THE BRANDES INSTITUTE

Value Investing: Has It Worked in Emerging Markets?

For the 5-year period as of year-end 2007, the MSCI Emerging Markets Index delivered an annualized average return of 33.6%,[1] well above its 15-year annualized average return of 9.6%. Similarly, the MSCI BRIC Index (which includes companies based in Brazil, Russia, India, and China) had a 5-year annualized return of 47.5% as of year-end 2007. Over the same period, the MSCI World Index, which represents developed markets worldwide, delivered an annualized average return of 14.9%. Investors in these developing countries may think that recent results reflect an increasing number of growth-oriented companies benefiting from rapidly evolving capital markets within these emerging economies.

But is this assumption accurate? Have "glamorous" companies in developing countries tended to deliver the greatest returns? And how have value companies performed? Has value investing even *worked* in emerging markets?

To answer these questions, we examined the historical performance results of value and glamour companies based in emerging markets, applying the methodology used in the Brandes Institute research paper, "Value vs. Glamour: The Value Premium in Non-U.S. Markets." (For the complete "Value vs. Glamour" report, visit the Brandes Institute website at www.brandes.com/institute.)

To quickly recap the methodology for this study, we used the Worldscope database and defined emerging market stocks as those securities of companies residing in countries designated by MSCI Barra as emerging. Consistent with our previously published research, our sample excluded the smallest 50% of all companies to represent a more truly "investable" universe. For example, this adjustment raised the median market capitalization of companies in the decile sets formed on June 30, 2002, from $294 million to $549 million.[2] Our sample size for this study increased significantly in the early 1990s, coinciding with economic growth and greater database coverage of emerging market companies. Exhibit 1 illustrates the number of companies included in our sample over time.

1 Unless otherwise denoted, all return data for indices in this report does not include dividends or capital gain distributions. Price return data offers a longer history vs. total return data.

2 Although the median market cap was $549 million (USD), the market capitalization of all companies included in the June 30, 2002 sample ranged from $294 million (USD) to $40 billion (USD).

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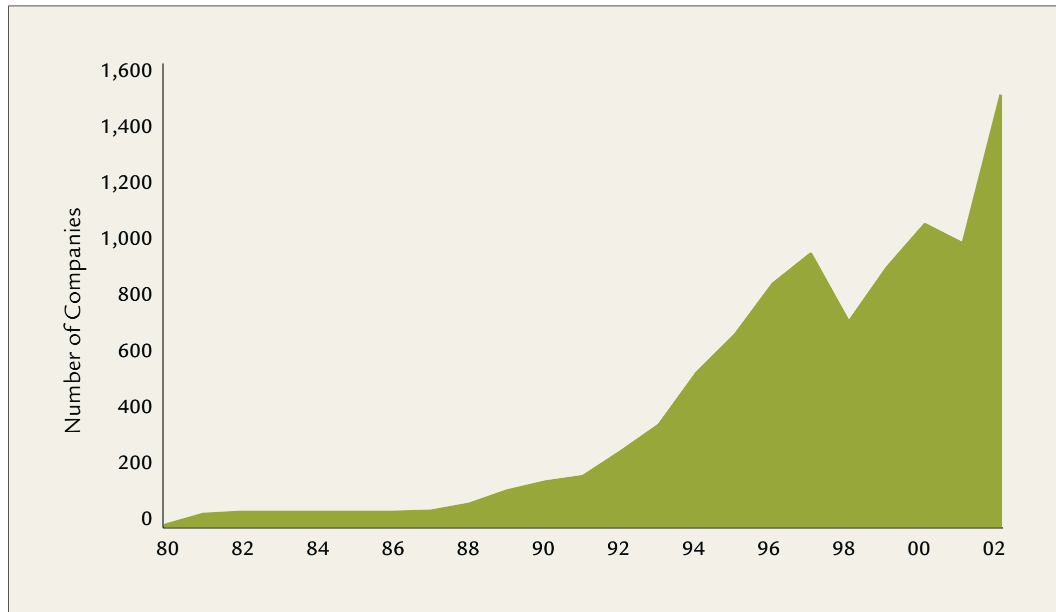
Exhibit 1: Emerging Market Sample Size, June 30, 1980 to June 30, 2002



Source: Worldscope via FactSet, The Brandes Institute as of 6/30/07

Starting with data from June 30, 1980, we segmented this universe into value and glamour constituents by dividing the sample into deciles based on price-to-book (P/B) ratios. Stocks with the lowest P/B ratios populated the higher deciles (i.e., the value stocks) and those with the highest P/B ratios (i.e., the glamour stocks) comprised the lowest deciles. We then tracked the aggregate performance of each decile over the next five years.[3] We repeated these steps for each of the remaining years of our study (through the 5-year period starting June 30, 2002) and averaged returns for each of these 5-year periods for comparative purposes through June 30, 2007. Exhibit 2 shows our findings.

