Emerging Thoughts – **May 2004**

"Dude, Where's My Alpha?"

Arjun Divecha

Over the last 4 years we've experienced a glorious value rally in emerging markets (for both cheap countries and stocks). As a result of this rally, spreads between cheap and expensive countries and stocks in emerging markets have narrowed. Given that we are primarily value investors, the narrowing of spreads would appear to reduce our ability to add value in the short to medium term.

We examine the contraction of value at the country level, the contraction of value at the stock level, what we're doing about it, and what we think you should do about it.

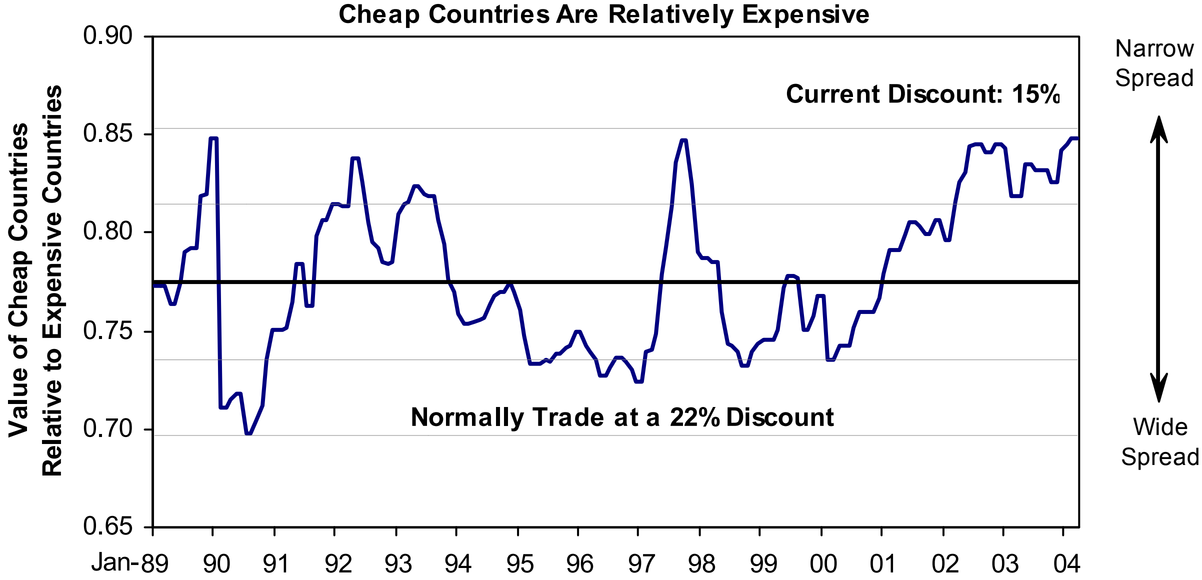
Country Selection – How Cheap Are Cheap Countries Relative to Expensive Countries?

Chart 1 shows the valuation of the cheapest countries relative to the most expensive countries.

In normal times, cheap countries trade at 78% of the valuation of expensive countries, or at a 22% discount. Right now, this discount has narrowed to 15%. Does this mean that cheap countries will do badly? Not necessarily. They were at a similar discount 2 years ago and value has worked very well for country selection since then. On the other hand, when they were at similar valuations in mid 1998 (during the latter half of the Asia crisis), cheap countries had their worst relative underperformance over the next 12 months.

What this means in our view is that the opportunity to add value by buying cheap countries has diminished, but has not disappeared. More importantly, the risk of buying cheap countries has risen.

Chart 1: How Cheap Are Cheap Countries?
Cheap Countries Are Relatively Expensive



Source: GMO

What Are We Doing About It?

It's important to note that while value is an important part of our country selection discipline (with a 45% weight in our country assessment model), it is not the only metric we use to determine country attractiveness. Momentum, Macroeconomics and Judgment form 55% of our country selection model and we have no evidence to show that they are poorly positioned to deliver outperformance right now. In addition, our work on currency vulnerability shows that very few emerging economies are currently vulnerable to an economic shock, lessening the probability of economic contagion.

