

Why Invest in These Six Sizzling Markets?

The history of international investing begins in ancient times. Two thousand years ago, wealthy individuals funded the growth of merchant trade along a harrowing 5,000-mile route from the Sea of Japan to China, the Middle East, South Africa, and Europe. The Silk Road, as it came to be called, laid the foundations of the modern world and helped shape the emerging economies of China, Egypt, Mesopotamia, Persia, India, and Rome. A few centuries later, investors began funding agricultural settlements known as “transplantations” to grow crops in remote lands. In 1100 AD, Europeans established sugar plantations in the eastern Mediterranean, and by the fifteenth century the practice had hopped across the Caribbean islands, finally reaching North America with investments in the settlement in Jamestown, Virginia. The first joint-stock company, the East India Company, was a forerunner of modern trading companies. Formed in 1600, the East India Company captured profits by exporting raw materials, such as cotton from India and finished textiles from Manchester, England. The lure of such investments in the so-called “dark continents” of North America and Asia, which could at that time have been classified as developing markets, was obvious. It was the lure of windfall profits, excitement, and speculation.

Today, the instant communications of fiber-optic technologies have brought investment opportunities in developing markets to the doorsteps of investors throughout the world. While there are similar elements of excitement, sophistication, and speculation surrounding such investments, the information gap has considerably narrowed, and the windfall opportunities are intertwined much less with speculation and more with education and information.

The risks inherent in investing in developing markets arise from a variety of sources. Even though information about the developing markets is getting better, investors continue to face a combination of challenges, such

as lack of in-depth information or transparency, inadequate regulation, and lack of adherence to rule of law. These issues get compounded by imperfect accounting standards as well as unstable currencies that may be a result of high inflation or recession. In addition, the government's role in these markets can be either constructive or detrimental to business, as some policies may result in monopolistic or oligarchic business practices that thwart free and fair competition.

As evidenced above, the litany of risks can be long and troublesome. So why would investments in developing and emerging countries be appealing? One belief built throughout this book is that investors who make the effort to arm themselves with information and knowledge about the unique characteristics of developing countries will benefit from improved performance. Thus, the purpose of *Six Sizzling Markets* is to provide readers with a basic knowledge of the political and economic history and the investment opportunities within each of these emerging markets.

Why Invest in the Six Sizzling Nations?

The six sizzling nations are commonly referred to as the BRIC+2 countries. These nations—Brazil, Russia, India, China, Mexico, and Korea—belong to a category of investments known as developing markets. A developing market is generally smaller, less liquid, and riskier than the more advanced markets in western Europe and the United States. The political and regulatory environments in developing markets are considered more volatile than in developed markets, and typically offer fewer protections to investors. In addition, currency exchange rate fluctuations can influence investment returns.

In the United States, some 80 million people try to make money over time by investing in stocks.¹ A somewhat smaller group invests in stocks of companies in developed foreign markets, such as the United Kingdom, France, and Germany; and an even smaller number invest in stocks of companies based in developing markets. Lately, many investors have warmed to the idea of investing in developing markets in order to take advantage of the growth opportunities afforded by them despite some of the risks posed by such investments. These investors are seeking the highest potential price appreciation from their investments and want to take advantage of diversification benefits offered by such investments. As such, we will cover both concepts in the six selected countries throughout the course of this book.

With all of these added risks of investing in a developing market, why might an investor choose to put money into these stock markets? Developing

¹The number of individuals owning equities in the United States stood at 84.3 million in January 2002, according to the Investment Company Institute (www.ici.org/shareholders/dec/02_news_equity_ownership.html).

markets have the potential to offer higher returns over time than their more established counterparts, making them attractive despite the higher risks. And, when combined in a portfolio with other types of investments, they potentially reduce portfolio risk by smoothing out some of the variability in returns over time.

The six sizzling BRIC+2 countries in particular are notable for their strong growth prospects. The picture of each country that this book provides will help the individual investor or professional investment adviser identify potential opportunities for long-term portfolio growth. Instead of quick snapshots, these country portraits offer enduring value, as the landscape for future prospects is painted from each country's unique historical and cultural context.

