Chapter 1

An Overview of Emerging-Market Investing

In This Chapter

- Explaining different market categories
- Understanding emerging-market investment opportunities
- Looking at your investment choices
- Seeing how investing relates to economic development
- Considering the risks of emerging-market investing

Investors are always looking for the Next Big Thing, and the Next Big Thing is happening right now in places of the world that you may have overlooked. People are developing new ideas and reaching new markets far from where you live. Emerging markets have great growth potential, and many of them are developing amazing new technologies, partly because they're not tied to existing infrastructure. If you have no phone lines, going wireless makes more sense than building land lines first. If you have no electric power plants, why not go straight to solar?

The term *emerging market* was coined at the World Bank's International Finance Corporation (IFC), which works to develop the private sector in poor countries. The IFC's strategy is to bring in private investors rather than government or nonprofit aid organizations. Antoine van Agtmael, an IFC investment officer, wanted investors to think about the world's lesser-developed countries in a new way. In the late 1970s, he hit upon the idea of *emerging markets* to help describe the investment opportunity for investors willing to look to the long term.

This chapter starts your tour of the markets and the key issues facing them. You don't need a passport, only a desire to discover more about the economic opportunities in the world today.

Defining Emerging Markets

Emerging markets are those countries that have growing economies and a growing middle class. Some of these countries were once poor, and some still have high rates of poverty. Many are undergoing profound social and political change for the better. Another class of country, *frontier markets,* includes those nations that are very small, are at an early stage of economic development, or have tiny stock markets. These markets present opportunities for patient investors with an appetite for risk. The poorest of the world's nations are considered to be *pre-emerging;* these markets have few opportunities for investors now, but they could become really interesting in the years to come, so they're worth watching.

Who decides which countries fall into which categories? The arbiter for most investors is MSCI Barra, a firm that puts together investment indexes used by portfolio managers to evaluate their performance.

The potential is real in these developing markets (the term *developing markets* includes emerging, frontier, and pre-emerging markets). A full 43 percent of the world's wealth is in those nations that are emerging out of poverty and onto the world's financial and trade markets. Most of the world's people are in such countries as well — some 5.5 billion live in emerging, frontier, or pre-emerging markets. And here's the thing: These markets are where the growth opportunities are now. The world's developing nations are growing faster than the developed ones. That faster growth can lead to higher profits than you may get from similar investments in the established markets found in North America, Western Europe, Australia, and Japan.

Appreciating What Emerging Markets Offer

Investors everywhere want to get a return for taking risk and to be a part of economic growth. The very function of investment in capital markets is to provide funds so that companies and governments can grow, creating jobs and improving people's lives in the process.

The needs in emerging markets create opportunities for investors, and that's exciting. These markets are growing, and they're doing so on a different economic cycle than most developed countries. They have new companies selling new products and bringing new energy and ideas to the rest of the world.

Companies and people in emerging markets are tough. They've had to work to overcome crises and hardships that barely register in the developed world. They've had to fight for attention on a crowded world stage. Talk about preparation for modern capitalism!

Great growth opportunities

The total value of goods and services produced in a country is known as the country's *gross domestic product,* or GDP. The GDP of the United States is $14.6 trillion. The U.S. economy is the world's largest, and the wonder is that it grows at all. Consider that a 1 percent increase in the U.S. GDP works out to $146 billion. Now consider the Philippines, an emerging market located in Asia. The entire GDP of the Philippines is $167 billion, according to the World Bank. That's about 1 percent of the entire U.S. economy. If the Philippines were to add $146 billion to its GDP, the country's economy would almost double — and it would still be a tiny fraction of the U.S. economy.

Many countries that have a small economy have a large population, and that's another opportunity for growth. The people of India and China don't enjoy all the goods and services that people in developed countries do. Combined, they have more than 2 billion people who need shoes, soda pop, and sunscreen; who want watches, washing machines, and window cleaner. There's just a huge demand for everything! Meeting the needs of the world's emerging middle class is enough work to keep many companies profitable for decades to come.

