Emerging Markets, Even in Turmoil, Have a Place in a Portfolio

By TIM GRAY  JULY 15, 2016

Over the last five years, investors in emerging-markets mutual funds have paid plenty and gotten little in return.

Emerging-markets funds lost an annualized average of 3.19 percent over the last five years, Morningstar said. Yet they are far more expensive, on average, than actively managed domestic large-cap funds, which returned about 10 percent a year annualized for the same period. Expense ratios for actively managed emerging-market funds were 1.55 percent, compared with 1.15 percent for domestic large-caps.

Investors have responded by fleeing emerging markets; money is churning out of the sector’s funds and E.T.F.s. Total net outflows hit a new high in 2015, when nearly $75 billion exited, according to EPFR Global in Cambridge, Mass. Through June this year, $7 billion more has been withdrawn.

The exodus is understandable, given both the returns and the worrisome headlines streaming in from around the globe. Just last month, the British referendum to leave the European Union roiled markets worldwide. MSCI’s Emerging Markets Index fell as much as the British-focused FTSE 100 in the days just after the ballots were counted. The vote was an additional bedevilment for emerging markets already made skittish by slower growth in China — some
commentators fret about a real estate bubble and banking crisis there — and a political crisis in Brazil. On top of that, low prices for commodities, especially oil, sapped stock markets in places dependent on natural resources, like Russia, South America and the Middle East.

The turmoil is a turnabout from just a few years ago. Then the acronym “BRIC” — for Brazil, Russia, India and China — was bandied about in investment circles as shorthand for the rise of a brash new bunch of economic powers. Lately, BRIC has become a four-letter epithet.

The reaction of emerging markets to the British vote has also underscored a new reality for investors: Emerging markets no longer provide the diversification benefit they once did, said Roger A. Aliaga-Díaz, senior economist with Vanguard’s Investment Strategy Group. “Correlations have increased since the 2000s between emerging markets and developed ones,” Mr. Aliaga-Díaz said.

During the surge of the 2000s, one of the attractions of emerging markets was that they tended to zig when the developed world zagged. They could buffer the ups and downs of developed markets in a diversified portfolio. To a greater extent these days, developing and developed markets have tended to move together.

Portfolio managers of emerging-markets funds say today’s worries, like yesterday’s euphoria, may be exaggerated.

“In terms of history, the last couple of years isn’t remarkable,” said James F. Syme, senior fund manager of the JPM Emerging Markets Opportunities fund. “Emerging markets have always been two steps forward and one step back. In the ’80s, we had the Latin American debt crisis, and in the ’90s, the Asian tigers and then the Asia crisis. All asset classes tend to be characterized by boom and busts. Emerging markets is a riskier asset class, so the booms and busts are bigger.”

Today’s economic challenges are real but manageable, said Joanne C. Irvine, a portfolio manager for the Aberdeen Emerging Markets fund. “Given the significant underperformance of emerging markets in recent years, you’d think most of the countries were in crisis, but the economies and corporate balance sheets are mostly in reasonably good shape,” she said. “Global growth has been very weak, and that’s
led to weak emerging-market exports.”

Even so, many emerging countries remain healthier than developed ones, with higher growth rates and lower debt levels, she said. And many of them have young, growing populations striving to join the world’s middle class.

China’s economy has been the engine of the developing world, but after a two-decade surge, growth there is slowing as the country shifts from an export-led economy to a consumer-driven one like the United States, said Arjun Jayaraman, co-portfolio manager of the Causeway Emerging Markets fund. “They’re going from a growth rate of high single digits to, realistically, 3 to 4 percent a year,” he said. The Chinese government’s official growth target is 6.5 to 7 percent this year.

That slowdown has caused worldwide commodity prices to sag. When China was investing heavily in infrastructure and industrialization, commodity producers thrived; now they’re pinched.

A strong dollar has meted out additional pain. Many companies and countries in the developing world borrow money in dollars, so a stronger dollar increases the real cost of their debts, said David Semple, portfolio manager of the VanEck Emerging Markets Equity. A stronger dollar also hurts the returns of American investors because the returns of emerging-market companies, denominated in weaker local currencies, must be translated into dollars. “For emerging markets, the precondition for them doing better is for the dollar to not accelerate strongly,” he said.

The emerging-markets sector is split by the debate over active management versus indexing just as every sector is.

Much of the discussion comes down to costs: It’s usually cheaper to run an index fund than an active one, and costs eat away at investors’ bottom line. The average emerging-markets index fund carries an expense ratio of 0.52 percent, compared with the 1.55 percent charge levied by the average actively managed emerging-markets fund, according to Morningstar. Some of the better-known index funds levy even lower fees. The Vanguard Emerging Markets stock index fund charges 0.33 percent for its investor shares, while BlackRock’s iShares Core MSCI
Emerging Markets E.T.F. charges 0.16 percent.

For the most part, the higher costs for active management haven’t translated into better performance, said Todd L. Rosenbluth, director of E.T.F. and mutual fund research for S&P Global Market Intelligence. Based on trailing returns, two-thirds of emerging markets funds underperformed S&P.’s emerging-markets index over the one, three and five years ending in December 2015, he said. “On the positive side, that means one out of three did outperform,” he said.

“There’s some value to active management, but the cheaper your actively managed fund can be, the better,” he said.

Costs aside, Patricia Oey, a senior analyst for Morningstar, said that active funds aren’t locked into the country allocations required by index funds. Both the Vanguard and iShares funds, for example, allocate about a quarter of their assets to Chinese stocks. That amount could grow in coming years, because China’s domestic A-share market is opening to foreign investors, she said. Given the heft of China’s economy — the world’s second-largest, after the United States — index providers might opt to include more Chinese companies.

A way in which some emerging-markets managers avoid overexposure to any particular country is by also investing in developed-world multinationals that sell into the emerging world.

Sammy Simnegar, portfolio manager of the Fidelity Emerging Markets Fund, takes that approach. As of the end of April, about 20 percent of his fund’s assets were developed-world stocks. He said that too many of the biggest, best-known companies in emerging markets, especially in China, are state-owned enterprises, which he shies away from.

“In my view, those aren’t run for shareholders — they’re run for the state,” he said. “I’d rather invest in an A. O. Smith, a U.S. company that makes water heaters. About a third of their revenue is from emerging markets, particularly India and China.”

Just as portfolio managers damp risk by diversifying, individual investors can
do the same with their personal portfolios. Ms. Oey of Morningstar said holding 10 percent of a stock portfolio, mirroring the proportion of emerging markets in the world’s stock market capitalization, would make sense for a long-term investor. A person with 60 percent of her money in stocks would then put 6 percent in emerging markets.

Campbell R. Harvey, a finance professor at Duke University, said he saw 10 percent as a floor, not a ceiling. In a 2014 paper, professors Harvey and Geert Bekaert of Columbia University noted that emerging markets account for about 30 percent of world G.D.P. Thus, they wrote, “Strategic allocations somewhere in between market capitalization weights and G.D.P. weights are easy to defend.”

Whatever else investors do, they should guard against the tendency to dump their holdings based on recent discouraging news or weak returns, Professor Harvey said. “The biggest mistake retail investors make is selling stocks if they go down and buying the ones that have gone up,” he said.

“This holds true for asset classes, too,” he added. “Just because emerging-markets equity has had low returns recently does not mean you should sell. One-third of world G.D.P. is being driven by emerging-market economies, and it makes sense that a globally diversified portfolio should have exposure to them.”

A version of this article appears in print on July 17, 2016, on page BU16 of the New York edition with the headline: An Exit From Emerging Markets May Be Hasty.