



# Differences matter in emerging markets

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## Executive Summary

There are many reasons for diversified, long-term investors to maintain exposure to emerging markets. Fundamentally, social and demographic trends continue to support economic growth and investment opportunity in these markets. In addition, a number of emerging markets suffered less from the global financial crisis than developed markets did. Indeed, some emerging markets are showing a degree of relative stability that historically has been associated with more mature economies. This rapid evolution means that countries now classified as emerging could be considered developed in a few years. And some so-called “frontier” markets, such as the oil-rich United Arab Emirates, may graduate to emerging-market status.

But in deciding where to invest, investors need to make distinctions between emerging markets rather than grouping them together. Among the risk factors that need to be weighed are the strength of a country’s currency and the stability of its government and political institutions. By this yardstick, emerging markets look very distinct from one another.

Many U.S. investors still think of emerging markets largely in terms of Brazil, Russia, India and China—the so-called BRIC countries whose growth and challenges have been the focus of investor attention for years. But these bellwethers are not the whole story. In fact, many smaller emerging markets offer significant opportunities to investors—particularly equity investors—including Indonesia, the Philippines and Mexico.

Another investment area getting an increased amount of attention is emerging-market debt, which is likewise looking better in light of fiscal problems elsewhere (especially in Europe). Of particular interest are emerging-market corporate bonds. These tend to offer higher yields than comparable corporate bonds in the West, even in cases where their risks of default are lower.

## Emerging markets have become less risky

Equities in many emerging markets got off to a weak start in 2012, as currency volatility and the global economic slowdown hurt performance returns. By mid-September 2012, price/earnings (P/E) ratios in emerging markets had fallen far below their historical average, trading at about 10.5x estimated earnings for the next 12 months, compared to about 13.4x in the U.S.

The low valuations, along with stagnant growth in developed nations, have prompted some investors to once again increase their positions in emerging markets, a category that goes well beyond the high-profile BRIC countries.<sup>1</sup> These investors have been lured partly by the



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countries' improved fiscal responsibility. Following the Asian crisis of 1997, the Brazilian currency crisis of 1999, and the Turkish banking crisis of 2001, many emerging-market countries improved their regulatory institutions. By contrast, in recent years, the most noteworthy deteriorating sovereign stories have been in "developed" markets: notably, the bank/real estate crises in Spain and Ireland; overleveraged sovereign balance sheets in Greece, Portugal, Italy and Japan; and high fiscal deficits in the U.S. Emerging markets also have the advantage of relatively high levels of GDP growth, with an average of 5.5% projected in 2013 compared to just 1.4% for advanced economies, according to the International Monetary Fund.

In addition, emerging-market equities have offered more dynamic growth opportunities than the developed world over the past few decades, with an average share price increase of 11.1% over the last decade in contrast to less than 4% for the S&P 500 (see Exhibit 1). Moreover, emerging-market stocks overall tend to have lower correlations with developed-market stocks (though emerging and developed markets have started to move more in tandem in recent years). They therefore play a role in creating a diversified portfolio.

In any event, index averages don't tell the complete story of emerging markets' performance. To truly understand the opportunities, investors need to understand the nuances of each individual country. In Asia, for instance, Philippine stocks are up about 42% for the year to date (as of early December), whereas Taiwanese stocks are up just 12% for the same period, based on MSCI indexes.

