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Strong growth doesn't equal strong stocks

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Selling investments is about telling stories. If you can weave a convincing yarn about how an investment will pay off in future, it is much easier to persuade people to buy into it.

The narrative of the Brics (Brazil, Russia, India and China) is a classic example.

The story tells of how the largest emerging markets will steadily overtake the world's current dominant economies. Economic growth will propel them to take over economic leadership by the end of this century. Therefore, the story goes, buy stocks in the Bric nations.

Unlike many other stories that investment managers tell their clients, this story has the benefit of being true, at least so far. When Goldman Sachs first introduced the concept in 2001, China's economy was due to overtake Germany's in 2008. It did, on schedule. The future remains unknowable, but the central narrative has unfolded just as it was supposed to do, so far.

But this story still has a flaw. Economic growth does not necessarily translate into stock market appreciation. Indeed, recent strong economic growth might even translate into poor stock market performance in the near future.

That, at least, is the message from the latest issue of the **Credit Suisse** Global Investment Returns Yearbook, an ever-impressive annual research project from Elroy Dimson, Paul Marsh and Roy Staunton, three academics at London Business School. They reviewed history and made a comparison with the most popular styles for picking stocks. When picking a country, they argue, a value style should work much better than a growth style. In other words, the thing to do is to find countries that are beaten down and out of fashion, rather than countries that are booming.

This is bad news for emerging markets proponents as the name for the asset class emphasises the notion we can catch a country in the explosive growth phase when it is emerging to become fully developed – just as growth investors try to spot companies as they are entering their period of significant growth.

Historical surveys are difficult because it is hard to nail exactly when a country was "emerging". The most painful example is Argentina, which was in the club of developed nations at the turn of the last century, with GDP per capita on a par with the richer nations of western Europe. Since then it has reversed and according to some agencies it has fallen so far that it is no longer even "emerging".

However, when the academics looked at the performance of the longest surviving emerging market index, started by the International Finance Corporation in 1981, and backdated it to 1975, they found that over the past 34 years Argentina had returned 9.5 per cent per year – slightly less than developed markets, which returned 10.6 per cent.

Moreover, their correlation with the developed world has increased over time. Despite the rubric that emerging markets have "decoupled" economically from the west, their markets are ever more coupled. There is no great diversification to be achieved by buying emerging markets.

They have, however, outperformed since 1987, a period that includes all the big Latin American and Asian crises of the 1990s. And of course they have outperformed over the past decade.

Is their economic growth, obviously now faster than in the developed world, any reason to expect this to continue? Apparently not.

From 1900 to 2009, for the 19 countries for which they had continuous data, the academics found that the correlation between real growth in GDP per capita and stock market performance was actually slightly negative.

Using all the data they could find, for 83 different national markets (over period of only a decade in some cases), they found that 99 per cent of changes in equity returns could be attributed to factors other than changes in GDP.

So arguments about economic prospects might be interesting, but for stock investors they are almost irrelevant.

Indeed, a "value" approach of investing in countries that have recently suffered weak growth – notably emerging markets as they came out of their crises – was the best way to go.

Buying where the hot growth has just been does not work so well. Just look at the Chinese stock market. It has been heading downwards for months, since its authorities started trying to rein in growth.

The story of continued economic growth in the Brics may yet come true – but it is not a good reason to buy stock there.