Investing in Emerging Markets RETURNS AND RISKS

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1. Features of Emerging Markets

Emerging markets can be interpreted as a set of investment opportunities, small but bustling. By combining theoretical and practical methods, we see the distribution of international stock portfolios in emerging markets may bring returns and adjust risks of long-term investment. The interest of such distribution is to increase returns of portfolios and reduce their risks by diversification.

In emerging markets, investment risks can be features which are offset by their potentially high returns. Annual returns or losses of more than 80% are not abnormal. For example, the Thai stock market's returns of 113.8% in 1993 led to losses of 86.7% in 1996 and 1997. At present, investors feel worried what will happen after the Chinese stock market's returns of 87.6% in 2003.

The practical analysis of portfolios in emerging markets faces obstacles due to inadequate historical data and data bias selection. Furthermore, economic, socio-political changes even in emerging markets have restricted the application of historical data. Therefore, theoretical and practical methods must be combined in investors' decision of proper distribution for diversification in emerging markets.

The finance market theory shows high returns will compensate high risks of emerging markets in the long run. These markets are expected to boost faster economic growth than developed ones. This will resulted to increasing internal returns and higher returns in the market. Through appropriate records, emerging markets to a certain extend bring higher returns than developed markets in Europe, Australia, and East Asia.

Both risks and investment returns in emerging markets are closely related to the success of economic development. An "emerging stock market", on the whole in a low or medium income economy, is a transit stock market which is growing in terms of size, operation or subtlety. The US was an emerging market during the nineteenth century. When it developed into a power in the twentieth century, it generated higher returns among the most developed markets.

Nevertheless, emerging markets are not all successful from their starting point of less development. The history shows previous emerging markets including Japan and the US – succeeded while others, such as Argentina and Brazil, reaped less fruits. For example, in 1970, Brazil's per capita GDP was equal to that of Japan.

However, in 1998, Japan's per capita GDP was 3.5 times that of Brazil. Similarly, in 1913, Argentina reached higher per capita GDP than Germany and France, and became a developed market. Recently, Argentina is an emerging market with per capita GDP which is only half of Germany.

Emerging markets are characterized by diversity, volatility, rapid economic growth and frequently, immature institutions. The Morgan Stanley Capital International Emerging Markets Index (MSCI EMF), one possible proxy for the asset class, currently contains 730 securities in 26 countries with an aggregate capitalization of US$1.1 trillion. Countries run the gamut from Taiwan and Korea, with per capita incomes well in excess of US$10,000, to Sri Lanka where per capita income is below US$1,000.

The first in strategic case for investing in emerging markets is diversification. As one would expect, as countries remove capital controls and increase trade openness, the correlation of emerging markets has gradually increased to about 0.75 with US equities. But, despite their volatility, by adding emerging markets to their portfolio, investors can create more efficient portfolios. The second reason for investing in emerging markets has to do with return enhancement. Over the past 15 years, emerging market equities have outperformed global equities by nearly 400 basis points per annum. Each year, one emerging market is frequently the best performing market in the world. Asia, led by China, is and will likely continue to be the world's most rapidly growing region. Output in China is growing at roughly 8% per annum; China represents a favorable shock to both global demand and supply.

Given faster economic growth in emerging markets relative to developed markets, plan sponsors often posit a long term 1-2% return premium (relative to developed market equities) for emerging market equities. Certainly emerging markets can have large runs: For example, over the past two years they have returned a cumulative 85%.

It is sometimes said that it is companies, not markets, that emerge. Gazprom is a Russian company that earns nearly US$6 billion a year and supplies roughly 20% of Germany's natural gas reserves. Its natural gas reserves are among the largest in the world.

In emerging market, there are "asset plays", growth stories and restructuring plays, among others. Many companies in emerging markets have absolute advantages, either in terms of labor costs or raw materials. By including emerging markets in the opportunity set, investors can access some world class companies, such as Samsung and Infosys.

Currently emerging markets sell at about 10 times forward earnings, a sharp discount to the forward earnings multiple of developed markets. It was believed that the outlook for global economic activity in 2005 was strong. And Asian currencies are likely to continue to appreciate over time. While it is unrealistic to expect returns from emerging markets like the last two years, emerging markets are attractively valued in a global context.

Several themes will characterize emerging markets investing in the decade ahead. These include the rise of China as a global manufacturing center, the growth of inter Asian trade, the emergence of Russja as major energy supplier, the enlargement of the EU, outsourcing, and the wiring of the emerging world, to name a few. Most investors continue to be underweight in non-US equities and, in particular, emerging markets. Political and other risks in emerging markets are substantial, and investors should carefully limit their allocations. But adding emerging markets to a portfolio can both increase return and diversify risk.

