



## STICKING WITH EMERGING MARKETS

*With greater economic stability, ongoing regulatory reform and some standout companies, emerging market equities have demonstrated why they should be a core element in a long-term international portfolio.*

BY STEVEN A. SCHOENFELD

**Whenever people say, “It’s different this time”** in regard to changes in financial markets, it’s probably a good idea to react with healthy skepticism. When it comes to investing in emerging markets, however, I admit I find myself suggesting that this time, it really is different.

With the strong run in emerging markets equities over the past four years, some investors may be inclined to take profits. In addition, there will likely be concern about the potentially negative effect of a slowing U.S. economy and worry about the next potential crisis to hit the asset class hard — as has so often happened historically. I, nevertheless, think there is good reason to be optimistic.

First, in response to past problems, such as debt crises and currency devaluations, developing countries have achieved important reforms. These include achieving fiscal surpluses; reducing foreign debt from 90% of GDP to 10%; transitioning from current account deficits to surpluses; and reducing the widespread inflation (at one point over 2,000% annually in Brazil) to single digits. In addition, greater transparency at government and corporate levels has fostered a much more stable investment environment.

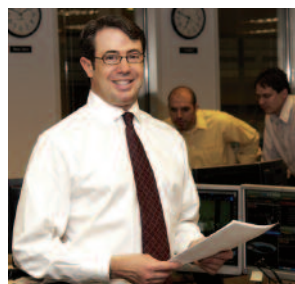
Second, developing countries now account for 85% of the world’s population and 45% of its economic output. The MSCI market capitalization of the emerging markets index as a share of the MSCI All Country World Index, excluding the United States, has expanded from \$526 billion at the end of 2002 to \$1.9 trillion at the end of August 2006. Simply put, these markets are too big to ignore.

Third, consider performance potential. Even after a four-year bull run, emerging market equities offer investors some of the best long-term return prospects in the world. As measured by

MSCI, these markets have outperformed both the U.S. and non-U.S. developed-world equity markets for the past 18 years. While the U.S. and other major economies slow, GDP growth in developing countries is forecast at more than 6% for 2006 and 2007.

Such strong economic growth supports robust company earnings. While Return on Equity (ROE) has risen around the world, companies within emerging markets have achieved ROEs one percent higher than companies in developed countries since 2002. Credit Suisse research as of October 2006 shows that aggregate ROE for emerging markets is 16.3% versus 15.2% for the rest of the world.

Many emerging markets companies — such as Samsung in electronics, Embraer in aeronautics, Teva in pharmaceuticals and Cemex in cement — are world-class leaders in their sectors. These successes can be partially attributed to improvements in technology, greater opening of the home markets to foreign competition and privatization of formerly state-run industries, as well as gains from both foreign direct investment and increased liberalization of capital flows. Adopting even a market weight allocation to emerging markets is a sensible move in a long-term international portfolio. ❖



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