TIP

One way to invest in the more than 2 billion people who want the same consumer goods that Americans and Europeans enjoy is to invest in multinational corporations. Most of the largest food-, beverage-, and consumer-product companies have a presence in emerging markets, and in many cases, they get much of their growth from sales in those places.

Uncorrelated returns

The basic philosophy of investing is that you take risk in exchange for the expectation of a return. The trick is that if you have investments with a range of different risks, you can actually reduce the risk of your overall portfolio and increase your long-term return. That's because a lot of the risks cancel each other out. In other words, the returns are uncorrelated.

One of the many attractions of emerging markets is that the risks are very different from those in developed countries. The United States and Western Europe have similar economic cycles, but the United States and South Africa are in different cycles. One country is fully developed and last had a revolution more than 230 years ago. The other is rapidly developing after a peaceful revolution just 20 years ago. (You can find out more about risk and return in emerging markets in Chapter 3.)

TECHNICAL STUFF

The *Markowitz Portfolio Theory* is the academic approach to investing. It says that adding new securities to a portfolio reduces its *covariance,* as long as the securities aren't perfectly correlated. That means that the new securities reduce the portfolio's total risk, even if they're riskier than the securities that are already in the portfolio. The securities' returns are averaged, so adding a riskier security with higher return reduces the portfolio's risk while increasing its expected return. In other words, diversification is the best deal in investing.

New technologies

The billions of people in emerging markets are putting their brain to work, coming up with new ideas for products and technologies for use at home and abroad. From sophisticated computers to low-cost cars to new pharmaceuticals to mobile-phone applications, businesses in emerging markets are serving the world, not just folks in their own countries.

Some emerging-market businesses have been helped by businesses in developed countries. For example, U.S. technology companies have hired firms in countries with less-expensive labor, such as Taiwan and India, to handle hardware manufacturing and software coding. Eventually, the firms developed enough expertise to develop new products and services for other customers. I'm writing this on a computer made by a Taiwanese company, Asus, designed for people in developing countries who can't afford a full-size laptop; I like it because it fits in my purse.

Another reason that companies in emerging markets have pursued new technologies is that many of these countries have poor infrastructure. That poor infrastructure has turned into a strange advantage because innovators aren't tied to an existing way of doing things. The result is that some of the best technologies for mobile telephones and solar power have come out of emerging markets, which have few land lines or electrical generation facilities.

New markets

The emerging-market countries are great customers for companies everywhere, both those based in developed countries and those in other emerging markets. The world no longer follows the old mercantile model, in which rich countries bought materials in poor countries, took them back home to their factories, and then brought the manufactured goods back to the poor countries to trade. Instead, everyone trades with one another. A company in China working on low-cost solar power has a ready market in Nigeria. An Indian company that develops a $2,000 car for the new middle class there can sell it in Indonesia and Malaysia, too. A Mexican cement manufacturer can find customers in the United States and in El Salvador.

Way back when, the World Bank's International Finance Corporation promoted investing in emerging markets because of their growth potential. The organization was charged with using investor-led economic development not only to lift people out of poverty but also to create new opportunities for businesses all over the world. And that creates great opportunities for investors.

You may think of some of these markets as new, but many of the countries considered to be emerging have a long, rich history and, in many cases, had a rich economy in centuries past. For whatever reason, they retreated while nations elsewhere became strong, but now, they're coming back!

The Big Categories of Investment

Before I get into such issues as buying stock versus buying mutual funds (I cover different ways to invest in emerging markets in Part IV), I want to cover investing at the broadest level. Basically, you can invest in emerging markets in two ways — buy securities as an investment or invest directly as a business.

No matter which area is your primary interest, understanding a little bit about both of them can help you analyze the overall investing climate.

Securities

The most common way for individual investors to participate in emerging markets is through purchases of *securities* such as stocks, bonds, or mutual funds. These securities give people exposure to the potential in emerging markets without the headaches of actually running a business.