Table 1: Annual risks and returns in emerging markets and developed markets

		Annual average rate of returns (%)	Volatility (%)
From 1985 to 2003	Emerging markets	14.82	23.78
	The US	13.89	15.97
	AEF	11.90	18.14
"Reviewing" period: 1975-1984	Emerging markets	15.73	15.35
	The US	12.68	13.72
	AEF	14.85	15.18
Before liberalization: 1985-1990	Emerging markets	26.87	25.04
	The US	16.45	17.54
	AEF	24.27	21.92
Initial liberalization: 1991-1996	Emerging markets	15.49	18.45
	The US	18.11	10.15
	AEF	9.11	15.15
Recent period: 1997-2003	Emerging markets	3.51	26.51
	The US	7.86	18.57
	AEF	3.39	16.52

(Source: SGP Emerging market Data Base and Thomson Financial Datastream)
AEF: Australia, Europe, and Far East

2. Diversification to Hedge Risks

Success or failure of economic growth in the long run is affected by a set of complicated factors. The theory explains the gap in economic development of countries is due to difference in geography, climate, or ecology as well as their socio-political system.

Developed economies generate high absolute returns in long-term stocks. This is rarely achieved in shrinking stock markets with their shortcomings of foreign exchange rate, banking system, and political stability. Although developing economies are expected to grow higher than developed ones, it cannot be forecast that which is dominating and returning investment capital for investors' risks. As a result, investors have to diversify their portfolio in emerging markets.

There is a wide range for emerging markets to attain. In December 2002, the capitalization ratio in GDP of low-medium income countries (rated by per capita income) was 20.5% as compared to 68.6% in the US. Nevertheless, investors in emerging markets often encounter unexpected risks. These following unexpected risks can place barriers to portfolios in emerging markets.

- Political risks: the factors such as wars, civil wars and ethnic conflicts cause political chaos in a nation; therefore, they may badly affect a company's total sales and returns in the market.

- Economic risks: Mistakes in policies and economic reforms may pose challenges to companies.

- Regulated and effective environment: The quality of market regulation, transparency and payment standards of emerging markets are often lower than developed ones. These factors cause more difficulties in securing appropriate prices and thus increase risks of underestimation.

- Limitations over investment: In December 2002, international investors could invest only 49.5% of total capitalization values of emerging markets. Foreign investors also met limitations over their companies or total negotiable shares. Malaysian government, for example, presented a tax rate of 10% on investment return in order to prevent investors from selling after the Asian financial crisis in 1996-1997 (this rate has been applied since 2001).

- High technology/ corporate concentration: In emerging markets, most of stock market capitalization may be concentrated on a special technology or several specific corporations. In China, on December 31, 2003 top ten stocks accounted for 68.6% of total market capitalization and corporations exploiting natural resources 35% of the value.

Market capitalization, often abbreviated to market cap, is a measurement of corporate size that refers to the current stock price times the number of outstanding shares. This measure differs from equity value to the extent that a firm has outstanding stock options or other securities convertible to common shares. The size and growth of a firm's market capitalization is often one of the critical measurements of a public company's success or failure. However, market capitalization may increase or decrease for reasons unrelated to performance such as acquisitions, divestitures and stock repurchases.

Market capitalization is the number of common shares multiplied by the current price of those shares. The term capitalization is sometimes used as a synonym of market capitalization; more often, it denotes the total amount of funds used to finance a firm's balance sheet and is calculated as market capitalization plus debt (book or market value) plus preferred stock.

The total market capitalization of all the companies listed on the New York Stock Exchange is greater than the amount of money in the United States . The global market capitalization for all stock markets was US$43.6 trillion in March 2006.

The diversification in emerging markets is seen as one of measures to reduce above-mentioned risks significantly.

According to Standard & Poor (S&P), Morgan Stanley Capital International (MSCI) and Thomson Financial Datastream (TFD), indexes of emerging markets measured by market capitalization has pointed out some troubles in assessment of emerging markets:

- Asymmetric differences between corporations from various countries may make them focus their operations on some specific countries.

- Strict limitations of foreign investment applied by several countries may lower their investable indexes. They are compared only with local ones. Investable emerging markets indexes mention only appropriate stocks negotiated by foreign investors in market capitalization.

The joining or withdrawing of several countries may change the measurement index significantly at the time of transaction.

- High volatility of emerging markets may cause high concentration on certain regions or nations and reduce diversification. It can also produce harmful effects on portfolio realization when a potential nation revokes its investment strongly. This is a feature of emerging markets.

Based on theoretical and practical analysis, the distribution ratio of hedging portfolio of international investors can improve returns and adjust risks. Nevertheless, the recommendation suggests investors should distribute their funds to emerging markets to avoid absolute risks ■

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