



INVESTMENT  
MANAGEMENT SERVICES

# Emerging Markets Investing: Short-Term Sell-Off Spells Long-Term Opportunity

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The John Hancock White Paper Series provides in-depth commentary and insights on a wide range of investment topics addressing the financial services industry.

## EXECUTIVE SUMMARY

During the past year, the equity and fixed-income securities of emerging markets have produced poor absolute returns and underperformed their developed market counterparts. We believe this downturn, which is largely the result of misplaced fears about the world's emerging economies, has created an opportunity for longer-term investors.

The recent underperformance is largely attributable to four factors that have had a vastly exaggerated market impact:

- Investors have grown concerned about a potential slowdown in emerging market economic growth.
- Emerging markets continue to be perceived as a risky investment, leading to weak performance during the recent period of elevated risk aversion.
- Rising inflation and the corresponding monetary tightening by emerging market central banks have rattled the markets.
- Investors remain fearful about fraud, corruption scandals and political instability in emerging market countries.

In our view, these concerns have distracted investors from the longer-term story in emerging markets. And in light of recent developments in the world's major economies, emerging markets may actually be less risky than developed markets. In fact, compared to their developed market peers, emerging markets offer:

- Better long-term growth prospects
- Stronger corporate performance
- A larger opportunity set
- Lower debt on the household, government and corporate levels
- Better corporate governance
- More attractive valuations

In this paper, we address each of the four major concerns and highlight the reasons why investors should consider adding to emerging market positions.

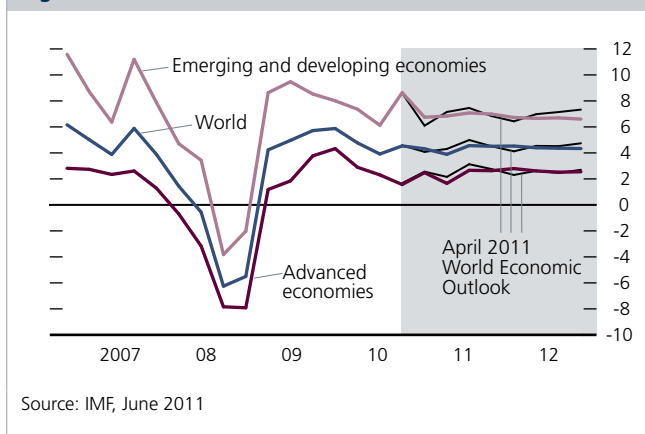
## LONG-TERM ECONOMIC GROWTH PROSPECTS REMAIN ROBUST

Concerns about the possibility of decelerating economic growth and diminishing corporate earnings weighed heavily on emerging markets' performance during 2011. We believe this fear is overstated, as the case for the emerging market fundamentals is in fact very strong: the drivers of future growth remain intact, profit margins are expanding and the opportunity set is growing.

### Superior economic growth relative to the developed markets

It is true that emerging market economies are no longer growing at annualized rates of over 10%, but it is also inconceivable that any economy can sustain double-digit growth after reaching a certain size. Nevertheless, emerging market economies are expected to grow at two to three times the rate of developed market economies in 2011 and 2012<sup>1</sup> (see Figure 1).

