



FISHER INVESTMENTS™ on

# EMERGING MARKETS



- An in-depth look at emerging markets, including recent history and today's investment landscape
- Tips and tools to develop emerging markets portfolios, including identifying portfolio drivers and security analysis
- A useful guide for investing in any market condition

Foreword by *New York Times* bestselling author Ken Fisher



# **Fisher Investments on Emerging Markets**

# FISHER INVESTMENTS PRESS

Fisher Investments Press brings the research, analysis, and market intelligence of Fisher Investments' research team, headed by CEO and *New York Times* best-selling author Ken Fisher, to all investors. The Press covers a range of investing and market-related topics for a wide audience—from novices to enthusiasts to professionals.

## **Books by Ken Fisher**

*How to Smell a Rat*

*The Ten Roads to Riches*

*The Only Three Questions That Count*

*100 Minds That Made the Market*

*The Wall Street Waltz*

*Super Stocks*

## **Fisher Investments Series**

*Own the World* by Aaron Anderson

*20/20 Money* by Michael Hanson

## **Fisher Investments On Series**

*Fisher Investments on Energy*

*Fisher Investments on Materials*

*Fisher Investments on Consumer Staples*

*Fisher Investments on Industrials*

*Fisher Investments on Emerging Markets*



FISHER  
INVESTMENTS  
PRESS

# **Fisher Investments on Emerging Markets**

**Fisher Investments  
with  
Austin B. Fraser**



**WILEY**

**John Wiley & Sons, Inc.**

Copyright © 2010 by Fisher Investments. All rights reserved.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning, or otherwise, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, Inc., 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 750-4470, or on the web at [www.copyright.com](http://www.copyright.com). Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 111 River Street, Hoboken, NJ 07030, (201) 748-6011, fax (201) 748-6008, or online at <http://www.wiley.com/go/permissions>.

**Important Disclaimers:** This book reflects personal opinions, viewpoints and analyses of the author and should not be regarded as a description of advisory services provided by Fisher Investments or performance returns of any Fisher Investments client. Fisher Investments manages its clients' accounts using a variety of investment techniques and strategies not necessarily discussed in this book. Nothing in this book constitutes investment advice or any recommendation with respect to a particular country, sector, industry, security or portfolio of securities. All information is impersonal and not tailored to the circumstances or investment needs of any specific person.

**Limit of Liability/Disclaimer of Warranty:** While the publisher and author have used their best efforts in preparing this book, they make no representations or warranties with respect to the accuracy or completeness of the contents of this book and specifically disclaim any implied warranties of merchantability or fitness for a particular purpose. No warranty may be created or extended by sales representatives or written sales materials. The advice and strategies contained herein may not be suitable for your situation. You should consult with a professional where appropriate. Neither the publisher nor author shall be liable for any loss of profit or any other commercial damages, including but not limited to special, incidental, consequential, or other damages.

For general information on our other products and services or for technical support, please contact our Customer Care Department within the United States at (800) 762-2974, outside the United States at (317) 572-3993 or fax (317) 572-4002.

Wiley also publishes its books in a variety of electronic formats. Some content that appears in print may not be available in electronic books. For more information about Wiley products, visit our web site at [www.wiley.com](http://www.wiley.com).

***Library of Congress Cataloging-in-Publication Data:***

Fisher Investments on emerging markets / Fisher Investments, with Austin B. Fraser.

p. cm.

Includes bibliographical references and index.

ISBN 978-0-470-45236-3 (cloth)

1. Investment analysis. 2. Investments, Foreign. 3. Securities. 4. Portfolio management. I. Fraser, Austin B. II. Fisher Investments.

HG4529.F58 2010

332.67'3—dc22

2009031921

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

# Contents

<b>Foreword</b>	<b>ix</b>
<b>Preface</b>	<b>xi</b>
<b>Acknowledgments</b>	<b>xv</b>
<b>Part I Going Backward to Move Forward</b>	<b>1</b>
<b>Chapter 1</b> The Five Ws of Emerging Markets	3
Who or What?	4
Where?	7
When?	9
The Most Important Question—Why?	12
But How?	13
<b>Chapter 2</b> Lions, Tigers, and Dragons, <i>Oh My!</i>	15
Roar of the Tigers	16
To the Brink of Extinction—The Asian Financial Crisis	22
Crisis Causes	26
Lessons and Legacies	33
The Dragon Unleashed	36
The History of China's Stock Market—A Lesson in Supply and Demand	39