[3] Performance includes dividend and capital gain distributions.

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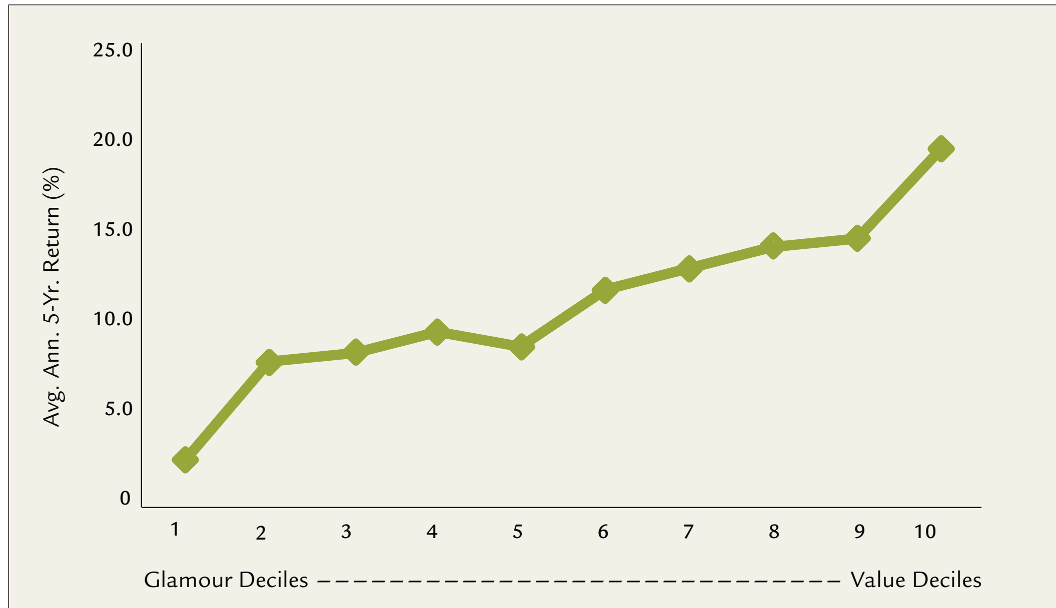
Exhibit 2: Annualized Average 5-Year Returns, Price-to-Book (P/B) Deciles, Value vs. Glamour in Emerging Markets, June 30, 1980 to June 30, 2007



Source: Worldscope via FactSet, The Brandes Institute as of 6/30/07

The results depicted in Exhibit 2 clearly point to the existence of a value premium in emerging markets during the study period. The distinct upward sloping line in Exhibit 2 indicates that the average returns of emerging market value stocks (the upper deciles) outperformed emerging market glamour stocks (the lower deciles) by wide margins.

At the extremes, the average annualized 5-year return for "glamour" stocks in decile 1 was 2.6% vs. 19.6% for "value" stocks in decile 10. The results published in "Value vs. Glamour: The Value Premium in Non-U.S. Markets" demonstrated that decile 10 stocks (value) delivered an 8.3% premium on average over their decile 1 (glamour) counterparts in *developed* non-U.S. markets. **In the case of emerging markets, the value premium was 17.0% annualized – more than double the premium found in non-U.S. developed markets.**

Given the volatility in emerging markets, we also were interested in investigating the year-over-year persistence of this premium. Did the 5-year average returns in emerging markets (illustrated in Exhibit 2) disguise a more volatile pattern in the relationship between decile 1 (glamour stocks) and decile 10 (value stocks)? Was there more volatility in that 5-year relative performance if it was measured year to year?

