Emerging market funds allow investors to participate in rapidly growing economies, while being diversified across various regions, avoiding country-specific risk.

The Mutual Fund Route to the Growth Potential of Emerging Markets

By Albert J. Fredman

"Emerging" (or "developing") markets are nothing new. About a century ago the British viewed the U.S. as an emerging market when their investment trusts bought shares of infrastructure companies here, especially railroads. At that time, the U.S. economy was a far cry from today's sophisticated nation, which churns out more than $7 trillion worth of various goods and services annually.

As the new millennium draws nearer, there's no shortage of opportunities for savvy emerging market investors. More than 17,000 companies valued at nearly $2 trillion traded on 60 emerging market stock exchanges around the globe, according to year-end 1994 figures from the International Finance Corporation, a World Bank affiliate providing financing for businesses in developing nations. Aggregate trading volume on the world's emerging stock markets reached an all-time high of more then $1.6 trillion in 1994. Argentina, China, the Czech Republic, India, Indonesia, Russia, Sri Lanka and Turkey are illustrations of the developing frontier.

In 1981, the International Finance Corporation's Emerging Markets Database was the first to begin tracking the performances of stock markets in developing countries. At the time, only a handful of nascent markets were open to foreign investors. Since then, the number of accessible stock exchanges has grown dramatically and they have generally become larger and more liquid. Emerging markets climbed from 4% of total global stock market capitalization at the end of 1985 to 13% at year-end 1994. Developing markets are pushing up the total capitalization of the world's stock markets.

Defining "Emerging" Markets

Deciding whether to classify a nation as "emerging" can be subjective. Far more heterogeneity is evident among emerging markets than in the developed world. But, at a basic level, an emerging nation has one or more of the following three characteristics:

- *Low or middle per capita income.* The World Bank classifies countries as high, middle, or low income. In 1994, a country having less than $8,955 (in U.S. dollars) in per capita gross domestic product (or GDP) was categorized as a developing market.
- *An economy that has not yet been industrialized*. These countries often lack a technological infrastructure such as adequate roads, telephones and power generators. The term "pre-emerging" market is sometimes used to describe nations that are at an even earlier stage of development such as Bangladesh, Egypt, Kenya and Tunisia.
- *Underdeveloped financial infrastructure*. The total market capitalization of an emerging nation's stock market is often a relatively small percentage of its GDP. (In fact, many do not even have stock markets.) In addition, a handful of companies may dominate the stock exchanges. Emerging markets are typically illiquid, volatile and difficult to evaluate. Securities transactions may be handled inefficiently. Sometimes an exchange is built before trading rules have been established.

According to the International Finance Corporation, 170 emerging countries are in existence in contrast to only 39 developed or industrialized nations. In addition, 85% of the world's 5.5 billion population resides in underdeveloped economies. By contrast, emerging markets account for only 20% of the world's $24.25 trillion gross national product. These countries are found largely in Asia, Latin America and Eastern Europe but exist also in Africa and the Middle East. Many have become accessible to foreign investors only in recent years. Some markets that were considered emerging a decade ago have now moved into the developed category. Of the 170 emerging countries, 83 currently have organized stock markets.

Giant strides have been made over

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the past several decades in emerging nations. With improved healthcare, life expectancy has increased markedly. Adult literacy has risen phenomenally and demands for education have skyrocketed. Industries that are considered mature in the U.S., such as banking, cement or telecommunications, offer exciting growth potential in developing economies. Technological change is progressing rapidly. Some areas, particularly Latin America, have extensive untapped natural resources.

Let's take a brief look at the two biggest emerging markets.

With more than 1.2 billion people and a vast land area of nearly 3.7 million square miles, China is the world's largest emerging nation. Like many other developing economies, it has a relatively young population, low wages, high export volume and a relatively primitive infrastructure. For example, there is only one telephone per 77 persons in contrast to one for every 1.3 persons in the U.S. Its stock exchanges are located in Shanghai and Shenzhen. The entrepreneurial urge is strong and, with its projected rapid growth in gross domestic product, China could eventually become the world's best long-term growth story. But patience is needed. The country is now a communist dictatorship and its stock market is still small and speculative.