Figure 1: Global GDP Growth Estimates

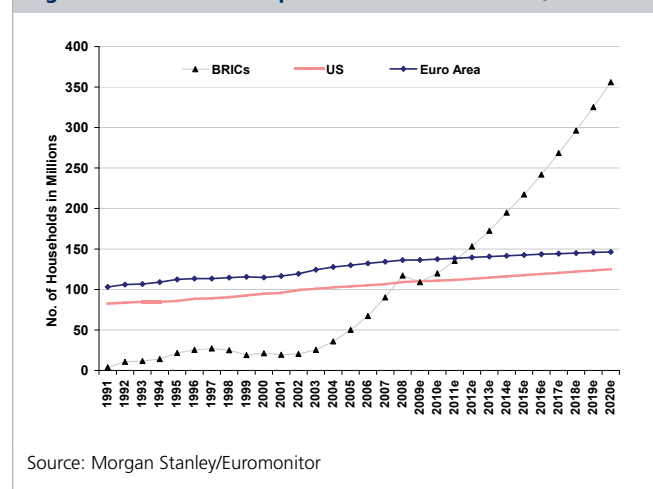


### Growth drivers ahead: massive consumption and infrastructure spending

The primary driver of future growth for emerging market countries is the rising domestic consumption by the growing middle class population. Based on estimates from Morgan Stanley, the number of households with disposable income more than \$10,000 in the BRIC countries — Brazil, Russia, India and China — surpassed the United States in 2008.

This indicator is on track to surpass Europe in 2012 and to double within this decade (see Figure 2). The crossing of this threshold level of disposable income drives consumption by enabling households to afford homes, cars, televisions and appliances for the first time. Furthermore, consumers start thinking about saving (which is beneficial to the financial services sector) and spending more on health care.

Figure 2: Household Disposable Income over \$10,000



Infrastructure spending is another major growth driver in emerging market economies. In a reversal from the past, when there was heavy reliance on Western investors to provide capital, emerging market countries, now armed with substantial reserves, are able and willing to spend. Two major events in Brazil, the 2014 World Cup and 2016 Olympics, are significant catalysts for infrastructure spending. In fact, Morgan Stanley estimates that infrastructure spending in Brazil will double from 2% of gross domestic product (GDP) to 4% of GDP just to accommodate these two events.<sup>2</sup> Foreign direct investment also continues to pour into emerging markets. Marriott, for example, announced last November that it plans to increase its number of hotels in Brazil from 4 to 54.

Further, BCA Research projected that China's urban population will increase by 530 million during the next two decades.<sup>3</sup> That is equivalent to twice the size of the entire

1 IMF World Economic Outlook, June 17, 2011

2 "Brazil Infrastructure: Paving the Way," Morgan Stanley, May 5, 2010

3 "The China Debate," BCA Research, May 6, 2011

U.S. urban population, and the corresponding infrastructure of spending and consumption that comes along with a shift of that magnitude could be astronomical.

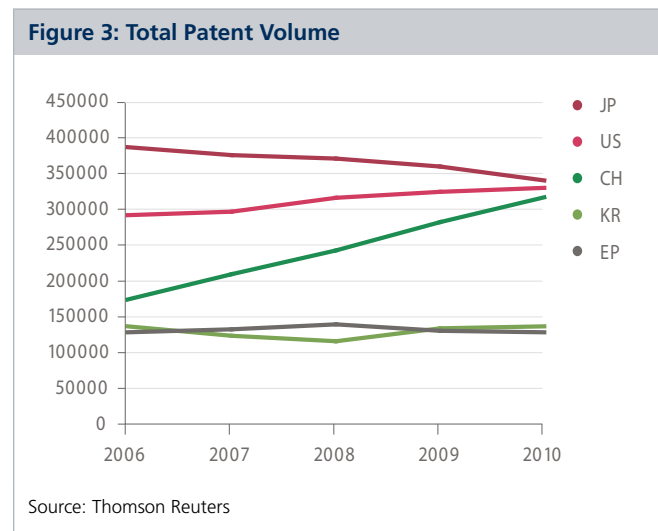
Some investors are concerned that because the Chinese economy is now the second largest in the world, surpassed only by the United States, there is no longer opportunity for significant growth. However, many investors may have failed to consider the country's output on a *per capita* basis. By this measure, China ranks a lowly ninety-fourth<sup>4</sup> in the world — with one-tenth the *per capita* GDP of the United States and Japan. These numbers indicate room for substantial economic growth.

### Margin expansion: emerging market companies are moving up the food chain

One of the factors weighing on emerging markets' recent performance is the idea that higher inflation and slower top-line growth will hurt the earnings of emerging market companies. We believe that margin expansion caused largely by two factors — structural changes and the move upstream within the “value chain” — will offset inflation and continue to drive both top- and bottom-line growth in emerging markets. On the structural side, the growth of higher-margin service sectors in emerging markets, which has been driven by the growth in middle class population and consumption, has contributed to margin expansion. In fact, the average gross margin of companies in the MSCI Emerging Markets (EM) Index has expanded from 23% in 1999 to 32% in 2010, and the operating margin has more than doubled from 6% in 1999 to 14% in 2011.

