



Emerging Economies can offer attractive Investment Opportunities

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Investing in emerging markets (EM) equities has been a very rewarding strategy over the last five years, producing annual returns in Canadian dollar terms of 8.82 per cent versus -3.11 per cent and 5.23 per cent for global stocks (MSCI World Index) and the TSX Index, respectively.

Even on a shorter-term basis, as Figure 1 shows, from the start of 2009 emerging markets relative to global

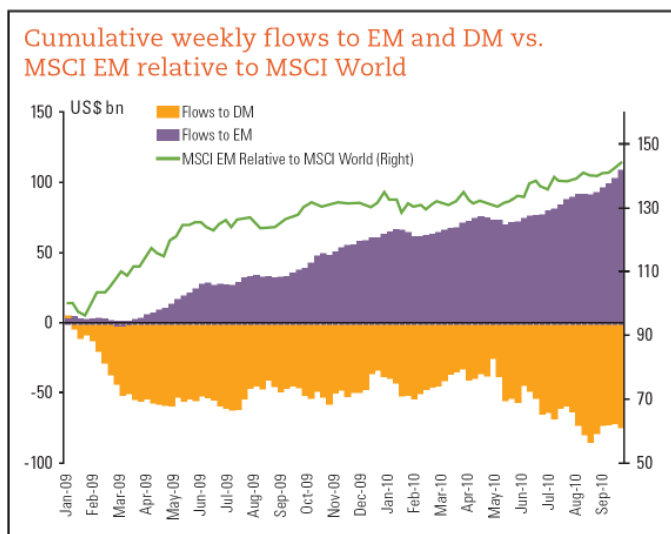


Figure 1 - Source: UN Morgan Stanley Research

stocks have done approximately 40 per cent better - notice the dramatic difference in weekly fund flows, massive redemptions in developed markets (United States, Europe, Japan) and very healthy positive fund flows to emerging markets. The questions investors face are: Will the fundamentals lead to outperformance going forward? How much should investors allocate to this asset class with regard to their total portfolio? And how should investors participate in this asset class?

The emerging markets in general have three distinct advantages over developed markets such as the United States, Canada and Europe that we believe will drive continued outperformance by this asset class. Firstly, in certain emerging economies like China and India, as examples, we see lower consumer debt levels, higher domestic consumer spending and, as a result, higher and more sustainable economic growth rates.

Secondly, we see select government bodies that have stable debt levels, pro-business regulatory reform and are doing an extremely good job of managing their overall economies to provide sustainable economic growth. The Asian economies have come a long way from the 1998 Asian crisis of high government debt, weak currencies and low investor confidence. In our view, China is one of the best-managed economies in the world, as they continue to implement policies from a fiscal and monetary perspective that sustain economic growth and prosperity while keeping a very close eye on potential asset bubbles.

Lastly, a number of the emerging economies have very favourable demographic trends that are simply a fact

of life. The age dependency ratio measures the size of the dependent population relative to the working-age population (the ratio of the elderly and children versus working civilians aged 15–64 years). As this ratio declines, the working-age population has been growing faster than the dependent population and this will help support a structural rise in domestic savings, which drives investment and infrastructure growth and future consumer spending growth. Figure 2 shows this ratio for the economies of India and China since 1950, with China slowly beginning to bottom and India's ratio still showing plenty of improvement. The implications from the differences between the two countries are that we expect China's economic drivers to transition toward domestic consumption and away from exports and infrastructure with India's economic drivers holding strong in the areas of exports and infrastructure. By 2020, India will have contributed 136 million people to the global labour pool versus 23 million for China and 11 million for the United States. To participate in these future demographic trends we have been overweighting companies in China that are directly tied to domestic consumption trends. We have also been investing in select European companies that provide consumer advertising services and products in China.

