With recent events in Egypt leading to suspension of that country’s investment market activity and the closure of its stock exchange on January 27,¹ the question of the risks inherent in emerging market investing is on many investors’ minds. While we do not believe recent events warrant a flight of capital from emerging markets, we do believe that the situation represents an opportunity for investors to consider the best way to access emerging market stocks. This Research Note delves into the risks of shifting an emerging market allocation away from broad, diversified coverage to a more concentrated focus. We conclude that diversifying across emerging market countries helps to minimize idiosyncratic or uncompensated risks and is analogous to diversifying across individual companies in developed markets.

Why focus on countries?

The appeal of investing in individual countries is the potential for higher returns compared with a more diversified investment. Figure 1, on page 2, shows the range of annual returns across MSCI Emerging Market Index countries since 1988. An investor who correctly picked the top-performing countries could have significantly outpaced the broad global market. Of course, the obvious risk in this strategy is that the investor might have instead selected the country or countries that significantly underperformed the market. And in emerging markets, the difference between the winning countries and the losing countries can be stark (much more so, for example, than when focusing on sectors within the U.S. market); this can mean significant volatility for portfolios focused on country selection.

Notes on risk: All investments are subject to risk. Foreign investing involves additional risks, including currency fluctuations and political uncertainty. Stocks of companies in emerging markets are generally more risky than stocks of companies in developed countries. Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index. Diversification does not ensure a profit or protect against a loss in a declining market.

¹ As of this writing (mid-March 2011), Egypt’s stock exchange was still closed.
Although the spread between best and worst performers appears to have narrowed during the 2000s—perhaps because of persistently rising correlations across emerging market countries and regions—substantial risks still remain for investors who use a country-selection strategy. For example, investors tend to display a natural behavior to migrate toward the winning sector or country. For instance, in Russia, following strong returns through mid-2008 (largely due to a rise in oil prices), cash flows into Russian exchange-traded funds (ETFs) peaked that June. Subsequently, the MSCI Russia Index fell −75% over the 12 months ended February 2009. Cash flows bottomed in June 2009, just as the Russian market was beginning its rebound. Then, as Russian stocks accelerated in 2009 and into 2010, cash flows picked up considerably. This relationship has not been unique to the Russian stock market.

Indeed, the correlation between 12-month returns and 12-month cash flows into China ETFs has been 0.61 since 2005.

**Challenges of country selection**

A primary problem with attempting to predict the winning emerging market country is that when evaluated individually, countries can be much less efficient than the broad market. In other words, stocks of individual countries have generally exhibited greater volatility without compensating investors with high enough returns. Figure 2 shows that from 1993 through 2010, the MSCI Emerging Markets Index delivered a combination of risk and return that exceeded the risk-adjusted performance of most of the individual countries in the index over that period. Although five countries offered
proportionately higher risk-adjusted returns, only one country (Chile) had volatility that was lower than that of the broad market. Of course, to have realized the lower average volatility, investors would have had to be invested in Chile for the entire period without adjusting their allocations. The question then is: Can those countries with superior risk-adjusted returns be selected in advance—and then held in a strategic allocation across both good and bad markets?

Economic performance

Often, economic performance is posited as a useful metric when evaluating expected market performance across countries. Vanguard’s research, however, has shown no correlation between realized economic performance and market returns. Figure 3 illustrates this in striking fashion: The correlation between long-run economic growth (as measured by real gross domestic product [GDP] growth per capita, a standard proxy for a country’s productivity growth) and long-run stock returns across emerging markets has been effectively zero. The challenge facing

Figure 2. A broad emerging markets index offers efficiencies in risk and return

Relationship between returns and volatility for individual MSCI Emerging Market Index countries, 1993–2010

Note: Results are shown since 1993 to balance the number of observations (16 countries) with a long-enough period.
Sources: Vanguard, MSCI, and Thomson Reuters Datastream.

Figure 3. Relationship between GDP growth and market returns

Emerging markets, 1988–2010

Notes: Sample includes the 12 emerging markets that had both economic and market return data available back to 1988. Evaluating alternative time periods (1993 or 1995, for example) would not alter the results.
Sources: Vanguard, International Monetary Fund, MSCI, Thomson Reuters Datastream, and the World Bank.

2 The result in Figure 3 was first documented in the book *Triumph of the Optimists: 101 Years of Global Investment Returns* by Elroy Dimson, Paul Marsh, and Mike Staunton, of the London Business School (Princeton University Press, 2002). See also Davis et al. (2010) for an in-depth analysis of this result.
investors is that while economic growth is certainly important for equity investors (economic surprises and the price paid for economic growth are the true critical factors), expected economic performance alone has not shown a strong positive link to equity returns. In other words, investors are not compensated for investing on the basis of economic growth that is expected and therefore priced into financial markets. And because outperformance is more dependent on unexpected growth, in order to profit, investors must be able to accurately predict unexpected growth, a decidedly difficult task.