India has one of the world's oldest civilizations. With more than 900 million people and a land area of more than 1.2 million square miles, it has a large middle class with a healthy appetite for goods and services. There is only one telephone per 131 persons. India has numerous stock exchanges that collectively list thousands of issues. The largest, in Bombay, lists more firms (which are mostly small) than any other exchange in the world. India's stock markets have a long history, rife with the kinds of problems typical of a Third World economy. The country received its independence from Britain in 1947, but fell under Socialist rule, which held back economic progress. Since 1991, however, there has been radical reform with growing interest in free enterprise.

Table 1.
Total Returns of Selected No-Load Emerging Market Funds and Benchmarks

	Total Return (%)			
	1993	**1994**	**1995**	**1996***
Fidelity Emerging Markets	81.76	–17.93	–3.18	9.45
Lexington Worldwide Emerging Markets	63.37	–13.81	–5.93	10.47
Montgomery Emerging Markets	58.66	–7.72	–9.08	6.12
Lipper Emerging Market Funds Index	72.17	–9.62	–4.59	8.51
Lipper International Funds Index	36.53	–0.51	9.42	4.38
Lipper General Equity Funds Index	13.02	–1.46	31.08	5.65

**Quarter ending 3/29/96*

Source: Lipper Analytical Services, Inc.

Favorable Investment Opportunities

Emerging markets represent a vast and exciting investment frontier offering a chance for generous returns to patient, risk-tolerant, long-term investors. Higher returns are possible because emerging economies and stock markets are both expanding rapidly. Infrastructure expenditures enhance the growth of developing countries as they did growth in the U.S. in the late 19th and early 20th centuries. Developing economies usually depend heavily upon revenues from their important exports to fuel rapid economic growth. Low wage rates, highly skilled workers, and abundant natural resources often provide a competitive edge.

Developing market investors can also benefit from the risk-reducing potential of global diversification. A globally diversified portfolio tends to have less volatility than portfolios with either a 100% U.S. exposure or a 100% non-U.S. allocation. Because they are affected favorably and unfavorably by unique circumstances at different times, developing markets can offer an additional layer of international diversification beyond that realized by investing solely in developed markets.

Emerging markets also offer unique pockets of inefficiency. In an efficient market, such as the New York Stock Exchange, new information is freely available and acted upon so rapidly that it's difficult to find and profit from a mispriced stock. However, in the smaller, thinly traded non-U.S. markets detailed information is more difficult to obtain and analyze. Astute managers can profit in this arena. Investor overreaction is another way global managers can profit. As sentiment shifts, small, thinly traded markets experience far wider price swings than the world's largest, most liquid exchanges.

Even though emerging markets can reward patient investors well, investing heavily in one or a few of them is highly risky. How can you be certain which one will deliver the best performance over the next decade? To reduce your country-specific risk, consider the emerging market funds that diversify throughout the developing world.

Recent Investment Performance

Changes in interest rates have had a big impact on stock prices in developing markets. In the early 1990s, when the Federal Reserve substantially reduced interest rates, Americans channeled large amounts of money into developing countries. Emerging markets soared in 1993, but tumbled in 1994 as the Fed raised interest rates from historically low levels. As rates increased concurrently worldwide, the flow of money into emerging markets reversed, triggering a collapse of stock prices. Mexico's severe peso devaluation in late 1994 led to huge losses for that market, but also reverberated throughout the developing world, in what has been called the "tequila effect." Market abuses in China, India, and Russia reinforced negative sentiment. Emerging market performance in 1995 was dismal in striking contrast to the roaring bull market in U.S. equities.

