

# EM versus DM Stock Returns: Recent Past and Potential Future



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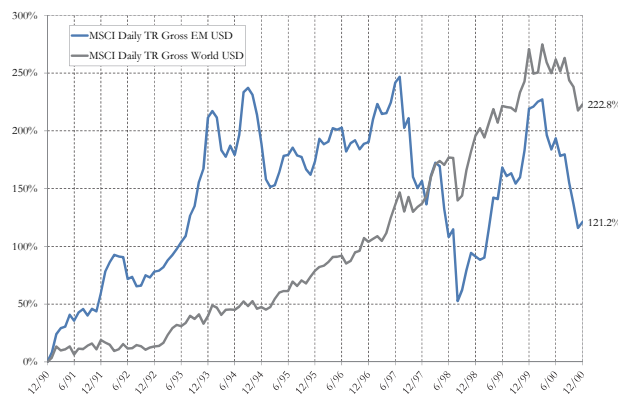
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An important question on investors' minds today is whether EM stock returns will continue to outperform DM stock returns. Many believe that EM returns will continue the trend of the past decade and economic fundamentals such as higher population growth, lower labor price, and lower debt to GDP ratio in the emerging countries will lead to even higher stock returns in the coming years. Others, with a more moderate view, say that while the economics in EM countries like Brazil, India and Turkey have improved in many ways, the stock prices in these markets already reflect these improvements. Therefore, these investors conjecture that EM equity returns may not exceed DM equity returns in the next decade or so. While EM equity flows have been negative year-to-date, we believe that emerging markets equity returns will perform in line with developed markets equity over the longer term. In this market environment, a more balanced approach to investing will serve our investors best.

## Historical Stock Returns

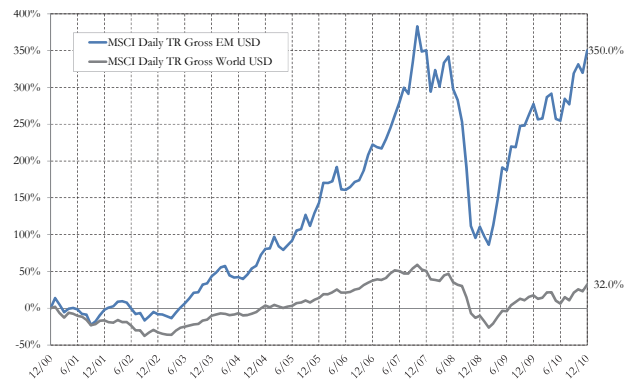
We begin with a review of stock market returns over the last two decades. Charts 1 and 2 below show accumulated total returns on the MSCI Developed World Index (DM) and the MSCI Emerging Market Index (EM) over this period. From December 1990 to December 2000 (Chart 1), DM outperformed EM. DM steadily rose throughout the period, moderately declined toward the end of 2000 and finished the period with a total return of 222.8% or 12.4% per year. During the same period, EM equities were more volatile, precipitously declined in late 1997 to 1998 and finished the period with a total return of 121.2% or 8.3% per year.

Chart 1: Total Returns of DM vs EM, Dec 31, 1990 to Dec 31, 2000



The decade that followed the performance in these markets was significantly different. From December 2000 to December 2010 (Chart 2), EM rose dramatically through the first half of 2007, declined significantly during the 2008 financial crisis but finished the period materially higher than where it began. EM accumulated returns were 350.0% or 16.2% per year. DM stock returns, on the other hand, were much more subdued for the period with accumulated returns of 32.0% or 2.8% per year.

Chart 2: Total Returns of DM vs EM, Dec 31, 2000 to Dec 31, 2010



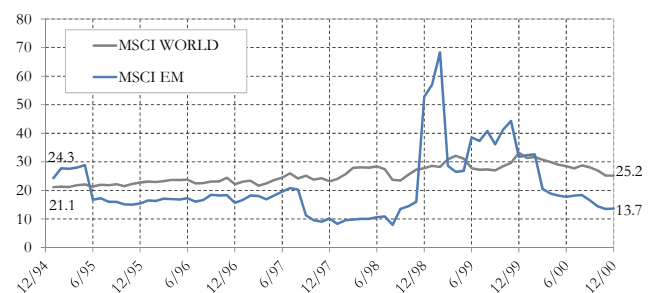
Charts 1 and 2, while interesting from an historical standpoint, also illustrate a point about forecasting returns. The relative returns we saw during the first ten years (Chart 1) turned out to be far different from the returns we saw in second ten years (Chart 2). Likewise, the returns that have yet to occur in 2011 and beyond will likely be a far cry from the returns that we have seen in the recent past.

## Valuations and Future Stock Returns

Looking beyond to the next ten years, we foresee EM stock returns looking a lot more like DM stock returns. We base this view on a number of factors – the simplest being the price to earnings ratio (P/E), a widely used measure to predict stock returns.

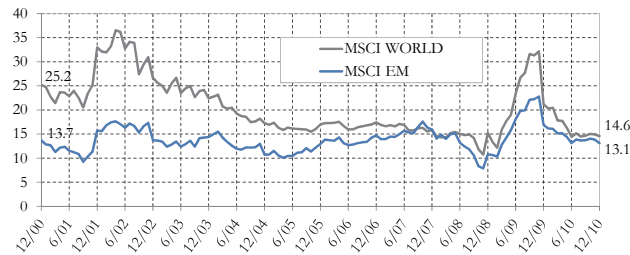
The charts below plot 12-month trailing P/E ratios over 16 years for DM and EM equity indices. From 1995 to 2000 (Chart 3), DM P/E ratios started at 21.1 times, and finished the period much higher than where it began at 25.2. EM P/E ratios began at 24.3 times, increased significantly in 1998 through 1999 but finished the period at 13.7, a great deal lower than where it began. From a valuation standpoint, EM equities entered the subsequent decade remarkably undervalued relative to DM, and therefore, were likely to outperform DM equities. In retrospect, that was indeed the outcome.

