HORIZON RESEARCH GROUP

Emerging Markets as an Asset Class

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EMERGING MARKETS AS AN ASSET CLASS

Emerging markets is an asset class that is relatively inefficient, unexplored, and poorly understood. The 10 largest ETFs in the United States, as a sample, will illustrate. As of May 31, 2014, these ETFs had $520.7 billion in assets under management.

Table 1: Ten Largest ETFs as of May 31, 2014

		Assets Under Management *($ in billions)*
SPY	SPDR S&P 500	$160.2
IVV	iShares Core S&P 500	56.8
EFA	iShares MSCI EAFE	55.8
VWO	Vanguard FTSE Emerging Markets Stock ETF	45.0
QQQ	Powershares QQQ	43.4
VTI	Vanguard Total Stock Market ETF	43.3
EEM	iShare MSCI Emerging Markets	38.0
GLD	SPDR Gold Shares	31.6
IWF	iShares Russell 1000 Growth	23.4
IWM	iShares Russell 2000	23.2
	TOTAL	$520.7

Source: Fund sponsor websites

The two emerging markets ETFs, the Vanguard FTSE Emerging Markets Stock ETF (VWO) and the iShares MSCI Emerging Markets (EEM), represent 15.9% of the total $520 billion, and that $520 billion represents 28.9% of the $1.8 trillion in U.S. ETFs, so it is a pretty good sample. It is a reasonable assumption that this nearly 29% of the funds invested in ETFs mirrors current asset allocation preferences in some way.

To look in detail at some of the leading ETFs, iShares products will be used, because the P/Es are all calculated using a comparable methodology.

One large ETF, the iShares Core S&P 500 (IVV), has $56.8 billion of assets under management and, as of May 31, 2014, its trailing 12-month price-to-earnings ratio was 22.2x and its trailing 12-months price-to-book value ratio was 4.5x.

Let us compare and contrast that with iShares MSCI EAFE (EFA). EAFE stands for Europe, Australia and Far East. The EAFE ETF has a nearly identical sum of assets under management, $55.8 billion. Its trailing 12-month price-to-earnings ratio was 20.8x, which is more or less equivalent to that of the S&P 500 ETF, and its price-to-book-value ratio at 2.8x was lower than the S&P 500 ETF ratio of 4.5x. The difference between EFA and IVV can easily be accounted for by the absence in EFA of a handful of large-capitalization stocks that have extraordinarily high price-to-book ratios, like Amazon.com and Facebook.

Compare and contrast these metrics with those of the iShares MSCI Emerging Markets (EEM), which has $38 billion in assets under management. Its trailing 12-month price-to-earnings ratio is 19.2x and its trailing 12-month price-to-book ratio is 3.04x. These valuations are more or less consistent with those of IVV and EFA. If one really wanted to understand in depth why the price-to-earnings ratio of MSCI Emerging Markets (EFA) is slightly lower than the iShares Core S&P 500 (IVV), all one need do is take note of the low valuation elements in the EEM index—the Chinese banks and stocks like Gazprom—that trade at very low price-to-earnings ratios and that are not present in the IVV index.

Focusing, now, on the iShares Russell 2000 Index (IWM)—one of the most interesting index examples—it had assets under management of $23.2 billion as of May 31, 2014. Its valuation statistics were as follows: a trailing 12-month P/E of 29.2x and a trailing 12-month price-to-book value ratio of 3.89x.

How can we state that the Emerging Markets Index is the least understood and most inefficient part of the marketplace when the valuations are more or less consistent with the valuations of other indexes and, to the extent that there are valuation differences, they are explainable by discrete pockets of controversial equities? How can we make that statement when the assets under management of the two emerging market funds, Vanguard FTSE Emerging Markets and the iShares MSCI Emerging Markets, comprise 15.9% of the total $520 billion sample size? It does not appear that investors in general are avoiding these so-called asset classes, which would make them inefficient and at least poorly understood in the first place. Of course, the fact that people own those shares and trade them does not mean that they understand them well.

To the degree that the valuation of the Emerging Markets Index is slightly below the developed market indexes and to the degree that one believes it will ultimately trade in equilibrium, if that were the purpose of the trade, it is essentially a valuation bet on Russia. Russia is the low valuation part in Emerging Markets and it is 5.5% of EEM. Why put 15% of a portfolio in Emerging Markets? Why not just put 50 to 75 basis points, which would be the equivalent allocation, directly in Russia and ignore the rest of it?

To illustrate the point, here are some valuation statistics from the Van Eck website. The Market Vectors Russia ETF (RSX) trailing price-to-earnings ratio on May 31, 2014 was 6.3x and the price-to-book-value ratio was 0.84x. Gazprom is 8.3% of the Russian market, as Market Vectors calculates it. Gazprom has a $104 billion market capitalization, so that means buying everything on the entire Russian market would be $1.4 trillion. That is more or less equal to the market capitalization of South Korea. It is 55% of the market capitalization of Canada. It is more or less equal to the market capitalization of Spain.

Interestingly enough, the theme of investing in Russia is about more than mere Russia. There also are the Eastern European countries that are not even included in the Emerging Markets Index. For a sense of the valuation proposition, the Ukraine has an aggregate market capitalization of $21 billion; in other words, one could buy every stock in the Ukraine for $21 billion. To put it another way, Apple could take about 13% of its $150 billion cash balance and buy every share of every publicly traded company in the Ukraine, for better or worse.

When emerging markets indexes were created, the outsized returns were similar to those of what might be called the frontier markets today. Perhaps a solution is that the frontier markets today are basically what were considered the emerging markets in the past. In simplistic form, here is a first step in testing that hypothesis using valuation statistics of the iShares MSCI Frontier 100 ETF (FM): the trailing 12-month P/E ratio is 20.56x and the trailing 12-month price-to-book-value ratio is 3.29x. If one is looking for valuation differences, one will not find them in the basic ETF categories. Once the securities have been sorted and are eligible for inclusion in the indexes, their valuation becomes a function of supply and demand, because under the rules-based selection criteria, a security is nothing other than raw material.

If one wants to have unique performances, one has to look either outside the indexes or, alternatively, at elements within the indexes that are controversial and poorly represented.