GLOBAL EMERGING MARKETS

MARTIN CURRIE

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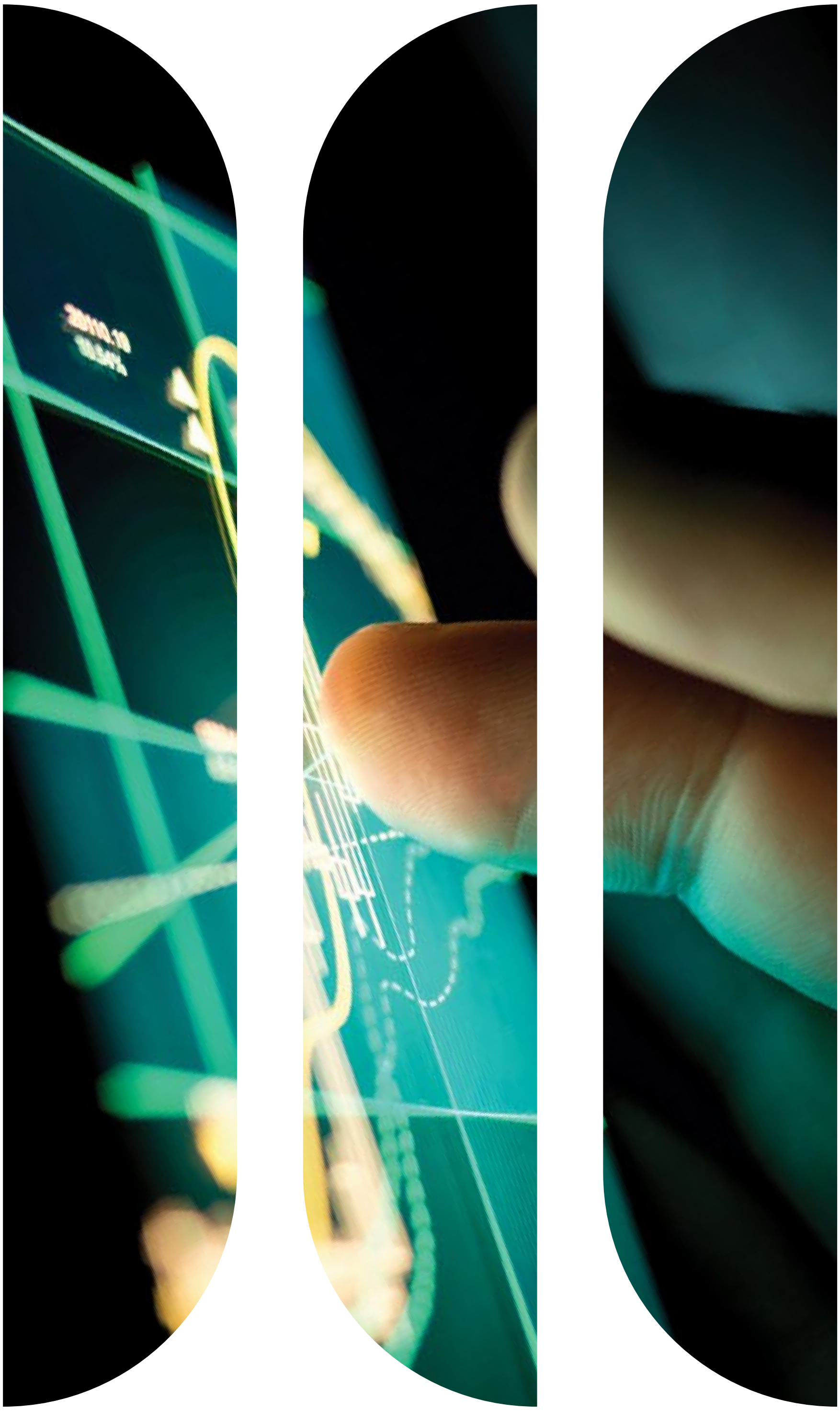
For institutional, professional and wholesale investors only



GROWTH VS. VALUE: WHERE'S THE QUALITY IN THAT?

The recent sustained style rotation from growth to value has been pronounced and has led many to say that value should be the preferred style. This has prompted us to revisit the question of which style best captures the emerging market opportunity. As we show in the following pages, we believe the answer lies not at the extremes of these styles and is firmly rooted in quality.