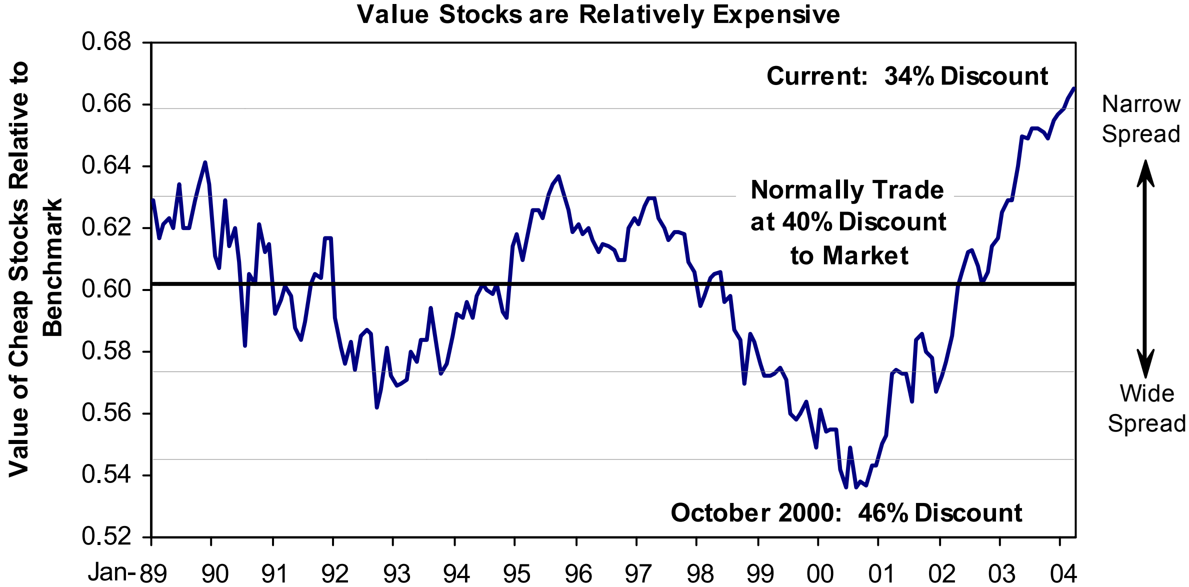
We normally run our country selection process at a tracking error of around 8%. In the face of diminished expectations and increased risk, it seems prudent to reduce our overall country bets, so we will be taking down the tracking error from 8% to around 6%. Thus, our current overweight of Brazil will decrease from the current 9.5% to about 7%, with similar changes in all our country bets.

Stock Picking Within Country – How Cheap Are Value and Small Cap Stocks?

Looking at how stocks are positioned within markets, one sees a similar picture. Chart 2 shows how cheap "value" stocks have been over time, relative to the index.

What this chart shows is that value stocks usually trade at a 40% discount to the index, but are currently at a 34% discount, the narrowest we've seen in the 15-year history for which we have data. In going from a 46% discount in October 2000 to a 34% discount today, value massively outperformed. In the last few months we have seen a similar contraction in the positioning of value in the U.S. and developed markets, but not to uncharted waters, which is where we are now in Emerging. The question to ask now is, if the discount has narrowed to 34%, does this mean that value will do badly (after all it's still at a 34% discount)?

Chart 2: How Cheap Are Value Stocks?
Value Stocks are Relatively Expensive



Source: GMO

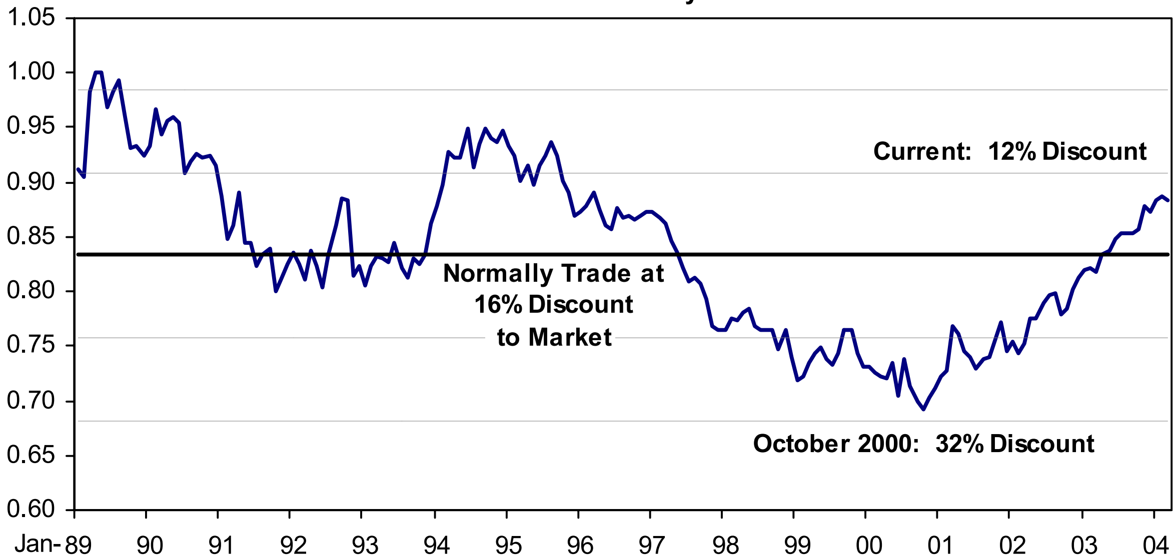
We have no data to tell us how value does when the discount narrows to this extent, but one thing we can say for sure – it's unlikely to be a good thing.

