PERKINS
INVESTMENT MANAGEMENT

LOST IN TRANSLATION:
INVESTING BEYOND THE HYPE IN EMERGING MARKETS

UNCOMMON VALUE℠

Emerging market equities have strongly outperformed developed market equities over the past decade. Many forecasts call for this long-term momentum to continue based on superior economic growth projections for these countries, prompting many investors to overweight the asset class. This paper evaluates the risk/reward characteristics of emerging and developed market equities and, given Perkins Investment Management's focus on downside protection, concludes that an outsized allocation to emerging markets does not currently appear to be merited. It also highlights various ways to gain emerging market exposure and discusses risks and opportunities presented by each approach.

A SEDUCTIVE STORY

The growth dynamics that have unfolded across emerging markets since the turn of the century have been remarkable. Whole economies have been transformed, increasingly drawing investors' attention to these countries. Annualized real economic growth of 5% in emerging markets over the past 20 years has been more than double that of the 2% in developed markets, with gross domestic product (GDP) in countries such as China expanding by more than 10%, on average, per year[1]. While few expect this type of double-digit growth to continue long-term (and indeed there are already signs of slowdown), the consensus outlook continues to forecast very favorable secular economic growth in these markets in the years ahead, especially relative to the developed world.

Incredible quality-of-life improvements have accompanied these economic advancements, with millions of emerging market citizens moving into a burgeoning middle class. This has been facilitated in part by rapid expansion in urbanization rates, as governments have flowed vast amounts of capital into infrastructure spending. Rising income has fueled tremendous increases in consumption of items and services that are commonplace in the West, including automobiles, televisions and other appliances, financial products, health care, branded food and beverage, fashion apparel, and high-end luxury goods such as watches and handbags. Many of these countries have demonstrated high degrees of fiscal prudence that have helped support economic gains, with low levels of government and household debt and notably higher personal saving rates than those seen in most developed nations. On whole, these consumers largely have had less access to and greater cultural aversion to amassing debt, but as this gives way to a growing acceptance of credit cards and other modern financing options, higher spending capacity should continue to drive steady future increases in consumption.

[1] Source: www.worldbank.org. World Bank national accounts data and OECD national accounts data. Emerging markets defined as "Middle Income Countries" in the World Bank database.

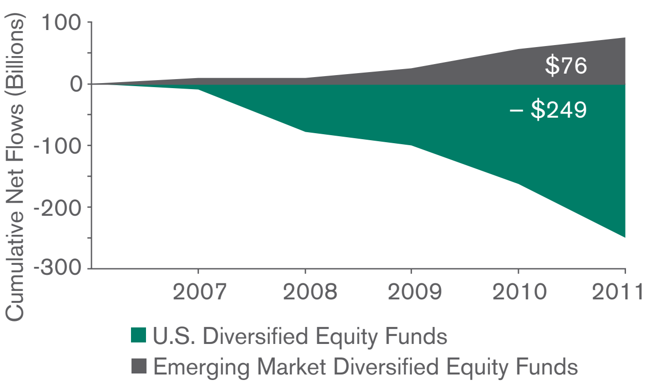
HIGH RETURNS, HIGH FUND FLOWS

Equity returns from these countries have also been impressive. Since the Asian financial crisis in the late 1990s, emerging market stocks have vastly outperformed those of developed markets. Much has been written about the "lost decade" in stock performance after the 2008 global credit crisis decimated major markets worldwide, but the MSCI Emerging Markets Index has delivered a total return of 273% for the 10-year period ended June 30, 2012, compared to the 66% and 68% achieved by the MSCI World Index and S&P 500 Index, respectively. For emerging market investors, nothing has been "lost."

Predictably, more and more investors have started to chase these rich returns, and it appears that emerging market equities have become the latest "must own" asset class. Cumulative net fund flows to developed market stock funds have declined by nearly $250 billion over the past five years, while inflows to emerging market funds have steadily increased (see Exhibit 1).