Susan Gim

Portfolio Manager
Global Emerging Markets

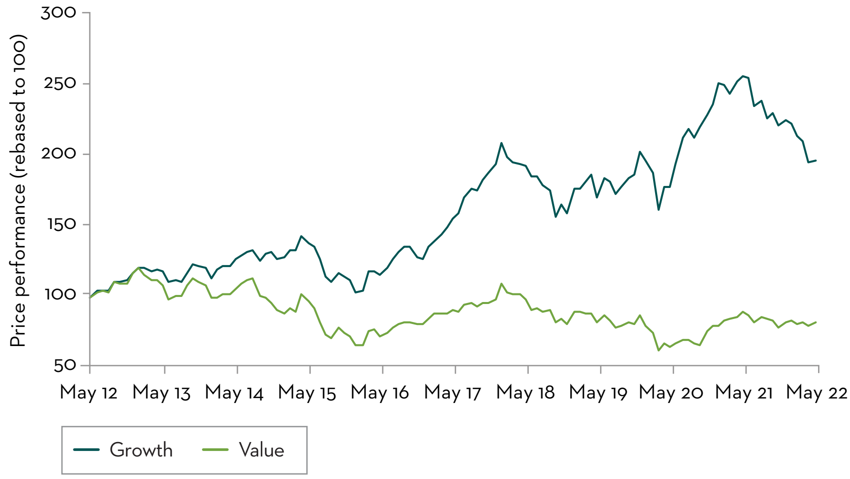
The bear market of 2022 has been impacted by many factors, including the conflict between Russia and Ukraine, subsequent supply chain concerns across many markets, regulatory concerns in China, the ongoing management of Covid-19, rising inflation and rising interest rates. A common theme which we have observed running through many of the industries affected by these macro events is that high quality, growth stocks have undergone a significant de-rating and that more cyclical, value stocks have done well. This is particularly evident in typically high growth names such as semiconductors and digital economy stocks.

The shift has resurfaced arguments which promote opposite extremes of the style spectrum as the key to long-term outperformance. We do not think the answer lies in such divisive analysis and to focus only on the extremes is restrictive. We believe value investing faces significant risk hurdles in emerging markets and that a combination of quality factors alongside growth is the best approach to capture the emerging market opportunity.

Growth outperforms value in the long term

We should still answer the first question, however. During 2021 and 2022 year-to-date, value has outperformed growth. However, we have seen that over the long term – both five- and ten-year periods – significant outperformance was achieved by growth over value stocks.

Figure 1: Price performance of MSCI Emerging Markets Index value and growth style factors



Source: FactSet, 31 May 2022. Value stocks defined as the lowest third of index stocks by price-to-book ratio; growth stocks defined as highest third of index stocks by delivered earnings-per-share (EPS) growth.

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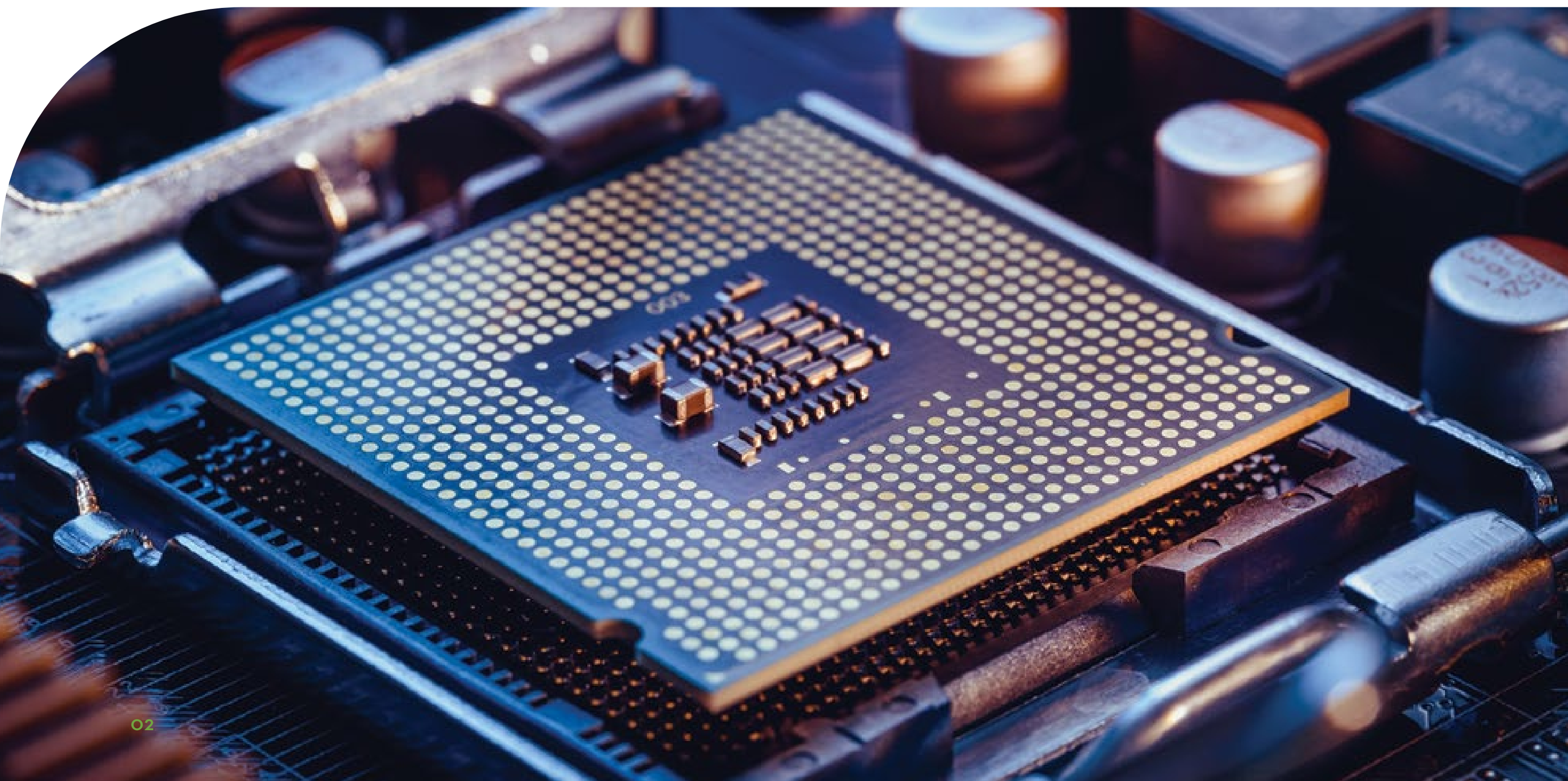


