

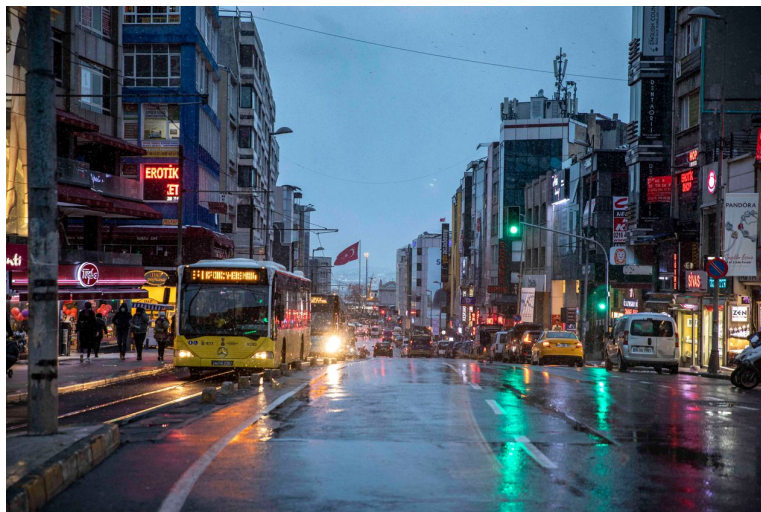
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# The Case for and Against Investing in Emerging Markets Now

Economic growth is expected to be relatively strong. But these stocks also carry risks.



Turkey is one of the emerging-markets countries facing high debt levels. Shown: Istanbul, Turkey, in February.

PHOTO: ONUR DOGMAN/ZUMA PRESS

*By Dan Weil*

July 4, 2021 5:24 pm ET

Emerging-markets stocks have outpaced developed-market shares over the past 12 months, making them a tempting investment option. So is now a good time to take the plunge, or should investors stay away?

On the plus side, economic growth in emerging markets is expected to surpass growth in developed markets in the next few years. And emerging-markets stocks can be useful to U.S. investors for diversifying a portfolio, since they don't move in lockstep with U.S. shares.

But emerging-markets shares come with higher volatility than developed-market stocks and an array of risks, including political risk, currency risk, liquidity risk—and economic risk, despite the rosy projections. And investors can get exposure to emerging markets more safely with a portfolio of U.S. stocks that includes

companies doing business in those markets.

“Investing in emerging markets is a high-risk, high-reward proposition,” says Eswar Prasad, a trade-policy professor at Cornell University. “Many emerging markets have done well growth-wise, and their financial markets have had periods of success, but it tends not to last too long.”

With that in mind, here’s a closer look at the cases for and against investing in emerging markets now.

## The positive case

The biggest advantage of emerging markets today is their potential for stronger economic growth than advanced economies, investment pros say.

“About 90% of the world’s population under 30 lives in emerging markets,” says Michael Sheldon, chief investment officer at RDM Financial Group, Hightower, a wealth-management firm in Westport, Conn. “This may lead to stronger labor-market growth, increased productivity and stronger GDP and corporate profits over time.”

In contrast, developed countries have rapidly expanding senior populations and low birthrates, which makes it more difficult to find workers to fill new jobs, says Karim Ahamed, investment strategist at Cerity Partners, a wealth-management firm in Chicago. That can limit economic growth.

The International Monetary Fund forecasts average annual GDP growth of 5.5% for emerging markets in 2021-23, compared with 3.5% for advanced economies.

Emerging markets also represent diversification opportunities for U.S. investors. That’s partly because economic growth and financial-market performance in emerging markets are less correlated with the U.S. than advanced economies and financial markets are. In addition, emerging markets give U.S. investors currency diversification, which can be helpful when the dollar is weak.

While investors can gain exposure to emerging markets through stocks of U.S. companies that earn revenue from those markets, those stocks won’t give investors the full diversification benefit, Prof. Prasad says.

The strong economic and corporate performance that is boosting emerging-

markets stocks also makes their bonds attractive, says Robert Koenigsberger, chief investment officer at Greenwich, Conn.-based Gramercy Funds Management, which specializes in emerging markets.

Inflation is less of a problem in most major emerging markets today than it has been at times in the past. Also, emerging-markets countries' external deficits generally have narrowed, or totally reversed in some cases. "This should give emerging-market central banks more flexibility to absorb external shocks and deal with post-pandemic inflationary pressures, allowing them to tighten monetary policy without slowing growth momentum too much," Mr. Koenigsberger says.

