Emerging Market Diversification

What do you think of when your hear the term, “emerging markets”?

What type of companies and industries exist in emerging equity markets?

I have no idea what you may think. But in case you do not know …

Emerging Markets May Mirror Developed Markets

In “iShares: Challenging Investor Assumptions About Emerging Markets”, ETF Trends compares portfolio holdings between emerging and developed markets.

> *But what’s so surprising to me is that over this 18 year period, how similar the sector weightings between these two types of markets has become.*

I like BlackRock and iShares. But if the article’s author is truly surprised by this similarity, I may need to rethink my view on BlackRock. That aside, realize that there are likely similarities between industries in equity market indices, whether they are emergent or not.

> *While investors often associate the emerging world with resources, these days, emerging markets are just as likely to be associated with banks. Financials make up 28% of the MSCI Emerging Markets Index, compared with a 22% combined share of energy and materials and, interestingly, a 21% financials share in developed markets.*

Mirrored Industries, But Still Local Flavour

True. And worth keeping in mind when seeking diversification through different asset classes and markets. But I would add though that this is not 100% accurate.

You need to look at local population, proximity to other markets, natural resource base, availability of labour, etc., as these items greatly impact what goes on in any one country. Country (and industry, company) specific factors influence local companies to a great extent.

Compare Switzerland to Canada. Both developed markets. Lots of natural resources in Canada, so you would expect related industries to dominate major indices. Lots of milk producing cows in Switzerland, hence Nestle as a major company. Not all developed markets are homogeneous.

Or compare the emerging markets of Brazil to Poland. Yes, Brazil is considered (for now) an emerging market. Country specific factors impact major industries. If we break down the major industry exposures, we see financials (Brazil 28% versus Poland 45%), energy (B 16%, P 14%), consumer staples (B 15%, P 4%), materials (B 15%, P 16%), and utilities (B 7%, P 8%). In some industries, extremely close percentages. In others, significant variance. Depending on which emerging markets you invest in, you may discover high similarity or you may find low. Part of your research into which funds you want should consider this point.

Even if companies operate in the same industries, there will be some significant differences in results based on local factors.

A bank operating in Poland may have a relatively low correlation with a bank in Brazil. There are common factors that inherently keep correlations high (global economy a big one). But there are local factors (customer base, local economy, government, trading partners, etc.) that reduce correlations. The greater the difference in local specific factors, the lower the correlations (and the better the diversification).

I would expect correlations between Brazilian and Argentine banks to be higher as compared to Brazilian and Polish banks. Owning a Brazilian, Polish, and Vietnamese bank will provide better diversification than three Canadian banks.

Energy accounts for 16% of Brazil and 15% of Poland equity markets. Very similar percentages in industry allocation. [Petrobras] makes up a large portion of the Brazilian component. [PKN Orlen] a large portion of Polish energy. If you go to the links, both are indeed energy companies. But Petrobras is the 7th largest energy company in the world and operates in 25 countries. It is renowned for deep water oil exploration. Whereas PKN Orlen specializes in refining crude oil. Both energy, but different emphasis. That provides diversification benefits.

Yes, there can be similar industries and percent composition between developed and emergent markets (as well as between developed markets or emerging markets). But the local situation and circumstances will [lower asset correlations] to some extent. Which means you can still get diversification benefits from investing in emerging markets.

Increased Globalization Increases Correlations

Okay, let's rein in the "diversify with emerging markets" horse a little.

Twenty years ago, investing in emerging markets provided strong diversification with domestic market investment portfolios. That was the investing mantra.

With each passing year, the world seems to get smaller. Domestic companies in developed markets increasingly operate in emerging and frontier markets. Emerging markets, especially larger ones like Brazil, Russian, India, and China (known collectively as BRICs), have extensive trade relationships with developed nations. This results in ever increasing correlations as the differences between developed and emergent continues to blur.

You can still get enhanced portfolio diversification by investing in emerging markets. Just realize that the benefits are decreasing over time. And that individual portfolio holdings within an emerging market index may be quite similar in nature and ratio as in your home developed market index.

It is beneficial to include emerging market equities in one's portfolio. But do not blindly assume that simply including them will bring positive results. Consider the components of the emerging market index. How they relates to your domestic equity holdings, as well as how they correlate to other emerging and non-domestic developed markets you wish to invest in.