Table 1 shows that the average emerging market stock fund surged 72.17% in 1993, then lost 9.62% and 4.59% in 1994 and 1995, respectively. Also appearing in the table are three no-load emerging market funds that have been in existence for the three full years. Note that the emerging markets category performed quite differently from the Lipper international funds benchmark (which generally reflects funds with more than half of their assets in developed markets) and also from the general equity funds category (which includes mutual funds with the majority of their assets in U.S. stocks).

This year, emerging markets are looking up thanks in good part to an inflow of new money from Americans, particularly institutional investors, who see greater values abroad than in the lofty U.S. market. Lipper data indicate that the emerging markets category gained 8.51% during the first quarter of 1996 (Table 1).

Table 2.
Privatizations in Developing Nations

Year	Sales Volume (U.S. $ mil.)	Number of Sales
1994	21,836	775
1993	24,459	763
1992	29,009	518
1991	23,568	498
1990	10,206	355
1989	6,154	117
1988	2,594	28

Source: World Bank Privatization Database

The Risks

The risks of investing in emerging markets are obviously greater than those associated with developed countries. Primary risk factors include:

- *Volatility*: Emerging markets can be significantly more volatile than developed markets. Table 1 contained a sample of this volatility. In any given year some fledgling stock exchanges may be up more than 100% while others plunge. Soaring stock markets can turn on a dime.
- *Illiquidity:* Because trading volumes are lower in emerging markets than in their developed counterparts, individual transactions can have a much greater price impact. It's often more difficult to sell a position at an acceptable price than it was to acquire it. It may take weeks to gradually unload a stock in the tiniest, least liquid markets.
- *Currency devaluations:* Unexpected exchange rate devaluations can cause major market meltdowns, as occurred in Mexico.
- *Unanticipated political and economic developments:* Various events such as coups and drastic changes in government policies can send tiny illiquid markets spiraling downward, especially if the stocks were overpriced.

Privatizations Fuel Growth

Privatization essentially involves shifting responsibility from the government to private industry for meeting peoples' needs for goods and services. Governments moving toward free-market economies are transferring shares of state-run enterprises into private hands in various ways. These are often sizable organizations and thus offer significant investment opportunities. New stock exchanges are created to handle the growing number of publicly traded companies and accommodate the inflow of capital from developed nations.

Table 2 shows the growth of privatization in developing nations. Telecommunications, energy, insurance, banking, steel, and mining are examples of industries where privatizations have occurred.

Why sell state-run enterprises? Benefits include the following:

- Privatizations often result in improved organizational efficiency and profitability as well as more competition, which leads to greater consumer satisfaction.
- A well-run enterprise can have better access to talented individuals and can tap the financial markets as needs arise.
- Government budget deficits are reduced because the sale of a state-owned business generates money and eliminates any drain on the government that an inefficiently operated enterprise may have been. Free markets do a much better job of allocating resources than a bureaucracy.
- The nation's capital markets develop simultaneously, encouraging domestic savings and investment, attracting an influx of foreign money and, ultimately, fostering higher growth.
- Even though job losses may result in the short-term, privatizations offer the hope of fuller long-run employment because of their favorable impact on economic growth.

Under prime minister Margaret Thatcher, Britain was a pioneer in privatizations in the 1980s; the $6.4 billion sale of British Telecom shares in November 1984 drew considerable attention. Privatizations were initially more common in developed countries but in the 1980s many emerging markets became involved, with those in Latin America being first. Since 1987, tens of thousands of enterprises have privatized in about 100 countries.

Of course, these transitions have not always proceeded smoothly. Mexico and Chile are among the developing countries that have fared very well with their privatizations. After the fall of communism, large-scale industry privatizations took place rapidly in Eastern Europe and the nations of the

Table 3.
Growth of Emerging Market Fund Category

	1992	1993	1994	1995
Total net assets ($ mil.)	611	6,251	8,925.5	9,649
Number of funds	8	17	56	66

Source: Lipper Analytical Services; data as of year-end.

former Soviet Union. Many Asian and sub-Saharan African nations currently have programs underway.

