

## Analyst Spotlight

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### Emerging Markets (Part II)

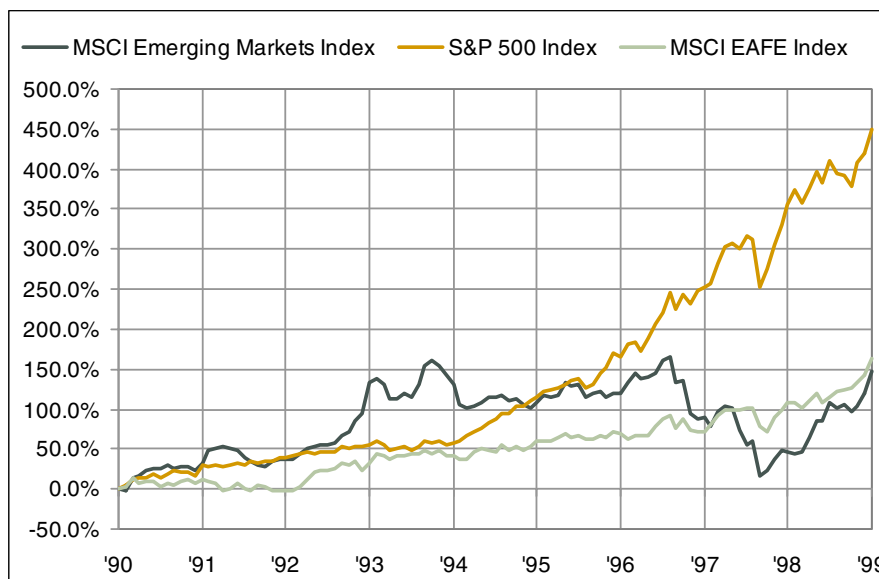
In March, Chris Keith wrote about the benefits and risks of investing in emerging market debt securities, in this article, I am going to address investing in emerging market equity securities, or stocks. While there are some differences in assessing the relative attractiveness of emerging market stocks versus emerging market bonds, the similarities are more important.

The major similarity, of course, is that they are both “bets” on the regions of the world whose economies are classified as “emerging.” Emerging markets are defined as countries with per capita GDP’s under 10,000 U.S. dollars, who are striving to become more integrated into the global economy through economic development, political reform and other stabilizing trends.

While the developed markets currently make up the lions share of the world’s economy, the vast majority of the world’s population lives in countries classified as emerging market economies, and much of the world’s economic growth potential exists in these regions. It is this potential for growth, which attracts investors.

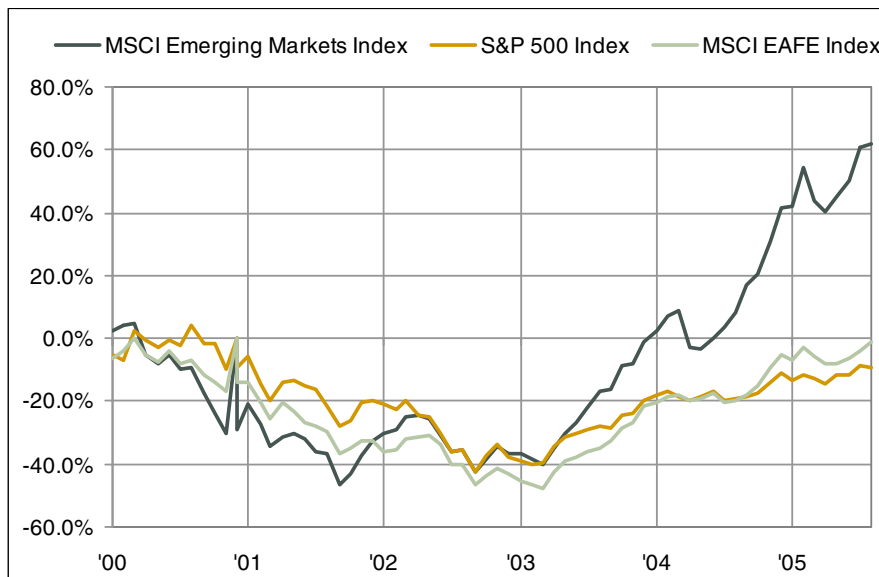
For most of their history, the flip side of this growth potential has been extreme volatility due to political turmoil and more fragile economies overly dependant on exports to developed markets.

