Investing in Emerging Markets

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It is only fitting that a seminar in Italy should have at least one session devoted to investing in emerging markets. The country described by the current boundaries of Italy has probably alternated between being "developed" and "emerging" more than any other country in the world.

The interest in emerging market stocks is relatively new for U.S. institutional investors. For example, only two funds in Morningstar's *Diversified Emerging Markets* category have ten years of returns, while thirty-five have five years of returns.

Going back five or ten years, the pioneers of investing in emerging markets had little high-quality data to rely upon, but that data looked unbelievably good. Emerging market stocks seemed to offer exceptionally high returns and large diversification benefits. Given the volatility of returns, emerging markets seemed to provide a great opportunity for actively managed funds to trounce their passive counterparts.

Now that we have five years of returns for a reasonable number of funds, it is time to reexamine the question of investing in emerging market stocks. Although this is too short a time period to make much of a statement about the expected returns of emerging market stocks, it is long enough to make a few observations about investing in emerging markets.

The last five years have proved to be a great testing period for investing in emerging market stocks. We have had a Mexican crisis that evolved into a Latin American crisis. We have had the Asian contagion that was associated with a worldwide financial crisis. Crises produce stock market volatility, and volatility tests the skills of investment managers.

DIVERSIFICATION BENEFITS

The first observation to make about the last few years is that emerging market stocks continue to provide great diversification benefits. Given the incredible performance of the U.S. markets, international diversification has lowered returns over the last few years. Improving returns, however, is not the purpose of diversification. The purpose of diversification is a reduction in return volatility. The benefit of international diversification is that international stock returns sometime offset U.S. returns when U.S. stocks are not performing well. The cost of international diversification is that international stock returns sometimes offset U.S. returns when U.S. stocks are performing extremely well, as they have over the last five years. Rather than increasing expected returns, diversification smoothes out returns.

Naturally, what investors want in diversification is an asset class that outperforms the S&P 500 when the S&P 500 does poorly and performs like the S&P 500 when the S&P 500 does well—and we don't know of asset classes like that.

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Exhibit 1. ASSET CLASS RETURN CORRELATIONS (R^2)
MONTHLY DATA IN U.S. DOLLARS

Last 5 years: 1995-1999	*IFC*	*S&P 500*	*EAFE*
IFC Emerging Markets Index	1.000		
S&P 500 Index	0.430	1.000	
MSCI EAFE Index (net dividends)	0.512	0.446	1.000
Previous 5 Years: 1990-1994			
IFC Emerging Markets Index	1.000		
S&P 500 Index	0.232	1.000	
MSCI EAFE Index (net dividends)	0.180	0.207	1.000

Emerging markets can be considered a separate asset class. The correlation between EAFE and emerging markets returns is about the same as the correlation between EAFE and S&P 500 returns.

Because of their large diversification benefits, the universe of emerging market stocks can be considered to be a separate asset class. As an asset class, they are as different from EAFE stocks as EAFE stocks are from U.S. stocks. Exhibit 1 compares the return correlations for three asset classes over the last five years to the correlations for the prior five years. The correlations are higher from 1995-1999 than they are for 1990-1994, but are still quite low.

The correlation between emerging markets and EAFE returns is about the same as the correlation between emerging markets and S&P 500 returns and about the same as the correlation between EAFE and S&P 500 returns. This justifies the consideration of emerging market stocks as a separate asset class and of making a separate commitment to emerging market stocks in an asset allocation.

