Diversify Your Portfolio with an Emerging Market Fund

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WHEN I RECOMMENDED INVESTING in an emerging market fund, I get one of two opposite reactions: eager to jump in or dead set against it. While there are reasons to be cautious, emerging markets can generate greater than average returns, enough that I usually recommend that an investment portfolio should include some exposure to that asset class.

DEFINING EMERGING MARKETS

The term "emerging market" was coined in 1981 by an economist with the International Finance Corporation to promote that organization's first mutual fund investing in developing countries. Today the term is broadly used to define countries that exhibit five distinct characteristics:

1. **Lower than average per capita incomes:** The World Bank defines developing countries with as those with per capita income of $4,025 or less
2. **Higher rate of growth than developed countries:** In 2019 the U.S. gross domestic product grew 2.3 percent; China's growth rate was 6.1 percent — and that, its slowest pace in the last 20 years.
3. **Highly volatile:** The economies of emerging markets are in their infancy stages, so they don't deal well with economic upheaval from the likes of natural disasters, external price shocks or political instability.
4. **Greater growth potential:** typically from exports, as citizens consume far less than those in rich countries.
5. **Susceptibility to swings in the value of its currency:** Volatile swings against the U.S. dollar but also in commodities like oil and food.

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ASSESSING THE EMERGING MARKETS

MSCI, formerly Morgan Stanley Capital International, identifies 24 countries as emerging markets. As of January 2019, they combined for 12 percent of global equity market values. The most important group is known as BRICS: Brazil, Russia, India, China and

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South Africa. The real powerhouses are China and India. Combined, the two are home to 35 percent of the world's labor pool — a low-cost, young labor force.

China's explosive growth over the last 30 years has enabled China, on average, to double its GDP every eight years and raise an estimated 800 million people out of poverty. The country has shifted from an agricultural to an industrial economy and is a prolific international exporter. The shift has most recently turned China into a consumer-based economy. Consider, for example, that in 2018 China had 40 times as many marathon runners as they had in 2014. An event hosting 30,000 runners will sell out in a few hours. People have the time and money to invest in themselves and their leisure activities, representing a major shift to consumer-driven purchasing.

Sixty-five percent of India's population is under 35, the largest group of young workers in the world. By the end of the next decade India will boast 110 million people of working age, between 15 to 64 years old.

PROS OF INVESTING IN EMERGING MARKETS

Emerging markets deliver several advantages to investors over the equities markets of developed nations:

- A willingness to embrace technology: Aadhaar is a system implemented by India's government that uses fingerprints to identify citizens and passport holders by biographic and demographic data. Aadhaar provides cardholders access to a host of services, such as getting a bank loan, buying a smart phone, receiving payments from one another, as well as to various public welfare programs. Nobel Prize-winning economist Paul Romer described Aadhaar as "the most sophisticated ID program in the world." Aadhaar gives India a platform that is easy and quick to use and streamlines economic activity.
- Portfolio diversification: Emerging market funds offer exposure to different stages of the economic cycle that can deliver growth beyond what is available in developed countries. The transition from an agricultural to industrial society moves millions from poverty into the beginnings of a middle class.

CONS OF INVESTING IN EMERGING MARKETS

- Less information on companies than in a developed nation's equities market: You need to invest in a mutual fund with an active manager, a fund with boots on the ground, visiting the countries and the companies they invest in.
- Insecure intellectual property rights: There is limited legal protection for companies' innovations and the funds that invest in them.
- Governments that lack transparency: Emerging markets can be open to fraud and other irregular government actions that can negatively impact fund values.
- Volatile currencies: Emerging markets currencies can be subject to wild swings in the wake of a natural disaster or government crisis. Such volatility calls for a long-term investment strategy.

Emerging markets require a higher risk tolerance than the equities of developed nations. But they also offer the potential of greater rewards. The MSCI fund reports average net returns of 8.76 percent annually since December 2000. In particular, shifts in China and India, including lowering barriers to trade and investment, provide opportunities for long-term strategies and active management to produce exceptional returns.

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