The other component of the margin expansion story is the upstream movement of the manufacturing sector. Emerging market manufacturers are moving up the food chain from low-margin contract manufacturing, where developed market companies keep most of the money, to higher-margin product development where they own their own brands, design and technology.

The most important aspect of this shift is that these companies are no longer simply winning with low-cost labor. Instead, they are advancing via growth in research and development. Figure 3 shows that the number of patents filed by China jumped threefold between 2003 and 2009. While the absolute number of patents is still lower than in the United States and Japan, the growth trend is hard to ignore. Finally, lured by the economic success of their native countries, an increasing number of U.S. engineers of Chinese and Indian descent are returning home to help build the fledgling information technology and health science sectors, creating valuable new businesses in the process.



### Expansion of the investment opportunity set

For emerging market investors, there is also a broader opportunity set compared to a decade ago. The only stocks available when emerging market equities first began trading were the large, state-owned financial and energy firms such as Brazilian firm Petrobras or Russian firm Gazprom. Now, there is a much wider array of companies from which to choose following the rise of private entrepreneurship and the emergence of new sectors such as health care, information technology and green technology. For example, the Chinese health care industry is projected to become the world's biggest by 2020, yet the sector represents just 1% of the MSCI China Index and 5% of the country's small-cap index. Clearly, the long-term opportunities have just begun to emerge.

4 Source: IMF, #74, per the World Bank

The opportunity set of countries in which to invest has also grown. Beyond the BRIC countries, there are the “Next 11” — Indonesia, Mexico, Vietnam, the Philippines, Turkey, South Korea, Nigeria, Iran, Pakistan, Bangladesh and Egypt — and other frontier markets that are supported by young, vibrant demographics and abundant resources.

The universe of emerging market debt, which is no longer confined to dollar-denominated sovereign bonds, is also expanding rapidly. In recent years, there has been a greater shift toward emerging market local currency debt and emerging market corporate and inflation-linked bonds. The recent past has also witnessed the development of the offshore Chinese bond market — which is projected to reach \$1 trillion by 2020. These new vehicles provide a significant catalyst for long-term growth in emerging market investments.

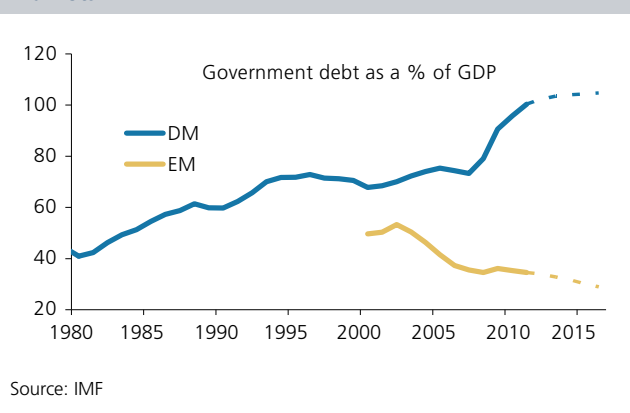
### PERCEPTIONS OF ELEVATED RISK ARE NO LONGER ACCURATE

While in the 1990s emerging markets were notorious for fiscal mismanagement, high debt and periodic financial crises, the asset class is on much stronger footing today. Nowhere is this more apparent than with respect to its debt profile. All three levels of debt — government, household and corporate — suggest that emerging markets are now a safer option than developed markets.

