

Emerging markets: how much is enough?

By Tom Stevenson, 3 February 2010

As investment funds flow into emerging markets, what is the right allocation to the developing world?

Emerging markets made a spectacular comeback last year. Just looking at the big four BRIC markets (Brazil, Russia, India and China), the worst performance during 2009 was a far from pedestrian 80% gain (China) while the best (Russia) rose by 121%.

Perhaps unsurprisingly those stellar performances prompted some significant interest from investors. Between the March low and November \$35bn was invested in emerging market equity and bond funds in Europe, according to investment statistics group Lipper Feri. That was 16% of all the money committed to the market over that period.



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That seems like a lot but is it? By definition, the lion's share of flows is still into developed markets. That is understandable because most people feel more comfortable investing in local markets where they are familiar with the company names in their portfolios. But is it right?

Certainly, the 10 year performance record of developed and emerging markets suggests that an apparently safety-first, close-to-home approach has been the wrong one. Over the past decade shares in Brazil have risen by 300% and those in Mexico by even more while the stock markets of Europe, the US, Britain and Japan have gone backwards.

There are some pretty compelling reasons why this should have been the case and why it is not unreasonable to expect further outperformance in future. One is the sheer size of the emerging market opportunity. Around two thirds of the world's population (65%) lives in emerging markets today and these markets account for almost three quarters of global economic growth. Twenty years ago, 70% of growth was generated by developed economies and nearly a third of this by the US alone.

Emerging markets have also come out of the financial crisis in much better shape than their developed counterparts. In large part that's because they went into it in better shape too. After the turmoil of the emerging markets crises in the 1990s, they have taken great pains to put their financial houses in order, building up big current account surpluses, for example.

A comparison of the developed and emerging worlds also shows clearly where the potential growth is to be found. The size of emerging market economies per head of population is still a fraction of the equivalent measure in places like Germany, France and the UK. In Japan, for example, GDP per capita stands at \$39,500 while in China it is still less than \$4,000.

That puts many emerging market economies at the investment sweet spot where household incomes allow large numbers of people to begin enjoying the fruits of economic growth, buying consumer goods and services and

allowing the development of more sophisticated retail sectors.

Emerging markets have a number of long-term advantages over the developed world. They have an abundance of natural resources, for example, which will be in demand thanks to the ongoing worldwide migration from the countryside to cities. It is estimated that 350 million new Chinese will move to urban areas by 2025. That will require huge investment in infrastructure such as roads, housing, airports and the like.

The creation of an urban society will move in parallel with the development of a new consumer society too. That is why many big Western companies are seeing their most exciting growth prospects in developing countries. Guinness is a fast-growing brand in Nigeria, for example.

All this growth comes at a time when most developed countries face a long hard slog out of recession. They are striving to recover, moreover, against serious headwinds caused by excessive levels of debts and over-spending by governments. The relative investment case has never been easier to make.

But what is the right allocation to emerging markets? The short answer is that it depends on a number of factors – how old you are, for example, how much appetite for risk you have and, at any one time, how much of the good news is already factored into emerging market share prices.

So there is no magic number. But ask yourself this question. In 20 years time do you think you are more likely to kick yourself for missing the unfolding of a great investment opportunity in China, Africa or Latin America, or for missing the returns in a mature, developed economy like Japan, the UK, western Europe or America?

Emerging markets are not a one way bet. The risks of investing in them may have reduced in recent years but they have not disappeared. When markets become “flavour of the month” investors should tread carefully. But for many long-term investors the answer to how much is enough is probably a bit more than you would have thought even five years ago.

Note the value of an investment and the income from it can go down as well as up, so you may get less than you invested. The ideas and conclusions in this column are the author's own and do not necessarily reflect the views of Fidelity's portfolio managers. They are for general interest only and should not be taken as investment advice or as an invitation to purchase or sell any specific security. Past performance is not a guide to what may happen in the future. Investments in small and emerging markets can be more volatile than more established markets. For funds that invest in overseas markets, changes in currency exchange rates may affect the value of your investment.