EXHIBIT 1: CUMULATIVE WEEKLY FUND FLOWS (2007-2011)

Emerging markets have attracted assets away from developed markets.

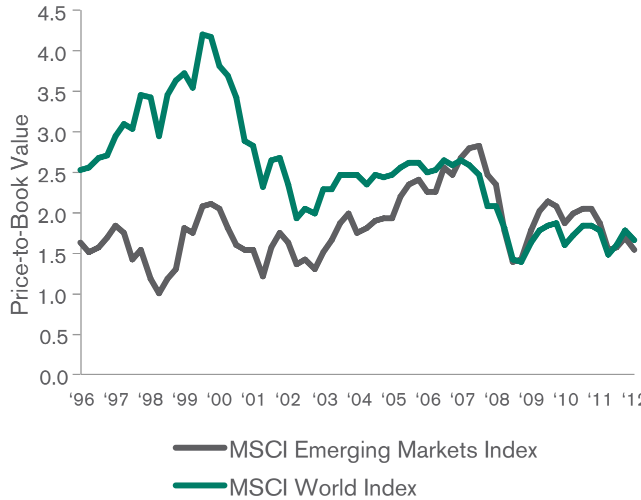


Source: Strategic Insight. As of 12/31/11

As this shift has transpired, the historic discount at which emerging market stocks have traded relative to developed markets has all but disappeared. For example, in mid-1998 emerging market equities traded at approximately 1x trailing price-to-book value (PBV), while developed market stocks traded closer to 3x. At the end of June 2012, these figures were basically at parity (see Exhibits 2a and 2b).

EXHIBIT 2A: TRAILING QUARTERLY PRICE-TO-BOOK VALUE

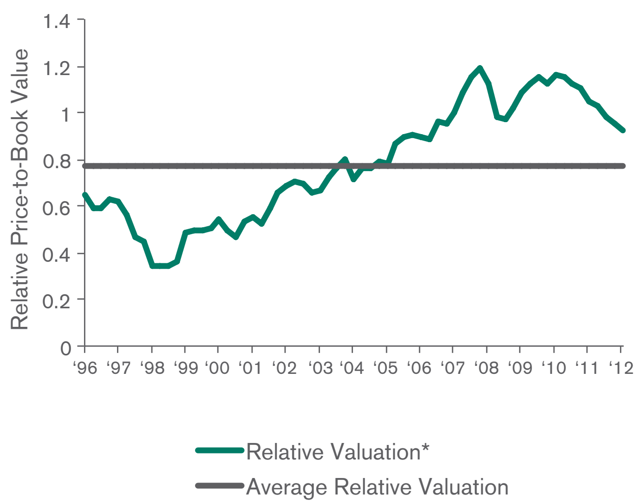
Emerging market stocks now trade at parity with developed markets.



Source: FactSet. As of 6/30/12

EXHIBIT 2B: RELATIVE VALUATION OF PRICE-TO-BOOK VALUE FOR MSCI EMERGING MARKETS INDEX VS. THE MSCI WORLD INDEX

Relative to the long-term average, emerging market stocks trade at a premium.



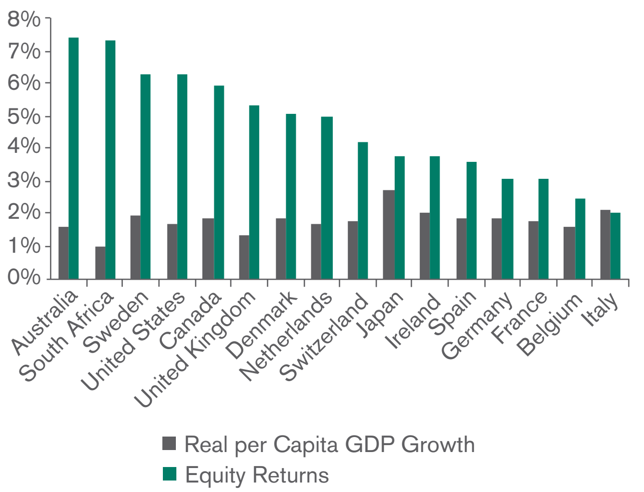
Source: FactSet. As of 6/30/12
**Relative valuation is the price-to-book value of the MSCI Emerging Market Index divided by the price-to-book value of the MSCI World Index.*

IS GDP GROWTH ALL THAT MATTERS?

