Clark Capital MANAGEMENT GROUP

Portfolio Perspectives

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Mason joined Clark Capital Management Group, Inc. in 2005 as a Portfolio Manager. He is a member of the Clark Capital Investment Committee, contributing to asset allocation policy and security selection. Mason has almost two decades of experience in the investment industry. He is responsible for quantitative investment analysis, security selection, and communicating the firm's investment policy to wealth advisors and consultants. He participates in the research and product development efforts of the Portfolio Team. A graduate of Dickinson College, Mason earned an M.B.A. in International Management from the Garvin School of Management at Thunderbird (the American Graduate School of International Management). He holds the CFA designation and is a Chartered Market Technician.

Can We Trust the Cheap Valuations in Emerging Markets This Time?

On March 9th, the bull market that began in 2009 reached seven years of age. Despite the market's impressive gains, recently many valuation conscious investors have been voicing doubts about the classic Graham-Dodd value-based investment style. In accordance with the basic principles of value investing, investors' believe that buying companies that are cheaper according to various balance sheet metrics should provide excess returns over time. However, in the past few years, the dreaded value trap (buying a company that is cheap only to see that company get cheaper — for good reason) has plagued value-oriented ETFs and mutual funds. The market decided that many apparently attractively valued companies were in fact overvalued, as their assets and earnings were overstated and unsustainable. The energy, financials, and materials sectors, all sector overweights in value-oriented ETFs, have been hardest hit. The worst price damage has been done to emerging markets, and valuations in the space are again appealing — at first glance. In this article, we will examine the opportunities and risks involved with investing using the value factor, particularly in emerging markets.

Screening for investment ideas based on comparative valuations is an idea that intuitively makes sense. Indeed, the value factor was the first factor identified by academic finance, in Fama and French's seminal 1992 article "The Cross-Section of Expected Stock Returns." Every factor has it weaknesses, however, and value investing's risks, in particular, have recently been exposed. While cheap comparative valuations might signal an investing opportunity, low valuations can also be a signal of the risks a company might face, including: higher financial leverage and stress (and thus higher risk of failure), negative market sentiment and technicals, and current business weakness. As the numbers below bear out (for the five years ended February 29, 2016), value investing has not delivered many benefits.

	5 Years Ending 02/29/16		
Index Name	**Annualized Return**	**Annualized Volatility**	**Sharpe Ratio**
MSCI USA Value Weighted Index	8.46%	12.62%	0.67
MSCI USA Momentum Index	12.75%	11.34%	1.12
MSCI USA Minimum Volatility Index	12.34%	8.70%	1.42
MSCI USA Index	10.01%	12.04%	0.83
MSCI EM Value Weighted Index	-5.57%	19.59%	(0.28)
MSCI EM Momentum Index	-1.75%	16.90%	(0.10)
MSCI EM Minimum Volatility Index	-0.38%	14.14%	(0.03)
MSCI Emerging Markets Index	-5.18%	18.02%	(0.29)

Source: State Street Global Advisors

Past performance is not indicative of future results. Please see attached disclosures.

In the U.S., the value factor has dramatically underperformed in the same five year period, producing lower returns at a higher volatility than the broad MSCI USA Index, while the momentum and volatility factors have produced comparatively strong returns, particularly per unit of risk. The factor also has fared poorly in emerging markets, producing returns that were lower than the broad Emerging Markets Index at a volatility of nearly 20% per year.

The recent poor returns of value investing help frame the dilemma facing investors in emerging markets, where valuations appear compelling but have been that way for some time. The cheaper valuations in emerging markets have indicated weakness and stress rather than strength, and returns have been very poor with above average volatility. Nevertheless, the case for emerging markets is not hard to make. Let's start with valuations, where emerging markets stand out globally. Here are valuations using 12-month forward P/Es as of March 9th.

