Understanding the Role of Emerging Markets in Your Portfolio

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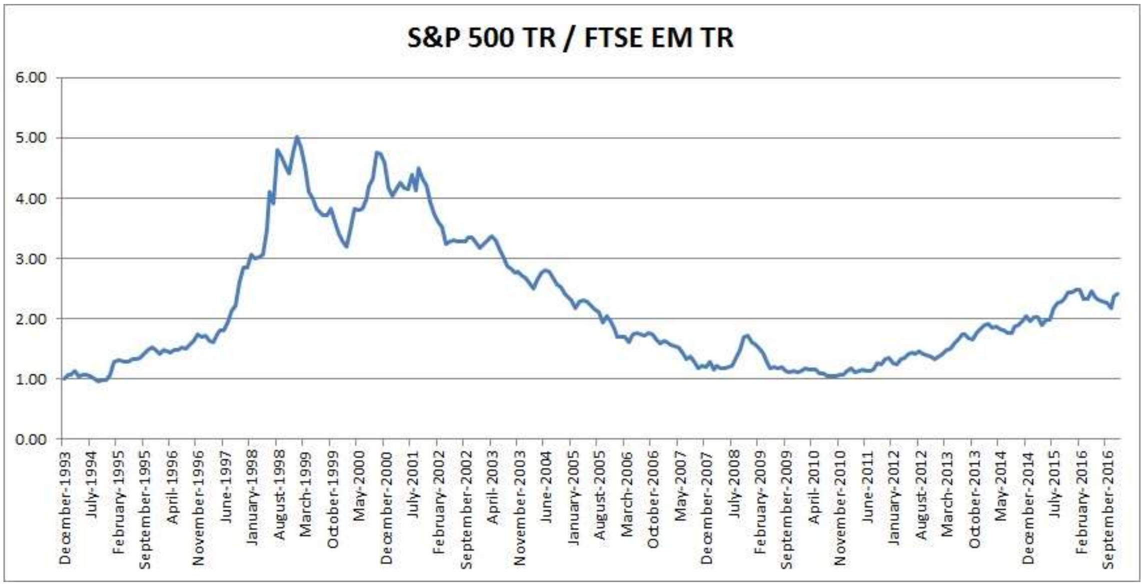
In his inaugural *Bloomerg View* column, Ben Carlson discussed the valuation differences among the various equity markets around the world:

Valuations Through Year-End 2016	United States	Europe	Asia	Emerging Markets
Price-to-Earnings	20.3	16.6	15.1	14.4
Price-to-Book	2.8	1.7	1.4	1.6
Price-to-Sales	2.0	0.9	0.9	1.3
Price-to-Cash Flow	12.3	9.4	6.5	7.3
CAPE Ratio	26.4	16.6	20.6	14.0
Dividend Yield	2.0%	3.5%	2.7%	2.5%
Trailing 5 Year Performance	14.6%	6.5%	6.9%	1.4%

*Sources: Morningstar, Star Capital

Not only do emerging markets appear considerably cheaper than US stocks (particularly on a CAPE basis), there is a case to be made that the most recent period of relative US outperformance vs emerging markets (or EMs) – the longest since the 1990s – is a bit long in the tooth:



Source: Morningstar

However, investors who are tempted to abandon ‘expensive’ US markets and go all-in with ‘cheap’ emerging markets should consider first just what the proper role of emerging market equities is in a portfolio. In my opinion, emerging markets are not core portfolio holdings. This is because they are extremely vulnerable to political turmoil, and currency instability. As JP Morgan’s chief emerging market strategist, Richard Titherington, puts it, many of the world’s emerging markets such as Russia and Brazil are actually very old nations, but they are still ’emerging’ because their economies and markets have been battered by ‘revolution and inflation.’

