THINKING STRATEGICALLY ABOUT A VALUE ALLOCATION TO EMERGING MARKETS

PZENA Investment Management

August 2023
For Professional Investors Only

A Value Advantage in Emerging Markets

A hallmark of emerging markets is growth. Some, therefore, suggest that these markets are not a natural habitat for valuation-based investing. To the contrary, our own research, along with that of many theoreticians, has demonstrated that using a valuation-based approach in the developing world has been a superior strategy.[1] Research has also shown that there is no reliable correlation between GDP growth and stock performance[2] — so the rapid economic development of the emerging markets is not an argument for applying the growth investment style.

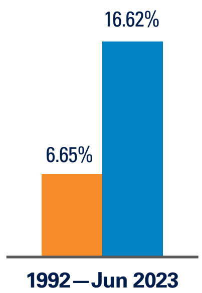
Figure 1 examines the difference in returns between low price-to-book stocks (Cheapest Quintile*) and the broad market over the period 1992 through June 2023. The data suggest a significant advantage for value stocks in emerging markets.

Figure 1

Returns of Cheapest Quintile* and MSCI Emerging Markets Index

6.65% MSCI Emerging Markets Index

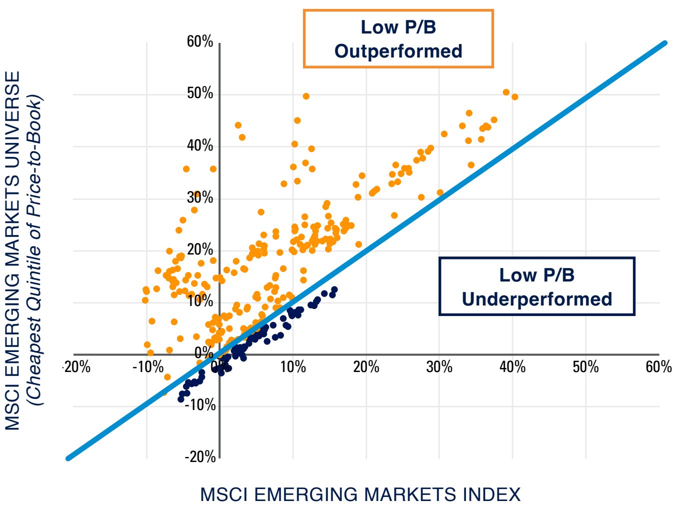
16.62% Low Price-to-Book



*Source: FactSet, Sanford C. Bernstein & Co., Pzena analysis. Annualized returns.*Cheapest quintile based on price-to-book of MSCI EM universe (equal-weighted data). Past performance is not indicative of future returns. Does not represent any specific Pzena product or service. USD returns. Returns could be impacted, positively or negatively, by currency fluctuations, where applicable.*

Figure 2

Rolling 5-Year Returns for Cheapest Quintile* and MSCI Emerging Markets Index 1992 – June 2023



*Source: FactSet, Sanford C. Bernstein & Co., Pzena analysis. Annualized returns. *Cheapest quintile based on price-to-book of MSCI EM universe (equal-weighted data). Past performance is not indicative of future returns. Does not represent any specific Pzena product or service. USD returns. Returns could be impacted, positively or negatively, by currency fluctuations, where applicable.*

A Research-Driven, Long-Term Approach is Key

Picking from the cheapest stocks within an investment universe, we rely on detailed research to distinguish companies facing near-term distress that's reparable from those that may subject investors to the permanent impairment of capital. While poor short-term earnings visibility can continue to weigh on these companies' stock prices, the longer the holding period, the greater the prospect of earnings improvement and subsequent returns for a stock. Over five-year rolling periods, deep value stocks (the cheapest 20% of shares in the universe*) beat the MSCI Emerging Markets Index 75% of the time (Figure 2: the most undervalued stocks are displayed on the y-axis, the broad index on the x-axis; orange dots above the line reflect value outperformance), resulting in average annualized outperformance of 7.96%. Because many investors are concerned about risk mitigation, we compared results when the emerging-market index posted negative 5-year returns. The cheapest stocks outperformed the broad index during these 5-year periods by an average of 12.80% (annualized). This illustration demonstrates what our data have shown more broadly — following extreme periods of market stress, deep value stocks tend to outperform by a wide margin.

