

# INVESTMENTMONTHLY

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## ARE EMERGING MARKETS WORTH THE RISK?

While many investors are satisfied with domestic equity markets given year-to-date returns, emerging markets (EMs) have not provided the same level of contentment. Through the end of August, the MSCI Emerging Markets Index was down 6.93%, underperforming the S&P 500 by 16.87%.

Just by reading the news, one can ascertain some of the rationale for the emerging-markets performance:



TRADE/TARIFF EFFECTS ON CHINA



POLITICAL UNCERTAINTIES  
IN LATIN AMERICA



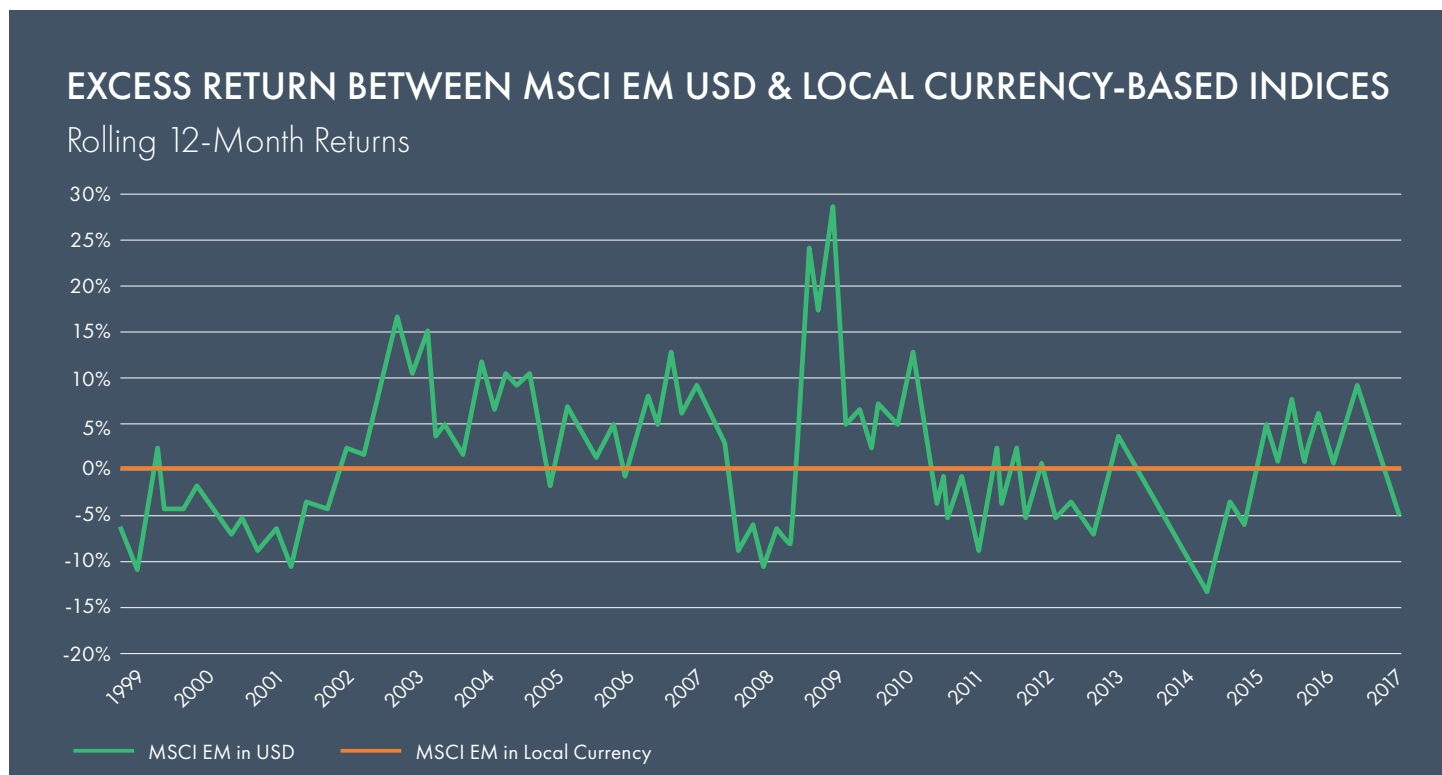
DEFICIT FINANCING  
IN TURKEY

# Shaping the EM Conversation

While subpar EM performance is disappointing to investors, we think it's important to put a couple of things into perspective:

The first is that 2018 index returns have been dominated by individual stocks' currency moves vs. the U.S. dollar (USD). Of the -6.93% performance this year, -5.48% has been driven by the translation of foreign investment back into USD. So, when the returns are converted into USD terms, the underlying companies are only down -1.45%.

An initial reaction to this might be: "So what? I'm still down 6.93% because I'm a U.S. dollar-based investor." However, history has shown that short-term currency movements tend to be mitigated over the long run. In other words, periods when the USD is strong (hurting U.S.-based EM investors) are followed by periods when the USD is weak (when investors benefit from money invested in other currencies). The rolling chart below illustrates this.