<b>Chapter 3</b>	Latin America and the Vagaries of Boom and Bust	47
	The Political Economy of Latin America	48
	Till Debt Do Us Part—The 1982 Crisis	53
	The Tequila Crisis	67
<b>Chapter 4</b>	From the Rubble of the Iron Curtain to the Legacy of Apartheid	77
	The Rubble of the Iron Curtain	78
	The Wild, Wild East	81
	Crisis Strikes Again—The 1998 Ruble Crisis	88
	Putin and the Modern Soviet State	91
	The Legacy of Apartheid—Race and Markets	96
<b>Part II</b>	<b>Developing an Emerging Markets Strategy</b>	<b>107</b>
<b>Chapter 5</b>	From the Past to Today—How to Approach Emerging Markets	109
	Prelude to a Portfolio: Choosing a Benchmark	110
	Getting Started: Emerging Markets Today	114
	The Best Way to Think about Emerging Markets	120
	Putting It Together: The Top-Down Method	122
	Top-Down Deconstructed	126
	Examples of Quantitative Factor Screenings	127
<b>Chapter 6</b>	Developing Portfolio Drivers	131
	The Importance of Portfolio Drivers in Emerging Markets	131
	The Proper Perspective	134
	Identifying Portfolio Drivers	136
	Translating Drivers Into Portfolio Allocation Decisions	145



An Illustration in Analyzing Portfolio Drivers—Brazil During the 2003–2007 Bull Market	146
What Can Drive Emerging Markets as a Category	154
Getting Information to Develop Drivers	160
<b>Chapter 7</b> Security Analysis	165
Make Your Selection	166
A Five-Step Process	167
Other Important Questions to Ask	175
<b>Chapter 8</b> Putting It Together	181
Two Initial Considerations	181
Instruments for Investing in Emerging Markets	183
Common Challenges and Risks	193
The Future—Frontier Markets	198
<b>Notes</b>	<b>201</b>
<b>About the Author</b>	<b>213</b>
<b>Index</b>	<b>215</b>



# Foreword

**I**n your hands is the latest in a series of investing guides from Fisher Investments Press—the first ever imprint from a money manager, produced in partnership with John Wiley & Sons. But this guide is a bit different. Whereas the others have focused on analyzing standard investing sectors (Energy, Materials, Consumer Staples, Health Care, Industrials, etc.), this is the first guide on a region.

Why start with emerging markets? After all, the developed world seems risky enough without adding unique emerging market risks—political instability, poor infrastructure, corruption, and obscure regulations. Except that's not really true anymore. Once economic backwaters, emerging markets are increasingly civilized, orderly, booming nations—though individually, risks remain. Over the last 15 years, they've annualized 4.5 percent, accelerating to 5.8 percent in the last five years, while the developed world averaged just 3.0 percent. And, with that growth, their relative importance has grown, too—from 16 percent of total GDP in 1989 to 28 percent in 2009. And their stock markets have boomed—20 years ago they were just 1.4 percent of the world, 10 years ago 4.6 percent. Today, they're 12 percent and growing. You can't get good global exposure without owning some emerging markets now. Ignoring emerging markets means giving up opportunities to enhance performance and manage risk.

But don't be fooled—growth doesn't automatically mean good stock returns. Example: China's economy grew 10.1 percent in 2004 while its stocks fell 15.4 percent. So, with emerging markets booming, how can you know where to invest, and when? That's what this book shows. It teaches how to apply a top-down methodology to emerging markets that guides you in making the big decisions first. Simply: Making better

big decisions—what asset class to hold, in what country or region, and in which sectors—will have bigger impact on longer term performance than individual stock picking. Though stock picking is and will always be important. This book can show you how.

For global investors, adding an emerging markets allocation is not only a logical progression but today a virtual imperative. Many emerging markets have immense natural resources and populations evolving toward middle class—vast untapped consumers as well as new human capital. And emerging market transparency continues to improve. Of course, many emerging markets still face political tumult, adding additional risk for stock picking in these nations. Some may emerge—like Israel, categorized as developed in 2009. Others, saddled by despotic governments and weak property rights, may submerge. But, as an overall category, you don't want to ignore nearly a third of the world—that's a sizable risk.

