of the pandemic. On this second point we believe the effects of the pandemic may not turn out to be long-term as many economic indicators rebounded very quickly when lockdowns eased earlier in the year.

The MSCI EM Growth Index delivered the strongest absolute returns in 2020, driven by slightly positive earnings growth amid a challenging macro environment. This justifies the strong performance and explains the large re-rating for the year (18%).

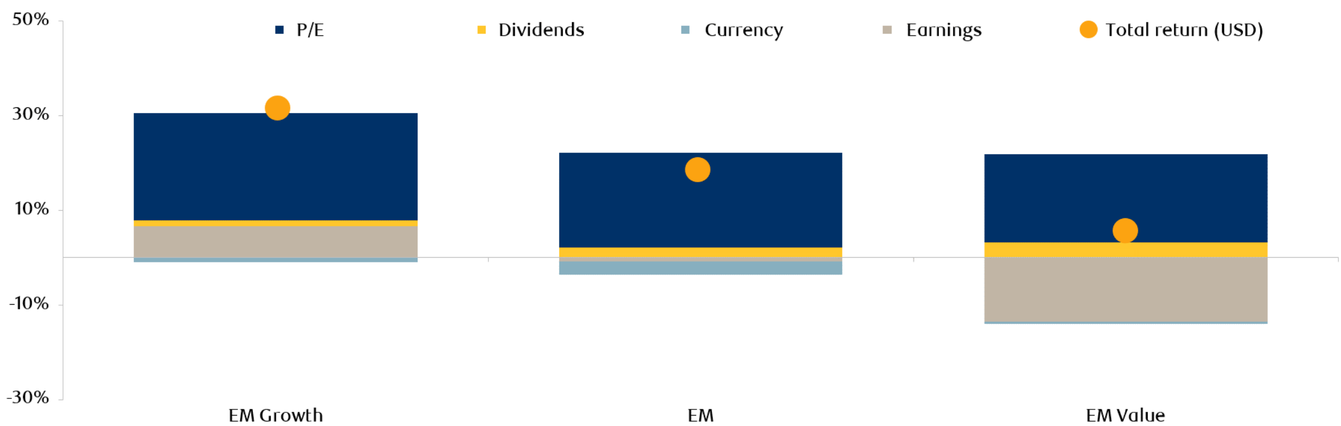
As expected, Value stocks, notably Financials and Energy companies, which were adversely affected by the pandemic, suffered a 10% drop in earnings since the beginning of the year. However, it is interesting that the MSCI EM Value Index has not de-rated over the year, hence limiting the underperformance.

Exhibit 3: MSCI EM Value and Growth Index sector weights



Source: MSCI, Bloomberg. Data as at November, 2020.

Exhibit 4: MSCI EM style indexes 2020 total return decomposition



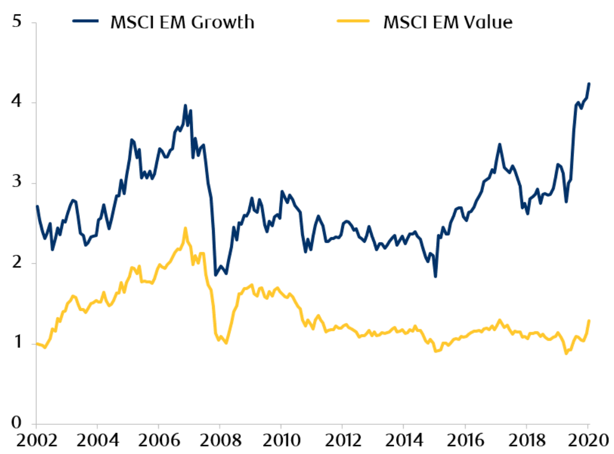
Source: MSCI, Bloomberg. Data as at December, 2020.

Current valuations for Growth and Value

In 2020, the strong performance of Growth stocks over Value stocks was justified by much better earnings, but also the acceleration in the shift to online. This move, fuelled by the pandemic, benefitted new economy stocks. The impact on earning of some traditional Value stocks, such as Financials and Energy, meant they performed the worst.

