UPSIDE

The World's Riskiest Stock Market?

Russia's Stock Market Is Now Among the World's Cheapest. It Could Also Be a Screaming Risk.

By JOE LIGHT CONNECT

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Soldiers in Crimea: Is the Russian stock market screaming risk? *Agence France-Presse/Getty Images*

Rarely does a nation's stock market get this cheap. But investors who want a taste better have a strong stomach.

Russia's RTS Index is down 21% this year on fears that an escalating crisis in Ukraine could lead to damaging sanctions from Western countries or armed conflict.

Many investors aren't sticking around to find out. This year, more than $600 million has left exchange-traded funds and mutual funds that invest primarily in Russian stocks, according to EPFR Global in Cambridge, Mass.

Investors who can afford to wait it out might find extremely good returns in Russian stocks and those of other countries trading at deep bargains because of geopolitical events.

To measure value, many investors divide a country's stock market price by its 10-year average earnings, adjusted for inflation. Using such a long span of earnings is supposed to weed out times when profits are inflated or depressed because of an economic cycle.

At the end of February, Russia had a price/earnings ratio of 6.5 by that method, according to Cambria Investment Management. The U.S. had a P/E of 25.

The firm looked at the long-term P/E ratios of 44 countries at the end of each year since 1980 and found that a country's P/E dropped below 7 only 28 times out of more than 800 cumulative market years.

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But investing in such a scenario paid handsomely. After its P/E sank below 7, a country's stock market on average went on to return 31% over the following year and 21% annually over the next five years, according to Cambria.

For example, stocks in Ireland started last year with a P/E of 5. The iShares MSCI Ireland Capped ETF EIRL +0.14% went on to rise 46% in 2013, including dividends.

Meanwhile, stocks dropped last year in many countries where prices were the most expensive, including Peru, Colombia and Indonesia. The U.S. stock market was a rare example of a country that began the year looking pricey only to continue its climb.

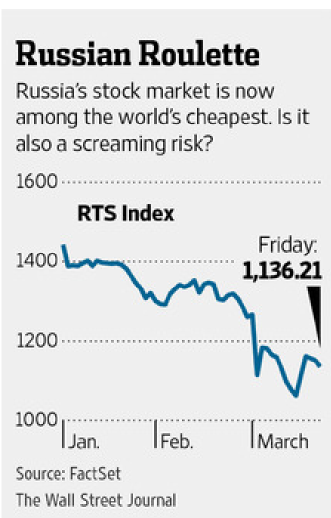
Of course, some major caveats are in order. Cheap countries frequently get even cheaper before they rebound. For example, Russian stocks had a P/E of 7.5 at the end of January 2013.

You might end up "riding a country down as well as up," says Cambria Chief Investment Officer Mebane Faber, whose firm this month launched the Cambria Global Value ETF, GVAL -0.03% which invests in countries based on value measures such as long-term P/Es.

As of the end of February, only one other country—Greece at 4.3—had a P/E ratio below 7. Other countries that came close were Hungary at 7.9 and Austria at 8.8. (Cambria doesn't calculate a P/E for Ukraine.)

A country with an extremely low P/E also might be merely much more risky than other countries, rather than a bargain, says Campbell Harvey, a Duke University finance professor who has researched ways to measure countries' sovereign risk.

Occasionally, stocks of countries facing geopolitical crises never rebound. After the Russian Revolution in 1917, the country's stock market ceased to exist for more than 70 years. Similarly, private assets were expropriated in China after the communist victory in 1949.



Even now, many investment advisers avoid Russian stocks completely because of corruption and concerns that the country could impose capital controls that wipe out investments.

"You don't want to take a one-off bet thinking that because a P/E is low, stocks must be cheap. Instead, the P/E could be low because it's screaming risk," Prof. Harvey says.

Funds that focus on Russian or Greek stocks also are relatively pricey. The Market Vectors Russia RSX +0.81% ETF has an annual expense ratio of 0.62%, or $62 annually per $10,000 invested. The iShares MSCI Russia Capped ETF ERUS +0.51% also costs 0.62%. The Global X FTSE Greece 20 ETF GREK +0.08% costs 0.65%. The average expense ratio for ETFs investing in international stocks is about 0.58%, according to Morningstar.

Less-intrepid investors—or those with less money to risk on stocks that could lose so much in value—might instead invest in a more-diversified emerging-markets ETF.

Though not as cheap on the whole as Greece or Russia, stocks of most such countries are much cheaper than the U.S., Cambria's Mr. Faber says.

The Vanguard FTSE Emerging Markets ETF, VFEM.LN +0.30% which invests about 6% of its portfolio in Russian stocks, has an expense ratio of 0.15%.

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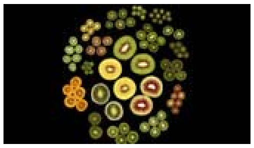

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