Those who are bullish on emerging market stocks often cite the powerful growth trends in these countries as justification for their enthusiasm. While these trends may exist in the short-term, long-term analysis does not support the popular notion that higher economic growth results in higher stock returns. In fact, academic research examining more than 100 years of economic growth and stock returns from 16 countries has found that the historical correlation between economic growth and equity performance has been far from stable, with no clear relationship between the two (see Exhibit 3). Moreover, equities in countries that have experienced the slowest economic growth have outperformed equities in higher growth countries, on average, over the long-term (see Exhibit 4). This is a startling fact to most casual observers.

EXHIBIT 3: GDP GROWTH AND EQUITY RETURNS (1900-2010)

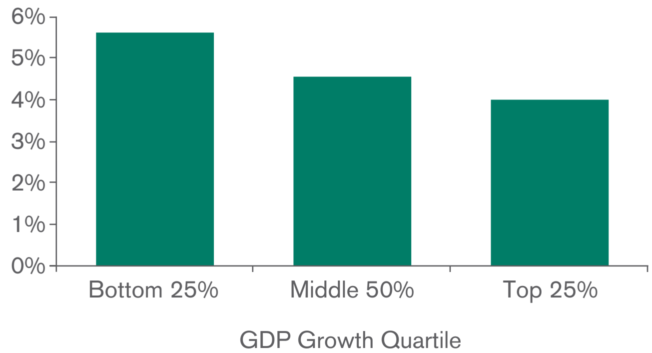
There has been no clear relationship between economic expansion and stock performance.



Real per Capita GDP Growth and Equity Returns are calculated on an annualized basis.
Source:
1900 - 2002 GDP Growth: Ritter, J.R. (2005), "Economic Growth and Equity Returns", Pacific-Basin Finance Journal 13, pp. 489–503
2003 - 2010 GDP Growth: World Bank
1900 - 2010 Equity Returns: Credit Suisse Global Investment Returns Yearbook 2011

EXHIBIT 4: ANNUALIZED EQUITY RETURNS BY GDP GROWTH QUARTILES

Over the past 110 years, stocks in countries experiencing the slowest economic growth have outperformed.

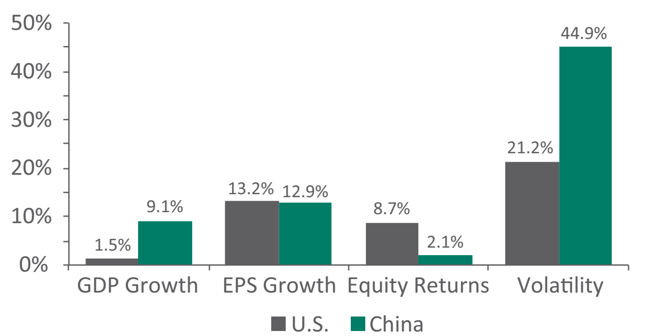


Source:
1900 - 2002 GDP Growth: Ritter, J.R. (2005), "Economic Growth and Equity Returns", Pacific-Basin Finance Journal 13, pp. 489–503
2003 - 2010 GDP Growth: World Bank
1900 - 2010 Equity Returns: Credit Suisse Global Investment Returns Yearbook 2011

China provides a more recent example of this phenomenon. Between 1995 and 2010, China's per capita GDP growth averaged more than 9% per year, nearly 8% faster than that of the U.S. Yet U.S. equities produced slightly higher earnings per share (EPS) growth and dramatically higher equity returns, all with far lower equity market volatility (see Exhibit 5). Clearly, buying stocks strictly on GDP growth prospects is too simplistic a view.

