



## Emerging Market Risk Premiums

### Will the past repeat itself?

BY CYNTHIA HARRINGTON, CFA

Investors seeking to diversify risk in their portfolios seem to have lost one tool. Emerging market risk premiums have narrowed, and return correlations with developed markets have risen. But investors are still pouring money into securities of the younger economies, so something must be attracting them. According to industry experts, the potential for growth in emerging versus developed markets is the big attraction.

#### Less Risky Business

Risk is a tricky thing to measure. Even in developed countries, the argument often rages about the drivers of the equity risk premium. But the trend in one such variable affecting emerging markets is hard to ignore. According to valuation expert Aswath Damodaran, a country's credit rating is both an accessible method of determining the risk premium and also a dependable method because the drivers of default risk are similar to those that drive equity risk. Over the past decade, emerging market debt ratings have climbed from the basement to middling investment grade.

Improvement has been swift. The credit-rating agencies now rank the debt of 12 of the top 13 emerging economies as investment grade — compared with half of that as recently as the mid-1990s. “The major rating agencies no longer consider these countries economic basket cases,” says Brad Durham, managing director of Emerging Portfolio Fund Research in Cambridge, Massachusetts. “And investors' risk aversion narrowed along with the spread of emerging debt over risk-free rates.”

Fundamental changes within the countries support the bump in credit ratings. Responsible fiscal policies have

helped to stabilize internal situations. Many countries have allowed their currencies to float, giving governments more control and leverage over monetary policy. Changes in retail banking are allowing rising middle classes to access and build consumer credit. Internal growth is reducing the need to rely on exports. “Compared to Japan, where internal demand is so slack, China and India are now seen as defensive plays against a world economic downturn,” says Durham.

External economic shifts have improved the condition of emerging markets as well. The weaker dollar supported higher commodity prices denominated in emerging market currencies, which contributed to higher equity prices in the natural-resource laden countries. Global demand for natural resources remains high. “The strong oil prices are part of this positive for emerging markets, though they are a negative for some countries such as Korea,” says Edward Baker, CEO of Alliance Capital Limited and chief investment officer of Emerging Markets Equities in London.

Lower risk premiums should drive investors looking for diversification elsewhere because smaller risk premiums usually translate into lower expected returns. But, notes Baker, “Expected returns are also a function of expected growth rates, and growth is expected to be considerably higher in the emerging markets.” Buoyed by internal demand and stable global inflation and interest rates, emerging economies sport 5 percent average expected GDP growth rates.

#### Growth and Diversification

Emerging markets still offer considerable growth opportunities in the world “On the returns side, emerging market

#### KEY POINTS

- Fiscal and political stability in emerging markets has lowered risk.
- Higher growth rates versus developed markets have attracted investors.
- Emerging market economies are growing more diverse.
- In the past, emerging markets followed a seven-year cycle.
- Growing acceptance of corporate governance principles in emerging markets is reducing risk, although problems remain.

opportunities can still be quite significant,” says Peng Chen, CFA, chief investment officer of Ibbotson Associates in Chicago. “Over the past five years, emerging markets exhibited 0.73 correlation with the S&P 500, while developed markets correlated by 0.85.”

Investors looking within emerging markets find greater diversification possibilities and challenges. Smaller economies are sometimes concentrated in distinct sectors or industries, such as natural resources, which results in wide variation in annual performance among emerging markets. Investors find further diversification with individual stocks. “Look at the Yukos oil situation,” says Chen. “There's one Russian company suing the domestic government because of too high a tax burden, and that could have a big impact on the individual company.”

Stronger economic growth paired with varied country and security performance creates great optimism about the industry among active managers, according to James Journlin, portfolio manager for international investments and backup portfolio manager for emerging market funds at the Russell Investment Group in Tacoma, Washington. “For many managers, emerging markets sit at the top of their lists of areas with compelling opportunities,” he says. “This money is likely to be invested in specific emerging market opportunities and more broadly diversified given recent run-ups.”

## Potential for Change

Investors question whether the narrowing premiums and strong emerging market growth will shift directions. Concerns of higher global interest rates slowing both economies and equity prices dominate the headlines. If slower earnings result in lower emerging market equity prices, then debt levels might rise again as companies find equity issuance less advantageous. “With globalization, companies go wherever they find the low-cost producers and the lowest cost of capital,” says Chen.

