I

GOING BACKWARD TO MOVE FORWARD

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THE FIVE Ws OF EMERGING MARKETS

Comprising 24 countries, 35 percent of the world's landmass, a whopping two-thirds of the world's nearly seven billion people, and almost a third of global output, emerging markets are fertile ground for the global investor.[1] These distant lands offer some of the most dynamic and unique opportunities—as investments, end markets for corporations seeking growth, or key cogs in the production of the world's goods. These prospects make emerging markets among the fastest growing segments of today's investing world.

Yet for all their allure, many avoid emerging markets out of fear, ignorance, or a belief they are radically different from developed world markets. This book aims to help shed light on these vital regions. To be clear, it won't tell you *where* to invest. Markets are too dynamic for that. By the time your eyes hit these pages, the market environment will have changed many times over. But we can demystify and take the fear out of investing in far-flung corners of the world, teaching you how to analyze this segment of the investing landscape for yourself.

To do so, you don't need a passport and a stack of plane tickets. See it this way: Many journalists don't write stories about events they've witnessed firsthand. More often than not, reporters uncover the details from others—experts or those who experienced something directly.[2] Using a variety of viewpoints, data, and internal perspectives developed over the years, we can do the same. To begin, we borrow an old-fashioned journalism technique—the five Ws—to lay the framework for the rest of this book.

WHO OR WHAT?

Who or what is an emerging market? This isn't a trick question. Any basic Internet search will get you more results than you could possibly peruse. This should provide more than enough information, right? Not quite. A single correct definition is far more important than many wrong ones. According to some of the results we found, an emerging market is:

> A foreign economy that is developing in response to the spread of capitalism and has created its own stock market.
>
> —*Answers.com*

> A financial market of a developing country, usually a small market with a short operating history.
>
> —*Investorwords.com*

> A euphemism for the world's poor countries, also known, often optimistically, as emerging economies.
>
> —*Economist.com*

It's evident there are a smattering of qualifiers—foreign, capitalism, poor, small, etc.; no doubt we could find dozens more in the Internet abyss. Yet what, for instance, does *small* mean? Is Indonesia, the fourth most populated country in the world, small? What about China, the third-largest economy?[3] Clearly, there are gray areas and plenty of conflicts. And where, for example, might the Investorwords.com definition lead you? Maybe you start looking for a market with a short operating history, thinking you'll be among the first to capitalize on the amazing growth potential therein. Hello, Zimbabwe! Bye-bye, retirement savings.

Truth is, there's no single definition of emerging markets that works as a sufficient catchall. America was an emerging market in the early 1800s. Same with Japan in the early 1960s. Even today, a poll of seasoned investment pros would certainly generate just as many answers. Fortunately, to successfully invest in emerging markets, you don't need to pin down an exact definition as much as understand the key characteristics they represent.

The following characteristics are not requirements to be part of emerging markets per se, but are generally found, to varying degrees, in most of them:

Fast-growing economies. In order to meet the demands of rapidly growing populations and shifts from agriculture to industry and production, emerging market economies are generally fast growing. A corollary is that emerging markets are characterized by a *rapid pace of change*. Many are familiar with China's economic growth story of the last decade, but Table 1.1 illustrates it has plenty of company.

Low levels of per capita income. On a per capita basis, emerging market countries are among the poorest. For example, Mexico's per capita income is \$8,340 and Indonesia's is \$1,650. By contrast, America's is \$46,040.[5]

Relatively immature capital markets infrastructure. Emerging markets generally have poor reporting standards, a dearth of publicly available information, lack depth, and may be illiquid. They may also have weak regulatory frameworks.

Weak property rights. Private property rights are essential to a functioning marketplace, but such rights are usually not as ingrained in emerging markets. Investor capital may be unexpectedly taken away without due recourse.

Tenuous adherence to capitalist principles. Emerging market countries often embrace capitalism warily, eschew it in times of turbulence, or practice mercantilism operating under the guise of capitalism. Many still operate under explicit or implicit forms of communism and socialism.

