

Emerging markets: Should you or shouldn't you?

While they are known for their risk and volatility, emerging markets - which range from high-profile markets like China and India to the lesser-known markets of Columbia and Egypt - have posted spectacular returns over the last four years. Since January 2003, the benchmark MSCI Emerging Markets Index has returned a staggering 267 percent equating to an annualized return of about 35 percent.

By comparison, equity markets in the more established financial centres returned much more modest gains. Stock markets in the US and UK generated less than half those gains during the same period returning around 15 percent and 17 percent a year, respectively.

Emerging market debt has also delivered remarkable gains. Over the past 10 years, emerging market sovereign (government) bonds have outperformed not only U.S. corporate bonds, but the S&P 500 equity index as well. Quite a mind-boggling feat in fact, which makes the case for investing in emerging markets even more compelling.

So is now a good time to take that plunge into emerging markets?

Emerging market economies tend to experience rapid economic growth which translates into strong earnings growth for the companies that do business there. Rapid earnings growth, in turn, often means big gains in stock prices and in the indices that track them.

According to the World Economic Outlook released by the International Monetary Fund in April 2007, "emerging markets and developing countries will continue to grow strongly, drawing continued support from benign global financial conditions". Not surprising when you consider that it's where most of the world's resources and people are.

Asia, led by China, is and will likely continue to be the world's most rapidly growing region. China's gross domestic product soared an estimated 10.5 percent last year. By contrast, U.S. GDP grew only 3.3 percent. Not surprisingly, China's stock market soared, rising 83 percent in 2006 while the Standard & Poor's 500-stock index gained just 15.8 percent.

Given that developing economies are expected to outpace developed markets for some time, emerging markets continue to offer investors an attractive investment destination. And despite six years of stunning gains, stock prices in emerging markets are not that high, at least in relation to earnings.

Stocks in emerging markets are trading at a price-to-earnings ratio of around 13, based on 2007 estimated earnings. Meanwhile, profits among emerging markets companies are forecast to grow around 14 percent. By comparison, the S&P 500 is trading at a P/E of around 15, but its earnings are expected to climb only around 7 or 8 percent.

Still, valuations are only as good as the earnings that they are based on and some experts are not overly confident about the quality and consistency of profits in emerging markets. One contrarian view, for example, suggests that the recent commodity price slow-down may put a damper on developing economies since many of the world's industrial commodities are mined or processed in the emerging markets.

Of course, no one can predict the market direction and with emerging markets now in their fifth year of a bull cycle a bear market could start at any time. But don't let short-term price considerations scare you away from long-term value. Remember that it's time in the market, not timing the market that counts. For long-term investors, there is never a bad time to gain exposure to emerging economies. A temporary price decline actually creates buying opportunities for investors allowing them to add to their holdings at a lower cost.

Unfortunately, most investors do just the opposite: they invest while emerging markets are hot and sell when they're not. Too often, emotions cloud our investment decisions. If you are going to panic and sell if volatility kicks up and the market swoons, it is probably better to be realistic and limit your exposure to such a volatile asset class.

Emerging market investments are certainly not for the faint hearted. They are inherently volatile which is why investors expect higher returns for the greater risk they are taking. Risk is usually measured by standard deviation in total returns which shows how past returns vary from the average rate of return for the time period considered. There is no top limit to this figure – the higher the standard deviation, the higher the price volatility and fluctuation.

The S&P 500 U.S. stock index has had an annualized standard deviation of 7.1 over the past 3 years. By contrast, the MSCI Emerging Markets Index has had a standard deviation of more than twice that at 16.6. And even if you could invest for the very long term, returns from any one emerging market are likely to be more volatile as the gains in a developed market.

Just look at what happened in February of this year when global markets over-reacted to news that China was taking measures to cool its overheated economy. In one day, the Chinese stock market suffered its worst trading day in over a decade, with the benchmark Shanghai Composite Index down almost 9 percent, while the S&P 500 Index fell a gentler 3.5 percent.

The best way to mitigate single country risk is through diversification. Instead of trying to pick individual stocks or specific economies to invest in, choose mutual funds or ETFs that will give you exposure to a variety of emerging countries. Because of the difficulty in predicting which countries will achieve sustained economic growth over the long haul, it makes sense to invest in several different emerging markets.

Beware that some broad emerging markets funds invest in numerous countries, but frequently have big positions in just a few. Similarly, single-country funds may buy an entire national market or just several sectors. So before you invest, compare the number and diversity of securities held to other available funds as well as to your current holdings. Choose funds that complement each other and the rest of your portfolio, not funds that have significant overlap.

Exposure to those truly emerging markets, which have a low correlation with developed markets like the US, Western Europe and Japan, will give you the most diversification. Although emerging markets are more volatile in isolation, they tend to react differently to changes in market conditions than other asset classes and can actually reduce the volatility in your overall portfolio.

Investors who don't want to wade through fund factsheets and sort through manager track records might consider buying an exchange-traded fund. The iShares MSCI Emerging Market ETF, which is correlated to the performance of the MSCI Emerging Markets Index, makes it easy to inexpensively buy into global emerging markets in one fell swoop.

For those who want to invest in specific emerging markets, single-country and regional ETFs offer a quick and efficient way to do that. Remember, however, that investing in a single country can incur significantly more market and political risk. Pick the right country and your investment can soar, while an investment in the wrong place can mean disaster.

While today's emerging markets seem more financially stable than they once were, single-country ETFs are only appropriate for sophisticated investors, active traders, and institutional investors who take positions based on macroeconomic calls – they are not suitable for the balanced portfolio of an individual investor. If you are still determined to make a country play, it's best to stick with the major emerging economies, namely Brazil, Russia, India and China (BRIC).

Stomaching the ups and downs of emerging markets can be difficult for most investors, but this asset class has a place in practically every portfolio because of its ability to both increase return and diversify risk. But don't make the mistake of allocating too large a share of your portfolio in emerging markets in the hope of a re-run of recent outsized returns. A portfolio overweight in the stocks of developing countries could mean taking on too much risk and losing more than you can afford to.

While emerging markets may not serve up the same dizzying returns over the next few years as they have in the past, they're still a good bet for investors who want to position themselves for the longer-term growth of these markets. So don't be scared to make emerging markets a permanent part of your diversified portfolio.