Emerging Markets Report
News & Commentary
Emerging-market rewards are worth the risks

Myra P. Saefong, MarketWatch
MarketWatch; mailto:mpicache@marketwatch.com; Myra Saefong is a MarketWatch reporter based in San Francisco.
1,712 words
10 February 2011
12:01 AM
MarketWatch
MRKWC
English

Flare-ups of antigovernment protests, political shake-ups, food riots and violence have soured investor interest in emerging markets, but the return of political risk could also present an opportunity for investors looking to buy emerging market assets on the cheap.

SAN FRANCISCO (MarketWatch) — Flare-ups of antigovernment protests, political shake-ups, food riots and other violence have soured investor interest in emerging markets, smothering investing prospects for countries that were already struggling with rising inflation and interest rates.

But the return of political risk, which recalls the prolonged series of protests in Thailand last year, could also present an opportunity for investors looking to buy emerging market assets on the cheap — if they look in the right places, balance investments and take the necessary precautions.

“Emerging markets are always risky — there you have the classic risk-return trade off,” said **Usha Haley**, chaired professor of International Business at Massey University in Auckland, New Zealand.

“The idea is to diversify. That is, choose other emerging markets with different risk profiles and always maintain some investments in low-risk, relatively lower-return markets,” said Haley, who’s also an author and consultant on emerging markets.

Investors have so far been pulling money out of emerging markets as food riots in Algeria in January spread to Tunisia, and Egypt, Jordan, Yemen and Lebanon have been hit by widespread antigovernment protests.

Outflows from emerging-markets equity funds were at their strongest level since 2008 for the week ended Feb. 2, as investors shifted funds to developed markets, according to a report from EPFR Global. Global emerging-markets equity funds marked their worst week on record with outflows of $4.5 billion.

“Investors, for the first time since 2007, see more opportunity in developed market equities than in emerging markets,” said Brad Durham, managing director at EPFR Global. Outflows from emerging-markets equity funds indicate that investors are “concerned about the possibility of political unrest spreading throughout the Middle East — and we all know that investors prefer even a bad certainty to uncertainty.”

And there’s been plenty of uncertainty, and violence, linked to antigovernment protestors calling for the immediate departure of Egyptian President Hosni Mubarak.

In Egypt, the instability serves as a “stark reminder” that political risk exists in emerging markets, said Nathan Rowader, director of investments at Forward Management. So investors, in the short term are likely to “revisit their overall exposure to the developing world and take some profits to remove some of the political risk.”

But cutting exposure to emerging markets isn’t a good idea for investors who are in them for the long term.

“Running away from emerging markets means you’d be unable to participate where most global growth is going to happen in the next 10 to 20 years on out,” said Sam Wilkin, associate director of global analysis firm Oxford Analytica’s Consultancy Practice.

“Flee from emerging markets and you’ll simply miss out,” he said.

EM anxiety

For now, investors seem content to walk away, if only slowly.

Aside from the spike in outflows from emerging-markets equity funds, the performance of the iShares MSCI Emerging Markets Index ETF (EEM, US) has been less than impressive lately, losing around 2% year-to-date so far.

“The prospective growth of the emerging-market economies is a great story,” said J. Michael Martin, chief investment officer of Financial Advantage. “However, with political risks heightened by rising commodity prices, we think the better part of valor is to postpone any meaningful expansion of our EM exposure until we get a better idea of the range of repercussions.”

“In the meantime, it’s probably a better bet to keep a good-sized exposure to food, oil, coal and metals,” he said.

Emerging-market consumers are much more sensitive to inflation and that’s part of the reason why investors are so wary of the sector against a backdrop of political unrest.

“Of inflation, political instability and rate hikes, inflation is the bigger threat to emerging markets, although it is not an imminent risk,” said Matt Lasov, practice leader of Frontier Strategy Group’s Quantitative Analytics. “Inflation impacts emerging markets consumers more severely than developed market consumers because emerging-markets consumers devote more wallet share to food and energy costs.” Read more about the emerging-markets consumer’s inflation dilemma.

And while Egypt is actually a very small economy, the impact of unrest can be “substantial,” given the potential for the situation to contribute to further increases in commodity prices, said Rowader.

“The successful removal of Egypt’s president might jeopardize the authoritarian leadership of other North African or Middle Eastern governments such as Libya, Syria or Sudan,” he said.

