The Telegraph

Isa fund bargain: Countries with cheap stock markets (and how to buy them)

This chart identifies cheap stock markets - we explain why they offer big discounts and how to back them

A sharp decline in the yen has forced up the cost of importing pricey fossil-fuels to plug the country's energy gap Photo: Alamy

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2 Comments

Investors who suffer from acrophobia - the fear of heights - face a dilemma. Over the past couple of years some of the world's largest stock markets have had a great run of form.

Many have broken through their previous record highs, with Britain's FTSE 100 index the latest to reach uncharted territory.

Naturally, some investors are wary about buying into a stock market that is trading at an all-time high, fearing that a fall could be around the corner. They may prefer to look at the markets that are well below their previous peaks in the hope that they will have their turn to shine in the coming years.

Our graphic shows which countries' stock markets are at or near their record levels, and which seem cheap, expensive or fairly valued according to one of the most respected measures of valuation, the "Cape" ratio, explained below.

Why certain stock markets are at record highs

As the chart shows, there are seven countries in addition to Britain whose markets are at all-time highs, most notably Germany, the United States and India.

According to Russ Mould, of AJ Bell Youinvest, the fund shop, there is an old stock market saying that you can have cheap share prices or good news but not both at the same time.

"This helps to explain why these three markets have soared," he said. "Germany and America are riding the wave from their superior economic momentum, while India hopes for political, social and economic reform under its new government, led by Narendra Modi."

Another factor that has helped US shares boom and played its part in driving Britain's FTSE 100 index past its previous record peak is the controversial money printing policy known as quantitative easing (QE). The measure, which involves central banks buying government bonds, aims to boost spending by consumers, and investment by companies, by cutting their cost of borrowing.

But QE also tends to boost stock markets because it sends bond prices higher, reducing their yield and encouraging investors to look to shares instead.

Jason Hollands of Tilney Bestinvest, another fund shop, said: "This cheap money has pushed both bond and share prices higher, so now the true bargains are much harder to find in much of the developed world."

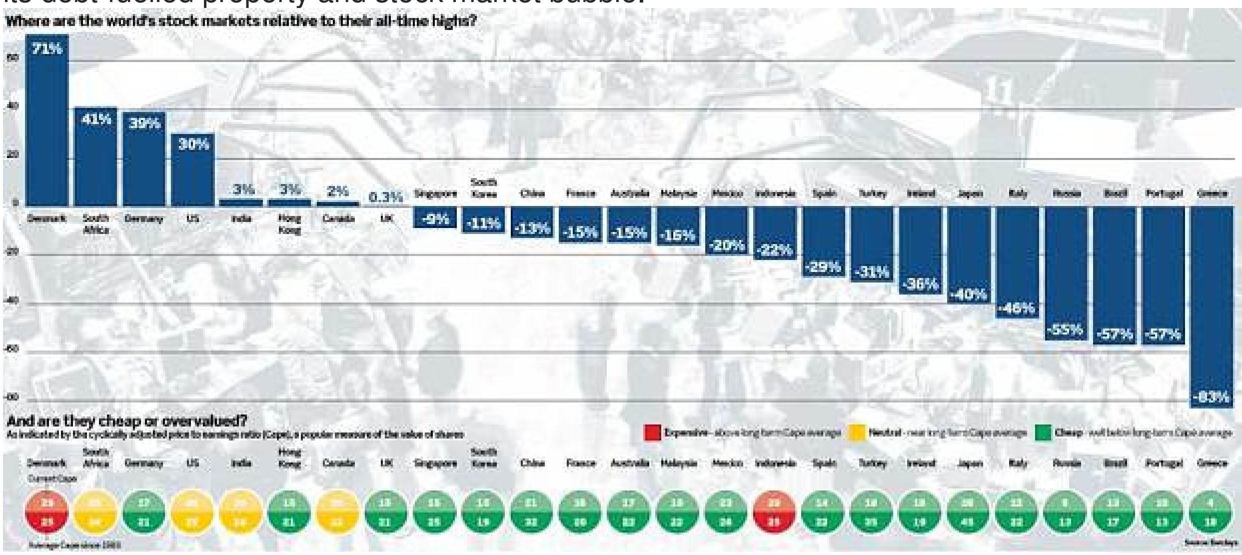
While others are well above their peaks

The countries whose stock markets are furthest from their previous record highs are Greece and Portugal, two nations that have been at the centre of the eurozone debt crisis. Greece, for example, has seen its economic output fall by a quarter since the financial crisis struck, while deflation is affecting companies' profits.