EXHIBIT 5: CHINA VS. U.S. PER CAPITA GDP GROWTH AND EQUITY PERFORMANCE

From 1995 to 2010, Chinese equities underperformed U.S. equities with greater volatility, despite stronger underlying economic growth.



GDP Growth is Real Per Capita GDP Growth. Volatility is standard deviation. GDP Growth, EPS Growth, Equity Returns, and Volatility are all calculated on an annualized basis.
Source:
EPS Growth, Equity Returns and Volatility: Russell 1000 Index for the U.S. and the MSCI China Index for China
GDP Growth: World Bank

STILL VERY RISKY

In hindsight, while emerging market stocks have outperformed developed market securities over the past decade-plus, we believe one of the primary factors was their considerably lower starting valuations. Looking ahead, it is uncertain whether emerging market stocks will continue to generate better returns now that valuation levels are roughly at parity with developed markets. And while all investments carry risk, below are several examples of the heightened risks associated with emerging market investing that should be considered:

- **Questionable accounting practices and poor regulatory oversight/enforcement.** Many of the standards and protections taken for granted in developed countries are newer and frequently more lax in most emerging markets. Consequently, these markets tend to have higher incidences of fraud, in addition to greater frequency of smaller problems such as graft and bribery. To look at one recent example, it was revealed in May 2011 that Longtop Financial Technologies, a Chinese software company with a $2.4 billion market capitalization only months earlier, had fixed its books by recording fictitious cash. This fraud was particularly audacious as it did not rely on sophisticated accounting manipulations but rather false confirmations from the company's banks. While frauds at smaller Chinese firms seem to happen with startling regularity, Longtop had all the markings of a bona fide company. It was taken public by leading investment banks, vetted for six consecutive years by a major accounting firm and owned by some of the most sophisticated hedge funds in the world. However, even simple fraud can be difficult for shareholders to detect when it is systemic. Although fraud does occur from time to time in developed markets, there tends to be far more of these kinds of unpleasant surprises in emerging economies, where high growth, more systemic corruption and weaker regulatory systems make it easier to hide these types of problems from investors.

- **Opaque government policies and tenuous property rights.** Consider the case of YPF Sociedad Anonima (YPF), an integrated oil and gas company based in Argentina. At the end of 2011, an investor accustomed to developed market investor rights and protections might have found a lot to like at YPF. It owned vast oil and gas reserves, traded at an inexpensive valuation and offered a high dividend yield, among several other potential attractions. In early 2012, however, the government expressed frustration that the company was paying so much money to shareholders instead of investing more of its cash in exploration and production. The government warned YPF that it would need to make drastic changes in its capital allocation if it wanted to avoid a more draconian outcome. This put YPF in a quandary as government-imposed price caps made further investment uneconomic and at least one of its large investors relied on dividend income to service debts. Investors steadily fled the stock, remembering forced nationalizations in Venezuela and Bolivia in recent years. The government followed through with its threat in April 2012, electing to expropriate majority ownership and leaving the original owners wondering when and how much they might be compensated. It has not been uncommon over the years to see heavy-handed government meddling in other popular emerging markets, such as Brazil, China, Russia and India. Government intervention does occur in developed markets during occasional emergencies, but it is difficult to imagine such targeted interference in the management of a major oil company like Exxon Mobil.

- **Weak legal systems and protections.** Many Chinese Internet companies, as well as firms in other industries, are listed outside the country using a complex investment vehicle known as a variable interest entity (VIE). The legal risks of this structure were highlighted when Alibaba, a large Internet company, surprised investors in May 2011 by transferring one of its assets to a private company controlled by the CEO without shareholder or board approval. The issue was eventually resolved privately, but given that VIEs appear to operate in a legal gray area in China, it is unclear what protections the legal system affords foreign minority shareholders. According to one lawyer quoted in a recent article in *The New York Times*: "It's prohibited for foreigners to own an Internet company of any kind in China – not discouraged, but prohibited. Every lawyer agrees that if this goes to court in China, those contracts are void; they're illegal."[2] This is but one example of the types of legal risks investors face in emerging markets.