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Why Value Works

Psychological Underpinnings

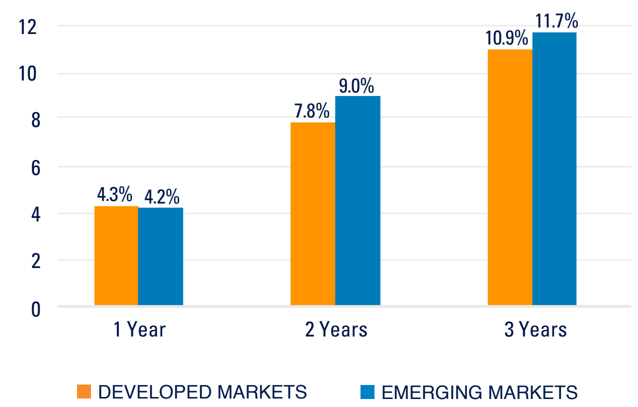
The history of investing demonstrates that valuation distortions are common, observable, and exploitable. A value investment style works in emerging markets for precisely the same reasons that it works everywhere else: Human beings are emotional creatures who tend to

- Overreact to near-term events.
- Misjudge the likelihood of a future event.
- Have an overconfidence in their ability to predict outcomes.

Emerging markets — less well understood and mature than their developed world counterparts — are just as susceptible to the cycles of fear and euphoria (i.e., overreaction). Therefore, it should come as little surprise that a valuation-based approach has worked as well, if not better, in the emerging markets as the developed world. Figure 3 (which shows the spreads in relative returns between the cheapest stocks and the respective market) makes a clear case for value in emerging markets. Over the 35-year-plus period shown, the cheapest stocks globally have outperformed their respective markets by a meaningful amount, in both developed markets and emerging markets.

Figure 3

Relative Returns (Cheapest Quintile vs. Respective Market) 1987 – June 2023*



Source: Empirical Research Partners. Based on Empirical Research Partners' multi-factor model.
**Developed markets is a proxy for MSCI World universe; returns USD-hedged since 1987. Emerging markets is a proxy for MSCI Emerging Markets universe; USD returns since 1992. Equally weighted data. Past performance is not indicative of future results. Does not represent any specific Pzena product or service.*
Returns could be impacted, positively or negatively, by currency fluctuations, where applicable.

Reversion to the Mean

Reversion to the mean exists in two key factors that contribute to stock returns — valuation and company performance. We see reversion to the mean in valuations precisely because cognitive biases cause investors to overweight information such as recent news and underweight salient fundamental data about long-term prospects, causing prices to temporarily swing away from their fundamental values. This leads investors to undervalue companies that are experiencing some form of distress.

As for company performance, we believe that very high levels of profitability or earnings growth usually are not sustainable and tend to be overvalued. The odds are against the sustainability of perfection, but the price of the stock is often set by investors whose confidence that their company will beat the odds is too high.

We also believe that very poor profitability can be temporary. Over time, cycles turn, management takes actions, costs are cut, and excess industry capacity diminishes. The odds favor improvement, but investors often cannot look past near-term problems. With fewer than 20% of emerging markets strategies identifying as value, chances are you are underexposed to this compelling opportunity set. Pzena has adhered to a classic value, research- driven approach rigorously applied since the firm's inception more than 27 years ago.

PZENA INVESTMENT MANAGEMENT: EXPLOITING THE VALUE ADVANTAGE

CONTACT US TO LEARN MORE: www.pzena.com +1.212.355.1600 info@pzena.com

FURTHER INFORMATION

Data through June 2023. Returns are calculated in US dollars. The information is provided for equity returns including dividends gross of withholding tax rates.

[1]See, for example; Eugene F. Fama and Kenneth R. French, "Value versus Growth: The International Evidence," The Journal of Finance, Vol. 53, No. 6 (1998), pp. 1975-99; Vladislav Kargin, "Value Investing in Emerging Markets: Risks and Benefits," Emerging Markets Review, Vol. 3, No. 3 (2002), pp. 233-44: Christopher B. Barry, Elizabeth Goldreyer, Larry Lockwood, and Mauricio Rodriguez, "Robustness of Size and Value Effects in Emerging Equity Markets, 1985-2000," Emerging Markets Review, Vol. 3, Issue 1 (2002), pp. 1-30. Although much of this research was published some time ago, the conclusions favorable to Value strategies in the emerging markets still apply.
[2] See, for example, Jay R. Ritter, "Economic Growth and Equity Returns," Pacific-Basin Finance Journal, Vol. 13, Issue 5 (2005), pp. 489-503.

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