#### Government

Government debt as percent of GDP has been on an upward trend in developed markets, and it now exceeds the critical 100% level. In contrast, this measure has been on a downward trend in emerging markets, and it now stands below 30% (see Figure 4).<sup>5</sup>

**Figure 4: Debt Levels in Developed Markets and Emerging Markets**



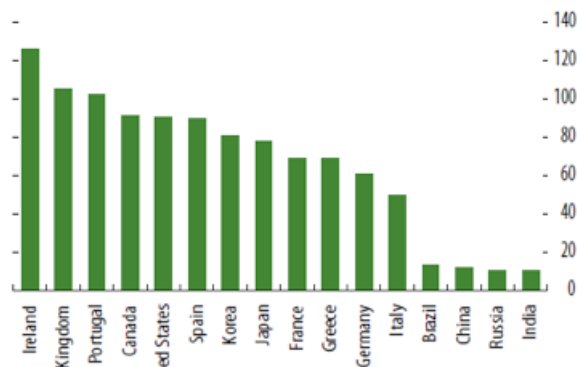
A number of reports have surfaced suggesting that the government debt levels in China are much higher than the reported levels of 18%, and that they may even be as high as 80% of GDP. The reality probably lies somewhere in the middle. However, even if the 80% figure for China is accurate, emerging market public debt as a percent of GDP would still be less than half the 118% level of the developed markets. With the GDP of emerging markets continuing to grow at double the rate of developed markets, debt coverage in emerging markets is much healthier than it is in the developing world. It is also important to consider that emerging market countries have more than twice the reserves of developed market countries, with China alone controlling over \$2.6 trillion.

#### Household

In terms of household debt as a percentage of GDP, the BRIC countries are also in much better shape than the developed market countries, thanks to high savings rates and absence of consumer credit in these regions (Figure 5).

<sup>5</sup> Based on 2011 IMF Forecast

**Figure 5: Leverage Ratios — Household Debt as a % of GDP**

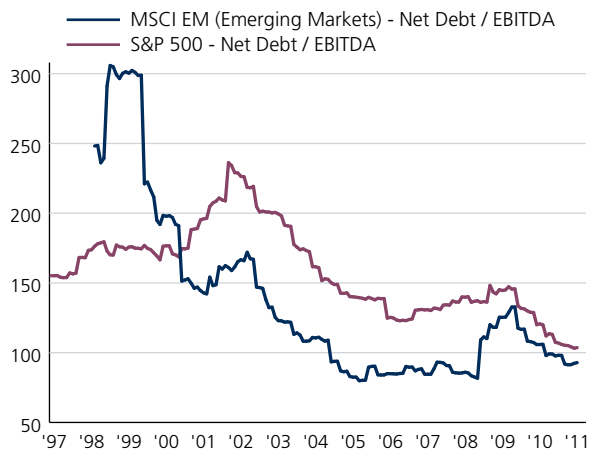


Source: IMF/McKinsey/Haver Analytics

### Corporate

The corporate debt profile of emerging market countries has also improved. The leverage of emerging market companies (as measured by Net debt/EBITDA for the MSCI EM Index) was double that of U.S. companies in the late 1990s, with an alarming three years of earnings required to pay off debt on average. Since 2001, however, the situation has reversed — the leverage ratios of emerging market companies have been consistently lower than those of U.S. companies, dropping below one-times earnings in 2011 (see Figure 6).

**Figure 6: Leverage of Emerging Market and Developed Market Companies**



Source: Factset

In addition, while most rating agencies are busy considering downgrades of the sovereign debt of developed markets, the opposite trend has occurred with emerging market debt. In fact, more than half of the debt represented in the J.P. Morgan Emerging Market Bond Index has been upgraded to investment-grade status. Nevertheless, the yields of emerging market bonds remain comparable to those of below-investment-grade corporate debt in the United States.

### THE INFLATION THREAT IS EXAGGERATED

For most of this year, emerging market investments have been pressured by the notion that inflation was rising to dangerous levels. Indeed, a number of central banks — China's included — raised rates to combat the threat. While this issue continues to erode confidence in emerging markets, inflation is in fact moderating, and interest-rate cuts may be just around the corner. What's more, inflation may actually represent a long-term opportunity rather than a threat.

