



Los Altos Town Crier

Emerging Markets offer tempting but riskier alternatives to U.S. stocks

By Don Martin

Lesser-developed Third World and Eastern European countries are known as Emerging Markets or EM. They are designated such because their annual growth rate can be as high as 9 percent, compared to 3 percent to 4 percent for the United States. Their shares typically have a Price-Earning ratio and a Book Value to Market Price less than 25 percent of those in the United States.

One prominent mutual fund estimated 6 percent real (inflation adjusted) return for EM stock versus -1 percent to 4.5 percent return for other nations' equities.

Foreign ownership is often restricted in EM economies, which include Taiwan, Malaysia, India and Russia. Investors have to buy mutual funds that are permitted to invest in those countries.

The key to investing in EM stock is to buy only after a crash, hold for the long run and diversify among countries and investment sectors. Some experts suggest one should allocate only 5 percent of one's portfolio to EM stock.

If the United States goes into a recession, it will hurt EM companies. In many ways they are similar to the U.S. market before 1933, when there was little or no regulatory protection for investors.

Today there is less risk than in the 1920s in the highly developed countries and thus less reward. To capture the bigger returns of past decades, it is necessary to go overseas into the riskier Emerging Markets.

Laws protecting the environment, consumers, employee safety, labor rights, etc., are more lax in the EM countries and therefore less expensive than in developed countries. That provides additional profit potential for businesses.

The value of EM stocks tripled in the past three years, so the easy profits have been made.

More than half of EM economies have attained an investment-grade credit rating. They are better engineered for a crash than in 1997, and their currencies are undervalued. In short, EM is no longer EM. Over the past decade many EM-designated countries have reformed their economies substantially to make them more solvent than those of some of the highly industrialized nations carrying large budget and trade deficits.

An analogy: in the 1980s in the United States the fear of recurring inflation drove interest rates far higher than necessary. The market was ineffective for years because people waited for confirmation that it was safe to buy U.S. bonds.

One hundred years ago, 25 percent of UK investment funds were in Emerging Markets, today only 10 percent, so there is room for additional investment. India, in particular, has had a run-up in stocks.

The Emerging Market is risky because it allows 80 percent margin purchases (only 20 percent down payment) instead of the 50 percent required in the United States.

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