Chart 3: P/E Ratios of DM vs EM, Jan 31, 1995 to Dec 31, 2000



Now fast forward to the subsequent decade (Chart 4) where the valuation advantage that favored EM over DM gradually vanished. DM declined from 25.2 times at the start of the decade, reached a low of 10.7 in November 2008, but finished the period at 14.6 times. EM equities, on the other hand, finished the period at 13.1 almost exactly where they began. DM P/E ratios significantly declined over the period and finished at levels in line with those of EM. From a valuation standpoint, EM equities are not undervalued nor are they overvalued compared to DM equities and both will likely perform in line with one another in the years to come.

**Chart 4: P/E Ratios of DM vs EM, Dec 31, 2000 to Dec 31, 2010**

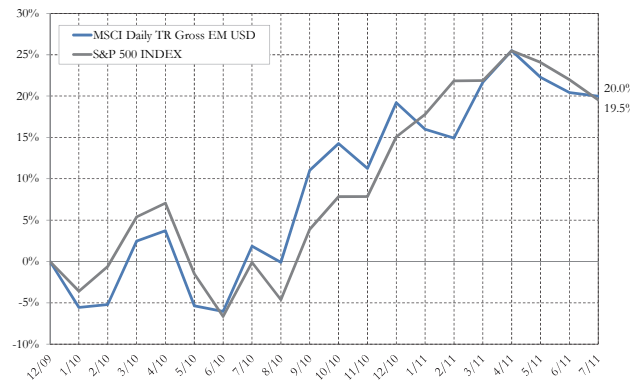


The valuation of emerging equities is no longer particularly attractive relative to developed equities. Emerging markets valuation has not reached the extremes seen in 2009, which means that periods of outperformance from here are perfectly possible. However, the valuation underpinning which existed until about 2006 has certainly now disappeared.

**Time to be More Cautious on EM Equities**

Taking a shorter time perspective, we already observe some weakness reflected in EM stock returns as the following chart indicates. Chart 5 below shows accumulated monthly performance of the S&P 500 Stock Index versus the MSCI Emerging Markets Index from December 2009 through July 2011.

**Chart 5: Total Returns of S&P 500 vs EM, Dec 31, 2009 –July 31, 2011**

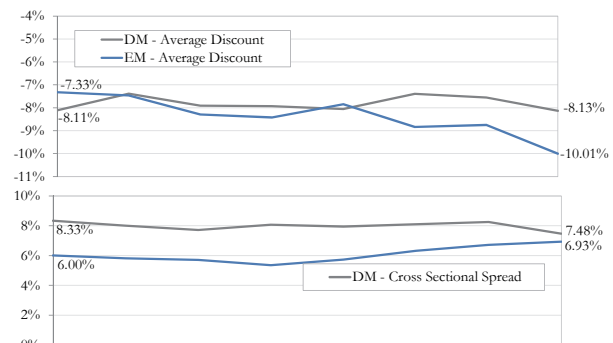


The chart indicates that over the last year and seven months U.S. equities and EM equities have performed on par with one another. However, on par performance across these asset classes is a technical break from the recent past. Other measures of valuation also suggest more difficult times ahead in EM equities.

One measure that the equity group at Gramercy has used successfully to forecast medium-term stock price movements are discounts of closed-end funds. Closed-end funds are an exchange traded non-traditional asset class that gives exposure to underlying equity markets. The distinguishing characteristic of a closed-end fund is the discount, the price at which the shares of funds trade in the market relative to the underlying value of its holdings. We use this measure to predict stock returns since discounts quickly reflect equity market sentiment in any one region, country or sector.

Chart 6 shows average discounts and cross sectional spreads of discounts on closed-end funds from the start of the year through July 2011. Discounts of DM funds began the year at -8.11% and ended the period essentially unchanged from where they began. Spread of discounts around the average actually declined from 8.33% to 7.48% or by 86 bps. In contrast, EM fund discounts widened from -7.33% at the start of the year to -10.01% at the end of July. The widening in EM funds of 2.68% is fairly large and was accompanied by a widening of the cross sectional spread of discounts by 92 bps indicating diverse sentiment to the sector. The interpretation of the discount behavior is a short-term reallocation of assets away from EM and toward DM funds. Since closed-end funds are proxies for the underlying equity markets, we see a short-term reallocation of capital in favor of DM equities. We read this as a change in market sentiment towards DM, at least in the short-run.

**Chart 6: Closed-End Fund Discounts by Investment Focus - Average Discounts and Cross-Sectional Spreads, December 31, 2010 to July 15, 2011**



**A more balanced approach to investing**

While short-term equity movement may favor DM over EM equities, longer term trends suggest each will perform in line with the other. Like other investments, EM equities will outperform in some periods, and underperform in others depending on the prevailing economic conditions at the time. We also expect to see increased levels of return volatility in stock markets globally, and therefore, we believe that a balanced approach to investing will serve investors best. We suggest that equity investors rethink their portfolio allocations at this point in time and attempt to reallocate their funds closer to market capitalizations of DM and EM equities.

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