Another Look at Emerging Markets

Eric Nelson, Equius Partners

In August 2006, Jeff wrote a controversial Asset Class article titled “Submerging Markets” that questioned the benefits of emerging markets in an asset class portfolio. Despite their popularity at the time (based on strong recent returns), Jeff asked: “Should we continue to invest in emerging market stocks? When you consider their extreme volatility, their increased correlation to the U.S. market, the unique risks associated with developing countries (social, political, financial, legal, etc.), and the fact that we have a very good alternative in small value stocks of developed countries, my inclination is to say no.”

Many clients took our research and guidance to heart and together we decided that a separate allocation to emerging market stocks was not a necessary ingredient to their portfolios’ long-term success. But some clients maintained their allocations and emerging markets stocks have dominated the headlines again this year. So we believe another look at emerging markets is appropriate.

Economic Growth and Stock Returns

The centerpiece of our asset allocation decisions has always been the Fama/French 3-Factor Model, which outlines the higher risks and higher expected returns of stocks vs. bonds, small stocks vs. large stocks, and value stocks vs. growth stocks when applied to the developed country markets. We also diversified into emerging markets, expecting higher returns than developed market stocks because emerging countries tend to have higher economic growth rates and a higher cost-of-capital (both of which would lead one to expect a higher return on capital over time).

But further analysis reveals something quite different from our expectations. The high rate of growth in emerging market economies has already boosted these countries’ current stock prices. The hope for even higher equity values in the future attracts new companies to the market while existing firms rush to issue more and more new shares to finance future activities. This divides profits across a greater number of companies and outstanding shares, thereby reducing the amount available per share for existing owners. This year alone, almost 70% of initial public offering values have originated in emerging markets, even though those markets represent only about 12% of the world’s total stock market wealth.

The most definitive study on the relationship between investment returns and economic growth came from three academics at the London Business School earlier this decade. Dimson, Marsh, and Staunton looked at 17 different countries over 100 years, shown in Chart 1, and concluded that stock markets of the slowest growing economies outperformed the markets of the fastest growing economies.
After realizing the flaws in the economic growth argument, we are left with the hope for higher emerging market returns based on greater risk. After all, risk and return are generally related. But not all risks are worth taking and in our view emerging markets represent one of those risks.

Emerging Markets and Downside Risk
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It is one thing to take business and economic risk in developed countries by investing in smaller cap and value-oriented stocks. But emerging markets are an entirely separate case, regularly experiencing currency crises, market closures and unexpected constraints on foreign investor capital, as well as severe political turmoil. This translates into much higher asset class volatility, a side effect that increases our portfolio risk at every allocation level.

The downside risk of emerging markets is especially severe, with dramatic declines each time our own market heads south. The first section of Table 1 shows the down years for the S&P 500 index since 1988 and the corresponding performance of U.S. and international small value and emerging markets stocks. Emerging markets did worse on average than the S&P 500 and substantially worse than small value stocks. Given their higher risk, investors should expect this. But too often the “low correlation to U.S. stocks” feature of emerging markets is touted by the financial press, creating false expectations and investor disappointment. Maybe they’re looking at the second section of the table showing emerging markets moving opposite of U.S. stocks. Is this the kind of diversification “benefit” investors really desire: bad performance when U.S. stock prices rise and fall sharply?

Dr. Jekyll and Mr. Hyde Markets
Unlike developed countries, we only have about 20 years of reliable securities data on emerging markets. It’s a leap of faith to make long-range plans based on risk/return characteristics using such a short data series (we have over 80 years of high quality research on the U.S. markets, for example). Our confidence is further challenged by the quality of data coming out of the emerging countries. But the one thing that really triggers our skepticism is the difference in performance of emerging markets before and after they became viable investments.

Table 1: Why Emerging Markets?

<table>
<thead>
<tr>
<th>Year</th>
<th>S&amp;P 500 Index</th>
<th>U.S. Small Value Index</th>
<th>Int’l Small Value Stocks</th>
<th>Emerging Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>-3.1</td>
<td>-27.3</td>
<td>-17.1</td>
<td>-7.7</td>
</tr>
<tr>
<td>2000</td>
<td>-9.1</td>
<td>15.7</td>
<td>-2.0</td>
<td>-30.4</td>
</tr>
<tr>
<td>2001</td>
<td>-11.9</td>
<td>27.0</td>
<td>-6.5</td>
<td>-3.6</td>
</tr>
<tr>
<td>2008</td>
<td>-37.0</td>
<td>-41.7</td>
<td>-42.5</td>
<td>-52.7</td>
</tr>
<tr>
<td>Average</td>
<td>-16.6</td>
<td>-8.0</td>
<td>-12.9</td>
<td>-20.8</td>
</tr>
</tbody>
</table>

