Emerging Markets and Domestic Bonds
Investors Rushed to Get in on the Act, but with Eyes Wide Open?

By Christopher Philips, CFA

For most of the past several years, two very different asset classes—emerging market stocks and U.S. bonds—were the focus of investors’ interest. But have investors bought in for the right reasons?

Investors pumped extraordinary amounts of money into these markets. The concern is that many investors gravitated to these assets based on past performance and without fully understanding their potential role in a portfolio or the unique risks these markets may face. As investment professionals, we should help investors to set reasonable expectations for these markets. This article looks at some key considerations for investors as they think about their current and future investments in these securities.

Emerging Markets: Growth at a Reasonable Price?

The surge in money flowing to emerging markets can be linked to investors’ growing comfort with diversification beyond U.S. borders and their newfound access to emerging markets through liquid, low-cost, index funds and exchange-traded funds (ETFs). Allocations to emerging markets have increased more than tenfold since 2000, far above the growth rate attributable to market performance alone. In fact, emerging markets captured most of the cash moving into non-U.S. and global equities in the most recent time spans: 67 percent over one year and 100 percent over three years, according to Morningstar, as of December 31, 2010.

It’s probably no coincidence that cash flow accelerated into emerging markets as both the U.S. and other developed stock markets have significantly underperformed. In addition, the growth of emerging market economies over the past decade has been impressive, both on an absolute basis and relative to developed markets. And faster economic growth typically is associated with stronger earnings growth, and therefore higher stock returns. But the key risk is investing today solely on the basis of these markets’ heady trailing returns and the widely held view that emerging economies will grow faster than developed markets.

My firm’s analysis shows that the average cross-country correlation between long-run gross domestic product (GDP) growth and long-run stock returns has been effectively zero. Instead, the following three factors have been the core drivers of market performance:

1. Growth surprises, or how a country’s actual GDP growth compares to the prior expectations for growth priced in by financial markets.
2. Valuations, or the price investors pay for a market’s expected growth at any given time.
3. Globalization, or how the composition of a country’s GDP growth relates to the earnings growth of the country’s domestic public companies.

Over the past 10 years, emerging markets investors have experienced sizeable investment returns in exchange for the risk they have borne due to the first and second factors: the surprise of higher-than-expected growth during much of the decade and equity valuations in the early 2000s that were relatively low compared with developed markets.

In fact, equity market valuations are arguably the most relevant and useful measure for estimating future market expectations. Figure 1 shows trailing price-to-earnings (P/E) ratios for developed markets (including the United States) and emerging markets since the mid-1990s. Emerging market valuations were not as elevated as U.S. valuations in the early 2000s.
markets’ significant outperformance over the past decade was driven primarily by systematic tightening of valuations between developed and emerging markets. In other words, relative to emerging markets, developed markets were overvalued in the early 2000s, whereas they are near parity today. Thus, expectations for continued outperformance by emerging markets similar to that experienced over the past decade may be optimistic.

U.S. Bonds: Safety at a Reasonable Price?

Investors also have been drawn to U.S.-focused fixed income products. Of the $849 billion that moved into U.S. bond funds since 2000, 56 percent came in the past three years, and 19 percent came last year, according to Morningstar, as of December 31, 2010. Two widely cited reasons for the strong investor interest in bonds have been the less-than-stellar performance of equity markets over the past decade and the low yields offered by money market securities. In addition, fallout from the European debt crisis and doubts about the strength and sustainability of the U.S. economic recovery further bolstered demand for Treasury bonds, which often are seen as a safe haven during periods of market stress and uncertainty.

These factors have combined to push yields far below what investors have become accustomed to over the past 30+ years. Indeed, for many segments of the bond market we are at or near historic lows for yield (even accounting for the modest increase at the end of 2010). While bonds play a critical role in most investors’ portfolios—mitigating the risk and volatility of equity investments—the clear risk today is for investors who are buying bonds and expecting a repeat of history when a repeat is impossible. Investors moving into longer-term bonds for additional yield are exposing themselves to greater potential fluctuations in principal because of longer-term bonds’ heightened sensitivity to changes in interest rates. If interest rates continue to rise—perhaps due to accelerating economic performance, rising inflation, or reduced demand—bonds with greater sensitivity to changes in interest rates stand to lose more than shorter-maturity bonds.

Because interest rates cannot fall below zero and rising rates result in price depreciation, bond investors today must become comfortable with a return environment that likely will look very different from the past 30 years, a period characterized by lower than expected inflation and falling interest rates that lead to bond returns that have averaged 8.8 percent since 1980. With yields today around 3 percent, it is improbable that future long-term returns will be significantly higher than 3 percent. The key issue is that because bond yields have been lower than at any point since 1980, bonds are unlikely to provide the same degree of principal appreciation as they did when rates were consistently falling.

Of course, if interest rates do start to push higher, the big question is how fast they’ll move up. If rates move sharply, we could experience a period of time where investors will receive a meaningfully negative total return from bonds. That said, the math of bond returns means that falling prices coincide with higher yields. These higher yields can help to offset some of the price volatility and shorten the recovery period. In fact, following an examination of 10,000 simulations, Vanguard’s Capital Markets Model anticipates that returns for the bond market will most likely be between 2 percent and 5 percent annually during the next 10 years.

Table 1 shows a hypothetical example of what could happen in both the short and longer term to an investment linked to the broad U.S. bond market if interest rates rise unexpectedly by a significant amount (it is unlikely that this would actually happen, but it serves as a worst-case scenario). In this example, we show the impact of a 4-percentage-point increase in interest rates across the yield curve.