- **Conflicting shareholder interests and company priorities.** The largest shareholder in many emerging market companies is the government of the country the firm is based in, which may have different goals for the business than profit-oriented minority shareholders. For example, a government objective at a given point in time

[2] Barboza, David. "A Loophole Poses Risks to Investors in Chinese Companies," The New York Times, January 23, 2012 .

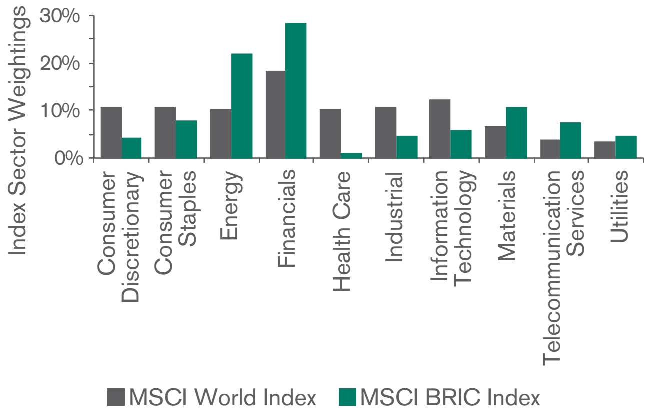
might be to maximize employment, while at another time it might be to minimize inflation. Both can be at odds with profit maximization. Estimates for direct and indirect government ownership as a percentage of total market capitalization include 67% in China, 35% in Russia, 29% in India and 14% in Brazil.[3] Even in the absence of undue government influence, emerging market companies have been known to exhibit empire-building mindsets and suffer from weak corporate governance. This can result in problematic issues such as poor cash utilization and dilutive equity issuances.

- **Greater inflation risk.** Emerging markets historically have been subject to higher levels of inflation and monetary growth than developed economies. From an academic perspective, all else equal, higher rates of inflation ought to result in higher cost of equity, translating into lower valuation multiples. For example, the latest reported consumer price index annual rate of change in Brazil was approximately 5%. Those with longer memories remember that Brazil struggled mightily with hyperinflation just a few decades ago, with the annual rate of inflation peaking at more than 2,000% in 1994. Reflecting the current level of inflation as well as other risks, Brazil's central bank has set the overnight lending rate at 8%, and the government must pay investors approximately 10% to issue Brazilian real-denominated 10-year sovereign bonds. Countries with such a high "risk free" rate tend to have an even higher cost of equity and thus low equity multiples.

- **Increased exposure to low multiple businesses.** The stock market composition of emerging economies is often skewed toward low multiple businesses, such as banks and natural resource firms, whereas the markets in developed countries tend to consist of a higher proportion of high multiple branded goods, service and health care businesses. As of June 30, 2012, the MSCI BRIC Index (Brazil, Russia, India and China) had a 29% weighting in financial firms and a 22% weighting in energy firms. These figures are far higher than in developed markets, as represented by the MSCI World Index (see Exhibit 6). In fact, if one applies developed market sector price-to-book multiples to average emerging market industry weightings, it helps explain the long-term historical discount at which emerging markets have traded, as seen earlier in this paper in Exhibit 2a. Over time, multiples in these industries tend to be low – even during periods of high rates of growth – owing to factors such as low barriers to entry, fierce competition, highly cyclical earnings streams, low or negative free cash flows and low rates of return on capital.

EXHIBIT 6: SECTOR WEIGHTS FOR BRIC COUNTRIES VS. DEVELOPED COUNTRIES

Emerging market sector weightings are significantly higher in financials and energy, compared to developed countries.



Source: FactSet. As of 6/30/12

Collectively, these risks should give investors clear reason for pause, especially now that emerging markets are no longer trading at a discount. Today we believe developed markets generally offer a more compelling risk/reward profile, with significantly less absolute downside exposure. Past market downturns in high-growth emerging economies have often been swift and severe, quickly wiping out investment gains and subjecting investors to steep capital losses.

