

Investing in emerging markets can mean developing profits

By KATHLEEN GALLAGHER
kgallagher@journalsentinel.com



U.S. stocks have performed adequately in the last 12 months, but their counterparts in some developing countries have provided much more excitement.

Take Mexico. Driven by an acceleration of exports, growth in consumer demand and more foreign investments, stocks on the Mexico Bolsa Index have rewarded investors with a total return of more than 32% in the last 12 months vs. nearly 9% for the Standard & Poor's 500 index.

That's just one example of the kind of potential Ed McIlveen is trying to harness when he recommends to clients that they add investments in emerging markets to their portfolio mix.

What makes emerging markets so attractive right now are their improving fundamentals and reasonable prices, even after their recent stock price run-up, said McIlveen, director of performance analytics and research at Francis Investment Counsel LLC in Hartland.

"A lot of emerging market nations are running budget and trade surpluses and will continue to attract foreign investment," McIlveen said.

The gross domestic product for China - the poster child for emerging market potential - grew 9.1% in 2004 vs. 4.4% for the United States.

The Organization for Economic Cooperation and Development, based in Paris, said last week that growth in Asian economies peaked in 2004, and that weaker demand and higher oil prices would depress overall growth in Asian economies to below 5% this year. But last week's report also said activity is expected to pick up again as oil prices ease and exports improve heading into 2006.

Prospects for other developing countries are looking better, too. In the first quarter, Standard & Poor's upgraded Russia's and Mexico's debt, citing improving cash flow for both oil-exporting nations that should strengthen their ability to repay debt.

Still, Morningstar Inc.'s emerging markets fund category is trading at 10.2 times earnings for the next 12 months compared with 16.1 times for the Standard & Poor's 500 index.

Emerging markets are never an investment slam dunk. They're incredibly volatile, as evidenced by the Morgan Stanley Capital International Emerging Markets Index, which soared as high as 66% in 1999 and swooned as low as negative 30% in 2000.

Emerging market countries are often at risk when the economies of big importers like the U.S. falter. They can be devastated by currency issues, as occurred in Thailand in 1997 after the Thai baht was devalued, or by political risk, which may have influenced tax evasion and fraud charges against Mikhail Khodorkovsky, former chief executive of the giant Russian oil company Yukos.

It's difficult for individual investors to buy stocks of companies in emerging countries like South Korea, Russia and Mexico because they trade in foreign currencies on exchanges outside the U.S. and operate under rules that can be quite different from here. Accordingly, many investors get their international exposure through mutual funds.

But stocks of companies in countries that are developing more efficient and productive economies are often overlooked by portfolio managers of big international stock funds, McIlveen said.

Many investors think when they buy into the American Funds EuroPacific Fund (AEPGX) - the largest U.S.-based international fund - that they're getting enough exposure to emerging markets, McIlveen said. But that fund has minimal exposure to such markets, he said.

It can be difficult for portfolio managers to adequately evaluate balance sheets of companies in developing countries because of different, or lacking, accounting standards. So McIlveen likes to invest with portfolio managers who focus on calculating companies' intrinsic values and how much cash flow they are producing.

"Due to the variances in international accounting standards, valuing stocks with cash flow from dividends is much more reliable," he said.

The managers of **Brandes Investment Partners'** emerging markets private portfolio use such techniques, but you must have a minimum of \$250,000 to invest in it.

A more accessible product is the **Delaware Emerging Markets Fund (DEMAX)**, McIlveen said. Led by the London-based portfolio management team of Robert Akester and Clive A. Gillmore, the fund seeks out undervalued

companies. McIlveen says the fund's ability to deliver consistently strong performance is a reasonable tradeoff for its 5.75% front-end sales charge and 1.91% expense ratio.

A solid record

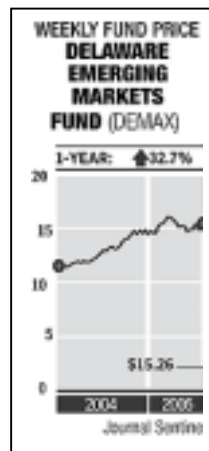
The \$761.3 million fund holds a smaller number of securities - about 84 - than many of its peers, McIlveen said. Its most appealing feature, he said, is that these two long-time managers have turned in such a strong performance and are still solidly at the helm.

The fund's total return has averaged 16.6% over the past five years, beating the average of 7.4% of competing funds, according to data compiled by Bloomberg.

"Even if a fund has a great track record, if there's been manager turnover, it's not as appealing to us," McIlveen said.

Investing in emerging markets can be a risky business. McIlveen recommends keeping these dynamic investments to between 5% and 20% of any portfolio. The Harvard endowment fund had allocated about 5% and the Yale endowment fund about 7% of assets in this category as of their last annual reports in June 2004, he said.

McIlveen's firm began recommending this fund to clients in 2001, and he said he would still buy it at current prices. He says emerging markets overall could provide an annualized total return of 10% over the next seven years, and expects the Delaware Emerging Markets Fund to keep pace with that.



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