You have a huge range of ways to invest in securities in emerging markets. You can invest from your home country through mutual funds or international securities listed on domestic exchanges. You can buy securities traded in other markets if your broker can handle the trade (and most can these days). You can find hedge funds that accept minimum investments of millions of dollars that seek out opportunities in emerging markets (see Chapter 18 for information), or you can commit just a few dollars to a microfinance fund (covered in Chapter 19) to help very small businesses get underway. Or you can make related investments such as cash or real estate. And in most cases, you can buy or sell with little fuss when your circumstances — or those in the target country — change.

Using the financial markets, you can participate in the exciting changes happening in the world no matter how much money you have to invest. And although emerging markets tend to be riskier than developed ones, that's not always the case for every market and every investment.

Foreign direct investment

Foreign direct investment involves starting a business, opening a subsidiary, making an acquisition, or otherwise expanding an operating company into an emerging market. It involves making a major commitment of time, money, and energy to a country that may not have a lot of experience hosting international businesses. Foreign direct investment isn't easy to get started in or to pull out of if the project fails.

For the most part, only large companies pursue direct investment, although some entrepreneurs have been known to run off and start new ventures in lands far from home. To be successful, foreign direct investment starts with a careful analysis of a market and its operating climate. And hey, that's what this book is all about!

TECHNICAL STUFF

Americans sometimes get stressed about the fact that the country imports more goods than it exports. It's almost as if the United States' global influence is waning. Yet if you travel anywhere in the world, the presence of American companies is loud and proud. That's because the largest American companies prefer foreign direct investment. American manufacturers operate facilities all over the world to serve local markets. McDonald's doesn't fry up hamburgers in the United States and ship them off to South Africa; it owns and operates restaurants in South Africa that make hamburgers there with local labor working with local ingredients. General Motors doesn't export vehicles to China; it makes them in Shanghai. Citibank has branches in Mexico City so that its customers don't have to cross the border to make a deposit. The profits, of course, belong here.

Pairing Investing and Economic Development

The International Finance Corporation wanted to get investors excited about the world's less-developed countries because it wanted to attract private-sector dollars to help eradicate poverty. When it invented the term *emerging markets,* though, the intention wasn't to get investors' charity. Rather, the point was to help investors see the tremendous profit possibilities that could come from making a country better off.

Creating opportunities, business, and jobs makes people better off. It's that simple. This section explains how investments work to create economic development.

Starting new businesses

Some emerging-market investors invest in *venture capital,* which means that they give entrepreneurs the money they need to get started. I discuss this method in Chapter 18.

Although starting a new business isn't an especially common way to invest in emerging markets, investment activity creates new businesses, and many businesses eventually issue securities that investors can buy. If a prospective entrepreneur sees that growth is happening and that she may be able to get a slice of it, she'll be more likely to start a business. Instead of venture capital, she may rely on friends and family at the start, but the *initial public offering* (the first time that a security is offered for sale to the public) may be a key goal along the way.

REMEMBER

New businesses hire employees, and that creates growth. People see that they can make a better life for themselves and their families not just by working hard (billions of people work very hard to eke out an existence on barren farmland) but also by working hard at a business that can pay a salary and offer opportunities for advancement.

Engaging on a world stage

Countries that trade and allow outside investors become modern more quickly than countries that don't. This modernization process doesn't happen all at once, of course, but over time, as a nation enters into trade agreements, upgrades its legal systems, and commits to buying and selling with people all over the world, its economy should grow, and investments are likely to become more valuable. That's the good stuff, yes?

REMEMBER

But the early stages of economic development may be slow going. Investors in frontier markets (covered in Chapter 7) especially may need to be patient because it can take a while for the effects of a more open market to take place. That patience is likely to be rewarded. After all, you buy low when a nation is in the early stages of development, hoping to sell high when it's more mature.