There's little doubt that the type of rapid growth occurring in emerging markets can open the door to higher inflation. The good news is that according to the latest International Monetary Fund (IMF) estimates, emerging market inflation is expected to fall in the second half of 2011 and in 2012.<sup>6</sup> On August 31, 2011, we saw the first sign of monetary easing in emerging market countries when the Brazilian central bank cut its Selic rate by 50 basis points to 12%. Mexico and Russia are expected to follow suit, and most analysts believe that China is probably finished with tightening.<sup>7</sup> If this trend proves out, the prices of both stocks and bonds in emerging markets should benefit.

It is important to note that lingering inflation and continued high interest rates would not necessarily be a bad thing for investors in emerging market bonds. Most of the developed world is expected to remain in a zero interest environment until 2013, and yield-hungry investors will need to look

6 IMF World Economic Outlook, June 17, 2011

7 "Investors Gear Up For Possible Rate Cuts In Emerging Markets," *Wall Street Journal*, September 1, 2010

elsewhere. Emerging market countries — which are maintaining relatively high interest rates to tackle inflation — may prove attractive to bond investors.

Currency appreciation may also become a significant source of return for emerging market local debt investors. The Chinese government has let the renminbi appreciate by a few percentage points per year in the past several years, and it will likely continue with this approach. As China buys commodities from the rest of Asia, Asian currencies should rise along with the renminbi. This would make Asian bonds attractive, especially in light of the troubles surrounding U.S. and European debt. It may be wise for investors to shift some of their dollar-based allocation toward emerging markets, since the U.S. government's efforts to cope with its debt burden likely will lead to further depreciation of the U.S. dollar.

### **THE ERA OF CORRUPT GOVERNMENTS AND RAMPANT CORPORATE FRAUD IS COMING TO A CLOSE**

Recent fraud allegations concerning a number of Chinese companies reinforce the historical lack of trust U.S. investors have in emerging market companies. However, we believe that the concerns about corporate governance in emerging markets are exaggerated.

To begin with, U.S. investors should recognize that there has been a history of spectacular fraud and corruption here at home. Examples include Bernie Madoff, Enron, Tyco, AAA-rated mortgage-backed securities, WorldCom and so on. This litany of failed oversight suggests that the regulatory structure in most emerging market countries is likely on par with or perhaps better than that of the United States.

We are uniquely positioned to see the changing approach of emerging market governments and corporations through our direct access to high-quality, experienced global managers. In some instances, we have accompanied local portfolio managers to on-site visits with management. What we have seen is that contrary to the negative headlines, the corporate

governance of emerging market companies has significantly improved over the years. A much higher level of transparency, an emphasis on shareholder value (for example, increasing dividend payouts) and greater corporate responsibility have become central to acquiring capital for companies that operate in these markets. This trend is driven by increased foreign ownership in emerging market firms, as many emerging market countries open up and the local regulators gain increased sophistication and knowledge gleaned from the West.

### **CORRUPTION ON THE WANE**

Recent political scandals in countries like India have made headlines, and emerging market countries continue to rank unfavorably in the Corruption Perceptions Index (CPI)<sup>8</sup> relative to developed market countries.

However, the headlines mask the underlying trend, which is that corruption in a number of emerging market countries has diminished significantly over the past decade. Indonesia, the poster child of corruption during the Asian financial crisis, has seen its CPI score move up significantly under the leadership of President Yudhoyono, who has zero tolerance for corruption. With respect to the largest emerging market country, in 2012, China will undergo a planned transition to the fifth generation of Chinese Communist Party leaders. Many of these leaders have been educated in the West, providing the prospect of improved economic transparency.