Other Down Years for Emerging Markets since 1988

<table>
<thead>
<tr>
<th>Year</th>
<th>S&amp;P 500 Index</th>
<th>U.S. Small Value Index</th>
<th>Int’l Small Value Stocks</th>
<th>Emerging Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>1.3</td>
<td>2.3</td>
<td>9.2</td>
<td>-6.4</td>
</tr>
<tr>
<td>1995</td>
<td>37.6</td>
<td>32.4</td>
<td>4.0</td>
<td>-1.0</td>
</tr>
<tr>
<td>1997</td>
<td>33.4</td>
<td>35.0</td>
<td>-15.1</td>
<td>-24.3</td>
</tr>
<tr>
<td>1998</td>
<td>28.6</td>
<td>-5.8</td>
<td>9.7</td>
<td>-3.3</td>
</tr>
<tr>
<td>Average</td>
<td>25.2</td>
<td>16.0</td>
<td>2.0</td>
<td>-8.8</td>
</tr>
</tbody>
</table>

Past performance is not a guarantee of future returns. Indices are not available for direct investment. Investors should read fund prospectuses carefully before investing.

Of the roughly 150 surviving emerging market funds in the Morningstar mutual fund database today, only 10 were available prior to 1994 and 6 of those were launched in 1993. Both Vanguard and DFA introduced their emerging markets index funds in 1994. So let’s divide the data series between 1988-1993 and 1994-2008 to see what the results were. Chart 2 on the next page shows the first period when emerging markets were on a tear, up 45% per year for those first six years! That return came with much volatility, but compared to the S&P 500 and U.S. and international small value stocks, the risk certainly looks worth taking.

Now, our anti-Wall Street bias might lead us to believe that these numbers were somehow manufactured by Morgan Stanley or others prior to the launch of the first real emerging markets “products.” After all, performance sells. Our skepticism is further validated, however, by the fact that the starting point of 1988...
suffers from severe sample selection bias by ignoring significant crises in Brazil, Mexico, Argentina, and Chile, as well as South Korea and Thailand in the preceding 10 years that resulted in debilitating stock market crashes.

But setting aside our skepticism for a moment, let’s look at Chart 3. Alas, what we see is a much different story. The relative outperformance of emerging markets has disappeared, and only the higher risk has remained. Not only have emerging markets underperformed developed country small value stocks since the beginning of 1994, they have even trailed the S&P 500! Maybe, just maybe, our skepticism is warranted.

Our primary alternative to emerging markets is international small value stocks, which have delivered much more consistent returns over time. Because small value stocks in all developed countries tend to have similar risk, we would expect to see similar returns. And if we look back to 1982 (the longest period for all regions of international small value stocks), that is exactly what we’ve seen—both U.S. and international small value stocks have compounded at exactly +13.7% per year.

An Emerging Roach Motel

Proponents of emerging markets tend to ignore returns since 1994 and instead look to the emerging markets “resurgence” since the turn of the century. Indeed, while U.S. markets have struggled since 2000, emerging markets have reversed course. DFA’s equally-weighted emerging markets index has generated a handsome 8.0% annual return through June of this year. But even during this resurgence, U.S. small value stocks have returned 8.3% and international small value stocks have returned 10.2% per year, both with less risk.

Worse yet, recent returns of emerging markets stocks have been fueled by “hot” money (speculative rather than investment dollars), pushing up valuations well beyond those of developed markets. Normally, riskier areas like emerging markets and value stocks should trade at a discount to safer large growth companies in developed countries. But at a price-to-book value of over 2.2 (based on the DFA Emerging Markets Fund), emerging markets have surpassed even the safest blue chip U.S. stocks in terms of valuation, now trading at levels two to three times higher than developed country small value stocks.

Unfortunately, unlike the “self purge” mechanism of small value stock funds that sell companies with rising stock prices (after becoming larger or more growth-oriented) and reinvest the proceeds in lower priced and smaller companies, emerging markets funds behave more like a “roach motel”—stocks check in, but they never check out. The main criteria to gain entrance to the DFA Emerging Markets Fund (or the Vanguard Emerging Market Index, for that matter) is simply location. As long as you are headquartered in an emerging country you are in the fund on a permanent basis, regardless of price. Well, not “permanent,” since you will get kicked out if you go bankrupt. This is how technology and REIT funds work as well, and you know how that has turned out.

We can no longer make a case for including emerging markets in a portfolio. A realistic longer term view reveals a very disappointing return history coupled with significant and unique risks. More recently, hot money has taken hold of emerging markets and they now represent the highest-priced asset class around. With a far superior alternative in U.S. and international small value stocks, we have made the decision to remove emerging markets from our portfolios.

