

# Investment Tutor Surgery

Chris Wagstaff, head of Aviva Investors Investment Tutor programme considers the optimal allocation to emerging market equities and whether equities markets have turned a corner

*I've heard a number of market commentators suggesting that pension schemes should make higher allocations to emerging market equities – some as high as 50 per cent – given that emerging nations account for around 50 per cent of global Gross Domestic Product (GDP). Is this the optimum allocation?*

Emerging, or developing, economies, which include Brazil, Russia, India and China (the “BRICs”), account for around 50 per cent of global output, or GDP, on a so-called purchasing power parity basis (PPP). PPP adjusts each nation’s share of global GDP, typically calculated in US dollars, for the over or undervaluation of their currency against the dollar – the latter is more commonplace – and the fact that a dollar usually buys more, or has greater purchasing power, in Beijing than Boston. The majority of economic growth in recent years, again in PPP terms, has also been accounted for by developing economies.

However, despite this, the value of emerging stock markets as a percentage of global stock market capitalisation, falls well below 50 per cent. That is, most major global equity benchmarks, such as the MSCI World, have around a 12 per cent weighting to emerging markets. The reason for this is that the relationship between the fortunes of the economy, corporate profits and the value of stock markets is somewhat tenuous. For instance, increased globalisation means that domestic company profits are not solely derived from the domestic economy – indeed corporate UK derives over 50 per cent of its profits from overseas. In addition, the profits generated by domestic private limited companies are not captured by the stock market, the share of listed company domestic corporate profits as a percentage of GDP changes over time, the valuation that investors place on company profits to arrive at a company’s share price – so-called price to earnings ratios – constantly change, not to mention the fact that corporate profits are much more volatile than the relatively steady

rate at which GDP changes over time.

In addition, in the UK and US for instance, given the historic importance of financing companies with equity rather than debt, or loan, or bank finance and the fact that many companies listed on their own domestic stock exchanges, notably Chinese companies, also list their shares in London and New York, means that the US and UK punch substantially above their weight in global stock market capitalisation terms relative to the global GDP weighting of their economies.

Whilst trustees, in making an allocation to emerging markets, should be mindful of benchmark weightings, strategic asset allocation is all about combining assets on the basis of their prospective returns, their expected volatility and correlations, or co-movements with one another, within the framework of an agreed risk budget. Whilst emerging economies, not least China, offer the kind of growth prospects the UK can only dream about, trustees should also bear in mind that research by Profs Dimson and Marsh at the London Business School in 2004, suggests that it is low growth, rather than high growth, economies that produce the most robust long run returns.

**Equity markets seem to have made a dramatic recovery over recent months on the assumption that the recession is over. Have we turned the corner?**

Many commentators suggest that stock market lows lead economic recovery by six to nine months. However, in 1921, 1932, 1949 and 1982 – the years in which the four major “bear” markets of 20th Century (which averaged 17 years in real, or inflation adjusted, terms), bottomed out – it was economic recovery that led an upturn in the equity market by several months. Whilst the two arguably most reliable indicators of how fairly valued the equity market is – (Tobin’s q ratio, which compares the value of the market to the replacement values of the assets that underpin

each company, and Shiller’s cyclical adjusted price earning ratio, that compares the price of the market’s constituent companies with the average profits generated by these companies over the past 10 years) – suggest that equity markets in general remain historically undervalued, recoveries from the four bear markets above were characterised by a number of common phenomena.

These comprised the threat of deflation having receded, a narrowing of corporate bond spreads – that is the difference between corporate bond yields and that of government bonds – and an upturn in commodity prices, corporate inventories and car sales. To date we have experienced all but the last two as manufacturing output and industrial capacity utilisation continue to decline. In addition, consumer confidence, which ultimately dictates consumer spending – the largest source of demand in any economy – remains fragile, not least because unemployment, a lagging economic indicator, will continue to rise for at least the next year or so. Therefore, whilst we’re probably very near the bottom, it’s likely we’re not there just yet. ■

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