A less bullish look at EM equities

By John Plender

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Now that the long bull run in emerging market equities has gone into reverse, the question has to be asked. Was it all hot air? The answer is yes only in the limited sense that most of the surge since the start of the last decade was driven by a change in valuation basis and by investment bankerly hype. Yet the underlying economic story remains largely intact, even if central banks in emerging markets are fighting a difficult battle with inflation and geopolitical risk has re-surfaced.

On a recent trip to Asia I read two excellent and complementary books on emerging markets by Ayhan Kose and Eswar Prasad*, both formerly of the International Monetary Fund, and by George Magnus**, an adviser to UBS. Both broadly agree that the shift in the locus of global growth from the advanced to the emerging market economies will continue, while noting the remarkable resilience shown by such economies as India and China in the financial crisis. Yet both take a nuanced view of the policy challenges that these countries face.

Mr Magnus in particular argues that those who believe China's rise is pre-ordained in the light of crude extrapolations of past economic growth rates fail to grasp the importance of institutional structures. The rule of law, contracts, property rights, neutral courts are, he rightly says, crucial to the sustained accumulation of capital over generations, which is the source of lasting economic strength and power. On this score there remains considerable uncertainty about China's future trajectory vis a vis the supposedly ailing US.

For investors, a notable difficulty with emerging markets is the widespread reliance on mercantilist exchange rate policies designed to subsidise exports. While this helps export earnings, it creates inflationary pressure and the risk of bubbles since currency pegs to the dollar cause countries to import ultra-loose US monetary policy that is wrong for their own circumstances.

A longer standing problem is that academic work by Elroy Dimson, Paul Marsh, Mike Staunton and Jay Ritter has shown there is no correlation between economic growth and stock market returns. This sounds counter-intuitive. Yet in practice emerging market growth is diluted, first by a high level of new issues; second, by poor corporate governance. Dominant owner-entrepreneurs in the developing world tend to be expert at diverting money from the quoted company into their own pockets through related party transactions.

At a recent International Corporate Governance Network conference in Kuala Lumpur 43 per cent of the attendees in an interactive poll saw related party transactions as the biggest risk in Asian initial public offerings. In some countries the government is often the dominant owner, which leads to widespread conflicts of interest. David Smith of ISS, the proxy voting service, told the conference that among the questions that have to be asked in an IPO is whether a government department is seeking to fund itself via the equity market.

Western models of corporate governance may have been tarnished after the financial crisis, but this does not suggest that Asia has an attractive alternative to offer, especially when dividend pay-outs are low or non-existent as they often are in China. In theory, dividends ought not to matter to shareholders, who own the money whether it is retained in the company or paid out, except to the extent that it affects their tax position.

Note, though, that the return on equities over decades comes almost entirely from the value of reinvested income. According to the Barclays Capital Equity Gilt Study, capital appreciation on UK equities between 1899 and today is the merest fraction of the total return. There is evidence that this compounding effect in dividend yields applies across global markets. In short, dividends matter. And the practical reality is that in many emerging markets shareholders do not own money that is retained in the company in any meaningful way. Nor do dividends provide a defensive prop if the stock market collapses.

People in the west cannot afford to be complacent about their own corporate governance. The related party transaction phenomenon in Asia is simply an extreme form of the principal-agent problem, where managers (the agent) take advantage of shareholders (the principal).

In the US and Europe, the great grab for bonuses tells us that banks are still being run in the interests of the managers, not shareholders. And, paradoxically, shareholders in Asian companies quoted in the US may enjoy less minority protection than in Asian countries where a shareholder vote is often required on related party transactions.

That said, I believe investors underestimate the importance of governance in emerging markets. Like the dividend stream, it matters.

* *Emerging Markets: Resilience and Growth Amid Global Turmoil (Brookings Institution Press)*

** *Uprising: Will Emerging Markets Shape Or Shake The World Economy? (John Wiley)*