As expected, the price decline is significant in year one, leading to the potentially worst 12-month return ever for U.S. bond investors. (Historically, the actual worst 12-month return ever for the Barclay’s Capital U.S. Aggregate Bond Index was –9.2 percent during the 12 months ended March 31, 1980. This was during one of the rare periods of significant jumps in interest rates, when the Federal Reserve drove rates higher in an effort to combat high inflation.)

### Table 1: Hypothetical Example of the Impact of an Increase in Interest Rates

<table>
<thead>
<tr>
<th>Yield (%)</th>
<th>Today</th>
<th>+1 year</th>
<th>+2 years</th>
<th>+3 years</th>
<th>+4 years</th>
<th>+5 years</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3.0</td>
<td>7.0</td>
<td>7.0</td>
<td>7.0</td>
<td>7.0</td>
<td>7.0</td>
</tr>
<tr>
<td>Price Change (%)</td>
<td>0.0</td>
<td>-20.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Total Return (%)</td>
<td>3.0</td>
<td>-15.0</td>
<td>7.0</td>
<td>7.0</td>
<td>7.0</td>
<td>7.0</td>
</tr>
<tr>
<td>Cumulative Total Return (%)</td>
<td>-15.0</td>
<td>-9.1</td>
<td>-2.7</td>
<td>4.1</td>
<td>11.4</td>
<td></td>
</tr>
<tr>
<td>Annualized Total Return (%)</td>
<td>-15.0</td>
<td>-4.7</td>
<td>-0.9</td>
<td>1.0</td>
<td>2.2</td>
<td></td>
</tr>
</tbody>
</table>

Note: This hypothetical example does not represent the return on any particular investment. Yields are as of January 31, 2011, for the Barclays Capital U.S. Aggregate Bond Index. For simplicity, duration is assumed to remain at five years, although in practice, as yields change, duration will also change. Importantly, the dramatic change in yields that we assume in this example would likely constitute a very significant adjustment to the fund’s weighted average duration. We assume no changes to yields in subsequent years purely for illustrative purposes.

Source: Vanguard
Indeed, even the worst bond market in history had less than one-sixth the losses of the worst equity market.

For a total return investor, the new yield level starting in year two is perhaps of greater importance. Following the initial year of pain, the investor would expect a 7 percent return, all else being equal. And two years following this hypothetically worst bond market return ever, the diversified bond investor would be close to breaking even simply by reinvesting interest distributions. This points out that an investor’s time horizon is important when thinking about the risk of rising rates. Over the long term, interest income—and the reinvestment of that income—accounts for the largest portion of total returns for many bond funds. The impact of price fluctuations can be more than offset by staying invested and reinvesting income.

Overall, the potential impact of a bond bear market is best seen in perspective. As table 1 shows, even a rapidly rising interest-rate environment in the bond market is not equivalent to an equity bear market, where short-term portfolio losses can be severe. Indeed, even the worst bond market in history had less than one-sixth the losses of the worst equity market. In addition, our research shows that in past rising-rate scenarios both in the United States and abroad, broadly diversified bond portfolios realized significantly positive returns in the periods following the rise in rates as investors benefitted from subsequently higher yields and, hence, income streams (as the hypothetical example in table 1 suggests).

The difficulty of correctly forecasting when and which (if any) of the scenarios of economic growth, the deficit, inflation, and interest rates will unfold is a powerful reminder that focusing on interest rate moves and short-term changes in bond prices can be counterproductive. In addition, a too-narrow bond allocation (such as shortening duration or investing solely in riskier bond instruments) involves important trade-offs that may expose investors to unintended yield curve or market risks while potentially depriving them of a higher future income stream. Most bond investors may be better off maintaining their long-term strategic allocation to fixed income.

A Bow to the Enduring Principles of Diversification

Investors may want to consider a long-term asset allocation plan that includes an appropriate weighting to emerging markets and U.S. bonds. A long-term asset allocation strategy can discourage investors from chasing past returns, which can lead to big disappointments.

In the case of emerging markets, it is certainly encouraging to see investors taking a more global view in the portfolio allocations. However, the speed and magnitude of the allocation to emerging markets, in particular over the past three years, is cause for concern. If those cash flows prove to be “sticky,” remaining invested even if the U.S. market enjoys a period of outperformance, then those concerns could be unfounded. But if investors are motivated largely by unrealistic expectations, their commitment to diversification might not last long enough to realize potential benefits. The risk is that if U.S. stocks do outperform for a time, many investors will reallocate back to the U.S. market after the fact, launching a new round of buying high and selling low.

The same diversification message holds true for bonds. Even though interest rates are low and return expectations are modest, investors should consider bonds in terms of their potential ability to provide stability within a portfolio and reduce volatility.

The uncertainties—and range of potential outcomes—represented by the bond market support the need for greater fixed income diversification in the years ahead and underscore the potential benefits of a broadly diversified fixed income portfolio regardless of the future direction of interest rates. A broad mix of fixed income securities or funds, or a total market bond fund, can offer exposure to bonds of all maturities and types of issuers.

Readers may be able to provide direction to investors on the aforementioned alternative ways of thinking about investments in emerging markets and bonds, educating them on the classic rule of strategic asset allocation as the most important consideration in portfolio construction.

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As with any investment, there is risk. Mutual funds are subject to risks, including possible loss of principal.

Stocks of companies in emerging markets are generally more risky than stocks of companies in developed countries. Bond funds contain interest rate risk, the risk of issuer default, and inflation risk. Diversification does not ensure a profit or protect against a loss in a declining market.

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