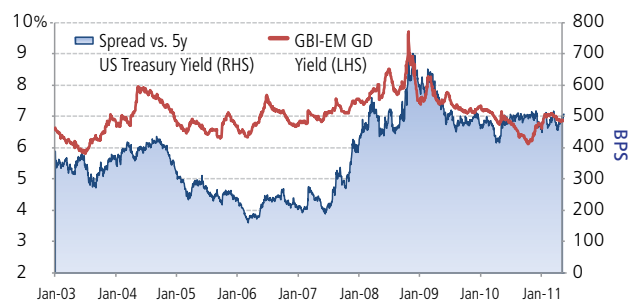
### **MISPLACED CONCERNS = COMPELLING VALUATIONS**

Despite all of the positive changes that have occurred in recent years, valuations for both stocks and bonds in emerging markets remain inexpensive relative to their developed market counterparts. As measured by forward price-to-earnings (P/E) ratios, emerging market equities are trading at lower valuations than global and U.S. equities. China's market is especially cheap: both the China (MSCI Free) and the China A share markets are trading at a P/E-to-growth (PEG) ratio of below 1, a level seen only during the 2008 credit crisis.

<sup>8</sup> Published by Transparency International

In terms of the debt markets, yield spreads for emerging market local currency debt over U.S. Treasuries are currently at the higher end of the historical average established during the past decade (see Figure 7). As illustrated previously, the debt coverage situation in emerging markets is far better than in developed markets, so this high spread may not be justified.

**Figure 7: EM Local Currency Debt Yields and Spread of U.S. Treasuries, 2003–2011**



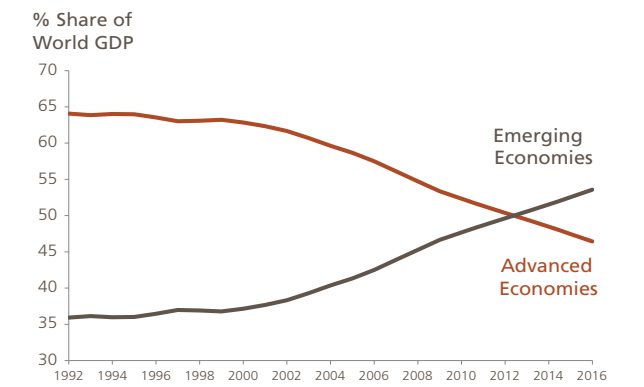
Source: Stone Harbor/Bloomberg

**EMERGING MARKETS REMAIN UNDER-REPRESENTED IN INVESTOR PORTFOLIOS**

Emerging markets offer a stronger profile, relative to the developed markets, in terms of growth, debt and valuation. Nevertheless, the share of global assets allocated to emerging markets is much lower than for the developed markets. We believe this shortfall will narrow over time, providing support for both stocks and bonds in emerging markets.

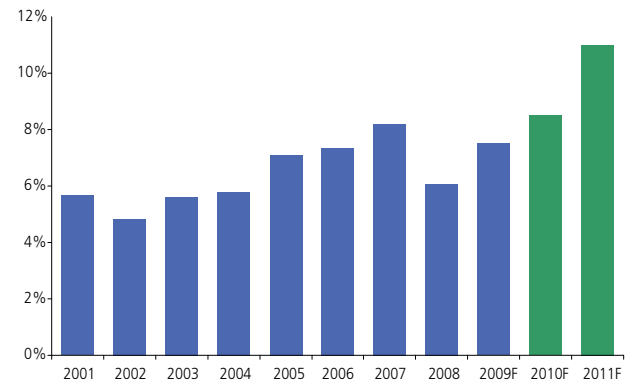
Based on IMF estimates, emerging market economies will overtake developed market economies in terms of share of global GDP by 2012 (Figure 8). However, total investments in emerging market debt and equities still represent less than 10% of global portfolio assets, even with the significant inflows that have occurred during the past decade (Figure 9).

**Figure 8: Share of World Total GDP Based on Purchasing Power Parity**



Source: Epoch

**Figure 9: Global Portfolio Allocation to EM (Equity and Fixed Income, % Total)**



Source: Morgan Stanley

This misalignment may be caused by investors’ perception that emerging market equity securities are riskier than those of developed markets. However, it is important to note that much of the volatility in emerging markets has been skewed toward the upside, while the volatility in developed markets has been skewed toward the downside. This is illustrated by the “average gain” and “average loss” numbers in Figure 10. As shown in the standard deviation figures, which express historical volatility in both negative and positive directions, volatility has been higher for emerging market stocks.