Table 1.1 Average Annual Economic Growth

Developed	5-Year	10-Year	15-Year	25-Year
US	2.5%	2.5%	3.0%	3.1%
Japan	1.7%	1.3%	1.2%	2.2%
Germany	1.7%	1.5%	1.6%	2.1%
UK	2.3%	2.6%	2.9%	2.7%
Developed Market Average	***2.8%***	***2.8%***	***3.0%***	***2.9%***
Emerging	5-Year	10-Year	15-Year	25-Year
China	10.8%	9.7%	9.9%	10.1%
Brazil	4.7%	3.3%	3.2%	3.1%
Russia	7.0%	6.8%	2.7%	n/a
India	8.7%	7.1%	6.9%	6.2%
Korea	4.2%	5.3%	5.0%	6.3%
Mexico	3.4%	3.0%	2.9%	2.7%
Turkey	6.0%	3.8%	3.8%	4.4%
Indonesia	5.7%	4.8%	4.1%	4.9%
Poland	5.3%	4.2%	4.8%	3.2%
Taiwan	4.2%	3.8%	4.6%	6.1%
Emerging Market Average	***5.8%***	***4.7%***	***4.5%***	***4.4%***

Source: International Monetary Fund World Economic Outlook Database April 2009, MSCI, Inc.[4] Select countries chosen for illustrative purposes. Averages are inclusive of all countries within the MSCI World Index and MSCI Emerging Markets Index.

Varying political models. Authoritarianism, populism, democracy, single-party state, and many more. There are almost as many political models in emerging markets as there are countries, which have profound impacts on their capital markets.

Relatively underdeveloped institutions. Legal, judicial, and regulatory institutions tend to be weaker and less established.

Restrictions on foreign investors. Emerging markets generally don't have a long history of foreign investment, and there may be restrictions. For example, domestic Chinese shares are largely restricted to domestic investors; foreign investors must purchase American Depositary Receipts (ADRs) or Hong Kong-listed shares.

Freedom of foreign exchange and fund repatriation. You probably wouldn't invest your money in an Italian oil refiner unless you could change your money from euros back into US dollars, right? Emerging markets foreign exchange is often not as liberalized as the developed world, and some restrictions or extra regulations may need to be navigated.

Inherently risky. They have substantially higher levels of political, economic, and social risk compared to their developed market counterparts.

Emerging markets are not developed markets. Sure, it seems obvious, but it's important to distinguish what emerging markets are *not*. Developed markets are more developed and adhere to higher standards of many of the characteristics listed here. For example, the US, Australia, and Japan are developed markets.

American Depositary Receipts

American Depositary Receipts, commonly abbreviated as ADRs, are shares issued by a US bank that directly represent a specified number of shares in a foreign stock and are traded on US exchanges. For example, "TM" is the ticker for Toyota Motor Corporation shares traded on the New York Stock Exchange. One share of TM represents two shares of the foreign ordinary shares traded in Japan. ADRs are a good way for US investors to gain exposure to foreign companies, as they help reduce administrative costs and lower barriers to investing on foreign stock exchanges. We'll cover ADRs in more detail later on.

WHERE?

So who makes the grade? Which countries are typically classified as emerging markets? We could conduct an in-depth analysis of every country using the previous criteria, but there's an easier way to figure it out. A number of equity index providers have their own unique methodology to answer this question. We'll let them do the heavy lifting.

With so many index providers, intuitively you'd think they'd represent dramatically different stock universes. As it turns out, most of the criteria they use are similar to those we just covered. Table 1.2

Table 1.2 Emerging Market Country Coverage by Index Provider

Country	S&P	FTSE	MSCI
Argentina	✓	✓	✓
Brazil	✓	✓	✓
Chile	✓	✓	✓
China	✓	✓	✓
Colombia		✓	✓
Czech Republic	✓	✓	✓
Egypt	✓	✓	✓
Hungary	✓	✓	✓
India	✓	✓	✓
Indonesia	✓	✓	✓
Israel	✓	✓	✓
Korea	✓	✓	✓
Malaysia	✓	✓	✓
Mexico	✓	✓	✓
Morocco	✓	✓	✓
Pakistan		✓	✓
Peru	✓	✓	✓
Philippines	✓	✓	✓
Poland	✓	✓	✓
Russia	✓	✓	✓
South Africa	✓	✓	✓
Taiwan	✓	✓	✓
Thailand	✓	✓	✓
Turkey	✓	✓	✓
Total Countries	**22**	**24**	**24**

Source: FTSE, MSCI, Inc.[6], Standard & Poor's. As of 12/31/2008. S&P is the IFCI or Investable index; FTSE combines the Advanced and Secondary Emerging Markets Index; and MSCI is the MSCI Emerging Market Index.

shows the country composition of three major emerging markets index providers—Standard & Poor's (S&P), FTSE, and Morgan Stanley Capital International (MSCI). Aside from Colombia and Pakistan's absence in the S&P index, they're *exactly* the same.

