



# INNOVA

# Market Insights



Jean-François Démoré  
CFP, MBA, LLQP, HB CCS

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## Issue #31 - “Emerging Market Dividends”

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*“Price is what you pay – Value is what you get” - Warren Buffett*

As we’ve discussed in previous issues of our IMI newsletter, we employ a strategy known as Tactical Asset Allocation as our primary investment methodology. In short, rather than focusing our efforts on WHAT individual securities to buy, we tend to look at markets, geographical areas and asset classes in their entirety and focus our efforts on WHEN to buy them. Rather than a fixed allocation to stocks or bonds based on your age (age model), we suggest changes to your portfolio in reaction to the present state of the markets while ensuring that they fit in well with your personal risk tolerance.

Part of this strategy involves looking across all industries, countries and asset classes (bonds, stocks, real estate, materials, etc.) to find value or to avoid bubbles and corrections. As we discussed in our May newsletter, we feel that Canadian and American stock markets are growing frothy and are beginning to show some signs of over-expansion. Although we no longer fear a large-scale correction believing that a moderate sector-specific pull-back is more likely, we feel that great values are few and far between on both those stock markets. Combined with ultra-low interest rates affecting the bond market, this has led us to widen our scope in search of investment growth ideas.

With this in mind, this newsletter will be focused on detailing the logic behind an investment allocation that we will be unrolling in some portfolios over the next quarter: **Emerging Market Dividends**

At the turn of the millennium, globalization was all the rage. ‘The World is Flat’, ‘No Logo’ along with every MBA course was preaching the merits, or pitfalls of a truly global marketplace. Among the 500 largest companies in the world (Global Fortune 500), only 5% of companies were based in emerging markets, most of which were based in the Brazil, Russia, India and China, collectively known as the BRICs.

Fast forward to 2014, and positions 5, 6, 7 and 20 on the Global 500 are now based in emerging markets who now represent 26% of listed companies, a number that is expected to swell to 45% by 2025.<sup>1</sup>

Despite their being home to over half the world’s population, generating some 38% of global GDP, companies headquartered in advanced economies only earn an average of 17% of their revenues from these countries. In fact, the top 440 cities in emerging markets will account for nearly half of all GDP growth over the next decade.<sup>2</sup>

With these impressive growth prospects, you’d expect stock valuations to match the growth to potential earnings. The most commonly used measurement of stock valuations, whether stocks are cheap, expensive or pricing in future growth, is known as the Price to Earnings (P/E) ratio, effectively dividing the current price you are paying for the security, by its earnings per share.

The lower the number, the better value you are getting on your earnings per share. To give you an idea of valuations, RBC is currently trading at a P/E of 13.7, Wal-Mart at 15.3 while another blue-chip, Coca-Cola is trading at 20.7 times earnings. Growth companies like Facebook, with a P/E of 84, will commonly trade on potential earnings, and so P/E ratios can get very high.



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This not only lets you compare company to company, but indexes as a whole across time periods. At the height of the tech bubble, the P/E ratio of the S&P500 as a whole rose into the 30s, while the 2008 crash sent it to the mid low teens. At the moment, the S&P500's P/E is approaching 20 and entering relatively expensive territory.<sup>3</sup> Comparatively, on the backs of a recent pull back in emerging market stock markets, some blue-chip emerging market dividend funds are posting P/E ratios below 10.

More importantly, dividend yields on high quality securities are more attractive on a relative basis in emerging markets. This means that even if the stock prices do not recover in the near term, we are getting paid to wait for that future growth to materialize.

All in all, low valuations on companies that pay dividends is a good bet; companies that pay growing dividends that are positioned in dynamic economies being offered at a discount is a bet that we feel is worth making.

That being said, emerging markets have more than their share of investment risk and are not for the faint of heart. Currency risk (1998 Asian Currency Crises), political risk (Russia, China), legal and transparency risks (Argentina, Sino-Forest) all add to the volatility that is inherent with investing in these economies. So where does that leave us as Canadian investors, often over-focused on our neighbour to the South? Can a long-term investment plan afford to forego participation in such growing economies? As is often the case with investing, it boils down to the goals and objectives of each individual investor.

If you'd like to discuss this further and how it might apply to your portfolio, please do not hesitate to call or email. In many cases, we will be contacting you over the next quarter to discuss the potential of allocating a small percentage (no more than 10%) of assets to these markets, should valuations sustain their current trajectory.

### Sources:

<sup>1</sup> Emerging Markets to Shake up Fortune 500 : HARJANI, Ansuya: <http://www.cnn.com/id/101079722#>.

<sup>2</sup> Closing the Fortune 500 Gap: BARTON, Dominic: <http://fortune.com/2013/06/05/closing-the-fortune-500s-emerging-markets-gap/>

<sup>3</sup> S&P 500 PE Ratio by Year: Multpl.com : <http://www.multpl.com/table>