However, the average gain for the MSCI EM Index is significantly higher than that of the MSCI World Index and the S&P 500 Index, while the average loss is similar for all three indexes.

**Figure 10: Performance of Emerging Market vs. Developed Market Equities**

As of 11/30/11	MSCI Emerging Market	MSCI World	S&P 500
YTD Return	-17.18	-5.00	1.08
1-year Return	-11.26	2.02	7.83
3-year Return	23.98	12.96	14.13
5-year Return	3.86	-1.41	-0.18
Std Dev 3-year	26.29	20.47	18.97
Std Dev 5-year	29.14	20.51	18.89
Average gain 3-year	7.58	5.50	4.51
Average loss 3-year	-4.28	-4.31	-4.65
Source: Morningstar			

What's more, a recent study by Ned Davis Research<sup>9</sup> showed that the beta — or responsiveness to market conditions generally — of emerging market equities relative to the MSCI World Index actually has been lower than that of U.S. equities since the 2008 credit crisis. On the fixed-income side, the near-default that occurred during the debt ceiling debate, together with the subsequent S&P downgrade of the United States' debt rating, has debunked the myth of Treasuries as the “riskless” asset.

Taken together, we believe these factors indicate that a greater share of investors' assets will flow into emerging markets over time, setting the stage for long-term outperformance.

## CONCLUSION

While the equity and fixed-income securities of emerging market countries have underperformed their developed market counterparts over the past year, the case for these asset classes remains strong. One reason is that emerging markets may actually be a “safer” investment than developed markets. This is evidenced by the fact that inflation, while still a concern for investors, appears to be moderating. In addition, while corruption and instability in emerging market countries may continue on some level, these issues are fast improving and should not be considered grounds to avoid emerging markets.

The case for emerging markets is also supported by stronger growth prospects: a budding middle class is expected to contribute to massive consumption and infrastructure spending in the near future, emerging market companies continue to make strides in margin expansion and innovation and new investment vehicles are fast becoming available. In addition, emerging markets are currently characterized by relatively low levels of investment, significantly lower debt levels on the corporate, household and government level and more compelling valuations.

We believe the conclusion is clear: investors should take advantage of today's short-term correction to add emerging market investments to their portfolios.

<sup>9</sup> “Emerging Markets for Offense and Defense?” Tony Welch, Ned Davis Research, August 19, 2011. Emerging market equities measured by the MSCI EM Index, U.S. equities measured by the MSCI U.S. Index

## About John Hancock Investment Management Services

The Investment Management Services (IMS) group oversees the Manulife/John Hancock investment platforms in the U.S., Canada and Asia, including Japan. These platforms serve the company's various business units, including mutual funds, retirement plans, college savings, variable annuities and variable life insurance. The portfolios that IMS oversees are managed by some of the largest and most respected asset management firms in the world.

### About the author



York Lo is a Boston-based, Senior Investment Analyst in Investment Management Services for John Hancock Financial Services. He joined the firm in 2008 and has over 13 years of investment experience. Mr. Lo is responsible

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The MSCI World Index is a free float-adjusted market-capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets.

The MSCI Emerging Markets Index is a free float-adjusted market-capitalization index that is designed to measure equity market performance of emerging markets.

The S&P 500 Index is a free-float capitalization-weighted index published since 1957 of the prices of 500 large-cap common stocks actively traded in the United States.

The risks of investing in foreign securities are greater for investments in emerging markets. Emerging market countries may experience higher inflation, interest rates and unemployment, as well as greater social, economic, regulatory and political uncertainties than more developed countries. Value stocks may not increase in price as anticipated or may decline further in value. The prices of medium- and small-company stocks can change more frequently and dramatically than those of large-company stocks. If the Fund invests in illiquid securities, it may be difficult to sell them at a price approximating their value. Currency transactions are impacted by fluctuations in exchange rates, which may adversely affect the U.S. dollar value of a fund's investments. The use of hedging and derivatives transactions could produce disproportionate gains or losses and increase volatility and costs. For additional information on these and other risk considerations, please see the Fund's prospectus.

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