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Towards a Genuine Emerging Markets Index

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TOWARDS A GENUINE EMERGING MARKETS INDEX

What is an emerging market? The common academic definition is that an emerging market nation that has a substantially lower per-capita GDP than those of developed markets. Or, more qualitatively expressed, my own belief is that an emerging market is a nation that has yet to accept fully the notion of private property, corporate governance, and the rule of law in a developed nation sense.

If the latter is true, the big returns come when the nation in question accepts those concepts. Let us take, for example, the iShares MSCI South Korea Capped ETF (EWY). South Korea is clearly considered to be an emerging market nation. At the time of this writing, Samsung has a 20% weight in this ETF, Hyundai 5.7%, and Posco, which is the steel company, 3.27%. . These companies all are integrated into the world economy. There will be no rerating of Korea, because it has accepted world standards of accounting and corporate governance, and that acceptance is already reflected in the price.

The only emerging markets level of profit growth will come if those companies, which are already integrated into the world economy and are dependent upon developed regions of the economy, grow at a faster rate than those companies in the developed world. They compete with companies of the developed world. Will Hyundai do better than Toyota, Ford, or Tesla Motors? The outcome is unknown but it has nothing to do with the fundamentals of Korea, even if Hyundai happens to be a successful entity.

On the other hand, let us consider the case of Venezuela. Señor Hugo Chavez died in March 2013. He was trying to socialize the economy, but was not as successful as he would have liked. Perhaps since he is no longer with us, the Venezuelan market was up 480% in 2013. I would call that an emerging market.

Returns of that magnitude are simply not possible if the companies comprising the index are well integrated into the world economy, are geographically diversified, and not subject to unusual political risks. Those returns are only possible when the unusual political risks and the unusual economic risks subside. Here are some examples of markets where such risks, to a greater or lesser extent, are present: Greece, Cyprus, Russia, Colombia, Venezuela, Nigeria, Lebanon, and Pakistan. Those are emerging markets; they are the nations known for corruption, political instability, civil strife, poor human rights, rigged elections—if there are elections at all—wide disparities of income, and unstable currencies.

It is worth noting that Carlos Slim Helú, the Mexican entrepreneur, became the richest person on the planet because he managed to buy a large proportion of Telefonos de Mexico in 1990 at a ridiculously low multiple. The reason it traded at such a multiple is that prior to the reforms in Mexico, if a resident wanted a telephone, he or she was required to buy shares of Telefonos de Mexico. The telephone customers were made into unwilling shareholders, who sold their shares when they were able. But Telefonos de Mexico used

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that money to build and maintain its infrastructure. Then all that changed and Telefonos de Mexico became a tremendous stock, with an enormously disproportionate impact on a very narrow index near the inception of its track record..

In the 1980s, John Templeton owned Telefonos de Mexico. It might have been his largest position and traded at a P/E perhaps not far from 2x.

Li Ka-shing of Cheung Kong fame was buying real estate in Hong Kong during the 1967 riots. People were fleeing Hong Kong at that time because of its proximity to China and the events of the Chinese Cultural Revolution, but he was buying. Hong Kong was an emerging market then, but today it is not.

If investors want to create an emerging markets index, that index needs to have much more political risk, economic risk, much more risk of corruption, instability, political strife, poor human rights, and currency risk as well, in order to provide the outsize rates of return that emerging markets have provided historically.