In fact, according to Journlin, emerging markets have a regular seven-year cycle from peak to trough and back again. “It’s hard to say where the cycle begins, but 1994 seems to be a peak and 2001 looks like a bottom,” says Journlin. “That would put the end of this cycle around 2008.”

But, he adds, “all bets are off in an extreme environment where markets react aggressively.”

The market reaction to the recent tsunami is encouraging. Despite the horrible devastation in affected regions, on the first trading day following the disaster, the Indonesian market rose 1.5 percent. Compare that with double-digit drops in vulnerable markets following the 1997-1998 Asian financial crisis and the 1995 devaluation of the Mexican peso. The response to the tsunami speaks to the underlying belief in the recovery.

“This is really a different asset class today,” says Durham. “The riots in Jakarta in reaction to the [1997] financial crisis tagged the market there by 10 percent, and Russia fell 12 percent in response [in 1998].”

## Global Governance

Wild cards in any analysis of emerging markets are the improving transparency and corporate governance policies. Both developments can greatly reduce fundamental risks in investing in newer economies.

“Improvements in corporate governance have helped, though this is still a problem in many places, particularly Korea and Russia,” says Baker.

Increasingly, organizations that support the development of emerging

markets are standardizing regulations and trading practices. In concert with such organizations as the World Bank and the Organisation for Economic Cooperation and Development (OECD), trade organizations bring together groups committed to stabilizing emerging markets. The Emerging Markets Traders Association (EMTA), for

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instance, has helped emerging market securities by providing trading liquidity in times of crisis. Formed in 1990 with a mission of “promoting the orderly development of fair, efficient and transparent trading markets for Emerging Markets instruments and to helping integrate the Emerging Markets into the global capital markets,” EMTA has been working to increase the credit quality of emerging market debt by creating standard documentation and building infrastructure for emerging market bonds, derivatives, foreign exchange, equities, and local currency instruments.

The 340-member International Institute of Finance (IIF) focuses on both debt and equity markets in younger economies. Formed in 1983, the IIF recently announced the “Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets.” The voluntary principles are a joint product of the leading sovereign issuers of international bonds, primarily Brazil, Korea, Mexico, and Turkey, as well as leading private creditors. “The role of governments in the corporate governance agenda is becoming an ever more important issue to which the IIF is paying increasing attention,” says Baker, co-chair of the IIF’s Equity Advisory Group (EAG). “We are contemplating the development of a country-level

corporate governance rating as a next possible phase of the EAG’s efforts.”

Baker’s group is developing country-by-country corporate governance task force reports that compare the corporate governance practices in the country under review with the IIF’s Code of Corporate Governance for Emerging Markets. Reports for Turkey and India are slated for the first half of 2005. “We have found that many companies have adopted the trappings of good corporate governance for the outside world, but have not really entered into the spirit of it,” says Baker. “The situation in Russia is a worrying example. When governments can use their authority unchecked the way the Russian authorities have, it underscores how vulnerable outside investors are to politically motivated government actions.”

## Greatest Growth Potential

Whether the past cycle for emerging markets will repeat itself, which would mean increasing emerging market risk premiums, depends on a number of factors. If governments of developing countries continue on the path of fiscal discipline, internal growth rates persist, and the world’s demand for their products stays strong, the current conditions may be around awhile.

Whatever scenario plays out, investor demand for growth is perennial, and emerging markets still seem to have the greatest growth potential — for now and possibly for a good time to come. ▀

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## RECOMMENDED RESOURCES

*Investing in Emerging Markets*  
2003 Research Foundation of CFA Institute monograph  
(cfapubs.org)

“Equity Market Liberalization in Emerging Markets”  
Abstracted in *The CFA Digest* (February 2004)  
(cfapubs.org)

“Are Emerging Markets as Risky as You Think?”  
McKinsey on Finance, Spring 2003  
(corporatefinance.mckinsey.com)

“Estimating Equity Risk Premiums”  
by Aswath Damodaran, Stern School of Business,  
(pages.stern.nyu.edu/~adamodar/pdfiles/papers/riskprem.pdf)