What is now priced in for Value and Growth stocks? Exhibit 5 shows the evolution of valuation since the MSCI style indexes were created. We already mentioned that Value stocks did not de-rate in 2020 while Growth stocks now trade about 18% higher than in January 2020. After almost 10 years of de-rating for Value stocks, and the more recent outperformance of Growth stocks, both indexes now trade at extreme levels.

Exhibit 5: Evolution of MSCI EM style indexes P/B



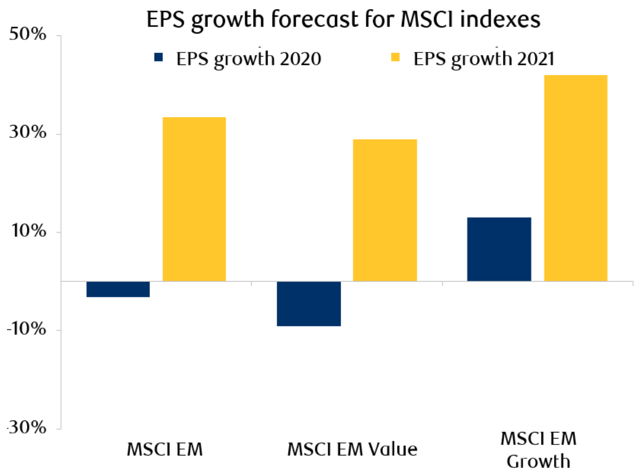
Source: MSCI Emerging Markets Value and Growth Index, Bloomberg, RBC Global Asset Management. Data as at December, 2020.

The consequence of this year's historical divergence in performance between styles is that the MSCI EM Growth Index trades at the largest-ever premium to the MSCI EM Value Index at 260%.

What has changed and could lead to better performance for Value stocks in 2021?

- Covid-19 provided a large boost for new economy stocks as people stayed at home, switching from offline to online very quickly as there was little alternative. However, this also means that the **base effect**, starting from the first quarter of 2021, will potentially be a negative for many of those companies unable to match the levels of growth reported in 2020. E-commerce penetration in China has now reached 35% and for certain categories, such as apparel and fast moving consumer goods it is likely the growth rate has already peaked.[4] For the Growth stock premium to remain at the current extreme levels, continued superior earnings growth will be necessary. Looking at earnings expectations for 2021, it is very likely that the premium for Growth stocks will narrow. As shown in Exhibit 6, earnings growth expectations for 2021 are 42% for the MSCI EM Growth Index and 29% for the MSCI EM Value Index.

Exhibit 6: Earnings growth expectations for MSCI EM Growth and Value Index

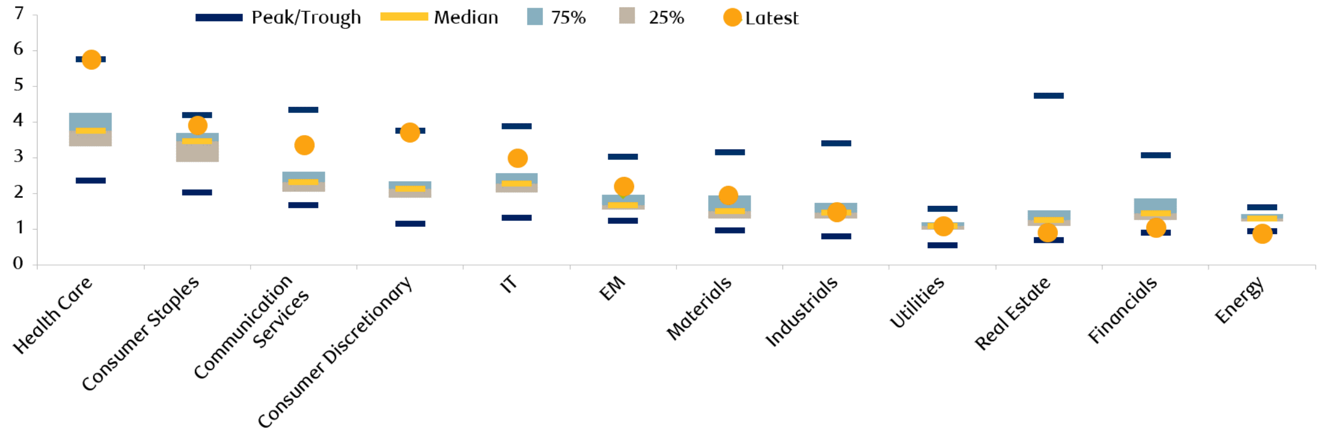


Source: MSCI, FactSet, RBC Global Asset Management. Data as at December, 2020.