Emerging Market Funds

The riskiest route to emerging markets is the single-country closed-end fund. These funds can alternate between double-digit discounts and double-digit premiums as investor sentiment swings from fear to greed, and vice versa. A volatile country fund with a manic-depressive personality could easily be up 100% one year and plunge 40% the next, taking shareholders on a wild roller-coaster ride. Owning a fund with exposure to many emerging countries in different regions of the world greatly reduces your risk. The growth in this fund category since 1992 has been striking, as seen in Table 3.

More of these world-wide portfolios have been introduced by no-load families in the last few years, as is evident in Table 4, which lists selected funds that had total net assets of at least $25 million at this writing. The recent country allocations of three of these funds appear in Table 5.

Each fund is relatively unique. For instance, Montgomery Emerging Markets diversifies widely and recently had about 300 stocks in its portfolio. It uses a proprietary optimization model to help set country allocations that maximize expected returns for a given risk. "Bottom-up" fundamental analysis is then used to select individual stocks. Fidelity Emerging Markets takes a bottom-up approach, searching for stocks with a strong earnings outlook at a reasonable price.

In contrast, T. Rowe Price Emerging Markets Stock uses both a top-down and a bottom-up approach, with a bit more emphasis on the latter.

Vanguard International Equity Index Emerging Markets is a passive portfolio that tracks stocks in a dozen developing countries. An emerging market index fund may seem to be an oxymoron because emerging markets are the most inefficiently priced stock markets in the world, offering astute managers a chance to show their talents. However, the appeal of the fund is its low costs. It has a 0.6% expense ratio, far below the average for the funds in Table 4. In addition, its minuscule 3% portfolio turnover rate gives it an edge over actively managed portfolios because of the high transactions costs associated with actively trading stocks in illiquid markets.

The Vanguard portfolio follows the Morgan Stanley Capital International Select Emerging Markets Free Index by investing in a sampling of stocks contained in that benchmark. The fund is probably more diversified than its peers in total stock holdings, which numbered 380 at this writing. However, the 12 markets it targets are among the more established in the category and thus may not offer the most dynamic growth opportunities. Malaysia, Brazil and Hong Kong, collectively, comprise about half of the market capitalization of the index.

The Vanguard portfolio is intended for long-term investors. Shareholders face a 2% fee to purchase shares and pay a 1% redemption fee. These fees are paid directly to the fund for the benefit of continuing investors to defray the high costs of buying and selling emerging market stocks. There is also a $10 annual account maintenance fee, which is waived if your investment is $10,000 or greater.

Don't confuse the emerging market fund category with the specialized group of international funds that target small or emerging companies, which normally have market capitalizations of less than $1 billion. Examples of funds in the latter group are Acorn International, Founders Passport, Montgomery International Small Cap, and T. Rowe Price International Discovery. These portfolios typically have substantial exposure to small companies in developed countries such as Japan and the U.K., as well as those in developing countries.

Getting Exposure

You don't necessarily need an emerging market fund to gain exposure to this slice of the globe. Some tradi-

Table 4.
Selected No-Load Emerging Market Funds

Fund	Date of Inception	Net Assets ($ mil.)	Expense Ratio (%)
Fidelity Emerging Markets	11/90	1,382.6	1.41
Lexington Worldwide Emerging Markets	6/91	342.4	1.65
Montgomery Emerging Markets	3/92	943.1	1.85
Robertson Stephens Developing Countries	5/94	30.1	1.85
T. Rowe Price Emerging Markets Stock	3/95	33.8	1.75
USAA Emerging Markets	11/94	40.9	2.50
Vanguard International Equity Index Emerging Markets	4/94	395.0	0.60
Warburg Pincus Emerging Markets	12/94	118.0	1.65

Source: Individual Funds; data as of 4/1/96 tional international funds such as Oakmark International, T. Rowe Price International, Strong International, and Warburg Pincus International—which invest primarily in major and second-tier developed nations—may move in and out of developing markets with a limited portion of their assets. This is also true for managers of small-cap international funds. A bullish manager might allocate more than 40% of the portfolio to emerging stock markets. When the outlook clouds, he could cut back or move out completely. To what extent—if any—does your international fund invest in developing markets? You can check a fund's country exposure in its shareholder reports or by calling the fund's investor representative.

