Dr. George Athanassakos

BNN Interview for the “MoneyTalks” program.

Dr. George Athanassakos was interviewed by Patricia Lovett-Reid of TD-Waterhouse December 10, 2010 at 9:15am

PLR: George, there is a large and widening gap in the rate of economic growth rates between emerging markets and the industrialized world. Will this be a lasting phenomenon on the world stage or do you see a more cyclical boom bust pattern to emerging market growth?

GA: No economy is immune to the business cycle, namely, the short term fluctuations of business activity around fundamental values, which is driven by human over optimism and over pessimism.

Of course, emerging market economic activity starts from a lower base and so emerging markets, on average, tend to show faster growth. And globalization and free flow of capital in recent decades has helped emerging markets grow faster than developed countries (commodity cycle, policy mistakes by developed countries' governments, increased investment). But can faster growth continue in the long run? It depends.

I trust more emerging markets with a **more diversified economy** as opposed to markets where growth is related to resources, which are very volatile, have shown no trend growth in the long run and are exhaustible. I also trust emerging markets with a more **democratic government** (or moving towards more democracy) that minimize chances of uprising/revolution or confiscation of private properties which scares investors away. And finally I trust more emerging markets with **population growth/middle class growth** and willingness to make **investments in education and innovation**. These considerations put me more on the side of India as opposed to China or Russia (less democratic, aging population) or even Brazil (commodity driven growth).

There is enough evidence which shows that high growth companies underperform low growth companies in the long run – it is also true from evidence I have seen that high growth countries, that is high growth countries in the long run may under-perform low growth countries as investors and humans, in general, get overoptimistic about growth, extrapolate it in the future and herd bidding prices way above fundamentals for the high growth countries (which could be security prices or prices of goods due to over investment leading to high inflation that forces governments to take actions which eventually dampen economic growth).

Nowadays, everyone is hot about emerging markets, and commodities, but when everyone talks about the same thing prices tend to be bid way above fundamentals and the risk of a bubble developing increases.

PLR: Does higher economic growth rate, translate into superior equity market returns for investors in the long term?

GA: There is no evidence that economic growth promises rising stock markets. If you look at evidence from previous decades from the 40s, 60s and so on to today and you assess economic growth over several decades and you relate this to stock market returns over the same periods, you will see there is little correlation between strong economic growth over ten year periods and stock market returns. We do not observe that decades with higher economic growth have led to greater stock market returns. Mr. Buffett has repeatedly mocked those who forecast the economy in order to forecast the stock market. He has pointed out examples of cases where in one decade economic growth was low and the markets rose and in another decade when economic growth was high and the markets stagnated.

And to relate this to emerging markets, as I indicated before, there is evidence which shows that the stock market for fast growth economies underperforms in the long run that of slow growth economies. This is additional evidence that economic growth and stock market gains are not highly correlated.

PLR: Emerging markets now make up about 30% of the global equity capitalization. Does that make them a necessary component of a diversified global equity portfolio?

GA: A fundamental tenet of modern portfolio theory is the notion of diversification. Rather than holding one or a few stocks, investors instead should hold a large basket of stocks. Diversification helps investors minimize risk and, so doing, avoid losses.

For diversification to work, one needs to find securities or assets that have low correlation with each other. The less correlated the assets, the better it is for diversification and risk reduction. As emerging markets are (apparently) less correlated than developed markets, adding emerging market stocks in a portfolio will decrease risk. But a word of caution: correlation is measured using historical data. And then one needs to expect that future correlation will be the same as historically. If historical correlations prove to be an inaccurate measure of future relationships (may be due to structural changes or globalization) then diversification that is based on this historical relationship may not work. For example, what we have seen in recent years is that when we most needed diversification and the negative correlation, we did not get them; that is at bad economic times all correlations turned positive and in this case diversification using emerging markets did not work very well. But despite that, emerging markets, especially the smaller emerging markets, have lower correlation than developed markets, affording investors greater diversification benefits and risk reduction in a portfolio setting. In academic lingo, a portfolio that includes emerging markets has higher risk adjusted return (and is more efficient) than a portfolio that does not include emerging market stocks.

PLR: As per Bloomberg, the stocks that make up the Brazilian Bovespa Stock Index trade at less than 11 times forward estimated earnings. Contrast that to 15 times for the S&P TSX Composite Index. Are Brazilian and other similar emerging market stocks more attractive than Canadian equities?

GA: P/E refers to the ratio of price per share and earnings per share (earnings per share can be trailing (historic) or forward (future)). It is a valuation metric. It shows what value markets put on a dollar of earnings.

Value investors use P/E ratios to screen stocks for possible undervaluation. According to value investors a low P/E stock does not imply a cheap stock; it simply implies a **potentially** cheap stocks. A stock can have a low P/E simply because it is a bad stock. Moreover, the P/E ratio is a function of risk – higher risk companies have lower P/E ratios.

To determine whether a stock is **truly** undervalued one needs to value stocks in depth.

So by looking at P/Es, Bovespa is **possibly** more undervalued than the TSX, but this does NOT mean Bovespa is truly more undervalued. This is because Bovespa stocks may not be as good quality as Canadian stocks. They may be also viewed as more risky than the Canadian stocks.

But beyond that, I do not wish to put too much emphasis on forward P/E ratios (especially for riskier stocks or industries or countries) as they are not as good value metrics in terms of forecasting future returns as trailing P/E ratios.