So, if value isn't attractive, what is? Let's first look at small cap stocks. Given that smallness tends to be correlated with cheapness, one should expect that they're not as cheap as they usually are either.

That's exactly what Chart 3 shows – the discount on small caps has narrowed from an all time high of 32% in October 2000 to 12% today.

This narrowing of the spread in both value and small occurred because both did extremely well over the past 4 years, greatly helping our performance.

Chart 3: How Cheap Are Small Stocks?
Small Stocks Are Fairly Valued



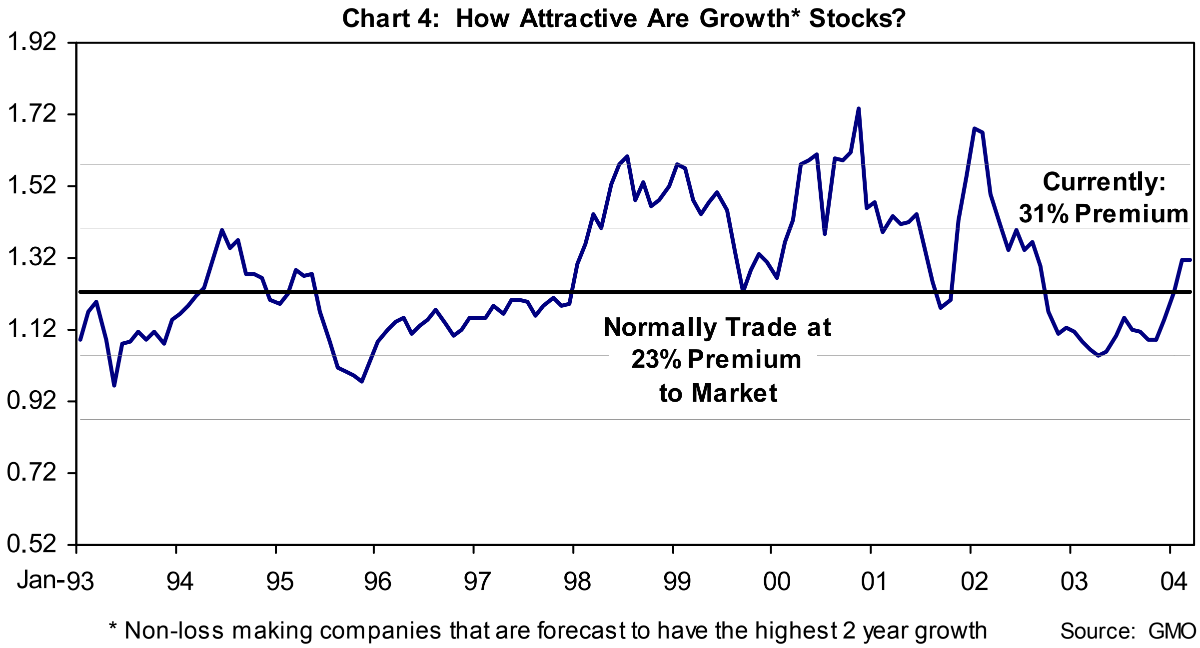
Source: GMO

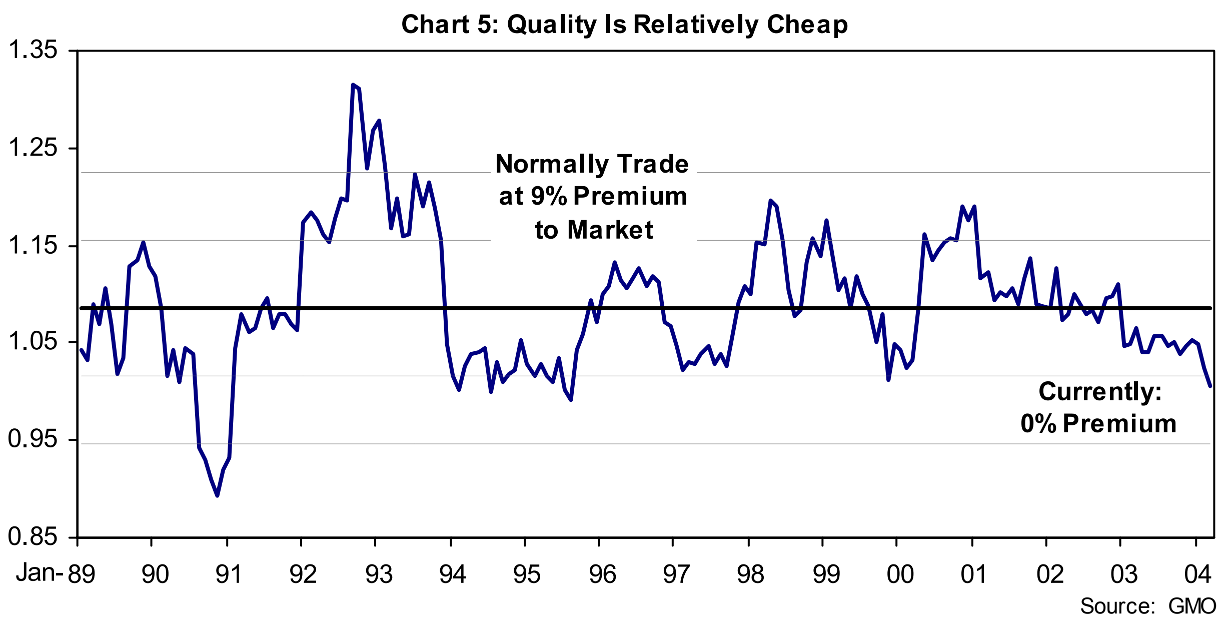
What Are We Doing About It?

