Is the era of the BRICs over?

The era of the BRICs in the stock market may be history. During the last years they, as a group, have continuously underperformed the old world, and their higher GDP growth levels are not a guarantee for good stock market performance going forward. In this analysis we give our view on the developed versus the emerging markets.

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All investors have probably been exposed to advertising for investments in emerging markets, and mainly the so called BRIC countries: Brazil, Russia, India, and China. One argument for investing in these countries is their high growth which looks attractive, not least nowadays when developed markets barely reach positive growth figures. Anyone looking at historical returns over the past ten years can also feel satisfied with their BRIC investments; MSCI BRIC has gained 408.4%, while MSCI Europe (with only developed countries included) has gained 114.8%, in EUR. However, there are several reasons to be wary of excessive exposure to the BRICs. We will present three reasons, of which returns is the first.

1. Returns have been better in Europe than in the BRICs. The past three years (Q1 2010 – Q1 2013), MSCI BRIC (Brazil, Russia, India, and China) has underperformed MSCI Europe – despite the problems in the PIIGS – by 19.2%. That emerging markets fall more than developed markets in a falling market may not surprise many; they are considered as high-risk markets where investors are expected to endure large drawdowns while being compensated in a rising market. However, we have not seen a negative overall trend the past three years; MSCI Europe has gained 21.3% while MSCI BRIC has fallen 2.0%, in EUR. The theory that investors in the BRIC countries should be compensated in a rising market has in other words not been working during the last few years.

At the same time, the standard deviation for MSCI BRIC has been significantly higher, with 16.4% compared to 12.6% for MSCI Europe. And when markets fall, the BRICs are hit harder. The largest drawdown seen in this period was 26.1% compared to 19.1% for MSCI Europe, in EUR. An exposure to large world leading growth companies – as in our European Quality Fund (EQF) – would at the same time have generated an even more attractive return profile than MSCI Europe: the fund's standard deviation for the period was 10.8% and the largest drawdown 17.6%.

	Return				Standard deviation				Sharpe ratio		
	BRIC	Europe	EQF		BRIC	Europe	EQF		BRIC	Europe	EQF
1 year	1%	15%	17%		11%	10%	7%		0.12	1.47	2.34
3 years	-2%	21%	32%		16%	13%	11%		-0.12	1.70	3.00
5 years	9%	11%	21%		24%	18%	14%		0.36	0.63	1.48

Figure 1. *The past 1, 3 och 5 years MSCI Europe has performed better than MSCI BRIC and with a significantly lower risk. The same is true for our European fund, European Quality Fund (EQF.) An exposure to emerging markets through well-run developed market companies offers a very attractive combination. Data in EUR as of Q1 2013. Source: MSCI, CB Fonder*

The higher growth in the BRIC countries has not produced higher returns in these countries' stock markets in recent years. One reason may be that companies are not restricted to sell in their home country but can take advantage of the growth elsewhere. Especially large companies (market cap > €1 billion), representing approximately 70% of the market capitalization in the West, often have a small percentage of sales in their home country. One way to gain exposure to emerging markets without having to invest in their volatile stock markets, with poor transparency, and in many cases inadequate corporate governance, is to select companies in developed markets with high exposure to emerging markets.

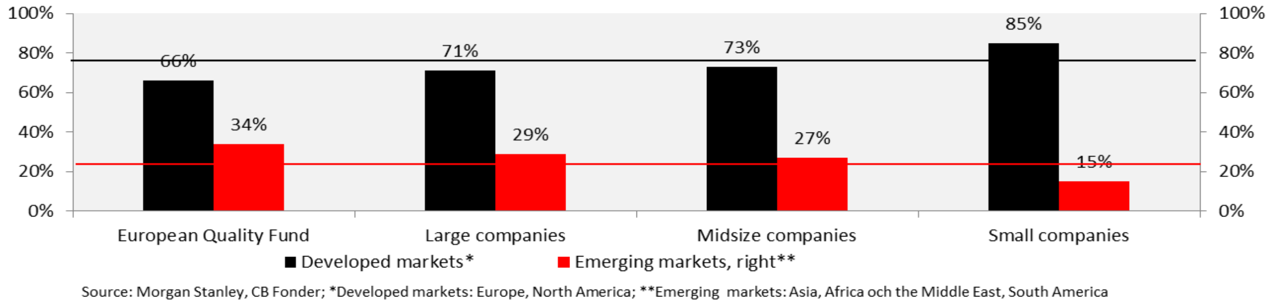

Figure 2. *The graph illustrates European companies' exposure, in terms of revenues, towards developed and emerging markets, respectively. The red line shows the average exposure to emerging markets (~25%) for the companies in MSCI Europe. The black line shows the average exposure to developed markets (~75%). On average, European companies generate a high proportion of their turnover in emerging markets. Large companies generate the largest share, ~29%. In our European equity fund, European Quality Fund, the proportion is even higher at ~34%.*