Foreign currency appreciation
A second metric often used to make the case for overweighting a particular country concerns expectations of foreign currency appreciation (and subsequent depreciation of the U.S. dollar), perhaps due to differences in a country’s fiscal standing, national balance sheets, and/or economic growth. Again, however, while seemingly theoretically sound, the historical data do not support this relationship. **Figure 4** compares currency return to market return across emerging markets. The regression trend line indicates that differences in currency values may largely be priced into equity prices. If investors were able to benefit from currency, we would expect a positive relationship. However, just as with economic performance, investors have not been rewarded for expected currency movements. And as with unexpected economic performance, accurately predicting unexpected currency movements is no easy task.

Valuations
Finally, we turn to a third metric, valuations, which have been found to be the critical factor in explaining relative performance. For example, in the United States, low initial price/earnings (P/E) ratios have historically led to higher subsequent returns. This relationship has been shown to be particularly valid during periods of extreme valuations (Davis, Aliaga-Díaz, and Ren, 2009; Philips and Kinniry, 2010). Based on this relationship, we conducted a similar analysis with emerging market countries. Unfortunately, however, **Figure 5** demonstrates that the relationship between initial P/E ratios and subsequent returns breaks down when we extend it to individual emerging markets.³ Here we clearly see that low initial P/E ratios have not signified higher subsequent returns, nor have high initial P/E ratios led to low subsequent returns. The trend line overlaid on the chart reveals the lack of any relationship.

Although Figure 5’s results are informative, it’s important to note that the absolute relationship between valuations and returns may obscure relative relationships. Indeed, sovereign risk, varied economic growth rates, or idiosyncratic economic uncertainty can lead to systematically different valuation levels from country to country. We therefore replicated Figure 5 using normalized P/E ratios, or a ratio of a country’s P/E in any given period relative to its average historical P/E. It is interesting that the results using normalized P/Es were nearly identical to those shown in Figure 5. While several countries displayed the traditional relationship between valuations and subsequent returns, a significant majority did not.

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³ P/E or other valuation metrics have proven to be much more useful at the broad-market level. For example, a positive historical relationship between initial valuations and subsequent returns has been shown to exist for the MSCI Emerging Markets Index. Similarly, Davis et al. (2010) showed that the relative spread between valuations in developed versus emerging markets has been a significant reason for the outperformance of emerging markets since 2000.
Relationship between initial valuations and returns

Notes: All countries in the MSCI Emerging Markets Index are represented that had at least 13 years of reported P/Es and returns (to supply at least 36 ten-year return observations for each country) as of January 31, 2011. P/Es as of 1/31/2001; ten-year returns as of 1/31/2011. The data represent 21 countries, accounting for 1,646 observations. For presentation, we truncated the x-axis for observations less than 0 or greater than 50. Those outliers accounted for 10% of the observations. By removing the outliers from the analysis, the theoretical relationship between initial valuations and subsequent returns appears, albeit to a lesser extent than observed in the United States. Returns denominated in U.S. dollars.
Sources: Vanguard, MSCI, and Thomson Reuters Datastream.

We also replicated this analysis with local returns, using the hypothesis that the volatility of currencies has overwhelmed the underlying relationship between valuations and returns for local investors. However, the results were again identical to those shown in Figure 5.

The key difference among individual emerging markets in terms of the relationship between valuations and return is idiosyncratic, or country-specific, risk. A case in point is Venezuela. From December 2004 through October 2006, the Venezuela stock market was valued at less than 10x earnings. Historically speaking, if a diversified, developed market such as the U.S. stock market were so valued, this would be a strong indicator of above-average future performance. However, for concentrated markets (as with individual stocks), valuation ratios could be low not just because prices are depressed but possibly because of expectations of slower future earnings growth. Indeed, in the case of Venezuela, geopolitical risks prevailed, and Venezuela was removed from the public investment space as private assets and foreign capital were seized by the government, thus making the potentially attractive P/E multiple meaningless.

Conclusion
The evidence presented here suggests that accurately selecting an emerging market country that will outperform is difficult, at best. At worst, an investor or advisor can experience significant volatility and underperformance, not to mention the potential for nonmarket risks. Although individual emerging markets have outperformed the broad emerging markets index over both the short and long term, selecting them in advance is extremely difficult and fraught with risk. Indeed, as with most concentrated and volatile asset classes or strategies, the risk of getting it wrong can far outweigh the gains from getting it right. The message, then, is simple: When investing in emerging markets, diversification is key. For a greater chance of success, investors have found broad-market vehicles to be their most reliable tool.
References


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