The question we ask ourselves is, "If value is not well positioned, is there something else that is, or has the fishing just gotten poorer overall?"

We first looked at "growth" stocks, based on companies that are forecast to have the highest earnings growth over 2 years. As one would expect, this group usually trades at a premium to the market, but as Chart 4 shows, they have not become more attractive as value has become less attractive.

Another group of stocks we follow quite closely is high quality stocks (see Chart 5). This sector appears to be the most attractively priced opportunity in the market today.





GMO's experience suggests that markets systematically underprice quality. In the U.S. and developed markets, quality has been priced cheaper and performed better than finance theory suggests it should. Similarly, in emerging markets, this group of stocks usually trades at a mere 9% premium to the market. More excitingly right now, we can pick up these profitable, stable, low-debt companies at the same multiple (i.e., no premium) as the rest of the market today.

Over the past 2 years, we have been working on a new measure of value that incorporates quality and had been planning to replace our current "Value" model for stock picking with a new "Quality-Adjusted-Value" model later this year. However, given the positioning of both value and quality, we started transitioning our stock selection process to this new model in May 2004.

In the new model, we explicitly adjust the attractiveness of a stock for its quality. One ramification is that the amount of quality we own in the portfolio is related to how attractive quality stocks are on a valuation basis. Thus, this change will have the effect of increasing our bet on quality right now, while reducing the bet on what one might consider "junky" value stocks. It will also have the effect of increasing the average size of company we own; given that small caps are no longer attractive, we are very comfortable with this change. In general we are very excited about this new "Quality-Adjusted-Value" model, and we will be writing more about it in the next *Emerging Thoughts*.

Finally, as in country selection, value is not the only strategy we use to pick stocks. 70% of our process is value and 30% is momentum. The attractiveness of momentum is not affected by the positioning of value (that's precisely why we use both strategies – to diversify each other).

Overall, the changes we are making will make us less vulnerable to a downturn in value investing at both the country level and the stock level, but we cannot pretend that we'll sleep much easier.

What Should You Do About This?

So, when you hear from us that our ability to add value is diminished, what's the appropriate response?

When we look at valuations for the asset class, we see that emerging markets are at approximately fair value. One option would be to reduce your overall bet on emerging, assuming you are overweight the asset class (like most of our clients). However, emerging equities are one of the most attractive of all asset classes, based on our asset allocation group's 7-year forecast, and GMO is quite heavily overweight emerging equities in all of our asset allocation products.

Another response would be to take money away from us and give it to another emerging manager. However, as far as we can tell, this contraction of value has not led to greater opportunities popping up elsewhere. Thus, moving money away from us (or any other value manager) to a different style does not seem to be compelling enough to justify the high transaction costs.

Those of you who have been with us for a while have enjoyed the value and small rally. While we try to deliver outperformance of 4% a year, for calendar year end 2003 the GMO Emerging Markets Strategy outperformed its benchmark, the S&P/IFC Investable Composite Index[1], by 13.1% after outperforming by 4.7% in 2002 and 8.1% in 2001. So, if the compression of value does lead to tougher times for our strategy in the next couple of years, at least you were able to reap the benefits of that compression along the way.

We're battening down the hatches and searching hard for opportunities that might be out there, but we have entered uncharted territory and there don't seem to be any easy answers. We will continue to do the best job we can for you, but it may just be time to grit your teeth, tighten your buckle, and hang on for what could be a difficult ride.

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[1] The S&P/IFC Investable Composite Index is an independently maintained and published emerging market stock index.

Notes:

Arjun Divecha is a portfolio manager, based in Berkeley, California, for GMO.

Performance indicated herein represents supplemental AIMR performance. A fully compliant AIMR presentation is available upon request and at www.gmo.com.