2. Economic growth differs from appreciation of invested capital. In the past 40 years, China has had an average profit growth of 41% per year, while growth in earnings per share has been a more modest 10% per year. The corresponding figures for Denmark are 15% and 12%, respectively (Source: Morgan Stanley Research). As earnings per share is what influence the price per share, and ultimately the return you get as an investor, the difference is important. The average investor in the Chinese stock market has thus seen the total market capitalization rise faster in value than their own investments. One reason for the difference is dilution by right issues that enable businesses to expand and increase their profits. Other factors that have an influence on this dissimilarity are repurchases, IPOs, dividends and buybacks.

An important argument for investing in emerging markets has been the higher growth in these countries compared to developed countries. Long term, the stock market in a country cannot grow faster than the country's GDP; if the stock market grew faster, it would be an increasingly larger part of the economy. But even if prices may skyrocket, the profits are always limited to 100% of the economy. The market capitalization should in other words be highly correlated with earnings growth on a long-term perspective. The example with Denmark shows that high economic growth does not lead to strong growth in earnings per share, even in the very long term. Good return on investment is achieved by strong profit growth in the companies you invest in – not good growth in the countries where the shares are listed.

3. High GDP growth in the BRICs is already discounted. A comparison between GDP growth and stock market return, where stock returns in year 1 are compared with GDP growth between years 1 and 2 (because the stock market is forward-looking), reveals a correlation for most of the countries and regions we looked at. The graphs below show GDP growth on the X-axis and stock market performance on the Y-axis. The point where the line crosses the X-axis shows the GDP growth needed for positive stock market performance, provided that the relationship holds; for developed European countries it takes just above 1% growth, while the BRICs require more than 10% growth.

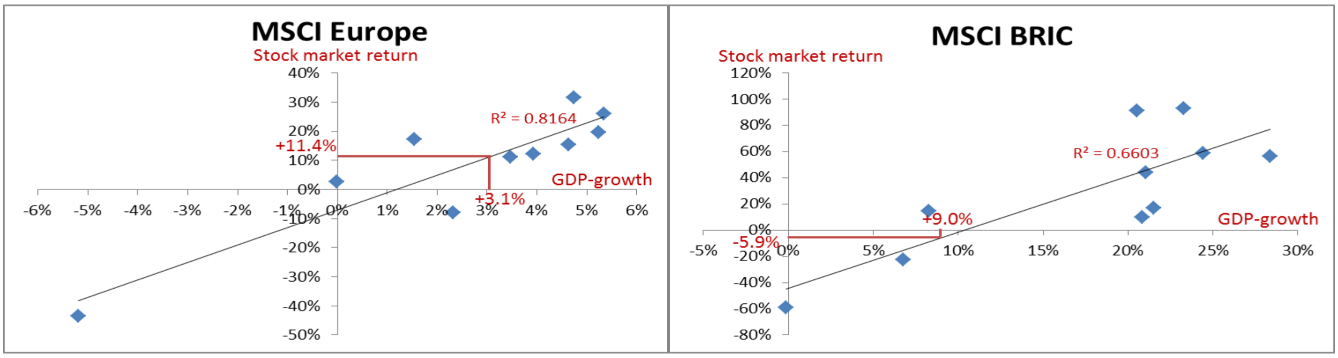

Figure 3. *The graph plots the stock market performance on the Y-axis and GDP growth the following year on the X-axis for each year between 2003 and 2012 (GDP forecast for 2012-2013). The line shows the best linear approximation. The GDP forecast for 2014 compared to 2013 is +3.1% for MSCI Europe and +9.0% for MSCI BRIC (Source for GDP forecasts: Eurostat, IMF). The approximation for this year's return would in this case be +11.4% for MSCI Europe (EUR) and -5.9% for MSCI BRIC (USD). Source: CB Fonder, Eurostat, IMF, MSCI*

In summary, the excess return of the BRIC countries compared to the developed countries of Europe has ceased in recent years, despite the fact that we have had long periods of positive overall returns. Furthermore, higher growth rates are not a guarantee for higher long-term returns. We would like to highlight the qualities of developed markets, and the possibility to benefit from growth of emerging markets through investments in developed markets, while keeping the risk in terms of both standard deviation and "skeletons in the closet" at a minimum. As the Swedish saying goes: Do not cross the river for water…

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