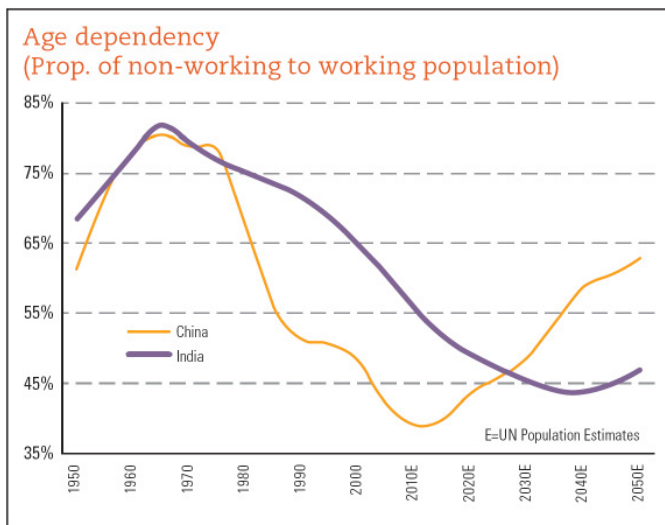


Figure 2 - Source: UN Morgan Stanley Research

When it comes to deciding which emerging countries to invest in, it is not simply a function of finding the economies with the highest economic or gross domestic product (GDP) growth. In fact, from 2004 to 2009 there was only a 32 per cent correlation between stock market returns and GDP growth rates. However there was a 75 per cent correlation between stock market returns and corporate earnings growth rates. Another way to gauge earnings growth is to review ROE return on equity (ROE). Figure 3 shows the trailing ROE of EM stocks relative to global stocks since 1992. Emerging ROE is 39 per cent higher and is still below historical peak levels.

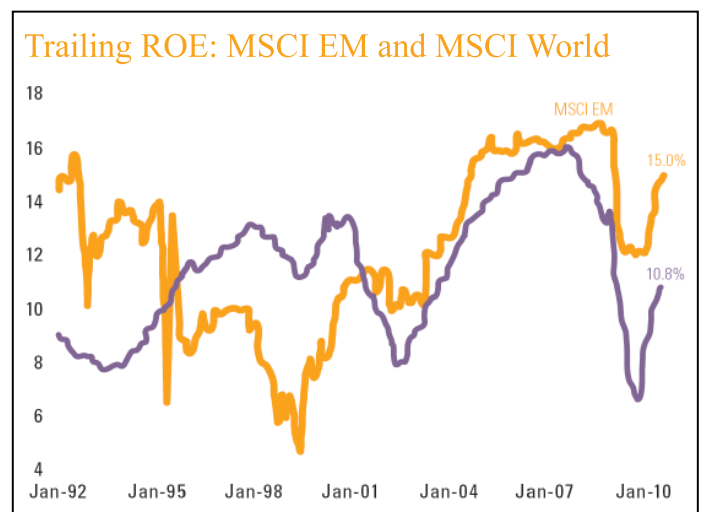


Figure 3 - Source: UN Morgan Stanley Research

From a valuation perspective using price to earning (P/E) and price to book (P/B) ratios, EMs are very reasonably valued compared to other equity markets across the world.

Global Valuations		
	2011 P/E	P/B
Canada	14.8	2.0
USA	13.3	2.0
World	12.1	1.8
EM	11.7	2.1

Figure 4 - Source: Morgan Stanley Research

Not all emerging stock markets are created equally. We are dealing with different political regimes, currency risks, growth prospects, demographic trends and valuations.

At McLean & Partners, we have been advocating an active stock-picking strategy that can be summarized as “looking inside the market to outperform.” Not all emerging stock markets are created equally. We are dealing with different political regimes, currency risks, growth prospects, demographic trends and valuations. A number of Index ETFs (exchange-traded funds) do not take any of these factors into account and investors need to be very mindful of this. In fact, a number of Index ETF investment vehicles can be very overweight in certain sectors and specific stocks simply because they are the largest sector or stock in that country’s index, not necessarily because they are the best investment.

Given the favourable long-term structural fundamentals that certain emerging economies possess, we believe investors should employ an actively managed investment strategy for this asset class to take advantage of superior returns in the future.

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