

Easy money already taken in emerging market stocks

Most seasoned investors understand that investing in quality companies with headquarters outside the United States can help reduce risk. By gaining exposure to different markets, currencies, economic cycles, demographics and more, global diversification can enhance the risk-return trade-off over time.



Gary Brooks

Look at the amount of money invested in international stock mutual funds over the past five years – \$413 billion through Aug. 31 – compared with U.S. stock mutual funds – minus-\$19.6 billion – and clearly investors are thinking beyond borders.

However, within this international emphasis, a tilt toward chasing performance, not necessarily toward building a more diversified, globally balanced investment mix is evident.

The shift focuses on emerging markets specifically. Emerging markets are those outside of North America, Western Europe, Japan and Australia. This includes most of Asia, Latin America, the Middle East and Eastern Europe.

In the past three years, the emphasis on emerging markets is startling. Research from Vanguard and Morningstar indicates that 97 percent of net mutual fund cash flow into all international investments for the three years ending Aug. 31 went to emerging markets.

Twenty-nine percent of the total amount invested in emerging markets in the past 10 years was invested in the past year. Whether this reflects the wisdom of crowds or the madness of crowds – well-regarded books have been written about each – is not known.

It's no coincidence that investors are piling into emerging markets because of their performance relative to U.S., Europe and Japan markets. The average annual return of the MSCI Emerging Markets Index over the past 10 years was 11.94 percent as of the end of October. The broad U.S. market (Russell 3000 Index) gained 0.62 percent per year over that period while developed international markets (MSCI EAFE Index) gained an annual 0.75 percent.

While performance is the lead attraction, investors also are lured by projections of strong economic growth relative to the rest of the world. Vanguard research suggests, however, that "strong economic growth does not necessarily lead to exceptional stock returns. In fact, there is zero historical correlation between economic growth and a country's stock market returns."

Here are some thoughts about managing your own investments in emerging markets.

- By fundamental measures of market value, emerging markets are no longer as clearly undervalued as they were in the early 2000s. They are now considered to be valued about the same as

U.S. markets. This means investors are paying about the same price for a dollar of a company's expected future earnings in the U.S. and the emerging markets. In other words, the easy money has already been made.

- Companies in emerging markets make up 16 percent of all the publicly traded companies in the world. Having a higher weighting than that among your own stock holdings might be excessive for all but the most aggressive investors.
- If you don't have emerging markets exposure in your overall investment mix, it might be wise to add it incrementally. As emerging countries continue to grow, their weight in the global marketplace will grow as well and a significant gap could develop in your investment approach.
- If your employer retirement plan doesn't offer an emerging markets option (many don't) consider using your IRA or taxable account to find an appropriate choice.
- Even if you don't invest in emerging markets directly, remember that you have exposure to these markets through multi-national companies that derive significant revenue from business there.
- Rather than overweighting stocks in emerging markets, consider emerging market bonds as another element of broadening diversification.