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## The Outlook For Emerging Markets Stocks

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Emerging markets stocks have been the premier asset class over the past five years, producing an annualized return of 33.8%, as measured by the MSCI EM Index. This equates to a 330% cumulative return, versus a 66% total return for the S&P 500 and a 138% total return for foreign developed markets stocks, as measured by the MSCI EAFE Index (see Exhibit 1).

Emerging markets stocks have demonstrated their diversification benefits as well. In the past year, as the U.S. economy has fallen into recession due to the credit and real estate busts and oil price shock, emerging economies and stock markets have powered ahead. In the past 12 months, the emerging markets index has delivered a total return of 21.9%, while developed markets indexes have produced losses, and the EM index has had a relatively low 0.65 correlation with the S&P 500.

**Exhibit 1**

	U.S. Stocks S&P 500	Foreign Developed Markets Stocks MSCI EAFE	Foreign Emerging Markets Stocks MSCI EM
Index Performance through 5/29/08:			
1 Year	-6.0%	-2.6%	21.9%
5 Year Annualized	10.1%	19.0%	33.8%
5 Year Cumulative	65.5%	138.4%	329.5%

Given the spectacular returns that emerging markets stocks have generated over the past five years, and the heightened risks confronting global financial markets, investors have a number of questions to contemplate:

1. Have emerging markets stocks become an overvalued asset class?
2. What are the return prospects for emerging markets stocks over the next five years?
3. What is the right allocation to emerging markets stocks in a global equity portfolio?
4. How can an investor manage risk in this volatile equity asset class?
5. What are the most attractive ETFs on the market today for investing in emerging markets stocks?

### Have Emerging Markets Stocks Become An Overvalued Asset Class?

The valuation of emerging markets stocks has definitely increased over the past five years, but not to the degree that one might expect given the huge appreciation in stock prices (see Exhibit 2). The increase in valuations has been held in check by the rapid earnings growth for emerging markets stocks, which has exceeded 20% per annum.

**Exhibit 2**

	Current Valuations		Valuations 3 Yrs Ago		Valuations 5 Yrs Ago	
	Price/ Earnings	Price/ Book	Price/ Earnings	Price/ Book	Price/ Earnings	Price/ Book
U.S. Stocks (S&P 500)	20.0	2.9	19.5	2.9	30.1	2.9
Foreign Developed Mkts Stocks (MSCI EAFE)	12.2	1.8	16.4	2.1	25.1	1.8
<b>Emerging Markets Stocks (MSCI EM)</b>	<b>15.0</b>	<b>2.5</b>	<b>12.3</b>	<b>2.0</b>	<b>12.8</b>	<b>1.6</b>

Prior to the bull run of the past five years, the price-to-earnings (P/E) multiple of emerging markets stocks historically averaged approximately 75% of the P/E multiple of developed markets stocks (including the U.S.), and the price-to-book multiple averaged 67% that of developed markets. Over this period (1985-2002), whenever emerging markets valuations moved to parity or to a premium to developed markets valuations, it was a signal to reduce exposure or avoid the asset class. The traditional attitude towards emerging markets stocks was that they warranted a discounted valuation because of their greater risk characteristics, their dependence on export activity rather than domestic demand, and their propensity to suffer political and economic crises.

Today, emerging markets stocks are valued at a significant premium to foreign developed markets stocks and a modest discount to U.S. stocks (see Exhibit 2). The current 20x P/E multiple of the S&P 500 is somewhat misleading because of the heavy write-downs that U.S. financial firms have taken in recent quarters. On the basis of calendar 2008 estimated earnings, the P/E multiples of the S&P 500 and the emerging markets index are much closer, at 15.7x, and 13.9x, respectively.

In light of the richer valuations now placed on emerging markets stocks, should investors be reducing their allocations to the asset class or perhaps concentrate their international stock exposure in foreign developed markets stocks where valuations seem relatively cheap?

### **The Case For Higher Allocations**

Several factors seem to argue in favor of maintaining commitments to emerging markets and perhaps looking instead to enlarge exposure to the asset class when opportunities present themselves. The leading factors include:

1. Globalization
2. The spread of prosperity on an unprecedented scale within developing economies
3. The transition from a long-term bear market to a long-term bull market in natural resources

Emerging markets have undergone such a dramatic transformation this decade that they bear little resemblance to their condition in the 1980s and 1990s. Financially, emerging economies have become creditors in the global economy, collectively amassing huge annual current account surpluses and controlling three-quarters of the world's foreign exchange reserves. The currency devaluations and debt defaults that plagued emerging economies in the 1990s seem like a very distant memory. Today, emerging markets are earning investment-grade ratings and their currencies are appreciating, or in the case of pegged currency regimes, viewed as significantly undervalued.