The Brazilian and Russian markets are also well below their peaks. This is partly because their economies depend heavily on sales of commodities such as iron ore, oil, gas and copper, whose prices have all fallen heavily over the past couple of years.

Another large economy whose stock market has a long way to go is Japan. Its main share index, the Nikkei 225, has soared over the past two years, largely thanks to a major injection of QE. A 62pc rise recently took the market to a 15-year high but it remains well below its peak of December 1989.

The country is still battling the deflation that arose in the aftermath of the bursting of its debt-fuelled property and stock market bubble.



For a larger version of the image click here

How we worked out whether stock markets are cheap or expensive

Looking at how a stock market is trading compared with its previous peaks is a useful starting point, but it does not tell investors whether the shares are "expensive" or "cheap".

To shed light on this, Telegraph Money looked at the "Cape" ratios for all 25 countries on the chart, then compared their score today with their long-term average, which for the majority dates back to 1983.
Cape (cyclically adjusted price to earnings ratio), is the aggregate price of a market's shares divided by the profits made by its constituent companies, with those profits averaged over the previous decade to iron out the fluctuations of the economic cycle.
On the chart we have highlighted the two countries trading above their average in red. One, Denmark, is also at a record high, but the other, Indonesia, is 22pc below its peak. The implication is that the market was considerably overvalued at that record level.
In green are the markets that are well below their historical Cape average, suggesting that investors who buy today may be getting a bargain price.
Japan, Russia and China look to be three of the cheapest. Both Japanese and Russian shares are at a 40pc discount to their historical average. Japan scores 26 against 45 for its long-term average, although this includes the bubble years, while Russia has a rating of eight today, compared with an average of 13. China has a rating of 21, a 35pc discount to its average figure of 32.
But the biggest apparent bargains are Greece, 80pc below its long-term average, and Turkey, which is 50pc below.
But some markets that are at or close to record levels also look cheap on the Cape measure. Both Hong Kong and Britain are below their long-term averages, both scoring 15 against 21.
Those that have a score near to their long-term Cape average, shown in yellow, are considered neither expensive nor cheap. Several stock markets that have recently hit new highs, including South Africa, Germany, India and Canada, have a neutral valuation rating.

How to buy the bargain stock markets

For each of the "cheap" markets Telegraph Money has identified a tracker fund, which passively follows the ups and downs of a stock market index and is the simplest and cheapest way to invest in them.
The other option is to buy an "active" fund, run by a professional fund manager, who buys a basket of shares in a bid to beat the stock market.
But bear in mind that, although these five markets look to be a bargain, they could become even cheaper. As with some shares, stock markets can be "cheap for a reason", such as poor growth prospects or deep-seated economic problems.

Japan

The cheapest tracker is the Fidelity Index Japan, which costs 0.12pc a year.
Favoured funds to play the Japanese market include Neptune Japan Opportunities(0.8pc) and Baillie Gifford Worldwide Japanese (0.8pc). Both also offer "hedged" share classes, which protect against currency movements. The yen is very volatile against the pound.

Russia

Experts regularly tip the Neptune Russia fund, which costs 1pc. Another option is to buy a fund that has a broader remit but has considerable exposure to Russia, such as the BlackRock Emerging Europe investment trust, which holds 40pc in Russia. But the charge, 1.3pc a year, is steep.
One tracker option is the DB X-Trackers MSCI Russia Capped Index, which costs 0.65pc.

China

Favoured funds include Invesco Perpetual Hong Kong and China (0.89pc) andHenderson China Opportunities (0.89pc).
But some experts, including Tom Becket, who buys funds for Psigma Investment Management, prefers to buy an Asian fund that has a high weighting to the region. He favours the little known Prusik Asian Equity Income fund (1pc).

Greece

For those who fancy a punt there is the Global X FTSE Greece 20 tracker. This fund holds the top 20 biggest companies listed on Greece's stock market and costs 0.69pc

Turkey

There are some Turkey specialist funds, including the JP Morgan Turkey Equity fund (0.9pc). A tracker option is the iShares MSCI Turkey ETF, which costs 0.62pc.