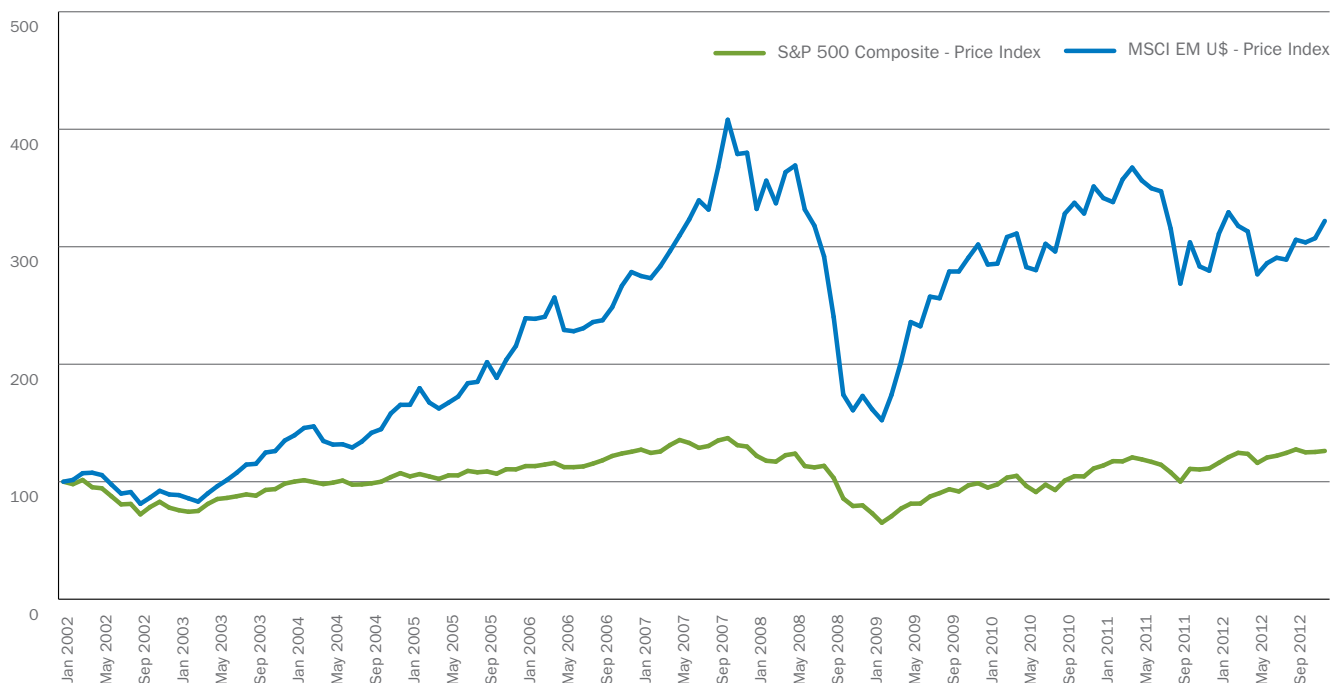
With such widely divergent opportunities lumped together under the overarching category of emerging markets, it takes an actively managed, research-based approach to find hidden gems and avoid significant pitfalls. In this paper, we look first at the overall benefits and risks of investing in emerging-market equities before discussing in detail what we believe to be some significant opportunities.

### The appeal of emerging-market equities

Before we look at a few countries that are of particular interest right now, it's important to understand what the majority of emerging markets have in common. These countries have three attributes that should be of interest to equity investors: economic growth; increasingly sizable

#### Exhibit 1: Emerging-market equities show stronger growth over the last decade than developed-market equities

10-year performance: MSCI emerging-market index vs. S&P 500 index, indexed to 100



Note: It is not possible to invest in an index. Performance for indices does not reflect investment fees or transaction costs.

Source: Datastream

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Exhibit 2: Emerging markets are forecasted to show stronger GDP growth than developed markets

GDP growth for select countries in % year-over-year growth (Percentage change in real GDP, over previous year)



Source: Economist Intelligence Unit

middle classes; and reasonable price-earnings ratios. In many cases, they also have economically sound governments that are not over-leveraged.

**Economic growth:** A country's GDP growth is critical because it is usually tied to earnings growth. By this measure, emerging markets have a big advantage over developed markets (see Exhibit 2). The IMF forecasts that China, the largest emerging-market economy, will grow about 7.8% in 2012, and that India will grow 4.9%. This does represent a slowdown from 2011, when China's GDP grew 9.2% and India's 6.8%. Still, it's far faster than the rate of growth in developed economies. U.S. GDP growth was 1.8% in 2011; German GDP growth was 3.1%. The IMF forecasts that advanced economies will grow even more slowly in 2012, about 1.3% on average.