The Search for Potential Return

If the purpose of investing in developing markets is to gain exposure to higher potential returns, one might wonder what signals of future value to look for in choosing stocks. Investors can be fickle in the pursuit of higher returns, sometimes driving markets to dizzying peaks and then abandoning them in valleys of despair. For example, during the great “tulipmania” of the Netherlands in the early 1600s, the price of a single tulip bulb rose to 10 times the typical person's annual income. More recent examples of the effects of excess optimism include the run-up in Atomic Age stocks in the 1950s and the dot-com bubble of the 1990s. In retrospect, these examples are viewed as investment fads—a time when prices become unhooked from fundamental factors, such as a company's earnings or its liquidation value.

While fads are short term and speculative (it's unlikely a tulip bulb will again be worth the price of a castle), investment style refers to classes of stocks that cycle in and out of favor with some regularity, much like clothing styles. For example, “value” stocks typically outperform “growth” stocks for stretches of three to five years, before growth stocks again take the lead. Similarly, small-capitalization stocks have historically tended to outperform larger companies when the economy is just beginning to recover from a recession, and large-capitalization stocks tend to be more in favor during periods of stable or rising economic growth. As with a speculative run-up, an investment that is thought to be in style outperforms in part because there are more investors who are willing to pay a higher price to own it. In contrast to fads, however, style investing is more closely tied to fundamental factors. A fast-growing economy, for example, might benefit a technology-based company such as Microsoft or IBM. However, in a weaker economy, companies geared toward consumer staples such as Procter & Gamble are likely to have stable earnings.

Developing markets as a group tend to go in and out of style with investors. These cycles can reflect weakness or strength in the domestic market, changes in perceptions about market risks, and the global economic picture. Following a downturn in 2000, investing in developing markets came back into style. Data from the Institute of International Finance Inc. show money moving into the stock markets of developing economies jumped 43 percent in 2005 to \$56 billion, and set a new record of \$70 billion in 2006. Global mutual funds—that is, U.S.-based funds that invest globally—held, on average, just 43 percent of assets in the United States in 2006, compared with 49 percent in 2005 and 63 percent in 2002 (according to Morningstar, Inc.). During this period, global funds' average allocation to investments in Asia skyrocketed, rising from roughly 12 percent in 2002 to 23 percent in 2006.

Meanwhile, developing-market stocks overall gained an average of 35 percent a year from 2002 through 2006, compared to an average annual total return on U.S. equities of 11 percent (according to S&P 1500 index). Individual developing markets are often among the world's top performers. For example, in 2006, Korea gained 46.3 percent, and Brazil 45.3 percent, while the U.S. market rose 15.3 percent.

In the short term, fads and styles can make it more difficult to choose the best investments—the companies that have the best prospects for achieving real growth in value over time. Our premise is that, in the long term, the return from a particular stock investment reflects the company's ability to manage its capital wisely in order to generate profits. Thus, a well-run company is likely to outperform its peers over a period of many years. And, given a favorable economic environment and the right line of business, over time it is likely to do well.²

Although there are more than 60 countries that have national stock markets, only about 25 are considered well-established developing countries.³ Yet, many of these countries are too small to offer significant opportunities

²Over a short period of a few years, stock prices can be affected by many transient factors. Perhaps real estate prices are rising rapidly, and investors sell stocks to buy houses. Although the price of the company's stock has dropped (its market value), the company's real value (the value of the future cash flow that it will generate) is unchanged. Once the boom in real estate ends, money is likely to flow back into the stock market, and the stock price will rise. The likelihood of short-term fluctuations in stock values is why stock investments should be reserved for money that one will not need to spend in the near term.

³The Morgan Stanley Capital International (MSCI) Emerging Market Index includes the countries of Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

to investors. Of these, we believe the BRIC+2 countries are particularly attractive. Success factors that will likely drive these economies and the companies within them are:

- Unprecedented economic growth
- Sound national financial systems
- Inflows in investment capital
- Investments in education

Unprecedented Economic Growth

The United States is today the world's richest economy, with gross domestic product (GDP) of around \$12.5 trillion. While the U.S. economy is the largest, it is not the fastest growing. U.S. GDP typically expands by 2 percent to 3 percent a year. China is a comet by comparison, with GDP typically growing by 8 percent to 10 percent a year. China is today much smaller—with GDP of \$2.2 trillion—and the remaining BRIC+2 countries are minuscule by comparison, with GDPs ranging from \$760 billion to \$800 billion. Research by the investment firm Goldman Sachs suggests that by 2040 the GDPs of the four BRIC economies could exceed the GDPs of the United States, Japan, Germany, France, the United Kingdom, and Italy combined. To achieve this result, the economies of the BRIC countries will have to grow at a much faster rate than these developed countries.