Contributing to economic development versus direct aid

Investing isn't *aid,* and you shouldn't confuse the two. Philanthropic aid is important to the world, especially in dire situations such as natural disasters or famine. But aid isn't the solution to all problems of poverty. In fact, sometimes aid exacerbates problems because it can prevent local institutions from developing, and corrupt governments can use it as a tool to keep people oppressed.

One type of investment, *microfinance* (covered in Chapter 19), ties aid and investing together. It involves providing small amounts of capital to entrepreneurs with small needs, such as a market stall operator who wants to buy a refrigerator or a carpenter who'd like to invest in power tools in order to handle bigger projects. Even though many microfinance investors are motivated by the feel-good aspects more than the total return, the best microfinance programs respect the business savvy of both the borrower and the investor.

You may well be looking at emerging markets as a way to make the world a better place for more people, and you may want to invest responsibly while you do it. That's fine. Just be sure to use your head and not your heart when you make decisions.

Risk Considerations for Emerging-Market Investors

Investing in emerging markets is exciting. You get to find out about new places and participate in the movement of billions of people out of poverty and into a more prosperous life. And you may be able to reduce your portfolio risk and increase its return at the same time. However, investing in emerging markets has its own issues, and the more you know about them, the fewer surprises you'll have.

Political and social risk

In any country, investors have to be concerned about changes in the political climate or in the way that society is organized. Even changes that make most people better off may leave a few behind, and sometimes those left behind are investors.

Many emerging markets began their economic improvement because of a major political change. For example, the emerging markets in Eastern Europe were once Communist nations that had to stay in good graces with the Soviet Union. However, the Communists fell out of power, the Soviet Union broke up, and most of these countries are now parliamentary democracies with market economies. The economic climate is really exciting for the people who live in these countries, not to mention for the people who invest in them. However, such profound changes create risk, and many nations in Eastern Europe have had economic and social upheaval on the way to economic stability. (One of these nations, Poland, has come so far that many observers are surprised to find that it's still classified as an emerging market.)

But politics being politics, things may turn against investors, too. A country could come into a situation such as war or a natural disaster that destabilizes the economy and pushes commerce down the list of priorities. Investors, especially those outside the country, won't necessarily be a consideration when the government is tackling what it sees as bigger issues (and in some cases, the government is right to do that if its top priority is the well-being of the nation's people).

Corruption

In many emerging markets, corruption is a fact of business. In some cases, it's rooted in cultural differences, where people receive tips for services that wouldn't be rewarded anywhere else. In other cases, corruption is rampant because the people have dealt with ineffective institutions for years and have had to figure out ways to work around them. And in still other cases, the problem is nothing more than basic human nature combined with lax law enforcement.

Corruption affects a business's ability to present fair financial statements. It adds costs that may not be predictable or manageable. It can throw in surprises and make contracts void in court. It may seem as though a bribe is the quickest way to get business done, but corruption is costly in the long run. Investors usually find that the less corruption a country has, the better its economy. Academic research shows that the less corruption a country has, the less volatile its investment returns are. You can find out more about corruption in Chapter 9.

Currency risk

In most emerging markets, you use a currency other than your own. That means that your investment returns are affected by changes in the value of both your currency and the emerging-market currency. You can reduce the risk with hedging techniques, but doing so may eliminate some of the return and diversification benefits.

Currency risk can work in your favor! In general, a country's currency becomes stronger (that is, more valuable) as its economy grows.

You can find out more about currency in Chapter 13.

Liquidity risk

It's not always easy to buy and sell securities in emerging markets. Some markets are just very small! Jamaica, for example, has a total market capitalization of $4.8 billion. Compare that to one company, Apple Computers, at $254.6 billion! Getting a position in some of these markets may be difficult, and you may have a hard time selling your position when you're ready to get out. This is known as *liquidity risk.*

If you limit your emerging-market commitment to the part of your portfolio that's intended for long-term goals, low liquidity will be less of an issue because you're less likely to have to sell your positions on short notice.