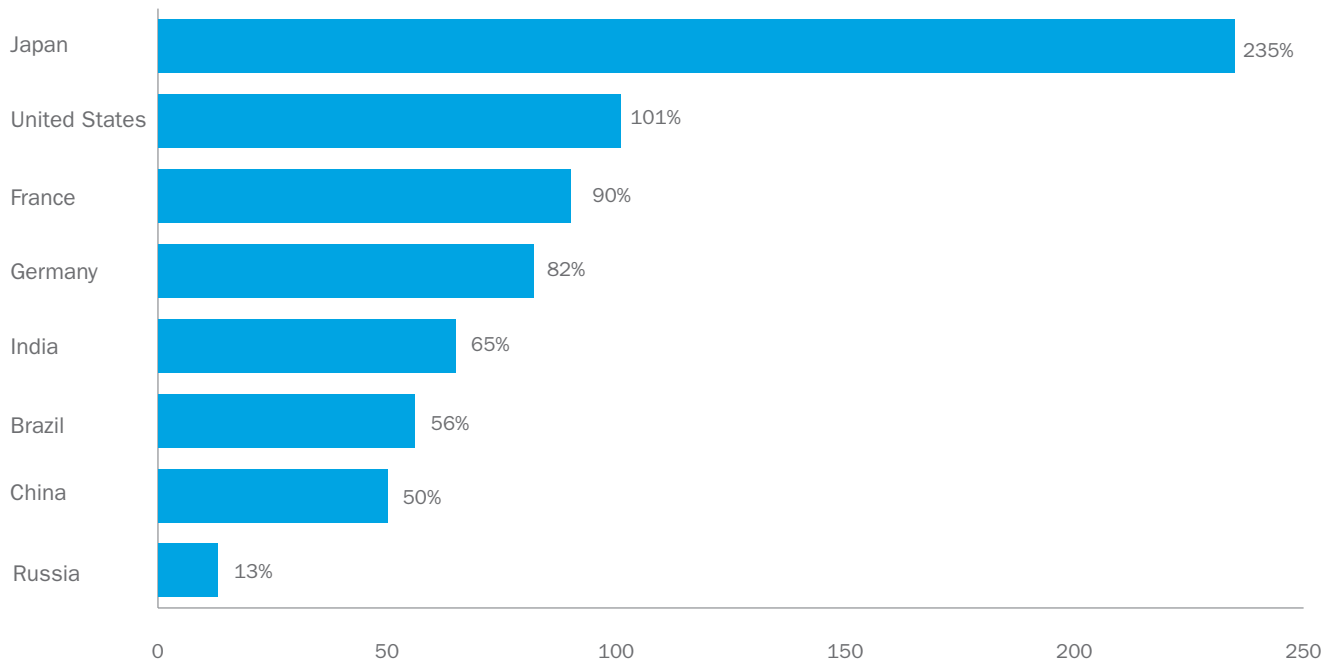
**Expanding middle classes:** The economic growth in emerging economies is benefitting more of the population, as evidenced by these countries' increasing per-capita income and larger middle classes. These growing middle classes—including, now, about 50% of Brazilians—represent a considerable amount of buying power and make countries' economies less reliant on exports.

In addition, a strong middle class benefits a country's stock market in several ways. First, it leads to more companies being listed. Stock exchanges in most emerging markets tend to be dominated by a few companies—a utility, a telecommunications company, a few banks, a big developer of energy or natural resources. As the country's middle class expands and has more disposable income, companies in the consumer discretionary and consumer staples sectors often get added to local stock exchanges.

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Exhibit 3: Emerging markets have lower debt as a percentage of GDP than developed markets

Total debt (% of GDP) 2012



Source: Fitch, December 2012  
Note: Estimated figures

Finally, higher incomes can result in an increased ability to save. That creates a new population of potential stock market investors among middle-class consumers. Individuals are more likely to invest on their own and to participate in the private pension systems and retirement savings accounts that are often created as demand for them becomes apparent. Both types of investment can bolster a local stock market's stability and growth.

**Reasonable P/E ratios:** Another attractive attribute of emerging-market equities is their relatively low prices. The global economic slowdown in 2012, which was accompanied by a decline in demand from the U.S. and Europe, precipitated a weakening in many emerging-country share prices. These are still, for the most part, inefficient markets, with securities prices of companies, industries, or sectors often not reflecting intrinsic values based on revenues, profits, or other fundamental drivers. For investors with a clear understanding of a market's opportunities and risks, the opportunity is significant.