1London Business School/ABN AMRO Global Investment Returns Yearbook 2005, a long-run study covering 105 years of investment since 1900 in all the main asset categories in Australia, Belgium, Canada, Denmark, France, Germany, Ireland, Italy, Japan, the Netherlands, Norway, South Africa, Spain, Sweden, Switzerland, the United Kingdom, and the United States. These markets today make up over 92% of world equity market capitalization.
An Antidote for Uncertainty

Phil Jonckheer, Equius Partners

The last twelve months have offered a dramatic illustration of uncertainty, subjecting us to extraordinarily volatile markets and economic declines throughout the world. These extraordinary fluctuations naturally sent investors' emotions on equally wild swings, rendering the uncertainty ever more unsettling. To compound the uncertainty, now governments have responded to the crises by becoming much more involved in the free flow of capital, goods and services as they attempt to find solutions by further regulating their economies.

Despite this uncertainty and change, since March of this year asset class returns have registered their best six-month performance in 80 years. Yet the budding feelings of ease that might be developing could easily be disrupted if we listen to those who profess that another economic and/or market decline will occur again. Since this period is no different from any other as far as the ability to know what lies ahead, how can we continue to maintain our balance in the face of constant uncertainty and prepare ourselves for the future, good or bad? What might we learn from those who appear to be more consistently settled and happier than average?

The Danes consistently rank at the top of studies on self-reported happiness. This is in part related to the facts that Denmark is one of the freer economies in the world, is considered to have the freest financial market by the Organization for Economic Co-operation and Development (OECD), and has a populace that strongly supports free trade. But I think there is another reason for the Danes' happiness: they typically are resigned to the fact that the future is uncertain and could include a difficult patch. Ask Danes how they're doing and they usually reply, "It could be worse." Danes don't try to control what's bad; they accept things the way they are. I don't view this as pessimism so much as a way of relating to one's world that allows one to accept uncertainty instead of fearing it.

Daniel Gilbert, who wrote the book Stumbling on Happiness, offers another perspective on this concept of control in that he observed that what we don't know makes us nervous. More specifically, he reports that people actually feel worse when they sense that something bad might occur than when they know that something bad will occur. In other words, what makes investors nervous is not the thought that the markets will fall again but rather that they don't know what precise direction the markets will take. The Danes, happy in their content state with their attitude that tougher times are inevitable, are well aware of this.

In light of these insights it strikes me that our asset class approach resembles the attitudes of the Danes. Like them, we at Equius are not pessimistic, but we expect downturns to occur. They are a natural part of the cycle that defines market risk. We acknowledge and embrace the risks of the markets and the uncertainty that risk causes. Volatility (the ups and downs of the market) in general and the downside of risk in particular are what investors must accept if they expect to benefit from the positive returns that markets will deliver over time. Last year's wrenching market (the worse year for stocks since 1931) graphically portrayed the downside of risk. The greater the volatility and the deeper these downturns, the higher the future expected return as compensation for the higher perceived risk. The dramatic increase in asset class returns of 55% to 100% since March of this year is a vivid example of the positive side of the cycle of risk. Those returns would not be as positive if the 2008 decline had been less severe.

We also are fully aware that market timing puts one in a constantly uncomfortable position. When, in what direction, and by how much will markets move before changing direction again? As we've witnessed since March (and outlined, coincidently, in the February Asset Class about prior major declines), these kinds of markets tend to recover very strongly and very quickly. Panic selling and then missing the recovery can lead to a very dangerous case of whiplash when one reenters the market again—eroding long-term returns dramatically.

Since we expect the downturns, we can act with confidence in difficult times by rebalancing to long-term target allocations. This is far superior to waiting in a state of paralyzed uncertainty for some unknown market movement to manifest itself (or, worse, bailing out completely).

Over any economic or political cycle we have seen that an asset class portfolio properly positions investors to take advantage of whatever occurs. This is important because another significant contributor to the uncertainty we face is not knowing how our political system might evolve. While this is true at any time, today there is the possibility that our government will become more and perhaps permanently involved in our health care, auto, financial and who knows what other industries. Our research indicates that long-term asset class returns have not been influenced by the degree of a country's socialist or capitalistic flavor. As investors we can afford to take the attitude of "it could be worse" as far as political developments are concerned and accept the uncertainty of any path our government takes with the knowledge and confidence that irrespective of that route, our asset class portfolios put us in the best possible position to be rewarded for the risk we embrace.

Unlike the Danes, we at Equius aren't satisfied with an "it could be worse attitude" as it relates to investments. As trusted advisors, our job is to create realistic expectations, not overly-optimistic or overly-pessimistic ones. This approach should result in meeting your expectations however our economic and political environment evolves.