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STOCK MARKET

FUNDAMENTALISTVIEWSBRYAN COLLINGS

Every week, a leading fund manager or expert at making money grow explains why savers and investors should see things their way

Emerging markets may be saviour for investors

Emerging markets have long been associated with higher risk but returns to investors have proved attractive.

Emerging market shares outperformed American equities by 157pc in dollar terms during the 10 years to the beginning of 2009. In the post-credit crisis world, risk is again on investors' minds and it is important to reassess the potential of emerging economies.

The risks associated with developed markets have been played down while those in emerging markets have been exaggerated.

Economic stability and growth, as experienced in the Western world in recent years, can lead to overconfidence in the status quo. It is only when cracks in the system reach critical levels that the real risks begin to be properly assessed. A reappraisal is needed of risk and reward across the reshaped investment world.

The developed world faces a wealth shortfall in coming decades. Ageing populations are approaching retirement without enough savings or financial assets to support them. Forecasts suggest the US will have a \$19 trillion (£12.8 trillion) shortfall in household wealth by 2024, equivalent to underfunding of 37pc. The UK faces underfunding of 34pc. This will not only affect individuals but strain state systems. There is a need for increased saving, reduced borrowing and improved returns on financial assets. To get anywhere near the growth required, investors in the Western world need rates of return significantly above those available in domestic markets. Estimates for growth in the US and Europe for the next five years generally remain below 3pc per annum. In contrast, emerging markets are forecast to expand in excess of 6pc per annum, with individual countries, such as China, well above this over the medium to long term.

REUTERS

Market of the future: a call centre worker in Bangalore

To maximise returns, investors need to have significant exposure to the countries contributing the most to global growth. Based on International Monetary Fund forecasts, this will be the emerging economies.

Emerging market cities are expected to grow. Capital and labour are portable, and in the medium to long term it will be the likes of Shanghai, Mumbai and Dubai that hold sway over global economics and prosperity. Brazil, Russia, India and China are firmly established as key players and expected to be the future "superpowers".

Importantly, these countries do not rely solely on consumers in the developed world to fuel their growth. They have built strong domestic demand, enjoy favourable demographics with the emergence of a middle class and a youthful working population, and have built vast foreign exchange reserves far exceeding those of the developed world. Emerging market corporate governance has improved, with the developed world dominating headlines for corporate scandals in recent years.

Sharp falls in emerging market equities in 2008 took company valuations down to extremely attractive levels. Stocks are trading at a significant discount to those in the developed world, despite far better growth potential and fewer structural problems in their broader economies. By this week, stock markets had risen 30pc off their lows and the macroeconomic outlook should offer further support.

While headwinds remain for emerging markets, mainly in the form of a lack of credit and lower demand from Western consumers, it is important to remember that stockmarkets discount the real economy by six to nine months in advance. On this time frame, there are a number of supportive factors.

The leading emerging economies are not leveraged to any significant degree, inflation concerns have eased and relatively high levels of savings should drive returns on capital. The rescue packages by central banks will begin to feed through to the global economy and commodities, in which many emerging economies are well endowed, will be in strong demand as developed-market governments embark on infrastructure programs. There is also cash waiting to be reinvested once there are improvements in macroeconomic signals, early indications are this may occur in June.

Misconceptions need to be tackled, both about the risk of emerging markets and the perceived safety of developed markets. Central to these considerations must be the need for a higher rate of return in coming decades. The question may shift from whether there is too much risk in emerging markets to whether investors have enough exposure to their growth potential.

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