What's different about value stocks in emerging markets?

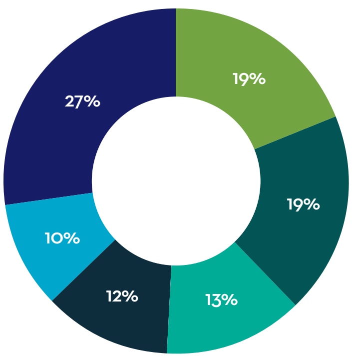
We are often asked about the return of the value style globally. Emerging market value stocks exhibit different characteristics to those elsewhere.

In our team's experience, value stocks in emerging markets have three key tendencies:

1) Misalignment of interests – significant government ownership and influence;
2) Value destructive returns – some sectors and companies show little evidence of value-creation; and
3) Weak ESG performance – storing up longer-term risks to equity owners.

An analysis of the MSCI Emerging Markets Index supports our observations; the meaningful outperformers in the emerging markets value universe have these attributes.

Figure 2. Core attributes of top quintile performers in Emerging Market Value



Source: FactSet and Bloomberg. Emerging Market Value stocks defined as the lowest third of the MSCI Emerging Market Index stocks by price-to-book ratio.

When enlightened to these defining attributes of value stocks, it is easy to understand why value underperforms growth consistently in emerging markets.

State-owned enterprises (SOEs) struggle to make a business strategy that is independent of what the political regime defines as "national interest." Our investment team has observed several attributes with SOEs in emerging markets:

1) Lack of continuity in senior management teams;
2) Capital return policies based on need to return capital to government holders;
3) Frequent interference in business strategy by political regimes.

High yield stocks in emerging markets can have numerous unintended sector concentration risks. As shown in figure 2, half of the best performing emerging market value stocks are Chinese banks, Chinese real estate or Chinese SOEs. When we include SOEs in other emerging market countries and ESG-related red flag companies, 73% of top performers are in these categories.

We have consistently observed weaker ESG characteristics in emerging markets value stocks than other index stocks. Governance is a core area of analysis for our team and we have found that SOEs often have a business strategy that is focused on supporting government policy rather than shareholder returns.

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Importance of Quality

Once placed under scrutiny, the opportunity presented by value stocks in emerging markets provides heightened risk exposure to political volatility, SOEs, sector concentration and poor ESG credentials compared to both growth and quality stocks. It is hardly surprising that value stocks in emerging markets have consistently underperformed the broader market and other styles in the long term.

However, in the long-run, success in emerging markets is not driven by growth or value characteristics alone. Quality clearly plays a crucial role too. This means financial strength, competitive advantage, profit leadership, good capital allocation strategies, strong ESG characteristics and strong returns on equity and invested capital. High quality in a company helps to create shareholder value because it enables the company to capitalise on the growth opportunity sustainably.

The chart below shows that a combination of styles more powerfully captures the long-term opportunity in emerging markets. Quality combined with growth consistently outperforms each style individually.

Figure 3: Price performance of MSCI Emerging Markets Index decomposed by style factors

Source: FactSet, to 31 May 2022. Quality stocks defined as the highest third of index stocks by return-on-equity (ROE); quality growth stocks defined as highest third of stocks by ROE, with an overlay of the highest half by EPS growth.

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The recent global style rotation away from growth and towards value has created a difficult market environment for many emerging market investors. In essence, the outcomes being experienced in the short term are in line with the style rotations in the market and specifically the de-rating of high growth, high return companies. Notable however, is that the share price strength in value stocks is not reflected in earnings; the market has deviated meaningfully from company fundamentals by excluding parts of, or entire, businesses from its valuations.

In the long term, a rally based on sentiment alone cannot be sustained. Despite the difficult environment, high quality growth companies continue to exhibit strong fundamentals and ultimately this should come through in the market. It is only a matter of time.

Companies with sustainable, long-term growth potential at reasonable valuations are the stocks which are best placed to benefit from the wider emerging market opportunity. These are the types of stocks our Global Emerging Markets team aims to identify through our research process, which includes rigorous ESG and fundamental analysis and company engagement.

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