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The Case for Emerging Markets: Reality versus Perception

The outlook for emerging markets has improved fundamentally.

The experience of investors allocating to emerging markets over the past decade has been mixed and, on balance, exposure to the emerging asset class has left a sour taste in their mouths. Relative to developed markets, the prevailing perception has become that emerging markets are poorly managed from an economic and political standpoint, that accountancy standards are of significantly lower quality, and that the volatility of the asset class is significantly higher.

The validity of this negative perception becomes questionable when each of these four issues are reviewed: economic management, political management, accounting standards and volatility of the asset class.

Looking at the issue of economic mismanagement, instead of analyzing a range of economic data, it is useful to review the evaluation of Standard & Poor's, the credit rating agency of the asset class. The agency monitors the underlying economic health of each emerging country and the credit rating provides a summary of their conclusions. The data over the last five years shows that, since the end of the spate of major crises in the region in 1998, the average rating of the asset class has steadily improved. This is indicative of the better economic management evident across much of the asset class.

Second on the issue of political management, it is helpful to look at the experience of Russia and Korea, where a change of political leadership during the last couple of years has been a significant improvement. In Russia, Vladimir Putin has consistently shown his commitment to pursue reform, most recently by his replacement of the Central Bank Governor, Viktor Geraschenko, with his more reform- minded successor, Sergei Ignatiev. Meanwhile South Korean president Kim Dae-jung has impressed investors with his policy of encouraging the banks to cease lending to the corporate sector, thereby forcing much needed capital discipline. The impressive result has been a corporate sector that is in much better financial shape.

Third, on the issue of accounting standards, in recent months the reputation of developed markets has been seriously dented by the Enron debacle. In the meantime, although not universal, standards have been improving in the emerging asset class. There has been increased adoption of internationally recognized accounting standards, more detailed reporting of results, and more open and transparent management. All of these items are important issues to consider when researching to identify investment opportunities.

Fourth, on the issue of volatility, risk could be examined from the perspective of the volatility of the asset class relative to developed markets. Over the last 12 years the ratio has ranged between one and two—i.e., at the peak, the emerging asset class has been twice as volatile as developed markets. However, since the last peak in 1998, there has been a steady decline once again toward one. This has been achieved, in part, by emerging markets becoming less volatile and, in part, by developed markets becoming more volatile. The declining volatility reflects the relative improvement in the fundamentals of the asset class and should be sustainable given the expectation that these fundamentals are set to improve further.

In conclusion, although most investors' perception is still that the emerging asset class should be avoided, the fundamentals do not justify this conclusion. The reality today is quite different—improvements have, and are still, taking place. Therefore, a change of view is justified. With returns from developed markets expected to be harder to come by than they have been in the last decade, the emerging asset class represents a source of added value that should be considered by investors. ■