

DIVING DEEPER INTO SPECIFIC EMERGING MARKET OPPORTUNITIES

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In a [prior blog](#), my colleague looked at the [dividend yield](#) of the [MSCI Emerging Markets Index](#) (MSCI EM) as a potential indicator of the emerging markets being “inexpensive.” Here, I turn to the [price-to-earnings \(P/E\) ratio](#) –specifically the P/E ratio of sectors and countries within the MSCI EM. As a starting point, the primary conclusion we arrived at based on dividend yields—that emerging markets are inexpensive—is equally valid when looking at current P/E ratios compared to their average over the last 10 years. The P/E ratio for the MSCI EM as of July 31, 2013, is at about a 15% discount to this historical average.¹ But one thing is also certain: Not all emerging market equities show the same low prices. I take a further step to look at where those valuation opportunities are more pronounced among sectors and countries. Structuring the P/E Ratio Analysis Using the MSCI Emerging Markets Index as a baseline, we asked, as of July 31, 2013: • which five underlying MSCI emerging markets country indexes exhibit the lowest P/E ratios? • which five underlying MSCI emerging markets sector indexes exhibit the lowest P/E ratios? However, we won’t stop there. Not only are we interested to know which countries and sectors look inexpensive on an absolute basis today, compared to others, we also want to have an indication of how their P/E ratios look compared to their own history. We therefore will also show a comparison of the July 31, 2013, P/E ratio for each compared to its 10-year historical average. Finally, since P/E ratios are a function of both the performance of price levels and earnings per share, we will indicate the cumulative performance over the prior three years, also as of July 31, 2013. This will give some indication as to whether a lower P/E ratio is related more to poor performance or to increasing earnings per share, both of which can lead to a lower value for the P/E ratio. **Valuation Matrix for the Major Emerging Markets Countries and Sectors**

	Current P/E Ratio	10-Year Average P/E Ratio	% Difference	3-Year Cumulative Return	Beta Relative to MSCI EM ¹
MSCI Emerging Markets Index	11.3x	13.4x	-15.6%	4.1%	1.00
5 Lowest P/E MSCI Emerging Market Country Indexes					
Russia	4.6x	8.7x	-47.1%	0.6%	1.31
Turkey	9.1x	10.9x	-16.2%	-2.4%	0.97
China	9.5x	14.4x	-33.5%	-0.2%	1.04
Poland	11.5x	14.5x	-20.5%	8.5%	1.08
Brazil	13.7x	12.2x	12.3%	-29.4%	1.19
5 Lowest P/E MSCI Emerging Market Sector Indexes					
Energy	6.9x	9.1x	-24.5%	-12.7%	1.23
Financials	9.2x	13.5x	-31.7%	-1.6%	1.02
Telecommunication Services	10.3x	13.9x	-25.7%	17.2%	0.75
Information Technology	11.5x	21.6x	-46.7%	24.6%	1.00
Consumer Discretionary	12.9x	14.1x	-8.4%	28.1%	1.00

Sources: Bloomberg, MSCI. Past performance is not indicative of future results. You cannot invest directly in an index.

¹Beta relative to

MSCI EM: Of the specified index, based on its 7/31/2013 constituents, relative to the MSCI Emerging Markets Index. • **Single-Digit P/E Ratios:** o **Countries:** When one looks at the

current P/E ratios, single-digit values certainly stand out for Russia, Turkey and China. China's current P/E ratio is more than 30% lower than its 10-year average, while Russia's is nearly 50% lower.

o **Sectors:** Energy and Financials also have single-digit P/E ratios that are approximately 25% and 32% below their respective 10-year averages.

o Not one of these single-digit P/E ratio countries or sectors delivered a strong performance over the prior three years, with Russia leading with a cumulative return of 0.6%.

• **Low P/E Ratios but High Betas:** Of the 10 indexes shown in this chart, eight have betas of 1.00 or greater relative to the broad MSCI EM. Russia and Energy, topping the country and sector lists, respectively, as the least expensive, each have betas above 1.20. We find this to be of particular interest, in that it indicates that approaches to emerging markets seeking [valuation](#) opportunities today might have to contend with greater potential sensitivity to broader market moves and, thus, increased [volatility](#). This can be a benefit if there is a subsequent rally, but as is the case with any value approach, the valuation opportunity can persist for an unknown period before that rally occurs.

What the Chart Isn't Showing In our effort to zero in on where the potential valuation opportunity may be within emerging market equities, we have, of course left out some of the more expensive countries or sectors. For reference, we will outline those countries and sectors with P/E ratios of 20.0x or higher as of July 31, 2013:

• **Taiwan, Mexico and Chile:** Each of these country indexes exhibits a P/E ratio of 20.0x or greater, but interestingly, Taiwan and Chile, which tended to trade at similarly high multiples over the past 10 years, are still below their 10-year average P/E ratios, albeit only slightly. Mexico, on the other hand, is approximately 30% above its 10-year average. Over the past three years, Chile's cumulative returns were down approximately 12%, but Taiwan's and Mexico's were up about 24% and 34%, respectively. Finally, each of these country indexes has a beta of less than 1.00 relative to the MSCI Emerging Markets Index.

• **Consumer Staples and Health Care:** Both of these sectors exhibit a P/E ratio of above 20.0x, and each is above its 10-year average. Over the past three years, Health Care and Consumer Staples were up approximately 25% and 50%, respectively. Additionally, these sectors are among the lowest beta sectors within emerging markets, with betas of .75 and below.

Conclusion We believe that this analysis takes our prior dividend yield analysis to the next level, as we now have reason to believe that any potential valuation opportunity is more likely to occur in some countries or sectors than in others. Additionally, we conclude that those valuation opportunities may have a higher likelihood of being confined to countries or sectors with higher betas—lower beta sectors and countries tend toward the more expensive end of their historical valuation ranges. Therefore, we believe we have built a foundation upon which to analyze the types of exposures being obtained from a few different types of equity-focused emerging market indexes.

Unless otherwise stated, data source is Bloomberg. Read the full research [here](#). ¹Source- Bloomberg, WisdomTree as of 7/31/2013

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DEFINITIONS

Dividend yield: A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

MSCI Emerging Markets Index: a broad market cap-weighted Index showing performance of equities across 23 emerging market countries defined as “emerging markets” by MSCI.

Beta: A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Valuation: Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Volatility: A measure of the dispersion of actual returns around a particular average level.