One thing this book won't give—and none of these guides provide—is hot stock tips for this year or any other. No book can give you stock tips worth following—claims otherwise are fairy tales. Instead, this book is intended to teach you a workable, repeatable framework for increasing the likelihood of finding profitable opportunities in emerging markets. This methodology should serve you not only this year or next, but the whole of your investing career, no matter what region or sector you analyze. So good luck and enjoy your tour of the emerging world.

Ken Fisher  
CEO of Fisher Investments  
Author of the *New York Times* best sellers  
*The Only Three Questions That Count*,  
*The Ten Roads to Riches*, and  
*How To Smell a Rat*

# Preface

**T**he *Fisher Investments On* series is designed to provide individual investors, students, and aspiring investment professionals the tools necessary to understand and analyze investment opportunities, primarily for investing in global stocks.

Within the framework of a *top-down* investment (discussed more in Chapter 5), each guide is an easily accessible primer to economic sectors, regions, or other components of the global stock market. While this guide is specifically on emerging markets, the basic investment methodology is applicable for analyzing any region or even global sector, regardless of the current macroeconomic environment.

Why a top-down method? Vast evidence shows high-level, or *macro*, investment decisions are ultimately more important portfolio performance drivers than individual stocks. In other words, before picking stocks, investors can benefit greatly by first deciding if stocks are the best investment relative to other assets (like bonds or cash), and then choosing categories of stocks most likely to perform best on a forward-looking basis.

For example, a Technology sector stock picker in 1998 and 1999 probably saw his picks soar as investors cheered the so-called “New Economy.” However, from 2000 to 2002, he probably lost his shirt. Was he just smarter in 1998 and 1999? Did his analysis turn bad somehow? Unlikely. What mattered most was stocks in general (and especially US technology stocks) did great in the late 1990s and poorly entering the new century. In other words, a top-down perspective on the broader economy was key to navigating markets—stock picking just wasn’t as important.

*Fisher Investments on Emerging Markets* can help guide you in making top-down investment decisions specifically for emerging markets. It shows how to determine optimal times to invest more heavily in the region, how geo-political events have shaped the investing landscape and what to watch for in the future, and how individual stocks can benefit in various environments. Though frequently lumped together, each emerging market nation has its own local drivers, opportunities, and risks. Using our framework, you should be better equipped to critically analyze the region, spot opportunities, and avoid major pitfalls.

## USING YOUR EMERGING MARKETS GUIDE

This guide is arranged into two sections. Part 1, “Going Backward to Move Forward,” starts with a discussion of exactly what an emerging market is—because definitions vary, and how you approach the region can impact how you build an emerging market allocation. But its primary focus is a brief history of several key emerging market countries. Whereas developed markets, the US in particular, have long-standing, well-developed free markets, the road to a market economy in emerging regions is still being developed and often filled with potholes. An understanding of how they got to their current market constructs is vital in understanding where they’re likely to go next—and how to game that for potentially superior returns.

Part 2, “Developing an Emerging Markets Strategy,” delves into a top-down investment methodology, macro-economic and regional portfolio drivers, and individual security analysis—everything you need to know to build an emerging markets portfolio allocation. You’ll learn to ask important questions like: What are the most important elements to consider when analyzing emerging markets—together and individually? What makes an emerging market stock different from its developed world peer? What are the greatest risks and red flags? This book gives you a step-by-step process to help differentiate countries and stocks so you can identify those with the greatest probability of outperforming. We’ll also discuss a few investment strategies to help determine when and how to overweight specific nations or even sectors within the region.

Note: We've specifically kept the strategies presented here at a high level so you can return to the book for guidance no matter the market conditions. But we also can't possibly address every market scenario and how markets may change over time. And many additional considerations should be taken into account when crafting a portfolio strategy, including your own investment goals, your time horizon, and other factors unique to you. Therefore, you shouldn't rely solely on the strategies and pointers addressed here, because they won't always apply. Rather, this book is intended to provide general guidance and help you to begin thinking critically not only about emerging markets, but also investing in general.