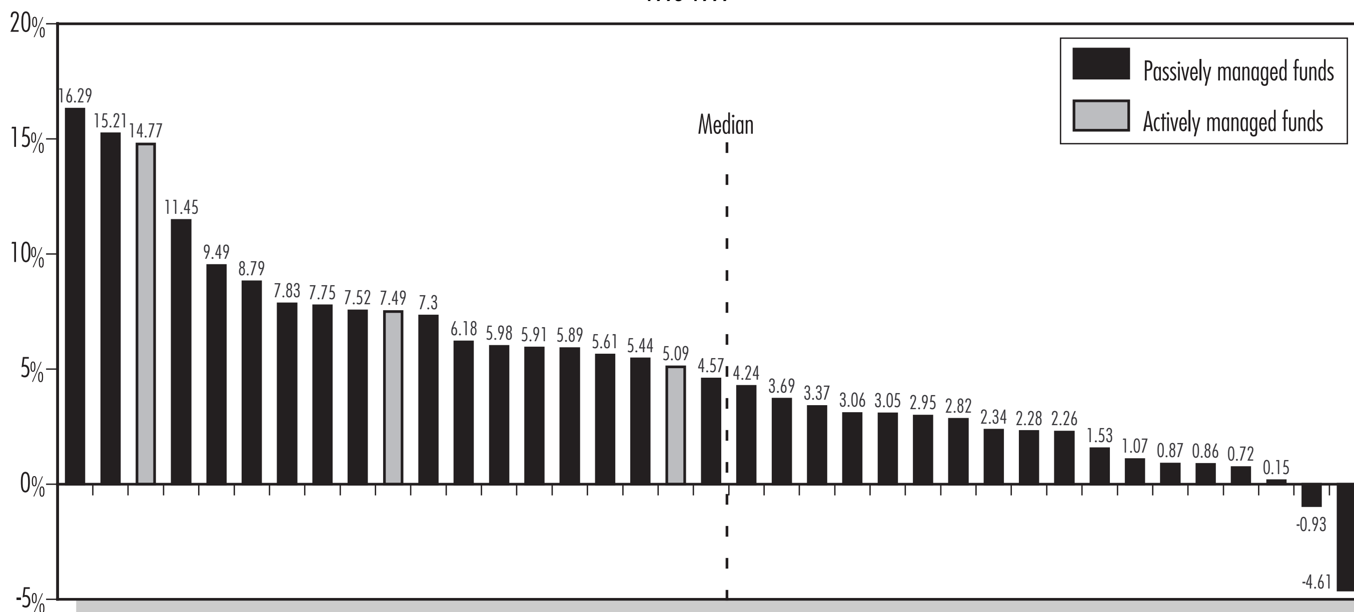
INVESTMENT PERFORMANCE

Exhibit 2 displays the performance of mutual funds that have five years of returns. Passively managed index funds are displayed in black. Actively managed funds are displayed in gray.

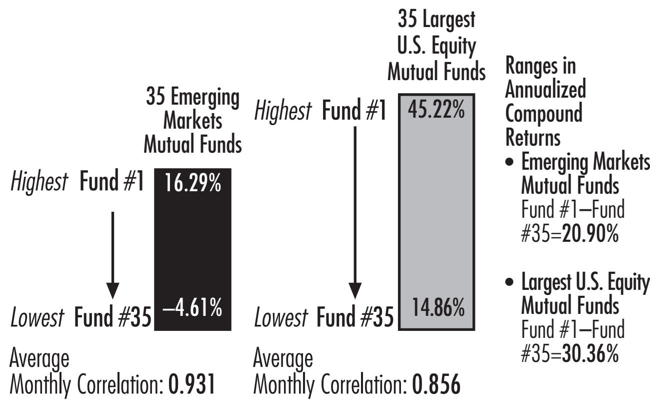
It is often asserted that active stock selection and market timing should work best when investing in emerging market stocks because they are less "efficient." Thus far, the evidence is to the contrary. All of the index funds have returns that are above the median. Five years is too short a time period to conclude much about the value added of active management. Nevertheless, there is not much evidence that actively managed funds have higher returns than index funds.

