The Case for Investing in Emerging Markets

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Emerging markets, once perceived to be much riskier than developed markets and suitable only for rugged and adventurous capitalists, have now grown up and deserve a sizeable allocation in the portfolio of any long-term oriented equity investor. They should, in our opinion, no longer be treated as a satellite asset class. Investors ignoring the very strong structural growth taking place in the countries containing more than 80% of the world's inhabitants do so at their portfolio's peril.

First of all, what are emerging markets (EM)? For the purposes of this paper, we consider EM to be all the countries in the world that are not so-called 'developed' markets such as the U.S., Canada, Australia, New Zealand, Western Europe and Japan. To be sure, however, the lines are beginning to blur between developed and emerging markets. For example, as measured by purchasing power parity, China is the second largest economy in the world. And according to the International Energy Agency, China has also passed the U.S. to become the world's largest consumer of energy—yet it is still considered to be an emerging market economy.

The Growth Baton has been Passed

The bald fact for those of us in the developed world is that our economies and financial markets, while still dominant, are becoming less important with each passing day. Said another way, emerging economies are on a steep upward trajectory and will be gaining ground rapidly for the foreseeable future. For example, Deutsche Bank estimates that EM economies will have GDP growth of between 4% and 7.5% through 2012, which at the median is at least 3 percentage points higher than developed markets are likely to see. This trend will likely continue well beyond 2012.

Relative to developed markets, the investment case for EM equities right now is compelling. It is no secret that the developed world is facing huge challenges to future growth that will persist for years and for which there are no quick fixes: aging populations, high levels of consumer debt, record-high federal debts and fiscal deficits, low consumer savings rates, large under-funded entitlement programs and a Baby Boom generation that is approaching retirement without the assets needed to fund said retirement.

Contrast this situation with the investment backdrop of emerging markets, which have young and growing populations, rapid economic growth, improving physical and financial infrastructure, much lower consumer indebtedness and comparatively light debt

burdens at the federal level. Half of global gross domestic product (GDP) is produced in emerging economies and the IMF forecasted that from 2008 to 2014 Brazil, Russia, India and China would produce more than five times as much GDP *growth* (in dollar terms) as the G-7 (U.S., U.K., Japan, Germany, Canada, France and Italy).

Another reason we are bullish on EM is that the asset class remains underrepresented in the portfolios of global investors and will see a flood of investment capital over the coming decades. This increasing flow of funds will, in our view, be supportive of valuations and will make capital more available to smaller EM companies which will in turn further support the expanding EM middle classes. Goldman Sachs estimates that the EM equity allocations of investors in developed markets—currently 6%--will rise to at least 18% by 2030. In flow of funds terms, this means these investors will be putting $4 trillion into EM over the next two decades. By 2030, the Goldman authors estimate, the countries comprising EM today will have an aggregate equity market capitalization of $80 trillion, which will be 55% of total world equity value.

The oft-cited risks of emerging markets remain and should be considered carefully. Governments can be deeply involved in EM economies, corruption remains a problem, legal protections may be spotty and in many places property rights leave much to be desired. There is even still the occasional *coup d'etat*, civil war, or nationalization of a foreign company's assets. These risks, however, are typically country-specific and can be very well managed through proper diversification of one's emerging market exposure. Volatility can also be expected to remain high in emerging markets, but keeping one's equity assets in developed markets hardly guarantees a placid ride: on two occasions during the last decade alone the S&P 500 Index lost half of its value. Simply put, the relative risk of investing in EM versus developed markets has converged and will likely continue to converge as EM growth marches on.

How to Invest in Emerging Markets

Equity markets around the world are developing and investment options are multiplying, allowing investors the ability to better target specific investment themes and countries. We believe investors should consider concentrating their exposure on companies that are benefiting from the increasing strength of domestic EM consumers, not by investing in the global companies based in EM that sell into global commodity or technology markets.

One method I will not address in this paper is buying local emerging market shares on local exchanges. While for many reasons this is an excellent way to access EM, the particularities and complexities of this topic are simply too extensive to do justice to it here. Excluding this method, there are four major ways in which US. investors can access emerging markets:

1. ***Mutual funds.*** There are an ever-increasing number of mutual funds that focus on EM. As always, the prospective investor should take a careful look at fees, portfolio turnover, manager tenure and track record. We generally would not suggest a mutual fund for a taxable account, as turnover is typically high with EM

funds and an unpleasant tax bill in December should never be considered a surprise. Morningstar is a good place to begin a search of EM funds.

2. ***ETFs.*** Some of the most popular EM equity vehicles are exchange-traded funds (ETFs). ETFs trade on a stock exchange just like a stock, but they represent a basket of underlying holdings. For example, the largest ETF devoted to the emerging markets category is the iShares MSCI Emerging Markets Index Fund (NYSE: EEM). This ETF has assets of $44 billion and attempts to track the eponymous index as closely as possible. At first glance it would appear to be a good way to get broad-based EM exposure, but we believe there are better choices than EEM for tapping the true EM growth drivers.

   The major weakness of such market-cap weighted ETFs is that they have too much exposure to the large externally-focused companies in a given EM and not enough to smaller companies serving domestic consumers. Another case in point is the popular iShares MSCI Brazil Index ETF (NYSE: EWZ). This ETF will give you plenty of exposure to the global energy and raw materials markets via its large weightings in oil company Petrobras and miner Vale, but it is not heavy on exposure to small domestically-focused Brazilian companies. In our view the Market Vectors Brazil Small-Cap ETF (BRF) accomplishes this objective more completely. The bottom line is that it is very important for investors to investigate the underlying holdings of ETFs to make sure they are getting their desired exposure.

   There are a few companies to watch in the emerging markets ETF business. EGShares (www.egshares.com) has a growing array of ETFs that permit investors to more directly target the domestic economies of several EM countries. Global X Funds (www.globalxfunds.com) and Market Vectors funds (www.vaneck.com) are also worth a look.

3. ***American Depositary Receipts (ADRs).*** An ADR is a negotiable certificate issued by a U.S. bank that represents a specified number of shares of a foreign stock. ADRs are traded on U.S. exchanges. According to my search of the BNY Mellon ADR database (www.adrbnymellon.com), there are 245 emerging market ADRs traded on U.S. exchanges and another 1000 or so accessible over-the-counter (OTC). ADRs are an efficient and transparent way to invest in a particular EM company.

4. ***Companies in developed markets which are levered to growth in EM.*** A back-door method of participating in EM growth is to buy shares in a developed markets company that does lots of business in the emerging world. YUM Brands (NYSE: YUM) is a frequently mentioned (and excellent) example. This U.S.-based company is expecting to generate 34% of its operating profit from its China business in 2010, where it now owns 3,000 KFC restaurants and is planning on building 15,000 by 2030. YUM's future growth is thus much more dependent on Chinese consumers than it is on its low-growth U.S. restaurant business and its

stock may offer an effective means to participate in the improving finances of Chinese consumers.

Emerging markets have gone through lots of changes in the last decade as they have started down the capitalist path. Globally-oriented equity investors should give them serious consideration.

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