**Solvent governments:** The governments of the most promising emerging-market countries have generally established sound regulatory institutions and have lower

levels of sovereign debt (see Exhibit 3). For instance, China's debt amounts to 50% of its GDP; the Czech Republic's is 46%; Indonesia's is 24%; and Malaysia's is 54%. By comparison, the debt of financially ailing Greece and Ireland are 167% and 118% of their GDPs, respectively; even the U.S.'s debt is 101% of its GDP. Indeed, many emerging-market countries now fund the deficits of more developed countries.

In some of the more fiscally advanced emerging countries, the governments also have high levels of foreign currency reserves. China has the most, with \$3 trillion in reserves, followed by Russia (\$499 billion), Brazil (\$352 billion), Korea (\$307 billion), and India (\$294 billion). Theoretically, this makes these countries better able to support their own currencies, which helps stabilize their economies and removes a potentially big risk for foreign investors—that a dollar-based investment in an otherwise healthy and good company could be undercut by a fall in the value of the local currency. In practice, however, most emerging market countries have moved, in principle, to more flexible currency regimes, intervening more to dampen excessive volatility.

### Understanding the risks of emerging-market investing

The currency swings mentioned above point to the ongoing structural issues that remain as a counterbalance to the opportunities in emerging markets. Indeed, a lot of the risk of investing in any emerging market revolves around currency volatility. Negative currency swings can significantly diminish returns for U.S. dollar-based investors (as happened in early 2012 to many who were long on the Indian or Brazilian stock markets). Emerging markets are also vulnerable to inflation, which has been above 6.5% in recent years in markets including Russia, Turkey and India.

Another factor to take into consideration when investing in emerging markets is sovereign risk. Although the high levels of sovereign risk that existed just a couple of decades ago have abated somewhat, sovereign risk remains a reality in emerging-market investing. For example, an industrial parts company in Russia, with better products, better management and a lower cost structure than any U.S. or European counterpart, still has to overcome a higher cost of capital, just by virtue of where it is located and how investors view the sovereign credit.

Emerging-market countries can also face questions of political stability, including regime change, recurring factional violence, or threats from a nearby sovereign power. Many countries that have favorable demographics and that might otherwise have investment potential fit into this high-risk category—notably, Egypt and other countries of the Arab Spring. So do some so-called frontier markets, including the Ivory Coast in West Africa and Pakistan in South Asia. Both Ivory Coast and Pakistan have high birth rates and sizable youth populations. But these favorable demographics aren't enough, in our opinion, to overcome the risks created by their volatile political situations.

Finally, emerging markets also have less-mature regulatory controls than developed markets—and at least in theory, a greater potential for theft and fraud. The theft could be mundane in character—as simple as a raw commodity being lifted off a cargo ship. The fraud can come in all forms. One memorable example is Longtop Financial Technologies, a financial software company in China, which fabricated revenues and the cash it had on hand with the help of local Chinese banking officials. After the exposure of the fraud in 2011, Longtop—which had once traded on the New York Stock Exchange and been worth \$2.4 billion—became worthless overnight.

One can legitimately question whether this is really any worse than some of what has happened recently in the supposedly better-regulated West. It was in the U.S. that Enron imploded, that federal politicians consorted with Countrywide Financial, that Bernard Madoff perpetrated

his massive Ponzi scheme. It was in the U.K. that Barings Bank, a 200-year-old institution, collapsed after a rogue derivatives trader hid more than \$1 billion in losses — which was more than double the bank's available capital. Nevertheless, the potential for corruption and fraud are also very real in emerging markets. China is a particular concern partly because the size of its markets opens the door to trouble on a large scale, and also because authorities there have tended to put Chinese investors first, ignoring the implications for the reputation of Chinese companies globally and for the development of their own capital markets. The possibility of getting surprises such as these adds an element of caveat emptor to emerging markets.

At TIAA-CREF, the emerging-markets equity team is able to draw on analyses done by our fixed-income peers to get insights into specific countries' macroeconomic risks. We use these analyses, which assess overarching factors such as currency movements and political stability, to determine whether to look at a country's equity markets.