### The negative case

Emerging-markets stocks are more volatile than those in advanced economies. The MSCI Emerging Markets Index had a standard deviation of 18 over the past 10 years, compared with 14 for the MSCI World Index of developed markets, according to [Morningstar](#). Standard deviation measures volatility, with a higher number representing more volatility.



Brazil, in addition to debt, has had a harder time than many other countries with Covid-19. Shown: São Paulo in February.

PHOTO: SEBASTIAO MOREIRA/SHUTTERSTOCK

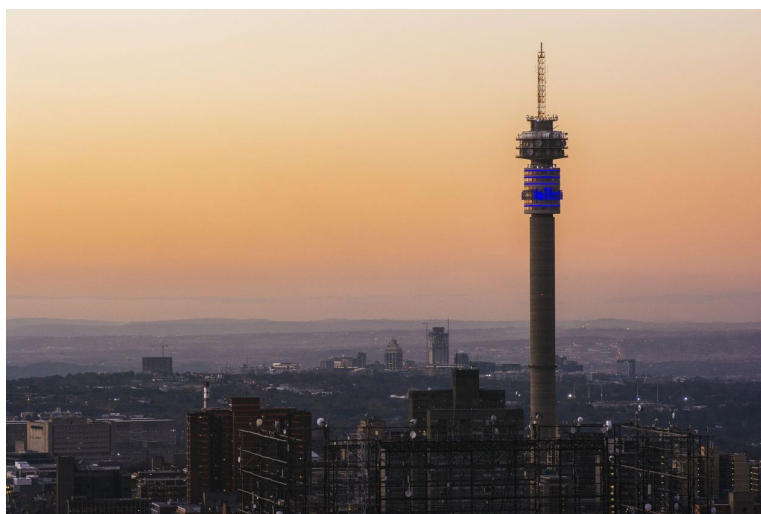
The factors behind that higher volatility in emerging markets include political risk, economic risk, currency risk and liquidity risk.

And while emerging-markets economies generally have been on a sharp uptrend for years, some also have experienced serious downturns. Russia's economy, for

instance, shrank 2% in 2015, compared with 2.9% growth for the U.S. that year.

Emerging-markets currencies are a double-edged sword, providing diversification but also volatility. “When you try repatriating your investment, everything may be going wrong at the same time,” with the emerging market’s economy, financial markets and currency dropping together, Prof. Prasad says.

A declining emerging-market currency makes an investment less valuable when converted into dollars. And emerging-markets currencies aren’t only vulnerable to trouble in their own country—they also tend to decline against the dollar when the U.S. currency is gaining against other developed-market currencies like the euro or yen, regardless of what’s happening in emerging markets.



South Africa is also dealing with debt. Shown: Johannesburg in July 2018.

PHOTO: WALDO SWIEGERS/BLOOMBERG NEWS

Meanwhile, market liquidity isn’t as deep in emerging markets as in advanced ones. “There’s always a risk with emerging markets: It’s easy to bring money in, but not always to take it out,” Prof. Prasad says.

On the bond side, corporate debt outstanding has soared 400% in emerging markets since 2010, Mr. Koenigsberger says. So, plenty of securities are available. But liquidity isn’t just about supply. “Due to fewer banks and smaller market-making operations at those banks, there is insufficient liquidity when investors look to exit the market” in many cases, he says.

Another issue for bond investors: “There are a handful of emerging-market countries—South Africa, Turkey and Brazil, for example—that face high debt levels and large current-account imbalances,” Mr. Sheldon says. These countries

are vulnerable to capital flight, which could trigger a plunge in bond prices.

One negative factor for emerging markets in the near term is that countries such as India and Brazil are having trouble dealing with Covid-19. That will likely weigh on emerging-markets stocks this year, Mr. Ahamed says.

## How to invest

For those who want to jump into emerging markets, what's the best way? Mutual funds and exchange-traded funds will suit most investors better than individual stocks and bonds, because researching and trading individual securities in these markets is often difficult.

When it comes to the question of actively managed funds versus passive index funds, "you can make an argument for active management to provide some downside protection," Mr. Ahamed says. "But an ETF gives you very broad-based exposure in a way that's generally cost effective, with lower fees." Most ETFs passively track a market index.

For bond funds, actively managed is the way to go, Mr. Koenigsberger says. The growth of emerging-markets debt amid continuing economic challenges in many countries puts a premium on active management to sort out the winners, he says. Emerging-markets bond indexes tracked by passive funds are usually weighted by market capitalization, so the most heavily indebted issuers have higher weightings. "Emerging-market debt isn't an asset class that is suitable for index funds," Mr. Koenigsberger says.

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*Appeared in the July 6, 2021, print edition as 'Emerging Markets: The Pro And the Con.'*

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