Further, *Fisher Investments on Emerging Markets* won't give you a silver bullet for always picking the best stocks. The fact is, the right emerging markets stocks will be different in different climates and situations. Instead, this guide provides a framework for understanding the region so you can be dynamic and find information the market hasn't yet priced in. There won't be any stock recommendations, target prices, or even a suggestion whether now is a good time to be invested in a particular region. The goal is to provide you with tools to make these decisions for yourself, now and in the future. Ultimately, our aim is to give you the framework for repeated, successful investing. Enjoy.





## Acknowledgments

**R**arely is a book the product of one or two people, and this one is no exception. This project would have been impossible without the support and help of many colleagues and business relationships.

It is often said the job makes the man. Fortunately, I have had the pleasure of working with some of the brightest minds in finance. Both this project and my career are better for it. To begin, special thanks go to Ken Fisher, Andrew Teufel, Jeff Silk—the members of Fisher Investments' Investment Policy Committee. Without their dedication to building Fisher Investments into the world-class firm it is today, this opportunity would never have arisen. I am particularly grateful for their many years of tutelage as a member of their research staff.

I am also particularly grateful to Michael Hanson and Lara Hoffmans, not only for their patient mentoring and editing of this book—they were integral in turning this from a jumbled set of ideas into focused, well-polished prose—but for their substantial contribution to my lifelong pursuit of knowledge and intellectual betterment.

Several members of the Fisher Investments research staff also deserve thanks: Aaron Azelton, Theodore Gilliland, Dan Sinton, Brad Pyles, Erik Renaud, Brendan Erne, and Brian Kepp each provided key feedback and input throughout the process. And special thanks go to Matthew Schrader for breaking the bank and racking up pennies in library fines in the name of sound research.

Dina Ezzat deserves praise for adroitly managing logistics, from proper citations to its on-time delivery. Evelyn Chea helped put the finishing touches on the book by offering her copyediting expertise, and Leila Amiri offered valuable graphic design contributions, including the cover design.

Of course this book would also not be possible without our data vendors, and we owe a large debt of gratitude to Thomson Datastream, Thomson Reuters, MSCI, Inc., and Global Financial Data in particular for their permissions. I'd also like to extend appreciation to Fisher Investments' team at Wiley, for their support and guidance throughout this project, especially David Pugh and Kelly O'Connor.

Last, I would like to thank Carolyn Feng for her patience, understanding, and invaluable feedback during this challenging process—the book is substantially better because of her. And to my mother, Nancy: We will continue to live the lighter side.

# GOING BACKWARD TO MOVE FORWARD



# THE FIVE Ws OF EMERGING MARKETS

**C**omprising 24 countries, 35 percent of the world's landmass, a whopping two-thirds of the world's nearly seven billion people, and almost a third of global output, emerging markets are fertile ground for the global investor.<sup>1</sup> These distant lands offer some of the most dynamic and unique opportunities—as investments, end markets for corporations seeking growth, or key cogs in the production of the world's goods. These prospects make emerging markets among the fastest growing segments of today's investing world.

Yet for all their allure, many avoid emerging markets out of fear, ignorance, or a belief they are radically different from developed world markets. This book aims to help shed light on these vital regions. To be clear, it won't tell you *where* to invest. Markets are too dynamic for that. By the time your eyes hit these pages, the market environment will have changed many times over. But we can demystify and take the fear out of investing in far-flung corners of the world, teaching you how to analyze this segment of the investing landscape for yourself.

To do so, you don't need a passport and a stack of plane tickets. See it this way: Many journalists don't write stories about events

they've witnessed firsthand. More often than not, reporters uncover the details from others—experts or those who experienced something directly.<sup>2</sup> Using a variety of viewpoints, data, and internal perspectives developed over the years, we can do the same. To begin, we borrow an old-fashioned journalism technique—the five Ws—to lay the framework for the rest of this book.

## WHO OR WHAT?

Who or what is an emerging market? This isn't a trick question. Any basic Internet search will get you more results than you could possibly peruse. This should provide more than enough information, right? Not quite. A single correct definition is far more important than many wrong ones. According to some of the results we found, an emerging market is:

A foreign economy that is developing in response to the spread of capitalism and has created its own stock market.

—*Answers.com*

A financial market of a developing country, usually a small market with a short operating history.

—*Investorwords.com*

A euphemism for the world's poor countries, also known, often optimistically, as emerging economies.

