



AGILE INVESTING Exchange Traded Funds: A Better way to Invest

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## **Emerging Markets Rebounding**

*By J.D. Steinhilber*

Which equity index offers a price/earnings ratio of 14x, a dividend yield of 2.6%, and annualized earnings growth over the past five years of 12%? The answer will come as a surprise to many investors. The MSCI Emerging Markets Free (EMF) Index, the best-known international benchmark for emerging markets, offers these enticing characteristics, and thanks to Barclays, investors can purchase an exchange-traded fund that tracks the index.

The *iShares MSCI Emerging Markets Index Fund*, which trades under the symbol EEM, was launched April 7, 2003. Barclays couldn't have picked a better time to introduce this ETF. From inception through the end of August, the fund has appreciated 35%, as emerging markets have been among the best performing equity asset classes in the global stock market rally that began in March.

Aside from its strong performance, the iShares emerging markets fund has tracked the MSCI EMF Index with a high degree of accuracy. After five months of trading history, the cumulative tracking error between the fund's NAV and the MSCI EMF Index is approximately 1.5%. At no point has the tracking error, or difference in percentage returns, exceeded 2.5%. This negligible tracking error is impressive given that the MSCI EMF Index is comprised of 676 securities from 26 countries (data as of March 31, 2003). As with its other iShares ETFs, Barclays uses a representative sampling strategy to approximate index performance. At 6/30/03, the iShares emerging markets fund held 229 securities. Reflecting the composition of the MSCI EMF Index, over 50% of the fund's assets were invested in five countries - South Korea, Taiwan, South Africa, Mexico and Brazil.

The iShares emerging markets fund has attracted an impressive amount of assets in its short history. With total assets of \$298 million as of 08/29/03, it is already larger than Barclays' seven other emerging markets ETFs, which track individual country or regional indexes.

Given that the iShares emerging markets fund seems to be living up to its billing, it is worth considering whether emerging markets is an asset class that is well-suited to an indexed investment approach. A widely held view in the "active versus passive" investment management debate is that indexing may not be as advantageous in less "efficient" asset classes, such as, perhaps, emerging markets equities. There is a certain amount of logic to the argument that the high degree of market efficiency found, for

example, in large-cap U.S. stocks may not exist in the securities markets of countries such as Russia and India.

However, while active managers may be more likely to uncover “mispriced” securities in emerging markets, they are also burdened by transaction costs that are substantially higher than in developed markets. Less liquid securities markets in emerging countries create wider bid-ask spreads and greater “market-impact costs.” (Market-impact costs reflect the difficulty an institutional investor faces buying or selling a block of stock without moving the market). It may be that these higher operational and trading costs offset any advantage active emerging markets money managers may gain from price inefficiencies.

Recent data suggest that for emerging markets, as in other asset classes, the index presents a formidable performance benchmark. As of July 31, 2003, Morningstar’s database contained 172 emerging markets funds having a minimum one year history. Eliminating duplications caused by multiple share classes for the same fund, the more meaningful number of active emerging markets funds with a minimum one year history is 58. Of this universe, 27 funds (46.5%) outperformed the MSCI EMF Index and 31 funds (53.5%) underperformed. As is always the case in evaluating active mutual funds, the difficulty lies in identifying outperforming funds in advance.

Notwithstanding strong year-to-date returns, the outlook for emerging markets remains positive in light of the following considerations:

- Emerging markets equities have dramatically underperformed domestic equities over the past ten years. Through 7/31/03, the 10-year annualized return of the MSCI EMF Index was -0.3% versus 10.3% for the S&P 500 and 10.9% for the S&P SmallCap 600.
- As of 8/31/03, the P/E ratio on the S&P 500 was roughly 20x, based on operating earnings for the four quarters ended 6/30/03. In contrast, the comparable P/E ratio for the MSCI EMF Index was approximately 14x, implying that emerging markets stocks are trading at a 30% P/E discount relative to the S&P 500.
- The countries that comprise the MSCI EMF Index collectively account for 20% of worldwide GDP, and these economies on average are experiencing GDP growth roughly twice that of the developed economies.
- When emerging markets experience bull markets, the gains are stout. This is to be expected given the higher volatility – measured by standard deviation – of this asset class. Emerging markets gained over 70% in both 1993 and 1999, the two best years for the asset class over the past decade.

09/02/2003

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