Index Name	12 Month Forward P/E	Earnings Yield
S&P 500 Index	16.71	5.98%
Russell 2000 Index	23.84	4.19%
MSCI EAFE Index	14.90	6.71%
MSCI Emerging Markets Index	11.86	8.43%

Source: Bloomberg

U.S. (P/E of 16.7) and particularly U.S. small cap (P/E of 23.8) valuations appear quite rich, while emerging markets, with a P/E of just 11.9, appear cheap. One way we like to think about valuations is to take their reciprocal, the earnings yield, and use it as a rough estimate of 10-plus year forward returns. The concept was popularized by Robert Shiller and his work with the CAPE (Cyclically Adjusted P/E Ratio). While the P/Es that we show here are not cyclically adjusted, at least for emerging markets, we can at least state that given the collapse in commodities and emerging market currencies, we believe these earnings are not at a cyclical peak – something we cannot generally say about U.S. valuations. When doing this, emerging markets again look attractive, with an earnings yield of over 8.4%. Now let's look more specifically at valuations within some select emerging market countries.

Index/ETF Name	12 Month Forward P/E	Earnings Yield
China ETF (GXC)	9.60	10.42%
China ETF (ASHR)	11.64	8.59%
Russia ETF (RSX)	6.46	15.50%
Korea ETF (EWY)	10.82	9.24%
Turkey ETF (TUR)	8.67	11.53%

Source: Bloomberg

China, and even the China A Shares (if and when they become included in emerging markets ETFs), offers a compelling P/E ratio and earnings yield. Russia and Turkey offer extremely attractive valuations on paper but, of course, the degree of risk must be considered. Both Russia and Turkey represent extreme political risk, and particularly risk of currency collapse. Even China now confronts talk by many that a crisis in its currency (and potentially a devaluation that would be a shock to global markets) is inevitable. Developed international or domestic markets simply don't have this magnitude of risk.

The argument for emerging markets is bolstered further by the longer-term potential for mean reversion in returns. Chart 1 below shows the difference in three year rolling performance between the MSCI Emerging Markets Index and the MSCI All Country World (ACWI) Index.

Past performance is not indicative of future results. Please see attached disclosures.

Source: Clark Capital Research

Back in 2005 and 2006, Emerging Markets outperformed the ACWI by over 20% over three years. Recently (as of December 31, 2015) over a three year period Emerging Markets underperformed the ACWI by just under 15% per year. That is dramatic underperformance, and emerging market's comparative valuations indicate that there is at least the potential for returns to mean revert over the longer term.

Conclusions

At Clark Capital our experience has been that investing based solely on valuations can be completely ineffective over the short and intermediate terms. Rather, we look at valuations as assessments of opportunities and risk in projecting returns over the longer-term. Given that viewpoint and the valuations picture discussed above, we would recommend the following for investors:

- Given the attractive valuations in emerging markets, investors willing to endure their substantial volatility may well be rewarded in the long-term. For long-term 10 plus year core positions, be sure that you are not underweight emerging markets. Emerging markets should represent 15 to 25% of your international allocations.
- Do not establish an overweight position in emerging markets until they have shown proven momentum and multiple quarters of outperformance.

Past performance is not indicative of future results. This is not a recommendation to buy or sell a particular security.
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- Consider adding the S&P Emerging Markets Small Cap SPDR (EWX) as part of an emerging markets allocation. EWX is the only emerging markets ETF that Morningstar classifies as small cap. Also, its holdings put it solidly in the mid cap/small cap value style box. Thus investors may benefit from a resurgence of the value factor and also the size factor (the small cap premium) in one holding that makes bullish bets on emerging markets.
- Consider reducing or removing currency hedges in emerging markets positions. When emerging markets equities are leading markets, often it is due to strong economic conditions in home countries and strong local currencies. Hedging the currency risk away substantially reduces potential returns.
- Consider supplemental, tactical positions in China and Korea and, for aggressive investors with strong stomachs, Russia and Turkey.

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CCM-910