Taking a Fresh Look at Emerging Markets

By Steven Schoenfeld and Alain Cubeles


Emerging-market equities are a dynamic asset class that seems to have grown out of its volatile past. Substantial economic and regulatory reform has dampened the political and financial risk of investments in emerging-market equities. And even after a four-year bull run, emerging-market equities still offer investors some of the best long-term return prospects in the world. Investors seeking a truly diversified portfolio may want to take a closer look.

Lands of Opportunity
Investors who still believe developed-world equities offer all the return and diversification they need for an effective international strategy may be missing opportunities for their foreign equity investments.

Several developed countries face formidable economic challenges such as persistently high unemployment and an aging population, while many emerging-market countries are enjoying strong economic progress. Consider these recent developments in emerging markets:

- Brazil’s Companhia Vale Do Rio Doce, already the world’s largest iron-ore producer, has submitted an $18-billion cash offer for Canadian nickel producer Inco as part of Doce’s quest for global nickel market dominance.
- Emerging markets now hold 75 percent of the world’s foreign exchange reserves.
- Real capital spending rose by 17 percent in emerging economies in 2007, compared to 1.2 percent in developed countries.
- Brazil was rated as investment grade for the first time by Standard & Poor’s in April 2008.

Many emerging-market companies are experiencing consecutive periods of double-digit revenue growth, steadily increasing balance-sheet strength, and are, in aggregate, more profitable than their developed-world counterparts. And while return on equity for companies worldwide has risen during the past four years, companies located in emerging markets have consistently produced a return-on-equity premium at least 1 percent higher than companies in developed countries. As a result, emerging markets have grown to account for a much larger portion of the world’s economic pie in the past five years (see figure 1).

Structural Reforms Are Providing Stability
Much of the economic success that emerging-market countries enjoy

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<th>MSCI Emerging Markets Market Cap</th>
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<td>Share of MSCI ACWI excluding U.S. Market Cap</td>
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<td>12/31/2002</td>
<td>3/31/2008</td>
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<td>MSCI Developed World excluding U.S. $5.6 Trillion</td>
<td>MSCI Developed World excluding U.S. $13.7 Trillion</td>
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<td>MSCI Emerging Markets $526.4 Billion</td>
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Source: NTGI, MSCI, 3/31/2008

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stems from serious structural reforms implemented after the various financial crises of the 1990s. Chief among these reforms in emerging-market countries are the following:

- dramatic reduction in foreign-currency (mostly U.S.-dollar) denominated debt from 90 percent in 1999 to 10 percent in 2006 relative to aggregate GDP
- reduction, and in some cases elimination, of fiscal deficit
- production of account surpluses, which starkly contrast with the trade deficits plaguing many developed countries
- a drop in inflation to single-digit levels
- adoption of generally accepted accounting principles used in the United States, bringing greater transparency to public and corporate governance practices

Despite these positive trends, we don’t recommend investing in emerging markets at the expense of exposure to developed markets. Canada, Europe, Japan, and Australia remain home to hundreds of excellent companies that are global industry leaders and represent essential holdings for most global-equity portfolios.

However, emerging-market countries are too significant to ignore—geographically, demographically, and economically. As shown in figure 2, these developing economies contribute more than half of the world’s economic activity, and they are growing at double the rate of developed-country economies. They account for 90 percent of the world’s landmass, include some of its most-valuable real estate, and are home to approximately 86 percent of the world’s population.

Adding exposure to emerging markets may help position your portfolio to benefit from the growth potential of dozens of emerging-market companies. Some fast-growing, industry-leading companies—including widely recognized global brands such as Samsung, Cemex, Teva, and Embraer—are located in emerging-market countries. In many ways, these are “blue chip” companies whose home addresses are less relevant than their ability to grow and operate profitably beyond their geographic borders.

Emerging Markets Are “Growing Up”

The emerging-markets asset class is growing up. Empirical evidence shows that while emerging-market investment risks have declined steadily over the past several years, emerging-market investors still are earning higher returns relative to similar equity investments in developed markets (see figure 3).

However, the correlation between emerging and U.S. equity markets also has increased during the past decade, prompting some analysts to minimize emerging markets’ diversification benefits. This rising correlation largely can be explained by the following factors:

- The Internet and other advances in communications technology have improved both the dissemination of financial data worldwide and investors’ access to all global financial markets.
- Government and corporate reforms enacted in emerging-market economies since the 1990s have proved both sustainable and effective, resulting in lower systemic investment risk.
- Globalization—the integration of international economic activity—produces higher correlations between developing and developed markets.

Nonetheless, the correlation between the MSCI Emerging Markets Index and the S&P 500 is only 63 percent. In other words, even after a four-year rally emerging markets still offer diversification benefits.

A Blend of Strategies is the Best Approach

Investors can gain emerging-markets exposure through either active or passive (i.e., index) strategies. These strategies differ primarily on cost and risk attributes.

Active managers have long played the dominant role in emerging-market equity mandates, and many investors still regard active managers as the de facto emerging-markets experts. But the argument that active managers can achieve superior returns bycapitalizing on emerging-market inefficiencies, such as lack of company research coverage and financial reporting delays, is less valid today because of the structural reforms noted above. In addition,
active-management fees remain higher (often considerably higher) than fees associated with passive strategies.

On the other hand, an active strategy used either alone or with an index approach offers investors the opportunity to overweight certain countries, regions, styles, or specialist managers. Perhaps more importantly, active strategies enable investors to benefit from adroit sector, industry, and individual security selections.

Using an index strategy can provide broad and efficient exposure to emerging markets while also neutralizing one of an active manager’s greatest challenges: making accurate country-specific allocations. A top-performing equity market in one year by no means is guaranteed to advance further in subsequent years. For example, Turkey’s stock market ranked among the world’s top five best-performing equity markets in 1997, but in 1998 it fell to the bottom of the ranks.

As with any investment, the best strategy is the one that is most appropriate for your unique personal situation, investment goals, and time horizon.

For Long-term Returns, Emerging Markets Are Worth a Look

If you are seeking higher long-term returns, you may want to consider adding emerging-market exposure to your portfolio. Allocating a portion of your international equity investments to emerging markets can give you access to these evolving markets, the higher long-term return potential they offer, and broader diversification. Regardless of whether you choose to follow an active or passive approach, emerging-market exposure is the key.

Steven Schoenfeld is the chief investment officer for the global quantitative management business of Northern Trust Global Investments. He earned a B.A. in history and government from Clark University, studied at the London School of Economics, was a Fulbright Scholar in economics at the National University of Singapore, and earned an M.A. in international relations from the Johns Hopkins University School of Advanced International Studies. Contact him at ss146@ntrs.com.

Alain Cubeles is a senior vice president and senior investment strategist in global quantitative management with Northern Trust Global Investments. He earned a bachelor’s degree from the University de Perpignan, France, in economics and a master’s degree in international management from Escuela Superior de Administracion y Dirección de Empresas, Barcelona, Spain, and Monterey Institute of International Studies, Monterey, California. Contact him at ac88@ntrs.com.

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