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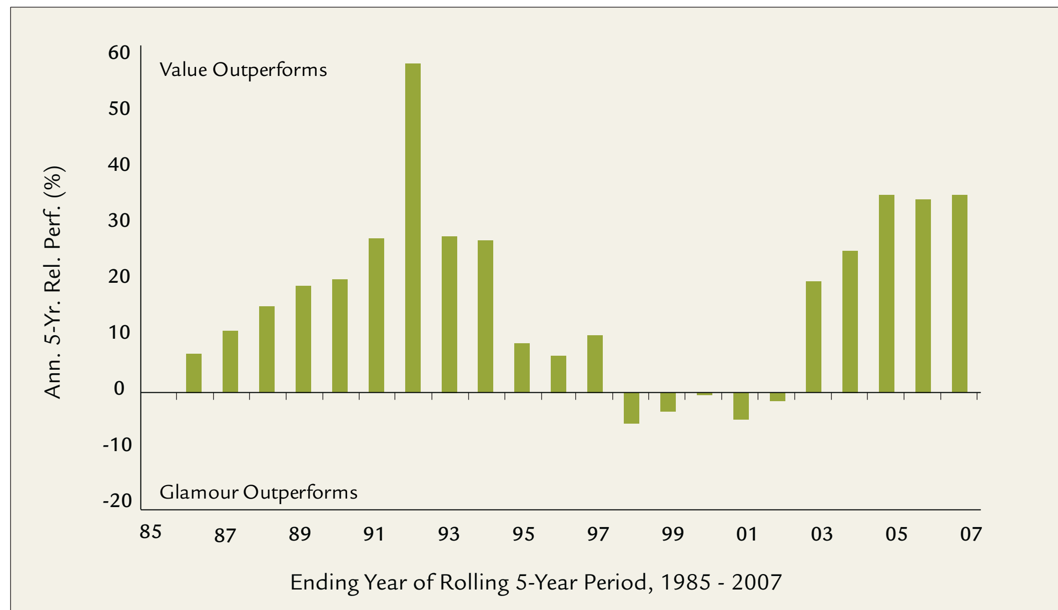
To answer these questions, we examined our findings on a rolling 5-year basis. In other words, we studied the relative performance of value stocks vs. glamour stocks for each of the 5-year periods under review, from the period starting on June 30, 1980 through June 30, 2007. For each period, we calculated relative performance by subtracting the annualized average 5-year return of stocks in decile 1 (glamour stocks) from the annualized average 5-year return of stocks in decile 10 (value stocks). Exhibit 3 illustrates these findings.

Exhibit 3: Annualized Average Rolling[4] 5-Year Relative Performance of Value vs. Glamour in Emerging Markets, June 30, 1980 to June 30, 2007



Source: Worldscope via FactSet, The Brandes Institute as of 6/30/07

Exhibit 3 demonstrates that in a clear majority of periods, decile 10 stocks outperformed decile 1 stocks based on the annualized average rolling 5-year return. This outperformance for decile 10 stocks averaged 16.6% over the 23 rolling periods reviewed. By comparison, during the five periods where decile 10 stocks underperformed their decile 1 peers, underperformance averaged only 3.2%.[5]

What accounted for this performance disparity between value and glamour stocks in emerging markets? Examining the industry composition of the most recently formed decile sets may shed some light on factors driving results over the most recent 5-year period. For example, at time of publication,

[4] Rolling periods represent a series of overlapping, smaller periods within a single, longer-term period. A hypothetical example is the 20-year period from 12/31/82 through 12/31/02. This long-term period consists of 16 smaller 5-year "rolling" segments. The first segment is the 5-year period from 12/31/82 to 12/31/87. The next rolling segment is the 5-year period from 12/31/83 to 12/31/88, and so on.

[5] The limited number of observations in our sample from 1980 through the early-1990s tempers the significance of our findings during these periods.

the most recently completed decile sets with a 5-year performance track record were those formed on June 30, 2002. Within these sets, we focused on deciles 1 and 10. The largest allocations for decile 10 were in the commercial banking, electric utilities, and metals & mining industries. In particular, decile 10 benefited from advances for a number of constituents in the construction & engineering, metals & mining, and oil, gas, & consumable fuels industries. Many of these firms benefited from broad-based surges in commodity prices and subsequently delivered exceptional performance.

Conversely, for those decile sets formed in 2002, decile 1 had its largest allocations in the real estate management & development, chemicals, and pharmaceuticals industries. Modest returns in these industries coupled with select stock-specific declines weighed on decile 1 performance. Among countries, decile 1 was 70% comprised of China-based companies with an average total return of 3.0% over the 5-year period ending December 31, 2007. In contrast to decile 1's heavy concentration in China, decile 10 had greater diversity among countries, and benefited most from constituents in South Korea and Brazil. While lackluster performance for Chinese securities may seem largely out of line with recent results for China's equity markets, bear in mind that advances for China's stock market during 2007 were largely driven by gains for companies in the wireless telecommunication services, oil, gas & consumable fuels, and insurance industries, firms generally underrepresented in decile 1.

Given decile 1's heavy weighting to China-based holdings, it was of additional interest to explore the performance disparity between the value and growth components of the MSCI China Index. Exhibit 4 illustrates the growth of $100 invested in the MSCI China Value Index vs. the MSCI China Growth Index over the most recent 10-year period based on total return. While an investment in the MSCI China Value Index yielded close to a fivefold return, an investment in the MSCI China Growth Index lost more than 10% of the initial investment over the 10-year period.