As we'll discuss further in Chapter 5, choosing a benchmark is vital to long-term investment success. We need a road map for our journey—a well-constructed index to guide us. Any of these indexes are suitable choices. So pick one! For the purposes of this book, we'll mostly use the MSCI Emerging Markets Index. But any appropriately constructed index would do.

WHEN?

While many emerging market societies and cultures rank among the earliest in recorded history, they're relative newcomers to the investment world. Standard & Poor's, then known as Standard Statistics, developed its first US stock market index in 1923.[7] Emerging markets are spring chickens by comparison, barely in their college years.

The Third World No Longer

In September 1981, Antoine van Agtmael faced a dilemma. Working for the International Finance Corporation (IFC), a division of the World Bank, he'd just pitched a room full of money managers at Salomon Brothers headquarters in New York City on a "Third World Equity Fund." Van Agtmael made a successful pitch; the room ate it up. But an especially prescient manager at JP Morgan made an insightful point, "This is a very interesting idea you've got there, young man, but you will never sell it using the name 'Third World Equity Fund'!"

Van Agtmael realized he had a point. "Third World" was chock full of negative images—backwater villages, starving children, cheap manufactured goods. It certainly wasn't the slogan of an ideal sales pitch. After the meeting, van Agtmael came up with a term that sounded more positive and invigorating: Emerging Markets. In his words, "'Third World' suggested stagnation; 'Emerging Markets' suggested progress, uplift, and dynamism."[8]

Emerging market stocks were still a long way away from widespread acceptance. At the time of van Agtmael's speech, investors weren't terribly interested in what the rest of the world had to offer. Foreign stock ownership in the US was abysmally low—only 1.2 percent of portfolio holdings consisted of foreign equities in 1981—a common cognitive error called *home bias*.[9] Home bias is the tendency of investors to favor stocks in their home countries. For example, a US investor owning mostly US stocks is exhibiting home bias toward the US. Same with a German investor who owns mostly German stocks. Essentially, it's a failure to diversify properly—that is, globally.

The Third World

Did you know the term "Third World" developed during the Cold War to represent countries or regions in Africa and Asia not aligned in either the non-Communist or Communist blocs? Over time, it began to take on a completely different meaning, generally referring to underdeveloped nations.

An enterprising group of institutional investors recognized the potential in emerging markets. The Capital Group, one of the world's largest investment management organizations, opened its first emerging market fund in 1986. Templeton Investments, another famous US fund company, launched one in 1987 (its portfolio manager, Mark Mobius, remains a well-respected investment voice on emerging markets today). These funds raised awareness of emerging markets, and the asset class became increasingly popular. Private portfolio flows into emerging markets surpassed $50 billion in market capitalization by the end of the decade.[10] Though tiny compared to the many trillions of dollars in total equity holdings, it was evident a seed had been planted.

Germination by Indexation

If the 1980s were the formative years for emerging markets, the early 1990s were its adolescence. There was enthusiasm in a small but growing segment of the investment world, but emerging markets were still struggling to find an identity.

Wall Street played a large hand in its transition into adulthood. Up to this point, there was no clear understanding of what defined an emerging market. The Street recognized this, and several firms set out to create their own definitions. The International Finance Corporation published the first emerging market index in 1993 (creatively entitled the IFC Emerging Markets Index). Other indexes soon followed.

The introduction of indexes provided emerging markets investors with a common framework. Now there were explicit criteria to define an emerging market. It also gave professional money managers a benchmark to offer new products against. Stellar performance didn't hurt, either. From 1990 through 1994, the asset class returned an average annual 20.9 percent.[11] Money poured in—over $200 billion in 1993 and 1994 combined, more than doubling the total level of private portfolio investment.[12] Emerging markets had arrived.

Toward the end of the 1990s, a series of crises reminded investors of the risk in these nascent corners of the investment world. Billions were lost in the Tequila Crisis of 1994, Asian Financial Crisis of 1997 to 1998, and the Russian Ruble Crisis of 1998. These events and their legacies will be discussed in greater detail in subsequent chapters.