Given that the risk profile of emerging economies has improved so dramatically, it seems incongruous to apply old valuation parameters to the asset class. When the current valuation of emerging markets stocks are viewed in light of their superior growth prospects, it is hard to make the case that the asset class is overvalued. Instead, it is likely that a re-rating has occurred as a result of profoundly altered fundamentals.

### **What Are The Return Prospects For Emerging Markets Stocks Over The Next Five Years?**

The returns on emerging markets stock indexes in the next five years will almost certainly be significantly below the extraordinary returns of the last five years. Emerging markets stocks were extremely cheap five years ago on a relative and absolute basis. Moreover, the pace of globalization and natural resource utilization that has occurred in the past five years is likely to moderate in the next five years, which will slow the growth of emerging markets somewhat.

Nonetheless, emerging markets growth is likely to exceed growth in developed economies by a substantial margin. The International Monetary Fund estimates that the developing world will grow at an average rate of 6.8% per year for the next five years, versus 2.7% for developed economies. Global companies based in developed countries such as the U.S. will capitalize on the growth of developing economies, but companies domiciled in emerging markets stand to benefit disproportionately. In addition to stronger earnings growth, emerging markets stocks should continue to benefit from rising relative valuations. It seems reasonable to expect the valuations placed on emerging markets will expand further relative to U.S. valuations over the next five years as investors seek out the best investments for capital growth and inflation protection and allocate an increasing percentage of their portfolios to emerging markets stocks.

In short, expect emerging markets stocks over the next five years to enjoy the same tailwinds they have enjoyed the past five years - namely, faster earnings growth and increasing relative valuations. This will equate to superior investment returns versus U.S. stocks. In U.S. dollar terms, emerging markets will also likely outperform foreign developed markets stocks as a group, even though the latter asset class currently enjoys relatively cheap valuations. The U.S. dollar has suffered a historic bear market against developed markets currencies and may be entering a bottoming process, which would cause currency translation to be a headwind to unhedged foreign developed markets' stock investments over the next five years. In contrast, emerging markets currencies as a group are widely viewed to be undervalued.

### **What Is The Correct Allocation To Emerging Markets Stocks In A Diversified Global Equity Portfolio?**

Opinions vary tremendously on the topic of how much of an equity portfolio a U.S. investor should allocate overseas. At one extreme is the argument that equity risk is equity risk, especially in a globalized world of multinational corporations and rising global stock correlations, and U.S. investors should have a strong "home bias" since they live in the U.S. and most likely will spend their assets in the U.S. At the other extreme is the view that the U.S. and its currency are in a long-term decline and returns will be far superior on overseas investments.

Ibbotson Associates, a leading asset allocation research firm, recommends that a U.S. individual investor seeking long-term capital growth allocate two-thirds of an equity portfolio to U.S. stocks and one-third to foreign stocks, with 6% of the total equity allocation invested in emerging markets stocks. Indexing specialist Vanguard recommends that between 20% and 40% of an equity portfolio be allocated to foreign stocks.

In addition to deciding how much of an equity portfolio to allocate to foreign stocks, broadly defined, an investor should determine how to divide overseas stock investments between foreign developed and emerging markets stocks. Given that emerging economies are home to 85% of the world's population and 75% of the world's natural resources, and account for 30% of global GDP, emerging markets stocks clearly deserve a healthy representation in a global portfolio.

One frame of reference to determine how much of an equity portfolio to allocate overseas, and to emerging markets stocks in particular, is to examine the composition of global equity indexes (see Exhibit 3). The difference between the composition of the world's total market capitalization and its investable market capitalization is striking. Investable market capitalization (also known as "free float"), which forms the basis for the most widely used market indexes, is the portion of total market capitalization that is freely tradable by investors. It excludes (1) shares held by governments and associated companies and (2) restricted shares held by company insiders. In developed stock markets, investable market capitalization represents 81% of total market capitalization, but in emerging markets the figure is only 38%. Even though market indexes are based on investable market capitalization, total market capitalization is a more accurate measure of economic significance. The data in Exhibit 3 suggest that the average U.S. investor, who typically has the majority of his equity portfolio in U.S. stocks, is underexposed to foreign stocks, and a growth-oriented U.S. investor with a tolerance for volatility should probably allocate 10-20% of an equity portfolio to emerging markets stocks.