Key factors that will support this growth include huge reserves of natural resources (Brazil, Mexico, and Russia) for export markets, and a large and well-qualified workforce (particularly in India and China) with relatively low wage levels. Korea's economy will also grow, as its more advanced industries will benefit from increased trade and services with China.

Economists also expect growth in domestic consumer demand within the individual six sizzling BRIC+2 countries, stimulated by increases in income across broad categories of their populations. When a country's national income is spread out among its citizens rather than concentrated among a smaller subset of the population, the result is sustained domestic demand for goods and services, which can support additional GDP growth.

Modern Shanghai's per-capita GDP is about \$14,000, while that of China nationally is only \$1,700, as much of rural China is low income. However, as labor costs rise in China's more developed cities, industry is beginning to migrate to smaller inland cities and rural areas. This is expected to lead to higher per-capita GDP nationally, helping to fuel growth in domestic demand.

Demographic changes can also contribute to stronger economic growth. China is the world's largest country, with a population of around 1.3 billion, followed by India with 1.1 billion. Brazil and Russia are also in the top 10

based on population size with Mexico ranking 11th and Korea, a small country geographically, ranking 24th (www.census.gov/ipc/www/idbrank.html). The United States is the third most populous country, yet its population is less than one-fourth that of China. By 2020, China and India together are expected to have grown by 367 million people—more than the entire U.S. population. Countries with large populations have the potential to develop large domestic consumer markets, making them less dependent on exports.

The structure of a country's population is also important. India and Mexico have relatively young populations, while China and Russia are gray-ing. The number of dependents per worker in India and Mexico is on a downward trend. Under the right circumstances, these countries can enjoy even higher economic growth as personal savings rates rise and provide capital to fund growing businesses.

Sound National Financial Systems

A strong financial system is built upon the pillars of well-managed government finances, a developed banking system, and the availability of capital to businesses to support expansion. Mexico, Brazil, and Russia have improved their government finances significantly since the 1990s, making them less susceptible to global economic cycles. Their current account balances—reflecting the net of payments for imports, exports, services, and interest to and from other countries—have improved substantially. Brazil and Mexico eliminated their current account deficits in 2006, while rising commodity prices have helped Russia accumulate a substantial surplus.

A strong private banking system is also a boon for business growth, as banks that have a healthy supply of customers' savings on deposit can in turn lend those funds to growing businesses to help fuel their expansion. The privatization of banks that has occurred in China and India is expected to be a strong impetus for growing liquidity in the financial systems of these countries. In addition, governments that gradually sell state-held assets into rising markets can realize substantial cash proceeds, boosting their financial reserves and providing funds to pay down government debt. In China, for example, privatization activities in 2005 generated \$13.9 billion in government revenue.

Inflows in Investment Capital

Foreign direct investment (FDI) is money that is invested directly in tangible assets in a foreign country, for example, by building a manufacturing plant or setting up a new joint venture company with a local firm. These investments benefit local economies in multiple ways, such as by consuming local goods

and services, providing jobs, generating tax and licensing revenues, and bringing advanced technology and management practices.

In general, the six sizzling BRIC+2 countries have made progress in allowing larger amounts of FDI. Limits on foreign investment, whether direct or indirect, restrict the percentage of ownership in a company that can be held by foreign investors. This limits the types of companies that foreign investors can own. In 1998, Korea passed legislation that greatly increased the number of business sectors open to foreign investment, simplified investment procedures, and established foreign investment zones. According to the *International Herald Tribune*, this has resulted in the soaring of foreign investment in Korean businesses, with foreigners owning 44 percent of Korean equities.

Investments in Education

Government spending on education promotes the development of an educated workforce, helping countries become better competitors in the world marketplace of the future. Labor economics studies assessing the effect of higher education on wages and labor productivity show a 3 percent to 6 percent gain in GDP in the long run for an additional year of education. Some recent studies also show that better efficiency in education spending can lead to similar effects on a country's GDP.