In addition, growth in the emerging markets arena offers more and better opportunities for large companies in developed economies to tap into huge markets in countries such as China and India. These are the kinds of companies most growth and income funds hold. Thus, you may already have sufficient exposure to the developing nations.

Table 5.
Recent Country Asset Allocations of Three Funds

Montgomery Emerging Markets

Country	Weight (%)
Argentina	3.9
Bangladesh	0.2
Brazil	12.5
Chile	3.1
China	2.5
CIS*	0.8
Colombia	0.5
Czech Republic	1.8
Greece	0.7
Hong Kong	2.6
Hungary	0.3
India	4.3
Indonesia	3.5
Israel	1.1
Jordan	0.5
Korea	5.7
Malaysia	13.3
Mexico	4.5
Pakistan	1.0
Peru	2.2
The Philippines	5.0
Portugal	3.1
Poland	0.1
Singapore	1.5
South Africa	7.0
Sri Lanka	0.2
Taiwan	6.4
Thailand	5.9
Turkey	1.3
Venezuela	0.6
Vietnam	0.1

T. Rowe Price Emerging Markets Stock

Country	Weight (%)
Argentina	4.1
Belize	1.5
Brazil	13.3
Chile	5.5
China	4.3
Colombia	0.8
Czech Republic	1.6
Estonia	0.8
Hong Kong	1.5
India	2.0
Indonesia	5.6
Israel	3.8
Malaysia	12.8
Mexico	10.7
Peru	2.3
The Philippines	3.1
Poland	0.1
South Africa	2.4
South Korea	6.2
Taiwan	0.5
Thailand	6.5

Vanguard International Equity Index Emerging Markets

Country	Weight (%)
Argentina	5.0
Brazil	13.5
Greece	1.5
Hong Kong	13.9
Indonesia	6.0
Malaysia	19.2
Mexico	10.5
The Philippines	3.6
Portugal	2.2
Singapore	6.3
Thailand	11.4
Turkey	1.4

**Commonwealth of Independent States, an alliance of former Soviet states*

Source: Individual Funds; asset allocations exclude short-term investments and are not necessarily representative of current allocations.

Selecting a Fund

Here are a few questions to ask if you want to allocate a portion of your assets to an emerging market fund to gain undiluted exposure:

- *What is the country diversification?* Are you getting exposure to a wide variety of truly developing markets in different regions of the world? Does the manager make big country bets, which increase risk?
- *What is the reputation of the fund group for international investing?* This is particularly important if the emerging markets portfolio has a relatively short history. You need to rely heavily on the track record of the organization for international investing.
- *What are the expenses?* Avoid funds with expense ratios and turnover rates that are high relative to their peers. Don't overpay for exposure to developing markets, especially if you hold a large international fund that already exposes you to these nations at a more reasonable cost.
- *Do you want more focus?* You can select a regional fund investing in Asia or Latin America, such as those offered by Fidelity, T. Rowe Price, and Scudder. With both an Asian and a Latin American portfolio you can be exposed to both regions in whatever proportions you choose. For more on regional funds see "Investing Overseas: A Look at Funds That Have a Regional Focus," by John Markese (*AAII Journal*, June 1995, pp.15-17).

Conclusion

Long-term trends look favorable for emerging markets.

The safest way to gain direct exposure to emerging nations is through a globally diversified, well-managed or passive developing markets fund or an international fund that allocates a significant portion of its assets to these markets. Limit your developing markets stake to between 10% and 40% of your total foreign market stock fund holdings, depending on personal factors such as your age and risk tolerance.

An emerging market fund is an aggressive growth portfolio and demands patience and discipline. I recommend these funds to those who have at least a 10-year time horizon.