<b>Exhibit 3: Distribution of Global Stock Market Capitalization</b>						
<b>Region</b>	<b># of Companies</b>	<b>Total Market Capitalization</b>		<b>Investable Market Capitalization</b>		
		<b>\$USD</b>	<b>% Weight</b>	<b>\$USD</b>	<b>% Weight</b>	
North America	3,811	\$ 18,369,735	37%	\$ 16,262,861	45%	
Europe	2,234	13,925,370	28%	10,672,212	29%	
Pan Asia	4,319	13,401,334	27%	7,243,669	20%	
Latin America	320	2,088,060	4%	994,494	3%	
European Emerging	253	1,613,463	3%	638,469	2%	
Mid-East and Africa	338	848,171	2%	480,532	1%	
<b>Global Index</b>	<b>11,275</b>	<b>\$ 50,246,133</b>	<b>100%</b>	<b>\$ 36,292,237</b>	<b>100%</b>	
Emerging Markets	2,341	10,355,713	21%	3,890,617	11%	
Developed Markets	8,934	39,890,420	79%	32,401,620	89%	
United States	3,262	16,606,978	33%	14,842,746	41%	
Global Ex-U.S.	8,013	33,639,155	67%	21,449,491	59%	

Source: S&P/Citigroup Broad Market Indexes (BMI) as of 4/30/08

### How Can An Investor Manage Risk In The Emerging Markets Asset Class?

The case for committing a significant share of an equity portfolio to emerging markets is compelling, but how does an investor seeking to increase exposure to the asset class manage risk given that emerging markets stock indexes are over 40% more volatile than the S&P 500, and emerging markets stocks may be at a cyclical high point and poised for a sharp correction?

Emerging economies are confronted with an even greater inflation problem than in the U.S. and will likely have to tighten monetary policy to restrain inflation, which in many countries is running at double-digit rates. The best way to manage price risk is to build a core position over time, making a conscious effort to increase commitments when corrections take place. Using periodic price weakness to accumulate exposure is a strategy that would have worked well over the past five years. In the course of that overall uptrend, emerging markets suffered five separate corrections of at least 10% percent and two declines in excess of 20%.

### What Are The Most Attractive ETFs For Investing In Emerging Markets Stocks?

ETFs and index funds are an attractive, low-cost way for investors to gain exposure to emerging markets. The argument is made that emerging markets are not as suitable for indexed investments because emerging markets are less "efficient" with respect to information and security pricing and "active" managers are more likely to outperform. That argument contradicts a basic premise of capitalization-weighted indexing (i.e., after investment costs, the average actively managed dollar by definition underperforms the index) and is not supported by the data, which show that approximately two-thirds of actively managed emerging markets mutual funds have underperformed their benchmarks on both a trailing five- and ten-year basis.

Today there are dozens of ETFs providing exposure to emerging markets. There are broad-based funds covering the whole asset class, regionally focused funds, and country-specific funds. There are funds based on (1) traditional, float-adjusted, capitalization-weighted indexes, and (2) alternative indexes based on "fundamentals" such as dividends, earnings, sales, and book value.

Exhibit 4 presents three broad-based emerging markets ETFs that are attractive for different reasons.

**Exhibit 4**

	<b>Vanguard Emerging Markets</b>	<b>PowerShares FTSE/RAFI Emerging Markets</b>	<b>WisdomTree Emerging Markets High Yielding Equity</b>
Fund Symbol	VWO	PXH	DEM
Fund Inception Date	3/04/05	9/27/07	7/13/2007
Fund Assets (5/29/08)	\$7.1 Bil	\$87 Mil	\$230 million
Expense Ratio	0.25%	0.85%	0.63%
# of Fund Holdings (5/29/08)	964	163	194
% Allocation to top 10 holdings	18%	43%	34%
Index Performance as of 3/31/08:			
1 Year	21.7%	27.4%	28.3%
3 Year	29.6%	35.6%	30.3%
5 Year	36.0%	45.9%	39.4%
Country Weights:			
Highest Weighting (%)	Brazil (15.7%)	China (18.0%)	Taiwan (28.1%)
2nd Highest Weighting (%)	Korea (13.7%)	Korea (16.7%)	Brazil (17.0%)
3rd Highest Weighting (%)	China (12.2%)	Brazil (16.0%)	Korea (8.2%)
4th Highest Weighting (%)	Taiwan (11.4%)	Taiwan (15.0%)	South Africa (7.5%)
Fund Dividend Yield (approx)	2.00%	1.40%	5.10%

The Vanguard Emerging Markets ETF (symbol: VWO) is attractive for its 0.25% expense ratio—lowest of any emerging markets fund—and its broad diversification (964 holdings).

Though the fund is expensively priced at 0.85%, the PowerShares FTSE/RAFI Emerging Markets ETF (symbol: PXH) will be interesting to watch to see if it can replicate in real life the impressive backtested results of its underlying index. The creator of that index, Research Affiliates, run by investment guru Rob Arnott, believes that their "fundamental" approach to indexing produces more "alpha" (i.e., outperformance vs. a cap-weighted index) in emerging markets stocks than in any other asset class.

Lastly, the WisdomTree Emerging Markets High Yielding ETF (symbol: DEM), which is screened and weighted on the basis of dividends, is attractive for its high dividend yield of 5.1% and the solid backtested performance history of its underlying index.

Each of these vehicles, used in isolation or in combination, will likely prove to be an effective means of investing in emerging markets stocks, whose prospects over the next five years appear bright, just not as bright as the past five years.

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