Many developing countries have relatively poor education infrastructure, with too few schools, books, and equipment for their young populations. Spending patterns show, however, that the six sizzling countries are increasing their education investments. Between 1995 and 2003, for example, spending on primary and secondary education in Mexico increased by 32 percent, amounting to about 6.3 percent of GDP (according to the Organization for Economic Cooperation and Development [OECD]).

Connecting Success Factors and Investment Returns

The strong economic growth potential of the six sizzling BRIC+2 countries has attracted the attention of some of the world's leading investment advisers, including Goldman Sachs and Lazard Asset Management. In 2004, HSBC Asset Management became the first major mutual fund company to launch a BRIC fund, and many more such funds have followed. As a result, investment in BRIC countries has surged, helping to propel market returns and creating, in essence, a self-fulfilling prophecy. The Standard & Poor's BRIC 40 index rose 360 percent from the beginning of 2002 to the end of 2006. Over the same time period, the U.S.-based S&P 500 index rose by 35 percent. In other words, a \$1,000 investment mirroring the BRIC 40 index

would have grown to approximately \$3,600, while a \$1,000 investment in an S&P 500 index fund would have grown to about \$1,350.

Are such high returns for BRIC investments sustainable, or are they just a reflection of the current popularity of BRIC investments? What might investors expect from the four BRIC countries, plus Mexico and South Korea, over the next 10 or 20 years? We will explain how the economic success factors for each country bode well for long-term stock investors.

To assess the relative attractiveness of the BRIC+2 countries, we analyzed historic stock market returns across many different countries. The results show that economic factors such as GDP and labor force employment, combined with monetary factors such as a strong banking system and the availability of capital, are highly correlated with stock market returns.

Over time, an increase in annual GDP typically correlates with rising stock prices, which in turn translates to higher stock returns for investors. This is not unexpected. For example, the so-called Gordon formula says that stock returns equal the stock's dividends divided by the stock price (the dividend yield) plus the growth rate of stock prices. Assuming a "normal" market environment—one free of fads and shocks—the growth rate of prices should be about equal to the growth rate of GDP (according to "What Stock Market Returns to Expect for the Future?" by Peter Diamond). Thus, strong GDP growth can be considered a positive fundamental for stock returns.⁴

As noted previously, many economists believe that BRIC countries will enjoy significant growth in GDP in the coming decades. The engines of this growth—India and China—will drive increased demand for basic commodities including oil, natural gas, and minerals. Many of these needs can be supplied by resource-rich Brazil, Mexico, and Russia. India, for example, already imports two-thirds of its energy consumption, and that figure is likely to increase dramatically. Meanwhile, Russia has huge reserves of oil, natural gas, and coal that are being developed for export. Similarly, China's needs for raw materials as inputs to manufacturing are growing rapidly, resulting in massive imports of iron ore, manganese, nickel, platinum, uranium, sugar, and timber from countries such as Brazil.

GDP growth in developed markets such as the United States and western Europe tends to be relatively stable at 2 percent to 3 percent per year. Developing market GDP growth rates are typically much higher. China has averaged 9.7 percent growth per year for the last 30 years, while Korea topped 8 percent a year from 1960 to 1990 (www.macauhub.com.mo/en/news.php?ID=3319). Average GDP growth for most of the six sizzling BRIC+2 countries is forecast at above 4 percent annually through 2050. By

⁴A stock's total return is made up of dividends and price appreciation. The growth rate of prices refers only to the price appreciation; it does not include dividend returns.

TABLE 1.1 Estimated Change in Real GDP, 2005 to 2050

| Country | 2005 GDP (\$millions) | Estimated annual GDP growth | 2050 GDP | % change |
|----------------|--------------------------|--------------------------------|------------|----------|
| United States | 12,485,725 | 2.4% | 36,300,434 | 290.7 |
| Japan | 4,571,314 | 1.2% | 7,819,232 | 171.0 |
| Germany | 2,797,343 | 1.5% | 5,466,604 | 195.4 |
| China | 2,224,811 | 6.3% | 34,776,833 | 1,563.1 |
| United Kingdom | 2,201,473 | 1.9% | 5,135,132 | 233.3 |
| France | 2,105,864 | 1.9% | 4,912,116 | 233.3 |
| Italy | 1,766,160 | 1.5% | 3,451,453 | 195.4 |
| Canada | 1,130,208 | 2.6% | 3,587,481 | 317.4 |
| Spain | 1,126,565 | 2.3% | 3,134,439 | 278.2 |
| South Korea | 793,070 | 3.3% | 3,418,424 | 431.0 |
| Brazil | 792,683 | 5.4% | 8,451,368 | 1,066.2 |
| India | 775,410 | 7.6% | 20,945,156 | 2,701.2 |
| Mexico | 768,437 | 4.8% | 6,336,741 | 824.6 |
| Russia | 766,180 | 4.6% | 5,797,712 | 756.7 |
| Australia | 707,992 | 2.6% | 2,247,292 | 317.4 |