### Finding the hidden treasures in emerging markets

The sovereign risk factor demands that emerging-market investors look at each country from two perspectives. One analysis should be top-down—looking at the macroeconomic, political and regulatory environment of a country; the other analysis should be bottom-up, focusing on industry sectors and individual companies. Using these two lenses, it is possible to identify good opportunities in a number of emerging stock markets at the moment—including Indonesia, the Philippines and Mexico, all countries in which TIAA-CREF has an overweight position vs. benchmark indices.

Indonesia's appeal lies primarily in the development of its commodity-based industries. With large natural resources of coal, palm oil, copper and gold, Indonesia is benefitting from recent increases in commodities prices. More important, however, it is focusing not just on exporting commodities but on processing them—the difference, for example, between shipping blocks of palm fat and upgrading it into palm oil, or between shipping copper concentrate vs. an upgraded, refined and higher-priced version of the mineral. This focus on processing has prompted the government to make policy changes. The country has begun to initiate an export tax on certain raw commodities as part of an effort to get its trading partners to set up processing plants in Indonesia itself. In doing so, government officials have two goals: to create jobs domestically and to generate a transfer of knowledge from more sophisticated economies to Indonesia. The idea is to push Indonesia in the direction of having a more skilled and educated work force.

### The emerging-markets fixed income opportunity

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If there was already a re-evaluation underway about which economies qualify as emerging vs. developed, the financial-system crisis of 2008-2009 accelerated it. The shift has done the same thing for emerging-market debt as for emerging-market equities: It has put the whole asset class in a more favorable light.

Since the crisis, and in the wake of the debt problems in Spain and Italy, the gap in financial strength between developed markets and emerging markets has narrowed. According to Fitch, only 46% of the global economy is now AAA-rated, compared with 55% in 2007. Emerging markets on the other hand have been improving in terms of their overall credit quality, as the percentage of investment grade countries in the JP Morgan Emerging Market Global Diversified Index has increased from 39% in 2007 to 62% in 2012.<sup>2</sup>

Another measure of their diverging fortunes—developed markets on the one hand, emerging markets on the other—is average debt-to-GDP ratios. Developed markets' average debt-to-GDP is now almost 114%, a 36.4 percentage point rise since the 2007 crisis, according to JP Morgan research. By contrast, emerging market debt-to-GDP ratios have actually fallen a couple of percentage points, to an average of 34% from 36.5% before the crisis. Faster growth and improved balance sheets of the large emerging market economies has lowered the concerns over their ability to satisfy and service their external and domestic debt, making investments in debt on a risk adjusted basis quite compelling.

Despite the improving credit profiles, however, emerging-market debt still has wide interest-rate spreads, particularly compared to the historically tight spread levels seen pre-crisis when the credit quality of the EMBI GD sovereign index was substantially weaker. This creates an opportunity, assuming emerging-market economies avoid contagion from the West.

Foreign investors may want to consider emerging-market corporates (both investment grade and select high-yield issuers). A foreign investor buying such bonds gets paid two premiums—for the country risk and for the company risk. For example, a Brazilian investment-grade company rated BBB- might issue a U.S. dollar-denominated bond with a higher yield than one rated BBB- in the U.S. This could be true even if the Brazilian company had better fundamentals, including less leverage, higher profit margins, greater global market share and better access to natural resources.

There are a couple of caveats, however. In local currency debt, in particular, as with equities, a decline in the value of

the underlying currency can potentially wipe out the fixed-income yields when those are translated back into U.S. dollars. A currency that appreciated, of course, would bolster returns. Indeed, the increased likelihood that many emerging market currencies will eventually appreciate against developed-market currencies is another thing that gives this segment its long-term appeal.

At the moment, given the low expectations for global growth, including somewhat slower growth in BRIC, we do not see inflation as an immediate concern in most emerging market economies. In any event, we do not create hedges against interest-rate risk when we make local currency bond investments, though we do sometimes shorten portfolio duration when we become concerned about steepening yield curves. Active investors can also invest in inflation-linked bonds, which provide a hedge against inflation risks and are an alternative to nominal rate instruments, which often see yields increase and prices decline during inflationary periods.