- The situation is very different for cyclical companies. A return to normal will be enough for many of these stocks to show very large top and bottom-line growth as they are starting from a very low base. For instance, the Energy sector is expected to deliver more than 200% earnings growth in 2021 as the oil price has rebounded from its lows of $20 in March 2020 to $55 at the beginning of 2021. Similarly, the Materials sector should see more than 60% earnings growth in 2021. Together those two sectors account for only 7% of the MSCI EM Growth Index but 18% of the MSCI EM Value Index. Currently there is a huge dispersion in valuation between the Covid-19 winners and losers (Exhibit 7). The gap began and has continued to narrow slightly since November but sectors such as Energy, Financials and Real Estate still trade near their 20-year troughs. On the other hand, sectors such as Health Care, Communication Services, Consumer Discretionary and IT are trading near all-time highs. We believe the divergence is too extreme if we consider a return to normal in 2021, and we would expect the range of valuation to narrow. This should lead to the outperformance of Value over Growth.

[4] Macquarie – December 2020.

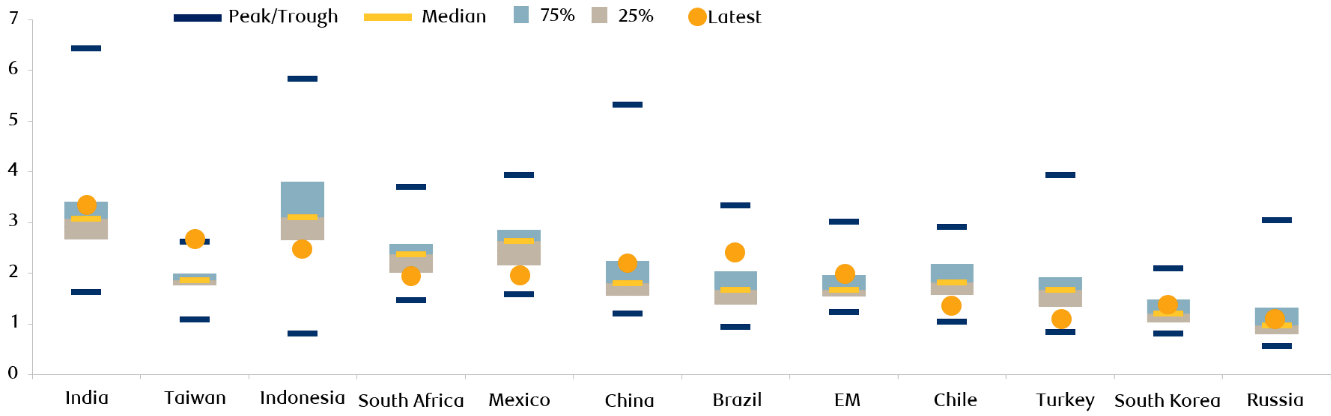
Exhibit 7: EM sector price-to-book (P/B) valuation relative to history



Source: MSCI, FactSet, RBC Global Asset Management. Data as at December, 2020.