The most striking result about fund performance is the narrow range in five-year returns. The highest return is 16.3% per year. The lowest return is -4.6%. That is extremely narrow given the wide range in results for individual market

Exhibit 2. MORNINGSTAR UNIVERSE OF EMERGING MARKETS FUNDS
FIVE-YEAR ANNUALIZED COMPOUND RETURNS (%)
1995-1999



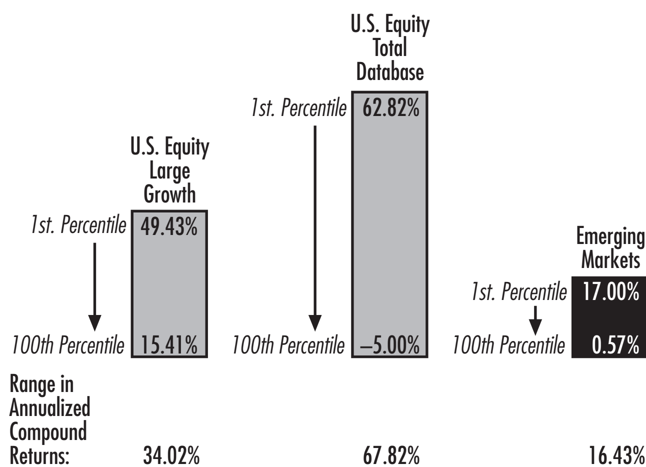
Source: Morningstar, January 2000; includes all emerging market funds in Morningstar which were in existence in January 1995, multiple manager funds were limited to Institutional or Class A Shares.



Source: Morningstar, January 2000; includes all emerging markets funds in Morningstar which were in existence in January 1995, excludes Dimensional; multiple manager funds were limited to Institutional or Class A shares.
U.S. equity mutual funds are 35 largest by net assets as of December 31, 1999.

returns. Exhibit 3 contrasts the range in emerging markets returns to the range in five-year returns for the largest thirty-five mutual funds that invest only in U.S. stocks. The range is 50% larger for the U.S. stock funds. The average correlation (r) between any two U.S. stock funds is .856. The correlation between emerging markets funds is .931.

Exhibit 4 displays similar results for comparative universes calculated by Callan Associates. These universes are for separately managed institutional accounts and are gross of management fees. The range in five-year returns for emerging markets mandates is almost identical to the range for mutual funds. Callan also provided two other comparative universes, one for managers of U.S. large cap growth stocks and one for all managers of all U.S. stock portfolios. Once again, the ranges in five-year returns are much greater for the U.S. stock managers than for the managers of emerging markets portfolios. There is no evidence that institutional money managers do better than the mutual funds.



Source: Callan Associates, Inc.

The narrow range in five-year returns for emerging markets funds is a result of active managers all doing pretty much the same thing when investing in emerging markets. This happens for two reasons. First, there are usually not that many stocks of institutional quality in an emerging market country. The managers end up buying very similar stock portfolios within a country.

The second reason for the narrow range in outcomes is that active managers move assets across countries in a similar fashion. Over the last five years, managers got out of Mexico after the Mexican crisis and out of Asia after the Asian crisis.

Getting out of an emerging market in the middle of a crisis may be costly. For example, suppose the risk of a country goes up as the country's prospects deteriorate. Over the near term, this may cause its stock prices to drop. When confronted with a deteriorating economic situation and declining stock prices, active managers have a tendency to reduce their country exposure. But, if risk and return are related, this causes them to get out when the expected country return is increased. Similarly, they move into countries whose prospects have improved and whose expected returns could reasonably have been expected to decline. The net effect of the shifting country commitments is to lower returns over what is achieved by index funds that make no timing decisions.

The financial crisis in September 1998 provides an example of the difficulty of timing emerging markets. At that time, there was a worldwide financial crisis associated with the Asian contagion. As a result, there were net withdrawals out of emerging markets funds and emerging markets funds shifted their country commitments to lower risk countries. With so much bad news around it was difficult for investment committees to stay committed to emerging markets. Those that did were handsomely rewarded. Exhibit 5 displays the one-year returns ending September 1999. The IFC index was up

Exhibit 5. ASSET CLASS RETURNS IN U.S. DOLLARS

Annual Compound Returns (%)	*1 Year ending 9/98*	*1 Year ending 9/99*
IFC Emerging Markets Index	-46.67	56.62
S&P 500 Index	9.06	27.79
MSCI EAFE Index (net dividends)	-8.34	30.95

The best time to invest in emerging markets may be in the middle of a financial crisis.

