May 5, 2014

Buy Your Straw Hats

Stock investors are consistently confronted with choices. As the markets seldom stand still, changing valuations tend to drive changing opportunities. In our opinion, investors are wise not to chase performance or short-term dislocations, but when changes in longer-term pricing trends occur, it is the wise investor who starts to ask what fundamentally has changed to drive asset-class returns/valuations beyond normal comparisons.

Such is the case, in our opinion, with the current disparity between the returns of two historically risky and volatile assets classes – U.S. small capitalization stocks and foreign emerging market stocks. Has a permanent change taken place in these two markets relative to each other, or are we witnessing a major fundamental opportunity? We will attempt to answer this question in this piece.

The Stock Markets During the Month of April

As most of our readers know, our opinion at Mariner has been positively skewed towards the world's stock markets for the last two years. We maintain that stance on the belief that we are witnessing a bull market, with stock prices continuing to grind higher. Following are returns for various asset classes as of the end of April 2014.

	Month of April	Year to Date	Trailing 12 Months	Trailing 2 Years
S&P 500 Index	+0.7%	+2.6%	+20.4%	+40.7%
Russell 2000 Index	-3.9%	-2.8%	+20.5%	+41.8%
EAFE Index	+1.5%	+2.4%	+14.2%	+37.1%
EEM (ETF)	+0.8%	-1.1%	-2.5%	+1.9%
ACWI Index	+1.0%	+2.2%	+15.1	+33.3%

As can be seen from the above, the top performing major global market segment during the month of April was the EAFE index (Europe, Australasia, Far East), which represents the developed markets outside the United States. It's about time this segment of the global equity market started to drive markets since the S&P 500 and the Russell 2000 (representing the large and small-cap U.S. stock markets) have, on balance, been the drivers behind the global bull market for the last two years.

The laggard during the month? The Russell 2000 index has declined by almost 4% over the last four weeks. Year-to-date, this segment of the U.S. market has shown negative overall returns. We addressed this issue fairly thoroughly in our April 14th piece, Flying Too Close to the Sun. If you would like to see our detailed thoughts as to small-cap issues (primarily the growth segment of the small-cap world), please refer to this piece.

Regardless of short-term index return variances, we continue to profess the opinion that the "stuff" driving stock prices higher over the last few years has not gone away. Rather, we believe stock prices, be they U.S. or foreign based, should continue to grind higher over the intermediate term.

Return Variances Between U.S. Small Cap and Emerging Markets

So given our positive bias towards equity investment in general, which of the world's markets look the most appealing for new investments? Let's take a look at which of these asset classes—small cap or emerging markets—have generated the best and worst returns over the last two years.

U.S. Small Cap Stocks

On November 29th of last year, we expressed some thoughts on small-cap equity valuations in our Extraordinary Popular Delusions and the Madness of Crowds piece. In that piece, we proffered the view that small-cap stocks were at a valuation level that normally leads to a certain degree of underperformance relative to larger capitalization stocks. At that time, we postulated that:

According to our friends at Ned Davis Research, small-cap companies have carried a median P/E ratio of 22.1x over the last 33-year period. Simple historical comparisons tell us that over the last 33 years, small cap P/E ratios have only been above 27x earnings 15% of the time (now at 26.9x). On average, the rate of return small cap stocks generated when they were priced at this level was -7.4% over the following 12-month period!

Since the writing of that piece, the Russell 2000 Index has generated a price return of -1.4%, while the S&P 500 is up 4.3%, for a return spread of 6.1% in favor of large-cap investments. The good news regarding small cap stocks is that the valuation level of the Russell 2000 index is now at 24x expected earnings. When we wrote the "Madness" piece, small-cap earnings multiples were closer to 27x, historically a warning level that has typically heralded lower stock prices.

Emerging Stock Markets

Another risk-based asset class that holds interest is emerging markets– stocks of companies in those parts of the world where changes in demographic trends and potential productivity both point to higher economic growth rates. Along with higher potential economic (and profit) growth rates come the higher levels of societal and political risks prevalent in many of these countries.

Investing in the emerging markets isn't for the faint of heart, as stock prices can move rapidly at times. But similar to the Russell 2000 Index (an index of smaller U.S.-based companies), the emerging markets have historically generated returns higher than those of their more mature, developed cousins. Over the last two years as the small-cap and emerging market returns have become divergent, political and economic risks have escalated within many of the emerging-market countries.

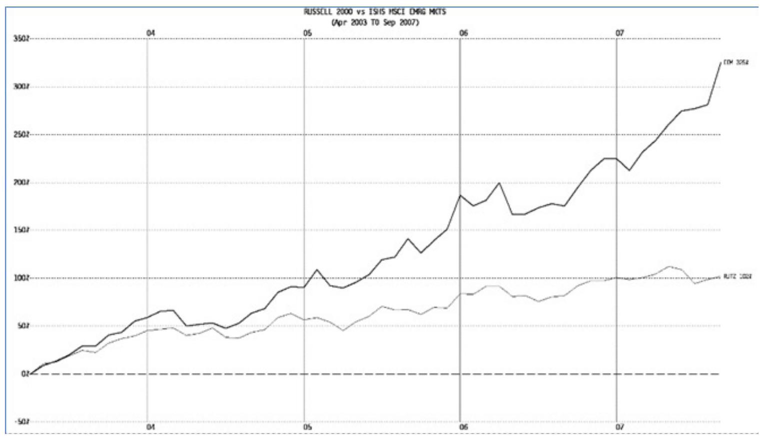
Our thoughts within the large (BRIC) emerging markets:

- **Brazil:** Some are suggesting that a political change is underway in Brazil, regardless of the upcoming elections. Even if current President Rousseff wins, political pressures are building for her to bring on a more conservative bias towards policies.
- **Russia** is the sore spot. We have written our thoughts on Putin and his motives. Russia, as a new international antagonist, isn't going away. The markets globally will, at times, reflect this new anti-democratic force.
- **India:** Election campaigns are underway for a new Prime Minister. Narendra Modi (Gujarat's chief minister) is

running for the office. If elected, he would probably support economic changes that would focus on making the "economic pie" bigger rather than focusing on how to equitably slice the pie.

- **China:** The political leadership is steering the country into an economic model that has real long-term staying power compared to the old model centered on unsustainable investment spending and a huge reliance on export growth. As these changes start to pay dividends over the next year, the prevailing poor market sentiment in China may turn into a positive force.

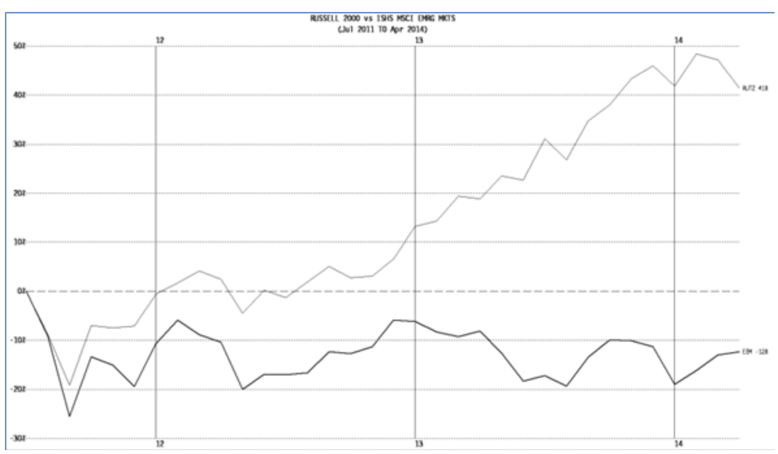
The point we are attempting to make is that the extremely low valuations of emerging market stocks appear to have already discounted, or factored in, some very bad news. And going forward, we are seeing signs that reality may not play out as badly as some currently fear in a number of larger emerging economies.



To the right is a price chart reflecting the performance of the Russell 2000 Index and the iShares Emerging Market ETF. This chart shows the performance of these two asset classes from April 2003 through September 2007 (emerging markets represented by the bold line). As can be seen, emerging markets outperformed the U.S. small-cap index by almost 225% over this period of time! During the crash of 2008 – 2009, the U.S. small-cap index outperformed emerging markets by a wide margin. Then, from the end of the crash in March 2009 until the beginning of 2011, emerging markets again outperformed small caps. The key here is that during all of these periods, emerging markets and the U.S. small-cap indexes moved in the same direction – when one was generating positive or negative returns, the other was doing the same thing. That relationship has changed over the last two years.

Divergent Returns

The chart below shows the performance of U.S. small cap stocks as measured by the Russell 2000 and the performance of emerging markets stocks, as measured by the iShares Emerging Markets ETF from mid-2011 to present. As can be seen below right, the small-cap stock index is up 36% while the emerging market ETF is down 13%, representing a return spread of 49% in favor of U.S. small cap stocks. We suspect this relationship will eventually reverse, or at the least the two will return to being more in-line with each other.



Don't get us wrong. We are very aware of why this disparity has arisen. Fundamentally, we are looking at two very different asset classes with very different drivers, as noted above. But at the end of the day, we need to understand why return relationships have changed between asset classes as ask the basic, simple question: Are the changes driving the disparity of return between the asset classes permanent or temporary in nature? While a number of factors between these two asset classes are certainly different, we suspect that a number of these drivers will prove temporary, and eventually investment in the emerging market space will once again make tremendous fundamental sense.

Fundamentals Matter

LOver the long-term, asset valuations matter. Many emerging markets stocks are now selling at multi-year lows. Other asset classes are selling at multi-year highs. There are a number of reasons for investors to be wary of the emerging equity markets, but we are of the opinion that low valuation levels in many of the emerging markets will reverse over the coming years.

The trailing 12-month P/E ratio of the MSCI Emerging Markets index is 11.7x earnings. Compare that to the developed markets average P/E ratio of 18x and 24x for small-cap U.S. offerings. The relative degree of undervaluation of emerging market stocks is now the largest in more than a decade. Could emerging market stocks continue to underperform their developed-market cousins? Sure. But according to the old sage of Wall Street, Bernard Baruch:

Buy your straw hats in the winter time.

Frankly, it is currently feeling awfully cold outside for the emerging markets.

Too cold, perhaps.
We will be back next week.

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