Opinion: Adding emerging markets to your stock portfolio is tougher than it looks

By Mark Hulbert  
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Large differences in returns between countries affects choice of active or index management

Bloomberg

China boasts the world's second-largest economy but is considered an emerging market.

Is South Korea a "developed" or "emerging" stock market? Most investors haven't thought about this question, but a lot is riding on the answer.

FTSE Russell, one of the world's leading index providers, considers South Korea's stock market to be in the developed category. Rival MSCI puts that country's market into the "emerging" category.

Welcome to the surprisingly complex world of asset allocation. Many investors are surprised to learn of this disagreement about how to classify South Korea. Investors have assumed that the "emerging market equity" category is well defined, both in terms of which countries are included and also how the category differs from others.

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The category is anything but. In fact, there isn’t even consensus among researchers that “emerging market equities” deserves to be a separate asset class. How can you decide what to allocate to an asset class when it’s unclear what it contains?

Here’s another difficult question: Is China’s stock market developed or emerging? Consider that China’s economy is the second-largest in the world, with a share of global GDP that is only slightly behind that of the U.S. And, yet, both FTSE Russell and MSCI put China’s stock market in the “emerging market equities” category, along with Egypt, Peru and Turkey. (FTSE Russell and MSCI classify China in this way because of the country’s capital controls and other restrictions that prevent its stock market from being fully integrated into the world market.)

My point in raising these issues is not to suggest that there is a better way to categorize countries than what FTSE Russell or MSCI have come up with. My goal instead is to remind us that categorization is a messy business. We forget that messiness when we focus only on index funds and ETFs that are benchmarked to those categories, overlooking the wide variability in the performance of their individual components.

What is an asset class, anyway?

When this variability is especially wide — as is the case with the emerging market equities category — then one wonders if each of its components really belongs with the others. It’s not clear, for example, that the same factors impact the returns of countries as diverse as China, the Czech Republic, and United Arab Emirates. Yet they are classified as emerging markets.

Take the range of stock-market returns in 2017 among the various countries in the category. The highest return, in U.S. dollar terms, was Poland, gaining 52.2% (according to MSCI). At the other end of the extreme was Pakistan, with a loss of 28.1%. (See accompanying chart.) This wide spread of more than 80 percentage points is one reason why some question whether the emerging-market equities grouping constitutes a coherent category.

Campbell Harvey, a finance professor at Duke University, said in an interview that this wide range of returns is not a good reason to conclude that emerging-market equities is not a distinct asset class, however. He points out that there is just as wide a range, if not more, among individual commodities, and yet investors don’t seem to have much issue calling "commodities" a distinct asset class.

The best performing commodity in 2017, in U.S. dollar terms, was aluminum, with a 56.3% return. The worst was zinc, which posted a 20.7% loss. The resultant spread of 77 percentage points is almost as big as in the case of emerging-market equities.

How to think about emerging-market equities

Perhaps the best way to focus your thinking on emerging-market equities is to ask whether you want to allocate more or less to the category than its proportional share of the total market capitalization of the world’s stock markets.

Currently, for example, South Korean stocks represent about 2% of the world’s GDP. If you invest in an index fund benchmarked to the world's stock market (such as the iShares MSCI ACWI ETF ACWI, +0.61%) you will automatically (if
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implicitly) be investing 2% of your portfolio in South Korean stocks. No asset-allocation decision is needed.

If you want to deviate from market weights, then you need to pay attention to which countries' markets are included and excluded. Indeed, some well-known investment managers currently believe that investors should overweight emerging-market equities. GMO, for example, the Boston-based money-management firm, argues that emerging-market stocks, and especially so-called "value" stocks in emerging markets, "represent the most attractive asset we can find by a large margin."

Another rationale for overweighting emerging-market equities comes from Duke's Harvey and Geert Bekaert, a finance professor at Columbia University. A recent study they co-authored pointed out that while emerging-market equities currently represent about 15% of the world's total stock-market capitalization, emerging-market countries' share of world GDP is more than 30%. The researchers believe that these two numbers will at least partially converge over time, and that at least some of the merging will be the result of "valuation convergence."

If so, emerging-markets equities could produce explosive performance in coming years.

For more information, including descriptions of the Hulbert Sentiment Indices, go to The Hulbert Financial Digest or email mark@hulbertratings.com.

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Mark Hulbert
Mark Hulbert has been tracking the advice of more than 160 financial newsletters since 1980.

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