56.6% after being down 46.7% the previous year. Investing in September 1998 required a belief that risk and return are related. No economic pundits were developing rosy economic scenarios. A commitment to emerging markets needs to be considered a rather permanent allocation. Trying to time emerging markets is more likely going to result in adverse, rather than positive, consequences.

EXPECTED RETURNS FROM EMERGING MARKETS

The last five years have not been a good period to estimate the expected returns from investing in emerging markets. The emerging markets indices have returns close to zero, while the S&P 500 Index has a return of over 28% per year.

An investor's return is a company's cost of capital. When a company sells 10% of its stock, it sells off the permanent value of 10% of the dividends and price appreciation forever. An investor's return is a company's return foregone. When a company issues stock, it receives a price that reflects the company risk. A lower stock price means a higher return for the investor and a higher cost of capital for the firm.

The last five years must be an aberration for it makes no sense that the average S&P 500 company should be priced so low that an investor could expect a 28% return while a company in an emerging market should be priced so high that an investor gets a zero expected return. Yet, these are the most recent five-year outcomes.

We believe that emerging market stocks have higher expected returns than the S&P 500 because emerging market companies are riskier in that they have higher costs-of-capital than U.S. companies. This is particularly true currently. While the average P/E of a U.S. stock is high by historical standards, the P/E ratios of emerging markets indices are closer to their average values.

NECESSARY CONDITIONS FOR INVESTING IN EMERGING MARKETS

The argument that emerging market stocks have higher expected returns than U.S. stocks relies on an assumption that market prices reflect relative values. This assumption breaks down for some markets. We have developed a list of criteria we feel must be met in order to accept market prices as indicators of value. These include the following: First, the country must have no restrictions on the repatriation of capital. We want to be able to get our money out. Second, the country must be governed by a rule of law and must have an adequate judicial system to insure the enforcement of contracts. Third, the country can have no major adverse tax treatment of foreigners. Fourth, we want payment vs. delivery for the settlement of contracts. Finally, there needs to be an adequate trading volume and an adequate trading infrastructure.

Given the lack of success of professional money managers in beating index funds thus far, emerging markets that satisfy these criteria appear to be "efficiently" priced. The notion of market efficiency is that stock prices reflect "fair" value. Market efficiency does not imply "perfect" markets. At any point in time, half of the stocks can be undervalued and half can be overvalued and the market is still efficiently priced if managers cannot take advantage of the imperfections. The evidence thus far is that managers are not able to take advantage of the imperfections and, therefore, that emerging markets are efficiently priced.

Emerging market stocks are illiquid in the same way as small cap U.S. stocks. Both types of stocks have wide bid/ask spreads. But, illiquidity does not imply inefficiency. The lack of liquidity in emerging markets appears to set insurmountable hurdles for active managers rather than to create a fertile ground for active trading.

SUMMARY

The history of investing in emerging market stocks is a relatively short one. Looking at the last five years, the benefits of considering emerging market stocks as a separate asset class are justified. Emerging market stocks are as different from EAFE as the EAFE is from the S&P 500.

Diversifying away from the S&P 500 has been costly over the last five years. This has been true

for investing in emerging market stocks as it has for almost any other asset class. Nevertheless, the arguments for diversification are still strong. Given that companies in emerging market countries are likely to have higher costs-of-capital than their U.S. counterparts, investing in emerging market stocks offers the possibility of an asset class with good diversification benefits and higher expected returns than the S&P 500.

The risk/return story for emerging markets is made with a few reservations. Risk and return can be assumed to be related only for those countries that meet certain legal and trading criteria. For those countries, the markets appear to be efficient in that actively managed funds do not appear to be adding value.

The most startling result is the herding instincts of actively managed funds. The range in returns of the funds is very narrow and the correlation of manager returns is very high. It will be interesting to see if these trends continue.

Notes