Emerging-market debt is like emerging-market equities in that each country's risks must be understood individually—their institutions and policies differ so much. For instance, high-yield corporate bonds in China are particularly risky because of policies that favor local investors over foreign ones in the event of a default. In general in emerging markets, when there's bad news, there's a dearth of liquidity.

In addition, one should not underestimate the risks of buying debt in politically unstable countries like Iraq, Pakistan or Lebanon, which is precisely why TIAA-CREF has no investments in these markets. But even markets that seem lower in risk and more developed economically can carry significant geopolitical risks. For instance, Israel and South Korea both face threats from neighbors that have been overtly hostile. In South Korea's case, even if the hoped-for reunification with the North eventually happens, the country will face a heavy burden and a years-long effort to re-integrate economically and socially. Geopolitical developments need to be monitored closely and factored into the risk/reward tradeoff analysis when investing in emerging-market debt. That said, our exposures in South Korea and Israel have factored in those risks, and we continue to view valuations in both countries as attractive for now.

At the moment, TIAA-CREF sees good opportunities for investing in emerging market corporates in Brazil, Mexico, Chile, Poland and India.



Such development of human capital will be essential to the advancement of the fourth most populous nation in the world, with an average age of 28 (versus 35 in China and 37 in the U.S.). Indonesia's population is increasingly middle class, not just in the capital, Jakarta, but throughout the country. Evinced their interest in technology, Indonesians are among the heaviest users of Facebook in the world.

The Philippines is also on the rise. Many investors have traditionally ignored this island nation, which has operated in the shadow of Indonesia and other Asian countries like Thailand and Malaysia. In recent years, however, the Philippines has had a dramatic macroeconomic turnaround. The changes include a steep drop in inflation, a budget surplus in place of a deficit and a current account surplus. In addition, there have been positive developments regarding a peace process and improved governance in Mindanao, a region which has been particularly violent and home to the MILF, a Muslim rebel organization. One result of the robust economics has been a very stable currency—something that has given investors confidence and allowed the stock market to perform well. The Philippines also has among the world's highest inflows of remittances, the money sent back to a country by those who have left it to work overseas. Remittances have helped power GDP growth in the Philippines, which was 4.7% on an inflation-adjusted basis in 2011.

Another growth prospect is Mexico, whose close trading ties to the U.S. means it may do well when the U.S. economy picks up steam. The country also has a growing consumer class that has offset sluggish export growth in recent quarters. Mexico also has some other positives, including expected reforms in the areas of labor law and the oil industry. Over the next few years, several economic reforms

will be on the country's legislative agenda, including the liberalization of labor markets and incentives for privatizing investments in energy markets.

Of course, not all emerging markets currently offer compelling investment opportunities. In Taiwan, for example, the economy is overly dependent on low-margin hardware and electronics industries; as a result, the TIAA-CREF Emerging Markets Equity Fund<sup>3</sup> has a smaller allocation to this market, relative to the fund's benchmark. Another underweight vs. the benchmark is South Africa, whose major industry, mining, has lately been plagued by labor strife and violent government crackdowns.

### Treacherous markets call for a knowledgeable guide

Investors need to be careful about the positions they take in emerging markets, cognizant of the risks, and aware that there is potential for sudden and unexpected change. Countries that are now emerging could be classified as developed in a few years. And some so-called frontier markets (notably the oil-rich United Arab Emirates) may graduate to emerging-market status.

As of September 2012, just 19% of fund managers had an overweight position in emerging market equities. That was well below the long-term average of 26% and suggests there may be an opportunity for some managers to increase their exposure. To be sure, there is still plenty of risk in emerging-market equities—as there is in most equity markets—so investors need to navigate carefully. But they shouldn't let the risks keep them from pursuing the opportunities offered by this asset class.

<sup>1</sup> The MSCI Emerging Market Index includes Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand and Turkey.

<sup>2</sup> J.P. Morgan's EMBI Global Diversified index is a broad emerging markets debt benchmark which includes U.S. dollar-denominated Brady bonds, Eurobonds, and traded loans issued by sovereign and quasi-sovereign entities.

<sup>3</sup> Please note that the TIAA-CREF Emerging Markets Equity Fund does not include fixed-income opportunities discussed in the sidebar on page 6.

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