Recent historical examples include the following (figures calculated in U.S. dollars):

- The Mexican peso crisis in 1994-1995, prompting a 75% peak-to-trough decline in the MSCI Mexico Index in 13 months.
- The Russian financial crisis in 1997-1998, when the MSCI Russia Index collapsed 94% peak-to-trough in 12 months.
- The Asian financial crisis in 1997-1998, with the MSCI AC Far East ex-Japan Index tumbling 69% peak-to-trough in 20 months.
- The global financial crisis in 2008-2009, when the MSCI BRIC Index fell 69% peak-to-trough in only five months.
- The European sovereign debt crisis in the third quarter of 2011, resulting in a 23% decline in the MSCI Emerging Markets Index for the quarter compared to a 17% loss in the MSCI World Index.

[3] Source: Goldman Sachs, "Stay the Course", by Sharmin Mossavar-Rahmani and Brett Nelson. January 2011.

While developed markets have also experienced large declines in the past, we believe investors are well served by keeping these types of declines in mind when evaluating potential downside risk in emerging markets.

MULTIPLE ACCESS POINTS

Investors attracted to emerging markets have various ways to gain equity exposure, both directly through emerging market listed companies or indirectly through developed market multinationals that derive a large percentage of profits from emerging market countries. It is also important to remember that the broader emerging market classification consists of a group of extremely diverse economies, each with its own specific investment merits and dynamics.

There are four primary ways to access these markets:

1. **The emerging market darlings.** This refers to the emerging markets most often referenced by investment commentators and the media. The big ones currently are the BRIC countries, Brazil, Russia, India and China. These markets are characterized by positive economic growth, and they make for a good investment story. Within each, however, there is enormous diversity in terms of investment opportunities and risks. Both China and India, for example, have huge populations and a growing middle class but are very different from an investment perspective, with China being a centralized command economy and India being a heavily bureaucratic democracy. Russia is the least expensive of the bunch, but this partly reflects its elevated political risk.

2. **The emerging market has-beens.** These emerging markets were once market darlings but have since become yesterday's news. South Korea and Taiwan are two examples. In the late 1980s, these were "must own" markets, but like many good investment stories the hype eventually became a bad thing for investors. After peaking in 1989, the South Korean KOSPI Index fell nearly 88% in U.S. dollars before hitting bottom in late 1997 during the Asian financial crisis. Taiwan's TWSE Index has still not regained its early 1990s peak. The overarching lesson of these markets is that the process of industrialization is rarely smooth and linear. Even when growth is fairly stable, as has been the case in China over the past 10 to 15 years, stocks can still exhibit extreme volatility as investors oscillate between euphoria and despair.

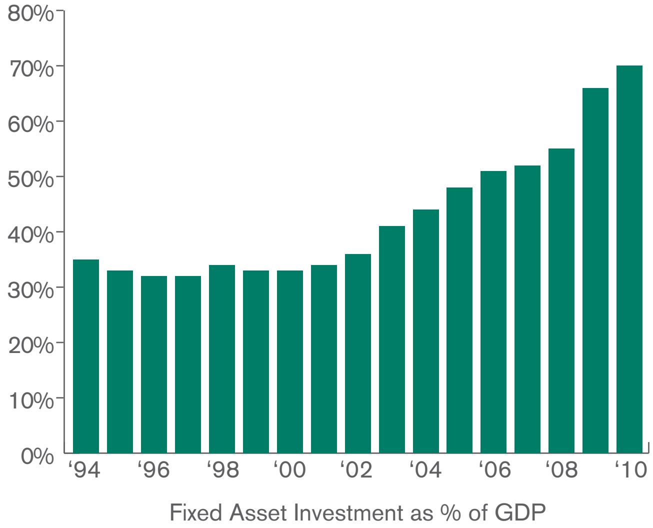
3. **Multinational branded goods companies.** Many of these global businesses are headquartered in developed markets but derive a high and growing percentage of profits from emerging markets. When these firms are trading at attractive valuation levels, they can offer the best of all worlds: superior free cash generation and returns on capital vis-à-vis emerging market competitors, potential downside protection, better corporate governance, etc. Quite often, these companies also enjoy a quality and reputational advantage compared to homegrown businesses. For example, pharmaceutical companies are able to command good prices for branded generics in markets such as China and India, where many consumers are wary of local comparable products. This example and others illustrate that investors can benefit from broader emerging market economic development without concentrating risk in direct country investment.