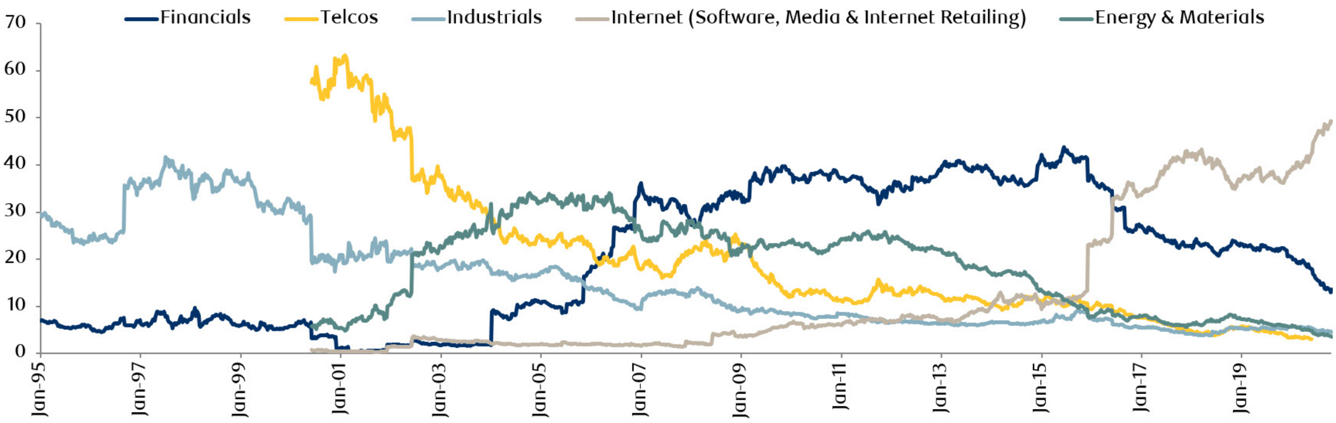
- Similar to sectors, country performance in EM varied largely in 2020. The countries most successful in containing the virus performed the best in 2020. Some poorer countries in EM struggled to deal with Covid-19 and their already precarious economic situations worsened. This led to some countries trading close to their peaks, with others at their troughs (Exhibit 8). In particular, Turkey, Chile, Mexico and South Africa appear very cheap compared to history, while China and Taiwan are close to near the most expensive they have been in 20 years.
- China has been the key driver for the outperformance of the Growth style and will probably be the main driver of its underperformance if we see a style reversal. As argued previously, the concentration of new economy stocks in the China equity index has become extreme, especially since 2016, when MSCI allowed US-listed Chinese stocks to be included. We have also seen a huge number of new economy IPOs over the past few years. By the summer of 2020, the weight of new economy stocks in the MSCI EM China Index surpassed 50%. (Exhibit 9) This weighting has since come down, after regulators halted the IPO of the Alibaba-backed fintech subsidiary Ant Financial and announced increased scrutiny on monopolistic practices. Those moves triggered a sell-off in new economy names at the end of 2020.

Exhibit 8: EM country price-to-book (P/B) valuation relative to history



Source: MSCI, FactSet, RBC Global Asset Management. Data as at December, 2020.

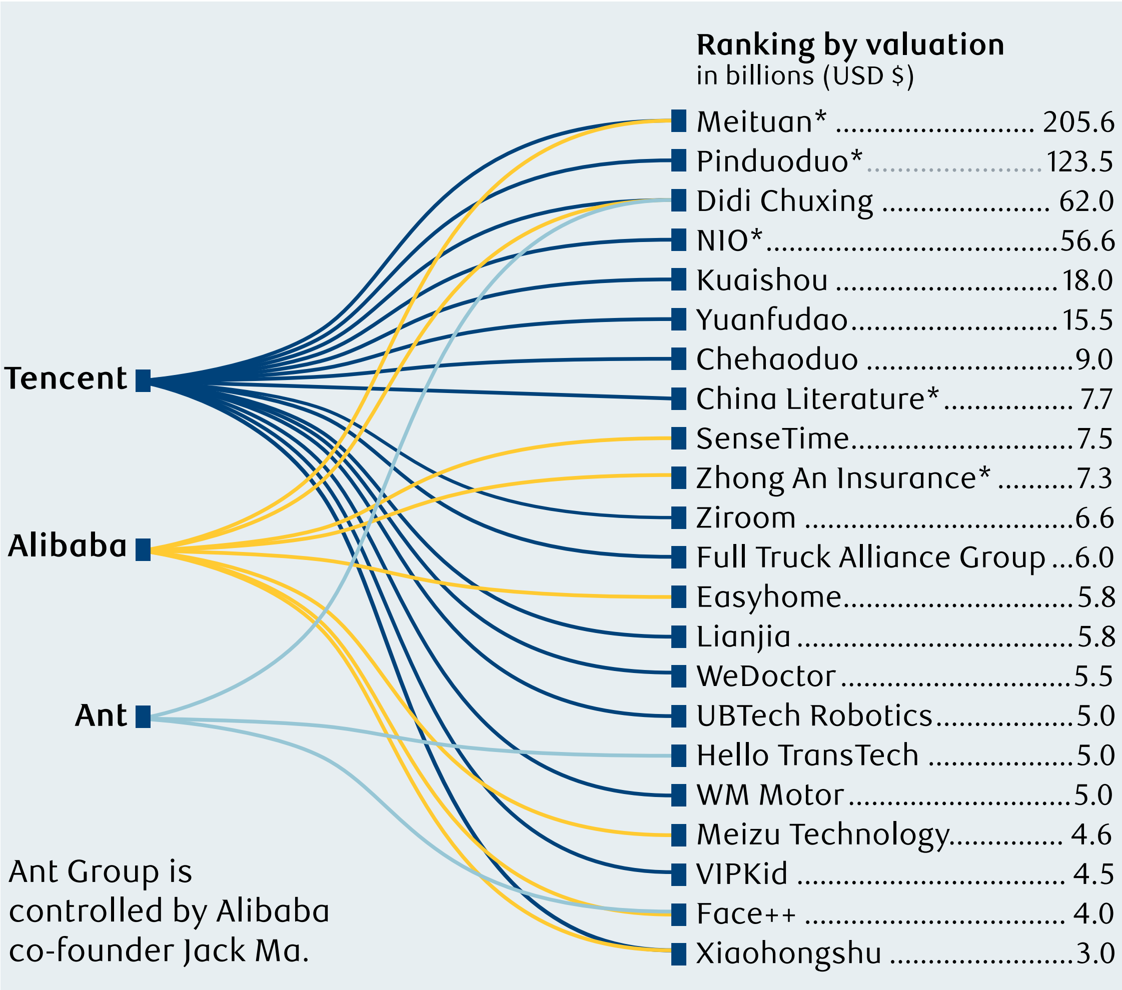
Exhibit 9: MSCI EM China Index sector weights since 1995



