Identifying and Removing Risk in Emerging Market Investments

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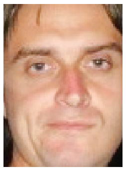

Investing in emerging economies has been one of the most popular market themes of the last decade, but many individuals have a hard time assessing which assets have the greatest value with limited amounts of risk. While the term "emerging markets" refers to countries experiencing rapid levels of economic growth relative to what is seen in the West, these markets are still in the process of opening up to allow foreign investment and liberalizing their political infrastructures. In most of these countries, securities markets are still in their early phases of development and this provides certain advantages and disadvantages that must be understood before selecting which areas and assets to invest in as a means for capitalizing on the latest global trends.

Advantages and Risks

The advantages of emerging market investment are many and varied. In recent years, the governments in many of these countries have experienced changes within their financial systems that are enabling foreign investors to engage in trading activities that were not available in past decades, as a large number of these markets restricted access, allowing only domestic investors to buy and sell assets. The latest trends are showing that governments are increasingly willing to open their country's stock exchanges for physical and derivative trading. The most significant advantage of this trend is that foreign investors now have access to a wider level of portfolio diversification and higher rates of annualized return on their investments.

With anything, however, greater rewards tend to present a greater exposure to risk and when buying the assets of developing economies investors need to be aware of the potential disadvantages that could lead to trading losses, so that the impact of these risks can be contained.

Political Risks

Developed economies generally have certain characteristics that help to ensure a high level of price stability, as accommodative political structures allow for peaceful transitions of power and bureaucratic processes are in place that are meant to allow businesses to reach their full potential. Historically, this type of political infrastructure has

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created the most efficient financial systems, allowing companies to channel funds and complete all necessary transactions, create access to liquidity and provide leverage for capital gains investment. Since these systems are still in their early stages of development in the emerging economies, there is always the possibility that financial stability will suffer until political reforms are in place to improve the economic foundations of the nation's securities facilities.

Recent years have shown that there are examples of this type of growth in action. The sovereign debt crisis is Europe and the political disagreements in the US with respect to the nation's debt ceiling have led many developing countries to slow credit growth, with both Brazil and China raising their reserve ratio requirements and the Reserve Bank of India enacting laws forcing banks to save more cash as a means for paying-off loans that are in default. All of these measures were taken so that excess volatility could be avoided in each regional stock market, and a greater level of price stability could be achieved in times of uncertainty.

Regulatory Risks

Even though most markets are making strides to achieve higher levels of market liberalization, there are still many examples of countries that place limitations on foreign investors. Some of these unequal differences include lower dividend payments, stock classes with more restrictive characteristics, and higher tax rates for capital gains. In addition to this, emerging markets, in many cases, do not have the stringent securities laws that are seen in the US. Instead, inconsistent regulatory standards can lead to fair dealing issues, with instances of front-running and insider trading being seen more often than in places where the main regulatory bodies have had the opportunity to enact legislation to prevent these practices.

Liquidity and Currency Risks

The securities traded in emerging markets can often be characterized as highly illiquid, as lower trading volumes tend to result in higher bid/ask spreads increasing the costs present in each trade. Furthermore, trading times are often more restrictive and subject to change during times of increased volatility. The main issue here comes when investors are looking to close a position (possibly based on an economic data release or a major geopolitical news event) but access to the market is restricted until price activity returns to normal. This can potentially result in unexpected losses, so investors will benefit by choosing assets with a wider trading window and fewer restrictions on market availability during times in elevated volatility. Another factor with significant implications for total profit and loss levels is the fluctuating exchange rate, which can have either a positive or negative effect on each investment. Currency risks in these investments can also come from the fact that emerging economies are often marked by inconsistent monetary and fiscal policy stances that can change with little notice.

One clear example of the negative effects of currency devaluation can be seen with the Asian Financial Crisis of 1997. In this case, market speculators sold-off Asian currencies as investors lost confidence in the region and the IMF was forced to act by giving loans to stabilize the situation. Any investors with heavy exposure to the region experienced losses in assets denominated in Asian currencies, even in assets where the stock price itself did not see a dramatic change. With this in mind, investors need to remember that investment in an emerging market asset is also an investment in an emerging market currency, and trading strategies should be based on all of these factors at the same time.

Emerging Market ETFs

Some of the most popular investment products available for those interested in emerging markets are Exchange Traded Funds (ETFs), which offer exposure to a wide range of international companies. Large, medium or small market capitalizations are offered, with varied levels of sector diversification.

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Funds that are composed of companies with a wider level of sector diversification tend to mitigate some of the larger risks seen in emerging market investments and some sectors (for example, utilities) tend to offer more predictable rates of return.

Since emerging market ETFs are inversely correlated to moves seen in the US stock market, investment in these instruments have the added advantage of balancing a domestic portfolio while at the same time capitalizing on the increased growth rates that are present in developing economies. Tabulating performance data in emerging market ETFs can be somewhat difficult, as many of the funds that are currently available have been trading 5 years or less. For the ETFs that do have life spans longer than 5 years, performance returns relative to the S&P 500 remain strong, as growth in the index remains consistent with the slower growth rates in developed economies.

Capturing the Global Growth Trend

Many individual investors have the erroneous belief that it is too late to enter into new trades with emerging market exposure. This idea that "the train has left the station" does have some merit, as many of these assets have made huge gains in recent years and are currently trading at historically elevated levels. But, at the same time, there is little evidence to suggest that consistent gains cannot be realized over the long term if emerging market risks are understood and preparations are made to reduce the potentially negative effects.

Despite the increased level of volatility emerging market assets generally experience, the data continues to show that the rewards outweigh the risks as long as investors exercise caution. Developing economies clearly have the largest potential for expansion, the most growth, and stock markets with the highest rates of return. Risk assessment will allow investors to diversify their portfolios in a protective way. ETFs offer exposure to the growth seen in a single country (or in a combination of countries) and there are currently a large number of fund managers with expertise in evaluating stocks of all sizes and performance goals. It remains clear that emerging markets assets can be risky investments but as long as these risks are identified and well-researched, investors will be better prepared for possible negative scenarios. These high growth assets are an integral component of most successful investment portfolios and there is little indication that this trend will be reversing any time soon. ■

At the time of publication, the author holds no position, long or short, in any of the assets mentioned in this article.