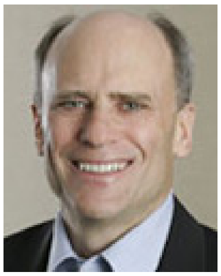

ETF STRATEGIST CORNER

Swedroe: Questioning Emerging Markets

By Larry Swedroe | November 11, 2013

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According to data from the International Monetary Fund, in 1987, China was not even among the top 10 countries in terms of contribution to world GDP. Brazil (No. 8) and Russia (No. 10) were the only two emerging market countries in the top 10, and their contributions were just 2.1 and 1.7 percent, respectively.

But by 2012, China had moved to second place, with a 12.8 percent share; Brazil had moved to seventh with a 3.5 percent share; Russia was eighth with a 3.1 percent share; and India had moved into the top 10 with a 2.9 percent share. Four emerging market countries are now among the top 10 contributors to world GDP, and those four contribute more than 22 percent to the world's GDP—virtually the same as the combined shares of Japan, Germany, France and the U.K. And the combined share of these emerging market countries is within 2 percentage points of the U.S.' share of 24.4 percent.

So it certainly seems reasonable to expect that, in the near future, the emerging market's share of global GDP will exceed that of the developed markets. Over the same period, the emerging market share of global market capitalization went from about 1 percent to about 13 percent.

With the dramatic globalization over the past 20 years, does it still make sense to segregate global equities into "developed" and "emerging" market buckets? That's the question that Geert Bekaert and Campbell Harvey sought to answer in an October 2013 paper **"Emerging Equity Markets in a Globalizing World."** The following is a summary of their findings:

> While the correlation between developed and emerging markets has increased, the process of integration of these markets into world markets is incomplete — there's still a large gap between the emerging markets share of global GDP and their share of global market capitalization.
>
> Currently, emerging markets account for more than 30 percent of world GDP. However, they only account for less than 13 percent of world equity capitalization when calculated on a free float basis (shares of a public company that are freely available to the investing public). That explains part, but not all, of the gap. Based on total market cap, the emerging market share

would be 20 percent.

For the full period studied, January 1988-August 2013, the MSCI World Index produced an excess return (return above the one-month Treasury bill rate) of 3.7 percent points—4.3 percentage points below the 8.0 percent excess return of the MSCI Emerging Markets. The excess return gap was even greater in the second half of the period (beginning January 2001), with the MSCI World Index producing an excess return of 2.2 percent versus the MSCI Emerging Markets' 9.5 percent.

The higher returns were accompanied by greater volatility. For the full period, the standard deviation of the MSCI World Index was 15.3 percent versus the MSCI Emerging Markets' 23.8 percent. (The authors noted the importance of diversification across the emerging markets, as the individual country volatilities were much higher, ranging from 27 percent for South Africa to 54 percent for Russia.) The authors also noted that emerging markets have more downside risk—though the returns are no more abnormally distributed than they are for developed markets (the skewness and kurtosis are similar). However, the higher returns more than compensated for the greater volatility, as the Sharpe ratio for the MSCI World Index was 0.24 versus the MSCI Emerging Markets' 0.33 percent.

When emerging markets were first touted as interesting investments for global investors in the early 1990s, their diversification benefits were stressed. The emerging market index had a correlation with the world index of about 0.40 percent, leading to massive diversification benefits. However, this correlation has increased considerably over time. More recently, the correlation stands at about 0.90. However, I would note that at least part of the increase is related to the global financial crisis, which drove the correlations of all risky assets toward 1.0. In 2013, the correlation of their returns has actually turned negative. That said, while there are still some diversification benefits, it's likely that they have been reduced over time.

The beta of emerging markets is more than one. Thus, we see them tending to underperform when developed markets are performing poorly and outperforming when they are doing well.

There's still a sharp contrast between emerging and developed markets, with emerging markets showing mostly medium to low scores on important issues such as restrictions on foreign investment, corporate governance, political stability and corruption. Thus, while there is a definite trend toward integration of emerging markets, which reduces diversification benefits, there's still quite a ways to go before they're fully integrated.

The authors concluded that emerging markets should still be treated as a separate asset class.

They recommend that because the relative market capitalization of emerging markets is much lower than their relative economic weight, a market capitalization-based benchmark can be viewed as a lower bound on the asset allocation to emerging markets. And while there has been increased integration, reducing the benefits of diversification, there are still unique country risks—which are priced in—that make emerging markets an attractive asset class. They are high risk, but they do have high expected returns.

The following are my own observations. First, when an asset class outperforms, investors should be careful to consider its current valuation. Remember, you cannot buy yesterday's returns, only tomorrow's. Often, long periods of outperformance result in very high valuations, which, in turn, forecasts low future returns.

This isn't the case with the emerging markets. For example, Morningstar data as of July 31, 2013 on the Vanguard Emerging Markets Fund (VEIEX) shows a price-to-earnings ratio (P/E) of just 11.7, versus the Vanguard 500 Index Fund (VFINX)'s 15.4 percent.

Secondly, investors require that assets that perform poorly in bad times carry large risk premiums. And their low scores on issues like political risk, corporate governance and so on cause investors to demand large risk premiums as compensation. We see that in the continuing relatively low P/E ratios of emerging markets—suggesting that emerging markets are likely to continue to produce high returns.

Thus, my conclusion is the same as that of Bekaert and Harvey—emerging markets remain an attractive asset class and, moreover, the asset class is generally underrepresented in individual investor portfolios.

Larry Swedroe is director of Research for the BAM Alliance, a community of more than 130 independent registered investment advisors throughout the country.