Source: MSCI, FactSet, Goldman Sachs Global Investment Research. Data as at September, 2020.

Exhibit 10 illustrates the incredible depth in holdings of Tencent and Alibaba. It is possible that this picture will look different in a few years, as the companies are forced to divest stakes.

Exhibit 10: Tencent and Alibaba have stakes in a vast array of Chinese start-ups and competitors



Source: Bloomberg. Data as at 11 November, 2020. *Listed or applied to list in an IPO.

Longer term outlook: Value stocks could embark on a multi-year rally similar to 2003-2008

- Relative EM/ DM equities performance: The underperformance of Value stocks over the past 10 years coincided with the underperformance of EM versus DM equities, as Growth stocks would be expected to take the lead in a risk-off environment.

Exhibit 11 shows that long periods of EM versus DM equities under and outperformance alternate, and we have found that the main drivers of this relative performance is the relative economic growth between the two regions as well as the direction of the U.S. dollar. We believe we are at a turning point and that EM could outperform going forward.

Exhibit 11: EM versus DM equities relative performance

Source: Bloomberg, MSCI Emerging Markets Index & MSCI World Index. Data as at October, 2020.

U.S. dollar strength has represented a significant headwind to EM equities performance in recent years. There are several reasons to believe this may be about to reverse due to the U.S. Federal Reserve's aggressive balance sheet expansion, the surge in U.S. fiscal deficit (24% in 2020) and a rally that looks extended both in terms of duration and degree.

There is also a powerful case that EM currencies can start to perform well, driven by extremely cheap valuations, high real rates and strong current accounts. Beyond currency, relative EM growth looks set to improve from cyclically low levels. The shift is driven by improved productivity, structural reforms and more growth-friendly fiscal policies.

If EM begin to outperform DM after 10 years of underperformance, it is likely that Value stocks would also do better in such a risk-on environment.

- Energy, Materials and Industrials stocks could perform well on the back of the next revolution: **Green Infrastructure.** Climate change is now a major focus, with the world's largest nations including China finally realising that dramatic changes have to be made in the near future. China announced in December 2020 that by 2030 25% of the country's electricity generation will be renewable and by 2060 the country will be carbon neutral. The government also announced that electric cars would account for 25% of car sales by 2025. Few seem to have appreciated the impact of those announcements. Firstly, when China sets targets, it has historically executed on and, more often than not, exceeded them. Secondly, the amount of commodity products needed to achieve carbon neutrality is huge and exceeds the projected growth in supply for metals such as copper or nickel. This would be coming at a time when capital expenditures have been cut, so we could see huge imbalances in the coming years that could lead to a new commodity cycle. This would be very positive for growth in EM and, in that scenario, cyclicals and Financials would perform well as the rise in commodity prices could also lead to an increase in inflation.