comparison, economic growth in the United States is forecast at a modest 2.4 percent per year. This translates to a 1,500 percent increase in GDP for China versus a 290 percent increase in GDP for the United States. Hence, one might expect stock prices in the BRIC+2 countries to appreciate at a much faster rate over the next several decades than prices in countries with slower economic growth (see Table 1.1).

How much of the expected future growth in BRIC+2 countries is already factored into current stock prices? This is an important consideration—if future growth is already priced into the market, then investors could not expect “windfall” returns.

One way to address this question is to look at the relationship between market capitalization and GDP. Market capitalization measures the current value of the all of the stocks traded in a given country. Again referring to the Gordon rule, if stock prices generally rise as GDP increases, then market capitalization would also rise as GDP increases.

Actual market capitalization data may indicate that individual BRIC+2 markets are underdeveloped or undervalued. An underdeveloped market means that companies are not issuing public stock to raise capital, but are relying instead on other sources of funding such as debt or private equity. An undervalued market is one in which stock prices are lower than might be expected given companies’ future earning prospects and cash flows. Market capitalization data can indicate that one or both of these factors is at play. China’s economy, for example, expanded at an average of 7 percent to 10

percent annually from 1999 through 2006. While its stock market returns moved up and down during that period, the cumulative return was -0.2 percent, or essentially flat (according to the CITIC China 30 index cumulative return). Its market capitalization at the end of 2006 was just short of \$600 billion, which was less than 30 percent of GDP. In contrast, the U.S. market capitalization was approximately \$23 trillion at the end of 2006, about 175 percent of domestic GDP.

Another approach to assessing valuation is to look at price-to-earnings (PE) ratios. For example, Union Bank of Switzerland estimated in 2007 that BRICs were trading at about 11 times estimated earnings, compared to a multiple of 13 times earnings for the world market index and about 17 times earnings for the U.S.-focused S&P 500 index. This clearly demonstrates that BRIC stocks are undervalued.

Within the individual BRIC countries there are significant variations, with some markets and companies priced closer to actual values than others. Thus, investors will need to be selective in allocating their BRIC+2 investment dollars to specific countries and stocks.

Diversification Benefits of Developing Market Investing

Investments in BRIC+2 countries offer opportunities to diversify among companies that may be underrepresented in the U.S. economy. Some of the largest companies in Mexico and Russia, for example, are commodity companies that are without peers in the United States, such as Cemex and GazProm.

India, Brazil, and China also offer opportunities to participate in the potential growth of industry leaders. Brazil, for example, began industrializing in the 1930s, and today is home to some of the world's largest companies, in industries ranging from aerospace to soft drinks. Thus, investments in these developing markets may offer investors growth potential that is superior to many alternatives.

When combined with investments in U.S. stocks, holdings in companies based in developing markets can also help lower the overall variability in portfolio return. Developing markets tend not to move in lockstep with the United States, so when the U.S. stock market is declining, developing markets may be rising. In financial terms, this is known as *correlation*. It is always desirable that portfolios be made up of investments that do not correlate with each other in order to reduce the overall risk of the portfolio. Perfect correlation is indicated by a correlation coefficient of 1.00, indicating that markets move together in lockstep. On average, the correlation coefficient between the U.S. market and developing markets is about 0.60, indicating that there are significant opportunities to benefit from diversification.

Attractive Opportunities for Investors

How do the success factors outlined in the book for the six sizzling markets, the relative stock market values, and potential diversification benefits translate to actionable investment decisions? As will be outlined in *Six Sizzling Markets*, we believe that investing in the six BRIC+2 countries discussed represents an extraordinary opportunity for current and future investors, for both macroeconomic and country-specific reasons.

COPYRIGHTED MATERIAL

COPYRIGHTED MATERIAL