My research shows that forward P/E ratios are a poor predictor of future returns for AMEX and NASDAQ stocks, namely the riskier groups of stocks, which also include emerging market ETFs. Bovespa stocks are riskier than Canadian stocks, as Canada has a more diversified economy and it is more stable politically and economically, and so on. So Bovespa will have lower P/Es by definition and the forward P/Es will not be a good predictor of future performance.

On the other hand, my research has shown that trailing P/E ratios - which are based on historical realized earnings, had much better predictive ability of future returns and this was independent of the risk of the stock, market or country. Choosing low trailing P/E stocks makes a large difference in future returns in all markets.

So I put much more emphasis on trailing ratios than forward P/E ratios.

PLR: But why is it that trailing P/E ratios have a better predictive power than forward P/E ratios?

GA: This has to do with the fact that analysts tend to be overoptimistic when forecasting earnings - that is, EPS used in the denominator is way overblown making the P/E look misleadingly low. This biases the forward P/E ratio and makes it an inaccurate predictor of future stock returns (particularly in riskier markets) in comparison with the trailing P/E ratio, which is based on realized earnings.

In research I carried out looking at the accuracy of U.S. analysts' forecasts, I found that, on average within a calendar year, analysts overestimate actual earnings by about 2.5 per cent. Accuracy starts poor at the beginning of the year and improves as we approach the end of the year which is forecasted. But, on average, analysts overestimate earnings over the year by 2.5%.

What is more interesting, however, is that analysts are not overoptimistic across all companies covered. They tend to be overoptimistic only for stocks for which there is high uncertainty about the future. For stocks with low uncertainty, analysts tend to be pretty accurate.

When it comes to the highest uncertainty group of stocks analysts tend to overestimate actual earnings by 21 per cent on average. At the beginning of the forecast period, the overestimation is 34.3 per cent. These are big errors, hence the inaccuracy of forward P/E ratios.

In other words, forward P/E ratios are quite inaccurate for high uncertainty stocks, industries and countries, such as emerging markets.

As a result, investors should consistently use trailing ratios across the board as they are a more effective metric to screen stocks and predict future stock returns.

PLR: Is it feasible to apply Benjamin Graham's value investing metrics to emerging market stocks or would one need to tweak them?

GA: The value investing process involves 3 steps. First, we use trailing P/E ratios to screen for possible undervalued stocks. Since we established above that emerging market stocks have higher risk than developed markets, there will be many more stocks that pass the first test having low P/E ratios. But then we have to move to the next step, which is to actually value individually each stock to find out if they are truly undervalued. The valuation principles are the same across the board. The same principles that apply here in Canada apply elsewhere too. The only difference is with regards to how much I trust the numbers I obtain from the emerging market companies – are they more massaged, falsified, less clearly audited (who are the auditors - reputable?), is there less corporate governance, regulation, more corruption, etc. All these increase the riskiness and reduce the reliability of the numbers. In my valuation, I will increase the discount rate to reflect the higher risk and potential problems - political and economic, social, accounting, management, corporate governance, etc that emerging countries may have.

The final step is to apply the concept of the margin of safety to make an investment decision. That is, I will not buy a stock unless it is well below the intrinsic value I estimated in the above step. This additionally protects me for errors, judgment problems, as valuation is an art NOT a science, and falsified numbers.

But you should know that there may be more opportunity for investing in individual stocks using the Ben Graham approach in emerging markets, as emerging markets are more inefficient than developed markets. Inefficiencies give rise to mispricing and mispricing gives rise to profitable opportunities if you value stocks properly and do your due diligence.

PLR: What are some of the key risks that investors should be aware of when investing in emerging markets?

GA: There are many risks, both macro and micro (company specific): Macro - Political, economic, social (social unrest), income inequality that feeds uprisings and revolutions, and then micro - management quality (education, experience, conflicted), accounting (reliability of numbers and experience of auditors), corruption (corporate and political), corporate governance, regulation (lax as opposed to strict, insider trading, etc), foreign exchange risk, liquidity risk, thin trading and its impact on measures of risk and so on.

PLR: Within emerging markets would you classify the likes of BRIC separately from other smaller and frontier emerging markets?

GA: The lower you go in the food chain the more potential problems may exist or emerge and the higher the risks. But from a portfolio setting, what you care more for risk reduction is how well these markets are correlated with other markets and how large the diversification benefits are. These frontier markets may be less correlated than BRIC as they have not been touched as much by structural changes and globalization as BRIC countries. Moreover, BRIC countries have gotten a lot attention in recent years, which may have made them overpriced.

PLR: Your thoughts on taking an indirect exposure to emerging markets through developed world companies that do significant chunk of their business in emerging markets?

GA: There are two ways one can take advantage of emerging markets potential. First is to invest directly in emerging market ETFs or stocks. The other is to invest in western companies with significant operations in emerging markets. The latter is a less risky way to do so and a good way to avoid some of the corruption, inept management and auditors, liquidity issues, economic and political problems. So I would totally agree with this, especially for risk averse small investors with less time, resources and know how, as this may be the best way to capture emerging markets' potential and avoid possible problems and sleep better at night.

But for sophisticated investors with time and resources, if you do your due diligence and valuation properly and if you apply your margin of safety as value investors do, you may be able to increase returns in these markets by investing in local companies without incurring as high a risk as you normally do when you buy indexes or even developed world companies with operations in emerging markets. Buying companies that are truly undervalued means higher returns without incurring higher risk. But you need to do a lot of due diligence.