- Many countries are talking about implementing **MMT (Modern Monetary Theory)** to reduce the income inequality, which has been rising rapidly across the world bringing social unrest and populism. In fact, MMT was already implemented in 2020 in the fight against the pandemic. If this fiscal stimulus continues to grow and target physical assets, this would be very positive for cyclicals, particularly if it led to larger than expected economic growth. Much like the Green Infrastructure revolution, this would be very positive for Value stocks.

- **Regulation could disrupt new economy stocks** if they are deemed too dominant, insufficiently regulated and monopolistic. Since November 2020 and the cancellation of the Ant IPO, the Chinese government has issued a series of policies aimed at regulating the likes of Alibaba, Tencent and Meituan. Some restrictions have already been put in place, notably around brand exclusivity on e-commerce platforms and lower prices to attract new customers. The largest players could be asked to divest some of their holdings. It is very difficult to assess how far the government will go and the damage this could have on future growth, but this issue may remain an overhang for the sector. This would probably lead to a derating of those stocks and a rotation towards names less impacted by government intervention.

- **Increased competition could present another headwind for new economy stocks**, particularly in the areas of e-gaming and e-commerce, which have attracted new entrants with the prospect of superior returns. Longer term, the outlook for Growth stocks depends on the ability of these companies to continue to generate **superior earnings growth.** We computed the annualised earnings growth required for Growth stocks to justify their current premium to Value stocks. Over the next five years, the growth needed is 46.1% per annum. Over 10 years, the number drops to 25.9%, and over 15 years to 19.2%.[5] This level of growth seems unlikely considering the MSCI EM Growth Index delivered an average of 18% earnings growth over the past 10 years.

What could go wrong for Value stocks?

- If the Covid-19 vaccines that are being rolled out globally were to fail, then this would present a significant challenge for the world and would likely lead to the underperformance of cyclicals and Value stocks, and allow the Covid-19 winners to outperform again.

- If the global economy remains sluggish even after the pandemic, as a result of high unemployment and weak consumption, central banks could once again apply QE, which would inflate financial assets. In that environment, we would expect Growth stocks to be the most likely to outperform, while the performance of cyclicals notably, Financials, Energy and Materials, could be challenged.

- If there is a lack of political desire or ability to break up the internet giants, or if competition fails to gain market share, we could see continued strong performance of new economy stocks at the expense of the old economy. In this environment, the abnormal growth of recent years could be repeated and competition eliminated. This could lead to the continued re-rating of the internet giants. This is a possible scenario, especially if we consider that the penetration of online services has not yet peaked, even after the Covid-induced boost in 2020. We may see a prolonged performance of new economy stocks, especially if habits do not revert back to pre-pandemic norms. The trend of shopping, working and entertaining from home, may be here to stay and could continue to grow further in the coming years.

Our approach to Value

Style performance will likely remain volatile in the coming years as the world faces multiple challenges in its recovery from the pandemic.

The positive scenario of a risk-on environment and strong economic growth would favour Value stocks, driven by the number of factors highlighted in this report. However, there are risks to this view. We therefore believe it is prudent for EM Value investors to diversify exposure to ensure protection in periods when Value as a style underperforms.

We highlight the following considerations for EM Value investors:

- **Invest in areas of structural growth and avoid those in decline:** It is crucial to be selective and recognise that the world is constantly changing. New technologies develop, habits evolve, and companies are created while others are disrupted. Top-down thematic research helps identify areas of structural growth while avoiding dying industries and value traps.

- **Importance of company management:** Our research suggests that management quality can make a significant difference to the performance of a company and its ability to navigate challenging market conditions. It is therefore important to evaluate company management as a core part of the investment process.

- **Identify under-researched opportunities:** There are many opportunities for Value investors even within what are traditionally Growth sectors. These tend to be smaller and undiscovered companies and segments which, if thoroughly researched, can offer significant upside.

We hope you enjoyed our research insights. For further information please visit the RBC Emerging Markets Equity Team Site.

[5] RBC Global Asset Management. Data as at October, 2020.

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