As the chart below shows, from 1991, when the first emerging market stock funds appeared on the scene, until the end of 1999 when tech bubble burst and the U.S. bear market began, emerging markets managed a cumulative gain of 147% similar to the gain in international developed markets



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(EAFE index) of 164%, but with a much bumpier ride. In contrast, the S&P 500, fueled by what is now recognized as enormous speculative fever, rose an astonishing 450%.



However, since the collapse of the tech bubble, the fortunes of emerging markets have been quite different. As shown in the next chart, from January 2000 to today (August 2005), emerging markets have risen 62%, while international developed markets are roughly flat (-1.3%) and the S&P 500 has yet to recover fully from the losses sustained in the bear market (-9.2%).

Risks Have Been Reduced... ■ ■ ■ ■ ■

There is more to this improved performance from emerging markets than just the steep decline of the dollar in recent years. While that has indeed been a positive, it has been the same positive for developed foreign markets, and they haven't performed much better than the S&P 500.

*Note: All index returns shown are in U.S. dollars, so foreign markets denominated in currencies that are appreciating versus the dollar will see their returns boosted in U.S. dollar terms.*

Nor is their success a result of just because they are “in favor” now. They are in fact increasingly in favor with investors today, but for three fundamental reasons. First, as Chris Keith showed with emerging market bonds, the appeal of higher returns overseas when returns in this country are low is a powerful lure. Second, despite much higher growth prospects, emerging markets are still selling at an average P/E of around 10 times earnings as opposed to 17-19 here in the U.S. The third, and most important piece of the puzzle, is that the risk inherent in emerging markets has been reduced.

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As noted before, emerging market instability – both economic and political has resulted in a great deal of volatility and risk in emerging market stock returns and limited their appeal. But there are several fundamental developments that point to greater stability on both counts moving forward.

1. Emerging market economies have been developing the material and production capabilities necessary to participate in the world economy and continue to reap the benefits of economic globalization – perhaps the most powerful trend of the 21<sup>st</sup> century.
2. As part of this trend, outsourcing will continue to increase, providing higher paying educated positions to workers in emerging markets as money flows in from U.S. corporations looking to cut costs. This inflow of capital will further drive the growing domestic consumption - another highlight of emerging market economies today – which reduces their reliance on exports to developed markets to drive their economies.
3. Overall, reform has been far outpacing close-minded traditional thinking, and serious opposition to pro-growth policies has dissipated. Even “radical” leaders, such as Luis De Silva of Brazil, have embraced pro-business policies as they recognize the benefits of growth on the standards of living of their countrymen.
4. With young and growing populations, increasingly educated and attuned to western culture through the Internet and globalization, the push towards reform should continue.
5. China’s emergence (the largest emerging market of them all) as a major consumer of a huge variety of products is yet another engine of growth for emerging markets. While China is not without worries, even if its growth slows, as it further integrates into the global economy it will provide a strong tailwind for many other emerging markets

#### But Not Eliminated ■ ■ ■ ■ ■

Despite these improvements, buying emerging market stocks is not like investing at home – or even in developed foreign markets. National and geopolitical uncertainties still remain. And while progress has been made in diversifying their economies, many still rely heavily on western consumption of their products, which makes these markets vulnerable to foreign demand shocks. Many of these economies are also very sensitive to rising oil prices, interest and exchange rate fluctuations that developed economies can weather far more easily.

#### A Smart, Calculated Risk For Growth Investors ■ ■ ■ ■ ■

However these caveats should not frighten growth-oriented investors away. While the emerging markets of the world have a distinctly subordinate relationship with the developed world this rela-

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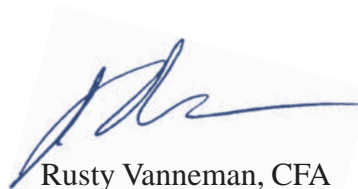
tionship is often a symbiotic one. For an investor willing to take on additional risk, the opportunity to participate in greater growth with cheaper valuations is compelling. In addition, emerging markets have a low correlation to both the U.S. market and developed foreign markets (although correlations are on the rise as emerging markets become more integrated into the global economy), so they provide excellent diversification for a portfolio.

Two last caveats are important to mention. First, given their higher risk profile, emerging markets should probably not be more than 10-15% of a growth portfolio. And lastly, given their incredibly strong run (they are up 20% this year alone) of the past few years, a near-term pull-back would not be a surprise.

Sincerely,



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