Source: Morningstar, MSCI; as of August 31, 2018

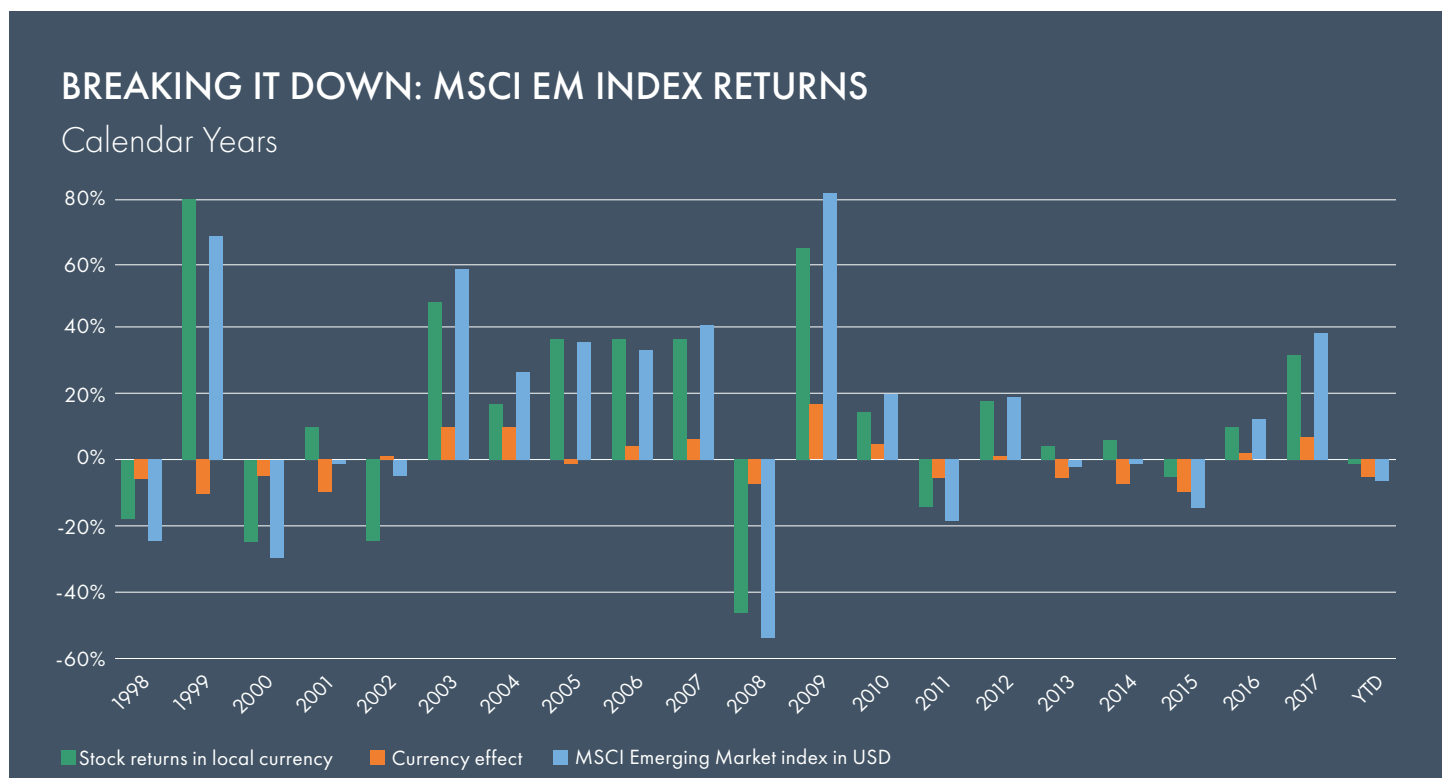
Second, it's important to remember that while a -1.45% return is still disappointing, the MSCI Emerging Markets Index is coming off a very strong 2017 calendar year when the returns in local currencies and in USD were both above 30%. One could reasonably expect markets to take a "breather" from time to time. Even U.S.-based markets seem to have benefited from a breather earlier in the year when the S&P 500 experienced increased volatility and fell nearly 4% for the month of February.

## Assessing EM Currency Risk

Is this type of currency risk worth taking? This is a fair question given that if it all evens out over time, what's the point? The reality is that currency hedging—or investing in a way that moderates the effect of currency-exchange risk—can be more complicated than it may appear.

For instance, many companies headquartered in one country have their operations and revenue based in other currencies. Samsung, for example, is based in South Korea but has a significant amount of revenue elsewhere, including in the United States. Simply hedging South Korean currency (the won) by converting it back into USD for an investment in Samsung might not be the prudent strategy if Samsung itself is doing the same thing. A hedge could, therefore, inadvertently result in an actual "bet" on one or more currencies.

Emerging markets are a fast-growing and ever-increasing part of the global economy, and therefore their allocation in investors' portfolios may be justified in appropriate circumstances. But it's important in international investing to recognize the return components and not overreact when one set of components is driving short-term results. The display below shows the calendar-year returns of the MSCI EM index and the return percentages driven from the currency translation.



Source: Morningstar, MSCI; as of August 31, 2018

As the chart shows, the majority of the index returns are being driven by the underlying stock performance—most of the time. The 2018 year-to-date period would be the exception.

## CLOSING THOUGHTS

Emerging markets represent the fastest growing portion of the global economy. We feel that equity exposure, when used in appropriate circumstances, can provide value to a well-diversified, strategically allocated portfolio. However, history suggests that exposure will come with higher volatility. That higher volatility will also periodically result in greater returns. Instead of avoiding it or attempting to time or hedge it, we simply size the allocation appropriately in the context of total portfolio construction.



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