Any instability in these countries could disrupt oil production and result in higher commodity prices and eventually jeopardize the global economic recovery, he explained.

Among developing markets, however, growth in Asia is most certainly contributing to the problem of food inflation.

“The biggest problems with most EMs is population explosion,” said Byron King, a contributing writer to the Daily Reckoning and managing editor at Agora Financial. “They’re literally eating themselves out of house and home.”

And with Asia’s contribution to food inflation, other markets are “priced out,” including Egypt where the average citizen earns some $2 per day, King said. Read more about King’s thoughts on commodities. http://dailyreckoning.com/author/byronking/

But instability in China would ultimately be of critical concern.

“An uprising in China, if such a thing should get traction, would be a much graver concern [than the unrest in Egypt and Tunisia] to the global economy,” said Martin. “China has become the economic engine and if it sputters [or worse], there will be serious restructuring in financial markets everywhere.”

Size up and mitigate risk

With political and economic risks such a prominent factor, it’s no wonder that so many investors have lost confidence in emerging markets.

Overall, however, Egypt and Middle East play a very small role among emerging-markets benchmarks and there are plenty of ways to mitigate the obvious political and economic risks involved with developing markets.

“Although Egypt is very much seen as a symbol within the Middle East, it doesn’t have a particularly large impact on global financial flows or trade flows,” said Deborah Medenica, portfolio manager of the Alger Emerging Markets Fund (AAEMX, US), which was launched in December.

Some of the larger developing markets have “headwinds” in terms of inflation and a bit of slowing growth, such as China, Brazil and India, but Taiwan, Russia and South Korea have lower expectations and, hence, a little more room to surprise investors with their results," she said.

Those countries offer a good sampling of various risks.

And "recent instability in emerging markets reminds us that emerging markets have a unique set of risks that comes along with the overall opportunity," said Frontier Strategy Group's Lasov.

Massey University's Haley said investors should diversify investments with low-risk, lower-return markets.

"Most western developed economies would fall into this slot" with many of those markets having smaller potential, but offering "transparent, stable political systems and freedom of information," she said.

Roger Schwartz, senior vice president at Aon Risk Solutions's Political Risk Practice, believes that preparation is key to mitigating the risks involved with developing markets.

"There are cautionary tales that are, perhaps, a result of all of this," said Schwartz. "The prepared investors [or] business is able to ride through these bumps in geopolitics and come through the other side unscathed, perhaps compared with those who are less prepared."

Preparation includes taking a look at exposure to contracts and "finding out what mitigants can be used to smooth out the bumps in the road," he said. "Identification and analysis of the exposures you might have" are important.

And there are products that insurance brokers can provide, he said.

"Political risk insurance products essentially protect investors against these factors — wars, civil wars, damage to property values, damage to investments — there are markets for this kind of insurance," said Oxford Analytica's Wilkin.

History's lessons

And if anything, what's happened in the Middle East should remind investors of lessons learned from past events, and that some developing markets may come out for the better.

True, there are some instances when a country has failed to benefit from uprisings such as Iran's change of government that "was not friendly to western governments," said Schwartz, referring to the 1979 revolution that deposed the U.S.-allied Shah of Iran that resulted in an estimated $4 billion loss for foreign investors in Iran.

And in the worst case, the concern for Egypt is that it ends up with an Islamist regime that's not friendly to the West, he said. Regardless of what direction Egypt's government takes, there will be "certain interruptions in commerce and business."

So far, most everyone seems to be betting on that worst case scenario.

"People have managed to put quite a negative spin on the Egypt situation but in the past, some countries have benefitted from such situations," said Wilkin.

In South Korea, under similar circumstances that occurred in the 1980s, "we've seen the rise of democracy and continued economic growth," he said. Likewise in Indonesia, which is much poorer and more on the level of Egypt, and there we've seen the end of a dictatorship and the start of a "relatively stable democracy."

Thailand, too, suffered from a prolonged series of political protests last year, but the iShares MSCI Thailand Investable Market Index Fund (THD, US) has gained close to 50% over the past 12 months. Read about Mark Mobius's thoughts on emerging-markets investing.

So "by no means are these uprisings necessarily the negative developments they have been seen to be," said Wilkin.

Flare-ups of antigovernment protests, political shake-ups, food riots and violence have soured investor interest in emerging markets, but the return of political risk could also present an opportunity for investors looking to buy emerging market assets on the cheap.|103

Document MRKWC00020110210e72a000ma