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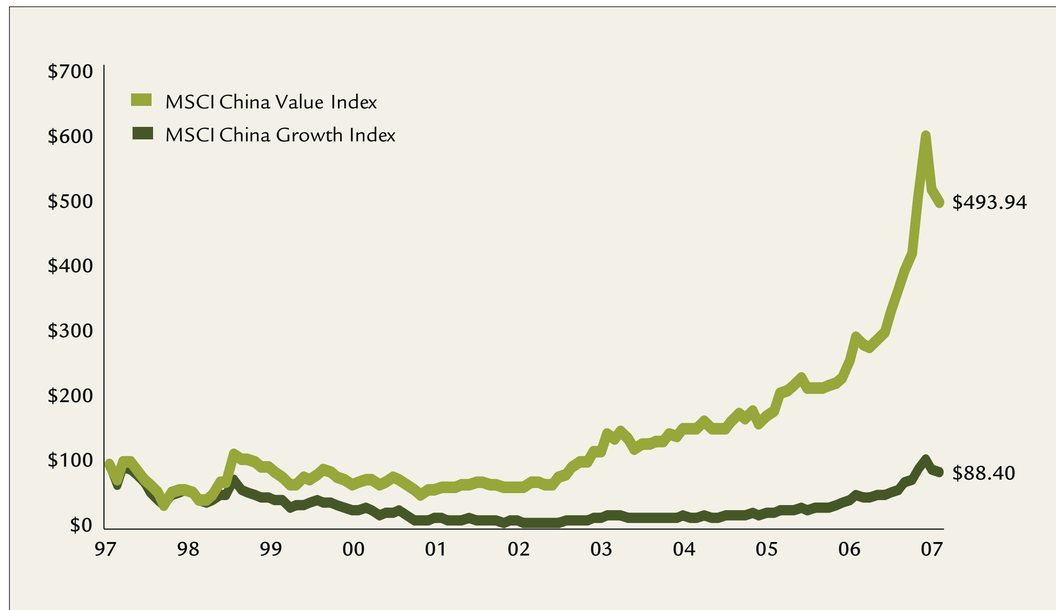
Exhibit 4: Growth of $100 in MSCI China Value Index vs. MSCI China Growth Index, Dec. 31, 1997 – Dec. 31, 2007



Source: MSCI via FactSet, as of 12/31/07

Astute investors may consider all the factors driving decile 10's recent outperformance. Exhibit 3 indicates that value deciles have not always outperformed glamour year over year. However, over the long term, investing in out-of-favor companies clearly has shown its merit in emerging stock markets. Additional studies, such as the July 2005 Brandes Institute article "New Insights into the Case for Emerging Market Equities," also have dispelled the common misperception among investors that a positive relationship exists between a country's gross domestic product growth rate and its stock market returns. (For the complete "New Insights into the Case for Emerging Equities" report, visit the Brandes Institute website at www.brandes.com/institute.)

To value investors, this research may confirm more clearly the opportunities available in emerging market investing. These results show it is possible to generate competitive returns by focusing on companies selling at attractive valuation levels, and by avoiding the temptation to chase after investments in glamorous companies in prosperous and fast-growing economies, regardless of their valuations.

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Index guide

MSCI Emerging Markets: The MSCI Emerging Markets Index is an unmanaged, float-weighted index consisting of securities listed on exchanges in developing nations throughout the world, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

MSCI BRIC: The MSCI BRIC Index is an unmanaged, float-weighted index consisting of components of the MSCI Brazil, MSCI Russia, MSCI India, and MSCI China Equity Indices. It does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

MSCI World*:* The MSCI World Index is an unmanaged index consisting of equities from developed markets around the world, including the United States. This index often is used as a benchmark for global equity portfolios. It does not reflect fees, brokerage commissions, or other expenses of investing.

MSCI China: The MSCI China Index is an unmanaged, float-weighted index consisting of securities listed on exchanges in China and includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

MSCI China Growth: The MSCI China Growth Index is an unmanaged index consisting of equities based in China. The index is generally considered to be representative of China growth stock market activity. The MSCI China Growth Index includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

MSCI China Value: The MSCI China Value Index is an unmanaged index consisting of equities based in China. The index is generally considered to be representative of China value stock market activity. The MSCI China Value Index includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

The investment return and principal value of an investment will fluctuate so that an investor's shares, when sold, may be worth more or less than their original cost. Past performance does not guarantee future results. All indices are unmanaged and are not available for direct investment.

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