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Investment Insights

Emerging Markets: A Source of Viable and Sustainable Investments

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In 1981, during an investor conference in Thailand, IFC Deputy Director Antoine W. van Agtmael introduced a new phrase to his colleagues: emerging markets. Consequently, third-world countries began to take on a new hue, piquing the interest of investors and raising questions about the viability of investments in these markets.

Today, interest in emerging markets continues to gain traction among investors—and for good reason. As we've observed at Ellwood, emerging markets present many attractive and sustainable investment opportunities. We encourage our clients to consider these investments as part of a diversified portfolio for the reasons outlined below.

Classifying emerging markets

While there's some debate over what constitutes an emerging market and which countries fall into this category, most agree that emerging markets are defined by their economic development, market size, liquidity and accessibility to offshore investors. For example, while China is considered a powerhouse in the global economy, it's still classified as an emerging market because the country is newly open to foreign capital. Emerging markets are not distinguishable by size, and therefore these countries can be both very large and very small.

The number of emerging markets has increased significantly over the years. When the Morgan Stanley Capital International (MSCI) Emerging Markets Index was introduced in 1988, it categorized 10 countries as emerging markets, which accounted for less than 1% of the world's market capitalization. Today, there are 23 countries that account for 10% of the world's publicly traded market capitalization. They include Brazil, Chile, China, Colombia, Hungary, Indonesia, India, Malaysia, Mexico, Peru, Philippines, Poland, Russia, South Africa, Thailand and Turkey, among others.

Currently, the largest countries in the MSCI Emerging Markets Index include China (27%), South Korea (15%), Taiwan (12%), India (9%) and Brazil (7%). The largest sectors in the index include Information Technology (25%), Financials (24%), Consumer Discretionary (11%), Materials (7%), Energy (7%) and Consumer Staples (7%).

Compelling reasons to invest

Investors are wise to consider investing in emerging markets as part of a diversified portfolio. These investments can provide exposure to new opportunities in global capital markets, enable currency diversification, and complement other investment styles or strategies. Here are other reasons why investors should take a serious look at opportunities in these markets.

- ***Low debt.*** Unlike many developed economies, most developing economies don't have excessive debt at the government level, corporate level or household level.

- ***High growth potential.*** In addition to representing a large segment of the global economy, emerging markets are growing faster than developed markets. According to recent projections, emerging economies are expected to achieve 5% of Gross Domestic Product (GDP) growth in the next several years—more than double the growth rate of developed economies. Increasing economic activity. Currently, emerging markets are responsible for more than one-third of global GDP. Over the next decade, these markets are expected to contribute more than one-half of global GDP.

• *Improved liquidity and attractive current valuations.* Not only has liquidity improved in developing countries, but the valuations in these markets are inexpensive compared to those in developed countries. This is true both in terms of currencies and equity markets.

• *Corporate governance improvements.* In the past, poor standards for corporate governance hindered growth in many developing countries. Now, in many countries, corporate governance standards are improving, which bodes well for future economic growth.

• *A growing population.* According to the U.S. Census Bureau International Database, about 83% of the world's population comes from emerging markets. In the next 20 years, the bureau projects, that figure will increase to 85%. During that time period, the bureau also predicts that the labor force in emerging markets will increase by about 900 million people, while the labor force in developed markets will decrease by about 40 million people.

• *Rise of the middle class.* The urbanization of emerging markets is leading to growth in the labor force and the emergence of a new middle class. The household income of many residents has increased to the point where they can purchase middle-class goods such as cars, appliances and real estate. In fact, over the next decade, one billion global consumers are expected to enter the middle class, thanks to urbanization, rising incomes and favorable demographics. A large percentage of this new middle class is expected to arise from emerging markets.

In short, we believe that emerging markets present viable and sustainable investment opportunities that can serve as valuable additions to a diversified portfolio. E

Important Disclosures

About Ellwood

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