BRICs Lay the Foundation for the Twenty-First Century

But these crises weren't enough to shake investor sentiment for long. Emerging markets were here to stay. After the upheaval, a period of stabilization and growth renewed confidence. In fact, many began to question whether some emerging markets were really even "emerging" anymore. In 2001, Goldman Sachs coined the acronym "BRIC" for "Brazil, Russia, India, and China." The investment bank believed these countries shouldn't be thought of as emerging markets in the classical sense—they were now critical and integral to an ever-growing globalized world. In a short 20 years, emerging markets had gone from an unknown to one of the most popular asset classes of the twenty-first century.

THE MOST IMPORTANT QUESTION—WHY?

Despite their ascendancy into the popular investment lexicon, conventional wisdom still views emerging markets as appropriate only for speculators or gamblers—those with abnormally high risk tolerance. These are assets meant for high-flying professionals or investors with a time horizon of 30 to 40 years, the wisdom says. For the rest of us, emerging markets should play little to no role in your portfolio. Why is this discouraging view so widespread?

The answer is rooted in fear. There's good sense behind this—emerging markets can be risky and uncertain, and investing in them, intimidating. Maybe you remember stories of entire countries nearly going bankrupt in the late 1990s. Or perhaps you're just put off by their *strangeness*. After all, their languages, business practices, political systems, freedoms of speech, and so on can be substantially different from the Western investing world. It's just plain easier to stick to what you know (and thus feel most comfortable with)—hence the tendency toward home bias.

But emerging markets *should* play a vital role in a properly constructed global portfolio of equities. Otherwise, you're forfeiting a huge opportunity. In today's global investment landscape, emerging markets make up an increasingly bigger piece of the pie. In 1988, emerging markets constituted a mere 1 percent of the MSCI All-Country World Index, MSCI's broadest index covering all developed and emerging market countries. By the end of 2007, this total had risen to a whopping 11.3 percent[13] (see Figure 1.1).

These aren't companies to ignore, either. In fact, they're some of the largest in the world. In 2001, there was only one company in emerging markets with a market capitalization greater than $50 billion out of 68 in the entire world. By the end of 2007, there were 21 (out of 170). Companies this size are well known globally. Heard of American Express

Figure 1.1 MSCI Emerging Index Market Value as a Percent of the MSCI All-Country World Index

Source: Thomson Datastream; MSCI Inc.[14]

($61 billion)? How about Kraft Foods ($51 billion)? We'd also be willing to bet you've heard of many emerging market companies too without even realizing it. Know anyone with a television made by Samsung? That's Samsung Electronics, an $87 billion South Korean technology company. No rational investor should restrict themselves from investing in some of the biggest and most dynamic companies in the world.[15]

BUT HOW?

"But wait!" you say. "You must have flunked journalism school! You've forgotten one more crucial question: the How!" Don't fret, that's what the remainder of this book entails.

To move forward, we must first move backward. Chapters 2 through 4 will illustrate, through historical narrative, the characteristics outlined here. Investing is about probabilities, not certainties. And history is the only rational way we can reasonably begin to assess probabilities for what might happen in the future. It enables us to see the interconnections, to make smarter investment decisions, and to realize what is truly unique about now, or what is being repeated.

Each of the next three chapters focuses on a different region of the MSCI Emerging Markets Index—Asia, Latin America, and Europe, the Middle East & Africa (EMEA)—through the historical lens of boom and bust. This may scare some readers. Volatility is always present in investing—especially in emerging markets. Certain countries and sectors outperform others at various points in time and sometimes by large margins. But correctly identifying these drivers is a critical variable to your success. With that in mind, the next several chapters are not intended to frighten you away from the category but instead to help you better understand its historical context and the differences across regions. In the long run, investing in emerging markets can be a good decision—the MSCI Emerging Markets Index returned an average annualized 11 percent in the 21 years ending in 2008.[16]

Armed with a historical perspective, we move on to discuss the tools required to successfully invest in emerging markets. Chapter 5 provides a layout of the emerging markets land today. We'll cover which countries and sectors hold the most influence and learn a distinct way of thinking about these markets that offers the best chance of investment success. Chapter 6 discusses developing portfolio drivers, a critical step in determining the areas of the market expected to perform differently than the whole. Only after you've developed portfolio drivers should you begin to think about picking stocks—a brief discussion of security selection comprises Chapter 7. Last, Chapter 8 provides a practical guide to the types of instruments and strategies an emerging market investor might use and common challenges faced.