—*Economist.com*

It's evident there are a smattering of qualifiers—foreign, capitalism, poor, small, etc.; no doubt we could find dozens more in the Internet abyss. Yet what, for instance, does *small* mean? Is Indonesia, the fourth most populated country in the world, small? What about China, the third-largest economy?<sup>3</sup> Clearly, there are gray areas and plenty of conflicts. And where, for example, might the Investorwords.com definition lead you? Maybe you start looking for a market with a short operating history, thinking you'll be among the first to capitalize on the amazing growth potential therein. Hello, Zimbabwe! Bye-bye, retirement savings.

Truth is, there's no single definition of emerging markets that works as a sufficient catchall. America was an emerging market in the early 1800s. Same with Japan in the early 1960s. Even today, a poll of seasoned investment pros would certainly generate just as many answers. Fortunately, to successfully invest in emerging markets, you don't need to pin down an exact definition as much as understand the key characteristics they represent.

The following characteristics are not requirements to be part of emerging markets per se, but are generally found, to varying degrees, in most of them:

**Fast-growing economies.** In order to meet the demands of rapidly growing populations and shifts from agriculture to industry and production, emerging market economies are generally fast growing. A corollary is that emerging markets are characterized by a *rapid pace of change*. Many are familiar with China's economic growth story of the last decade, but Table 1.1 illustrates it has plenty of company.

**Low levels of per capita income.** On a per capita basis, emerging market countries are among the poorest. For example, Mexico's per capita income is \$8,340 and Indonesia's is \$1,650. By contrast, America's is \$46,040.<sup>5</sup>

**Relatively immature capital markets infrastructure.** Emerging markets generally have poor reporting standards, a dearth of publicly available information, lack depth, and may be illiquid. They may also have weak regulatory frameworks.

**Weak property rights.** Private property rights are essential to a functioning marketplace, but such rights are usually not as ingrained in emerging markets. Investor capital may be unexpectedly taken away without due recourse.

**Tenuous adherence to capitalist principles.** Emerging market countries often embrace capitalism warily, eschew it in times of turbulence, or practice mercantilism operating under the guise of capitalism. Many still operate under explicit or implicit forms of communism and socialism.

**Table 1.1 Average Annual Economic Growth**

Developed	5-Year	10-Year	15-Year	25-Year
US	2.5%	2.5%	3.0%	3.1%
Japan	1.7%	1.3%	1.2%	2.2%
Germany	1.7%	1.5%	1.6%	2.1%
UK	2.3%	2.6%	2.9%	2.7%
<b>Developed Market Average</b>	<b>2.8%</b>	<b>2.8%</b>	<b>3.0%</b>	<b>2.9%</b>
Emerging	5-Year	10-Year	15-Year	25-Year
China	10.8%	9.7%	9.9%	10.1%
Brazil	4.7%	3.3%	3.2%	3.1%
Russia	7.0%	6.8%	2.7%	n/a
India	8.7%	7.1%	6.9%	6.2%
Korea	4.2%	5.3%	5.0%	6.3%
Mexico	3.4%	3.0%	2.9%	2.7%
Turkey	6.0%	3.8%	3.8%	4.4%
Indonesia	5.7%	4.8%	4.1%	4.9%
Poland	5.3%	4.2%	4.8%	3.2%
Taiwan	4.2%	3.8%	4.6%	6.1%
<b>Emerging Market Average</b>	<b>5.8%</b>	<b>4.7%</b>	<b>4.5%</b>	<b>4.4%</b>

Source: International Monetary Fund World Economic Outlook Database April 2009, MSCI, Inc.<sup>4</sup> Select countries chosen for illustrative purposes. Averages are inclusive of all countries within the MSCI World Index and MSCI Emerging Markets Index.

**Varying political models.** Authoritarianism, populism, democracy, single-party state, and many more. There are almost as many political models in emerging markets as there are countries, which have profound impacts on their capital markets.

**Relatively underdeveloped institutions.** Legal, judicial, and regulatory institutions tend to be weaker and less established.

**Restrictions on foreign investors.** Emerging markets generally don't have a long history of foreign investment, and there may be restrictions. For example, domestic Chinese shares are largely restricted to domestic investors; foreign investors must purchase American Depositary Receipts (ADRs) or Hong Kong-listed shares.