Emerging Markets: Profit or Peril?

By David G. Dietze, JD, CFA, CFP™
Founder, President and Chief Investment Strategist
Point View Wealth Management, Inc.
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Emerging market (EM) stocks have gone from first to worst over the last three years. Equities from this region suffered through a horrendous first month of the New Year, and are now being widely blamed for the Dow's worst start since 2009. Sentiment has soured tremendously, as the pundits cite contagion fears from EM, the market's new pariahs.

Of course, it's not just EM stocks that have tanked, as the region's currencies have also come under attack. This creates fresh head winds, as investors now have to factor in that EM companies' revenues must be depreciating as a result.

With tapering now a reality, and not just a possibility, analysts warn that EM countries will be hard hit as domestic investors repatriate funds to take advantage of what's expected to be more competitive interest rates and profit opportunities at home.

How should investors now treat EM stocks?

In A Nutshell

While sentiment and conditions are extremely negative, we believe longer term investors would be well rewarded by selective investments in EM stocks. Valuations are significantly more attractive than are available Stateside, while growth prospects, both for the companies and the countries they're domiciled in, are superior.

Paradoxically, the ugly sentiment now helps create the weak demand and hence favorable pricing for attractive entry points. Nevertheless, investors need to be selective in order to obtain the best risk versus reward potential.

Huge Value Disparity

It's not just that EM investments have performed miserably so far in 2014, down 6.6%, their worst start since 2009, it's that they been poor performers, especially relative to domestic stocks, for the last three years; this category has eased on average 4.4% for the last three years versus the S&P's 14.5% annual gain. As a result, there's a significant valuation gap that's opened up in favor of EM investments.

Consider that the exchange traded Ishares MSCI Emerging Markets Fund (EEM), representing a wide basket of EM stocks, is now trading at just over 11 times earnings, versus nearly 16 for the S&P 500. We believe that spells long term opportunity.

Growth Potential

Few dispute the growth opportunity in the EM countries. The demographic profile is favorable; the average age of the population is significantly lower than in the developing world. For example, the Phillipine's median age is just 23 versus Japan's 45.

Further, the lower level of current economic development, coupled with the rapid introduction of technology and knowledge of first world lifestyles, is spurring growth. While investors fret over some degree of deceleration in China's growth trajectory, the fact is the latest 7.7% gross domestic product reading is more than double this country's.

Sentiment is Ugly, But That May Be Beautiful

Investors have gone from worshiping the BRICs, the short hand reference for the fast growing EM countries of Brazil, Russia, India, and China, to fretting over turmoil enveloping the "Fragile Five", a new catchphrase for Brazil, India, Indonesia, Russia, and South Africa. Logic and history suggests that by the time you get a moniker there's been a profound change in perception.

January has been filled with stories of plunging EM currencies, think Argentina and Turkey, and even concern about political unrest, like Thailand. When you overlay with EM stocks' poor performance over the last several years you've got an asset class that is now the butt of investors' jokes.

However, remember canny investor Baron Rothchild, who advised to buy when there's "blood in the street." Similarly, Warren Buffet admonished that you "pay a very high price" for a "cheery consensus." So, today's ugly EM sentiment, from a contrarian perspective, is a positive for long term investors.

You Must Be Selective

If it's not in the developed world, it's in the developing (EM) world. But that term covers a wide swath of territory.

We think that, with the advent of exchange traded funds, being selective offers greater than usual benefits. That's because, with, for example, the exchange traded Ishares Emerging Markets Fund (EEM) investors can buy or sell the whole basket of EM stock in seconds. However, that's anathema to being selective, and so offers opportunities for investors to sift through the EM constituents and focus on those where the fundamentals are sound but are being sold just because of the location of their headquarters – and their being part of a widely diversified EM fund.

Prefer larger countries over smaller countries, as a general proposition. Brazil has more resources, people, diversity, and may be a better bet than Argentina. Similarly, China, as the world's number two economy, may fare better than, say, Vietnam.

To better diversify your portfolio, look for countries where concerns may be unrelated to the global economy. South Korea is discounted more over what the North Korea dictator may do than what our Federal Reserve may do.

The point is, many investors throw the baby out with the bath water when they mindlessly trade hundreds of stock via the ETFs. Take the time to sort through them.

What's Your Time Horizon?

One can identify value and opportunity, but exactly when the value might be realized, or what the catalyst might be to cause investors to gravitate in that direction, is unclear. It might take years, so investors in this area are well advised to have a longer than normal time frame.

What might be the catalyst? Certainly, if whatever is working now, like domestic stocks, were to see a reversal in fortune, then investors might look to these fast growing regions abroad.

Better than expected news out of China may provide the necessary leadership for renewed interest. Many EM countries depend heavily on the commodity trade, so an upward movement in raw materials could be the spark.

As the initial fears in this area were sparked by the Federal Reserve's plans to taper, greater clarity on those plans or some return to normal monetary policy may do the trick.

Of course, the sometimes the best cure for low prices is, well, low prices; further, sharp descents may make the valuation disparity simply too wide to ignore.

Further depreciation of the local currencies may be helpful, too. It automatically puts the EM markets at a discount for a Dollar buyer; it also improves EM fundamentals, making exports cheaper and imports pricier.

Best Vehicles to Profit

Some argue that the safest if not the best way to obtain EM exposure is through a large US based multinational, say **Coca Cola (KO)**. While that's true, because of the valuation disparity between the stocks in the developed world versus the EM world, your most profitable approach may be to invest directly in EM stocks.

To simply play the EM theme consider a fund. We prefer an indexed, low cost, approach; consider the **Spartan Emerging Markets Index Fund (FPMAX)**, with an expense ratio of just 0.2%. Or, try the granddaddy of the EM ETFs, Ishares Emerging Markets Fund (EEM), which sports an expense ratio of 0.67%.

We favor closed end funds over open end or exchange traded funds, as we seek to buy into well managed portfolios at up to a double digit discount from net asset value. For stocks south of the border, consider the **Latin American Discovery Fund (LDF)**, which sport a 10% discount to net asset value.

The **Korea Fund (KF)**, too, sports an attractive near double digit discount from net asset value. The Korean market did little in 2013, resulting in its stocks trading at less than 9 times earnings. But, expected growth far outstrips our outlook; this year Korean corporate earnings are expected to climb over 14%, while the following year expect growth to top 19%. Its companies, like Samsung and Hyundai, are making steep inroads into our economy.

As to individual stocks, your best bets may be in the energy, banking, basic materials, and automotive sectors. **Vale (VALE)**, based in Brazil, is the largest and lowest cost iron miner.

Petrobras (PBR), the largest company in South America, offer cheap exposure to the energy business, but is currently hampered by the price controls imposed on its local gasoline business. Auto maker **Tata Motors (TTM)**, while based in India, controls the storied Jaguar and Land Rover brands, which definitely enjoy strong demand outside the EM.