4. **Commodity producers.** Much of the growth in demand for commodity-centric businesses is being driven by emerging market industrialization. For example, developed market oil demand has actually contracted slightly over the past decade, whereas emerging market consumption has grown by approximately 3.8% annually.[4] This has helped create upward pricing pressure to the extent that marginal supply cannot keep up with marginal demand, as evidenced by the rise in Brent Crude oil from approximately $10/bbl in late 1998 to an average level of more than $100/bbl in early 2012. This trend is even more exaggerated in other commodities, where a fixed asset investment boom has caused China alone to be responsible for as much as 60% of global import demand in certain commodities such as iron ore, a key ingredient in steel. This focused demand, however, also presents a substantial risk for commodity investment plays. Given how China's fixed asset investment accelerated to unprecedented levels in the aftermath of the 2008 global financial crisis, largely financed on credit, we worry that potential malinvestment could lead to credit problems down the road (see Exhibit 7). Should the Chinese growth miracle experience a sizable hiccup, it could have serious implications for global commodity producers. We are not forecasting an economic collapse in China but do believe many investors have become complacent about its potential risks after years of high, consistent growth.

[4] BP Statistical Review of World Energy, June 2012 .

EXHIBIT 7: CHINESE FIXED ASSET INVESTMENT AS A PERCENTAGE OF GDP

Investment has reached unprecedented levels largely financed with credit.



Source: National Bureau of Statistics of China

Based on the run-up in emerging market equity prices, we believe multinational branded goods companies generally represent the most prudent strategy to gain exposure to these markets. Considering the attractive risk/reward characteristics of many of these stocks, these companies remain the primary way that the Perkins Global Value strategy accesses positive emerging market growth potential in the current market environment, although we have found some opportunities for direct investment. Of course, a marked decline in country-specific valuations could change this approach, if direct emerging market assets become available at attractive discounts.

CONCLUSION

There is an old investment adage that when developed markets sneeze, emerging markets get the flu. This premise still largely holds true, which makes us cautious with these markets based on current valuations and risk exposure relative to developed markets. The cornerstone of the Perkins investment process is an extreme focus on downside protection and capital preservation. Avoiding large losses is crucial to maximizing investment compounding potential and delivering attractive risk-adjusted performance over full market cycles. After a decade of strong emerging market equity returns, on both an absolute and relative basis, and with valuations now generally at parity with developed market stocks, the potential downside risk in most of the individual emerging market stocks we evaluate is outside our comfort zone. We have seen some emerging market opportunities on a very selective basis, but on the whole we are simply finding better value opportunities in developed markets.

Although we recognize that emerging markets are seductive from a thematic standpoint, long-term data do not support the notion that higher economic growth necessarily translates into superior risk-adjusted returns. This type of research might seem surprising, but from a practical consideration it means that investors must pay close attention to valuations, regardless of how strong macroeconomic fundamentals may be. Paying too much for an investment rarely leads to greater gains and instead simply raises the stakes in how much might be lost in the next cyclical downturn.

While our strong commitment to downside protection dampens our enthusiasm for emerging markets today, risk/reward relationships can and do change. If some event were to occur and induce a sizable price correction, or if enthusiasm simply wanes, we would expect to deploy more capital into these opportunities. We like providing liquidity when it is scarce, but today there is no shortage in emerging markets. ■

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