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Emerging Market Equities

By Andrew Menachem

From a global perspective, where do you think the strongest economic growth will occur in the next year? Will it be the United States, which is still struggling to create new jobs, or Western Europe with its sluggish outlook?

According to recent projections from the International Monetary Fund (IMF), the world's emerging markets will grow around 6.6 percent in 2011, compared with just 2.2 percent for the developed nations. That means China, India, Russia, Brazil and dozens of smaller countries in Latin America, Asia and Africa have tremendous growth potential in the next few years.

Take China, for example, the International Monetary Fund (IMF) recently estimated that China's gross domestic product (GDP) would grow approximately 9.4 percent in 2011 and another 9.5 percent in 2012. That's actually a slowdown from recent double-digit growth to a more sustainable rate.

Based on those economic fundamentals, it may make sense for you to consider adding emerging market equities to your investment portfolio. Buying shares of companies based in these developing regions can create opportunities for potentially higher returns while actually reducing some of your investment risks. And since most investors buy emerging market equities through an index fund, mutual fund, exchange traded fund (ETF), managed account or hedge fund, you don't have to spend your time conducting research on individual companies.

Boost potential returns

Emerging market equities offer significant benefits for individual investors. Purchasing shares in a Chinese manufacturing company, an Indian technology firm or a Brazilian mining concern might generate a higher-than-expected return (or "alpha"), improving your portfolio's performance.

For the first quarter of 2011, the *MSCI Emerging Markets Index*, which measures the performance of 21 emerging markets, rose 2.1 percent, following a 19.2 percent increase in 2010. Those are not stellar results, but like all investments, performance of emerging market equities varies from year to year.

Because fewer analysts track companies in emerging markets, particularly in smaller countries like Vietnam, Chile or Hungary, there are also opportunities for diligent researchers to uncover hidden gems – strong companies that are almost unknown in the United States.

Investing in emerging market equities is also an excellent strategy for diversifying your portfolio. Each of these economies is influenced by its own set of historical, cultural, population and natural resource factors. Owning shares in companies in several emerging markets actually reduces the risk of losing a large percentage of your portfolio's value in another Wall Street meltdown.

In general, returns generated by international equities – in both developed countries and emerging markets – are not highly correlated to U.S. stocks. If U.S. equities and bonds are moving downward, for example, non-U.S. equities may act as a stabilizing force, smoothing out the peaks and valleys.

Stronger government balance sheets, lower indebtedness and increased transparency – at least in some emerging nations – as other positive factors for considering emerging market equities.

Diversify your portfolio

Diversity is one of the defining characteristics of the emerging market sector, even within Latin America. For example, the Brazilian economy has been particularly strong in the past year, because of Chinese demand for commodities and infrastructure investment for the 2014 World Cup and 2016 Olympic Games.

Mexico had been lagging Brazil's growth, largely because of its close ties to the slower U.S. economy. But in recent months, Mexico's exports have started to climb, boosting share prices of many companies.

In a challenge to the dominance of Brazil and Mexico, the stock exchanges of Chile, Colombia and Peru recently combined to create an Integrated Latin American Market (called MILA for its Spanish name, *Mercado Integrado Latinoamericano*).

In terms of the listed companies, MILA is now the biggest exchange in Latin America and the second largest in market capitalization. U.S. investors can now buy shares of exchange-traded funds (ETFs) or mutual funds guided by money managers familiar with these emerging markets. That's important because the projected 2011 GDP growth for the MILA countries is 5.5 percent compared with 4.2 percent for Brazil and Mexico combined.

Consider the risks

Of course, no investment is free of risk, and emerging market equities are no exception. Historically, developing nations from Argentina to Malaysia, Mexico to China, have experienced boom-and-bust economic cycles. Investment funds flow in when times are good, but depart quickly when conditions change.

A new political regime, high inflation, falling commodity prices or restrictions on corporate profits are among the risks faced by U.S. investors. The debt crises of Greece and Portugal provide another example of the volatility in smaller economies.

In general, the level of transparency and corporate governance is lower in emerging countries than in the U.S. or Western Europe. Therefore, it's possible for investors to be misled by a company's balance sheet or draw the wrong conclusions about its financial strength. Finally, a rise in the value of the U.S. dollar can cut into an investor's return, even if the foreign company does well. That foreign exchange risk is another factor to take into account when constructing your portfolio.

In weighing the balance between potential rewards and risks, a well-diversified portfolio today, even though it does not guarantee a profit or protect against loss, might include 5 to 15 percent emerging market equities. So, take a look at your current assets and see whether it makes sense to put more of your funds into this important investment sector.

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