To illustrate Mr. Titherington’s point about emerging market susceptibility to revolution and inflation, he provides a great graphic that shows the frequent epochs of each in the recent histories of several prominent emerging markets:

EXHIBIT 3: TEN LARGEST EMERGING MARKETS REVOLUTION AND INFLATION

	Proportion of the MSCI All-Countries World Index (%)	Revolution	Inflation
China	2.47	1911, 1937-1949	1990-1995
Brazil	2.14		1979-1993
Korea	1.80	1910, 1945, 1950-1953	1998
Taiwan	1.45	1911, 1949	
India	1.08	1947	
Russia	0.84	1917-1922, 1991	
Mexico	0.57	1910	1980-1988
Malaysia	0.41	1963-1965	
Indonesia	0.31	1945-1949	1998
Chile	0.24	1973	1970-1975
Turkey	0.24	1918-1923	1973-2004
Thailand	0.22		1998
Total	**11.76**		

Source: MSCI, World Bank, IMF, CIA World Factbook, September 2010.

Some might argue, though, that the world is a much different place from what it was in the 20th century. As much as we might like this to be true, it simply isn't. As the Cato Institute recently noted, many of the countries on the list above are also among the highest-ranked (or lowest, depending on how one looks at it) economies when it comes to the 'Misery Index,' or inflation plus unemployment:

2016 Misery Index

Rank (Worst to Best)	Country	Misery Index	Major Contributing Factor
1	Venezuela	573.4	Consumer Prices
2	Argentina	83.8	Consumer Prices
3	Brazil	75.0	Lending Rates
4	South Africa	44.9	Unemployment
5	Egypt	43.9	Consumer Prices
6	Ukraine	36.0	Lending Rates
7	Azerbaijan	35.9	Consumer Prices
8	Turkey	30.7	Lending Rates
9	Iran	29.3	Lending Rates
10	Colombia	28.7	Lending Rates
11	Greece	28.1	Unemployment
12	Russia	27.4	Lending Rates
13	Algeria	24.2	Unemployment
14	Kazakhstan	24.1	Lending Rates
15	Saudi Arabia	23.0	Unemployment

To illustrate further my point, it may be helpful to consider the case of Russia in isolation. Russia, by almost all measures is a 'cheap' market. At 5.9, it currently boasts the lowest CAPE ratio in Star Capital's fantastic database. But Russia is cheap for a reason. The economy is currently under sanctions because of its actions in Ukraine, and inflation has been extremely high. Furthermore, with an autocratic government under Vladimir Putin, investors can never feel really safe putting their capital in Russia, given the risk of nationalization.

However, with such a low CAPE ratio, are all those myriad fears appropriately priced into Russian equities?

To answer that, would-be investors in Russia should understand that Russia is essentially a bet on oil prices. Consider the relationship between the FTSE Russia All-Cap Index (left axis) and oil (right axis) since:

Sources: Morningstar; FRED

Furthermore, Russian equities are extremely volatile – since data begin in 2002, the standard deviation of the FTSE Russia All-Cap Index is 33%, with a max drawdown of 78% – and it is not clear that they are really that cheap when you consider, as Philosophical Economics pointed out, that high-quality US energy stocks such as Exxon-Mobil and Chevron trade with CAPE ratios of 11.7 and 12.3, respectively.

For reasons such as these, to make a large bet on single-EM stocks is conceivably riskier than making a large bet on any individual stock. Bearish investors like to chide their bullish counterparts for saying 'this time is different' when it comes to higher-than-average valuations in the US. However, emerging market bulls who insist that the long histories of inflation and political instability in EMs can safely be ignored are guilty of the same.

To be clear, I am not suggesting that emerging market equities have no place in an investor's portfolio. I am simply arguing that because of their unique characteristics, they should be viewed more as diversifiers or satellite positions within a portfolio. But to expect emerging markets eventually to become diverse, prosperous, and stable markets like those in the US and Europe is probably misguided, and a foolish bet to make for investors with little room for error.

Disclosure: The results are hypothetical results and are NOT an indicator of future results and do NOT represent returns that any investor actually attained. Indexes are unmanaged, do not reflect management or trading fees, and one cannot invest directly in an index.

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