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Can Relative Price-to-Asset Values Determine Which Countries Provide Best Returns?

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In an August post, Applying value principles at a country level, we discussed The growth illusion, an article appearing in a Buttonwood's notebook column of The Economist. In that article, Buttonwood argued that valuation, rather than economic growth, determined investment returns at a country or market level. Buttonwood highlighted research undertaken by Elroy Dimson, Paul Marsh and Mike Staunton from the London Business School, which suggested that chasing growth economies is akin to chasing growth stocks, and generates similarly disappointing results. Buttonwood concluded that higher valuations – determined on an earnings, rather than asset basis – led to lower returns:

> What does work? Over the long run (but not the short), it is valuation; the higher the starting price-earnings ratio when you buy a market, the lower the return over the next 10 years. That is why buying shares back in 1999 and 2000 has provided to be such a bad deal.

It raised an interesting question for us: Can relative price-to-asset values be used to determine which countries are likely to provide the best investment returns? It took some time, but we've tracked down some research that answers the question.

In Fundamental Determinants of International Equity Returns: A Perspective on Conditional Asset Pricing (9.17MB .pdf) Journal of Banking and Finance 21, (1997): 1625-1665. (P42), Campbell Harvey and Wayne Ferson examined, among other things, the relationship between price-to-book value and future returns from a global asset pricing perspective. Harvey and Ferson found that "the price-to-book value ratio has cross-sectional explanatory power at the country level," although they believe that its use is mainly in determining "global stock market risk exposure."

An earlier – and slightly more readable – study by Leila Heckman, John J . Mullin and Holly Sze, Valuation ratios and cross-country equity allocation, The Journal of Investing, Summer 1996, Vol. 5, No. 2: pp. 54-63 DOI: 10.3905/joi.5.2.54, also examined the link between equity returns at a market level and valuation measures. Heckman et al found that, despite the substantial accounting differences across countries, price-to-book measures are useful for predicting the "cross-sectional variation of national index returns."

The results are perhaps unsurprising given the various studies demonstrating the relationship between valuation determined on a price-to-earnings basis and country level returns. We believe they are useful nonetheless given the ease with which one can invest in many global markets and our own predisposition for assets over earnings valuations.