

Emerging and Developed Markets: A Blurred Line By: Jim Jensen, CIMA®, Senior Consultant

Emerging countries continue to make headlines within the investment world, garnering attention for their economic growth prospects and correlating investment potential. The appeal is somewhat surprising when you consider emerging market equities lost over 18% in 2011¹. Yet with developed market economies laden with enormous levels of debt and failing to show signs of a sustained economic recovery from the downturn of 2008, investors remain attracted to emerging countries. The Institute of International Finance forecasts that net private capital flows into emerging markets in 2011 will exceed \$1 trillion, following a 54% rise to \$990 billion in 2010. Given the sustained interest in emerging market investments, we will first take a step back and clarify what makes a country's economy "emerging" and if it's possible for an emerging country to shake its "emerging" label and become "developed". The analysis ultimately indicates that there's no clear cut answer.

The term "emerging markets" dates back to the early 1980s when the International Financial Corporation wanted a more attractive term, primarily to Western investors, for what at the time was commonly referred to as "third-world equities"². Though the term was a marketing success, it did little to define the variables that differentiate emerging versus developed. At the highest level, two components need to be considered: emerging countries and emerging markets. The majority of economists and investment professionals first view a country on its economic merits. The most popular approach defines an emerging market country by its wealth, more specifically, its per capita national income. A few major index providers such as Morgan Stanley Capital International (MSCI) and JPMorgan take this approach. According to MSCI, an emerging country fails to have a per capita gross national income of 25% above the World Bank high income benchmark for three consecutive years. Another method, often used in tandem with the first, utilizes the country's credit rating. Barclays Capital's international fixed income indices rely on credit ratings in defining their global classifications. With developed countries being downgraded and upgrades occurring more often on the emerging side, not to mention the questionable credibility of credit rating agencies, the relevance of this factor is slipping.

Without question a country's economic standing is momentous in defining its emerging versus developed status. That being said, a country's investable market, from rule of law and the development of financial systems to adequate levels of liquidity, also significantly impacts its market categorization. On the other hand, an asset market is not necessarily more liquid if it is located within a developed country. The real estate market within the United States, particularly in places like Florida and Nevada, provides a recent example of this argument. Political risk and changing levels of governance can create additional contradictions. During the 1990's a surge of reforms were implemented in many emerging economies to liberalize and privatize their economies. As a result, the credibility of numerous emerging market governments and central banks has improved,

¹ MSCI Emerging Markets Index

² Alexander Kozhemiakin, "Emerging Markets as ASTERISCS", *Standish Mellon* (September 2011)

lending confidence to investors and the resulting flow of capital described above. In contrast, developed markets have recently trended in the opposite direction. In the wake of the financial meltdown, governments have become involved in the banking sector through quasi-nationalization programs and forced mergers as well as increased taxes on commodities and energy firms, further blurring the distinction between developed and emerging markets. All told, defining an economy as emerging or developed is very subjective and lacks true defining characteristics. Consequently, the transition from emerging to developed market status is extremely challenging. There is perhaps no better example than South Korea.

South Korea

While South Korea certainly fit the emerging market profile decades ago, it is increasingly harder to justify that classification today. Starting in the 1960's, South Korea has forged an incredible record of growth and global integration, resulting in the country joining the ranks of the G-20 major global economies. South Korea's market based economy, which according to the World Bank ranks 14th in terms of Gross Domestic Product (GDP), has become a dynamic, high tech power. Interestingly, South Korea leads the world with the highest percentage of households with access to the internet (94.3%) and more than 80% of the population has access to home computers. In addition, the literacy rate is equal to that of the United States at 99%. These are some of the factors that lead the International Monetary Fund (IMF) to declare South Korea an advanced economy in 1997. Yet, according to the index manager, MSCI, and the majority of the investment community South Korea remains classified as an emerging economy. MSCI maintains its focus on market accessibility and investability. Following their annual review in June of 2011, MSCI cited a lack of full currency convertibility, including the absence of active offshore currency markets as well as a "rigid" investor ID system which leads to friction and inefficiencies. Though not mentioned by MSCI, one can not overlook the ever-present political risk stemming from South Korea's neighbor to the North. South Korea, often identified as an "Asian Germany" of the technology sector³ and classified as developed by the IMF, continues to be recognized as emerging by MSCI and most major market participants. South Korea's dramatic economic progression yet mostly stagnant recognition as a developed country underscores the subjectivity inherent in the classification of developed and emerging countries.

Global Diversification

The blurring distinction between developed and emerging only holds true for the "middle ground" when a country has experienced significant growth and with it global acceptance (South Korea) or has incurred significant challenges and therefore lost confidence (Greece). Significant differences of all facets remain when comparing the majority of developed countries versus emerging. It's because of these differences and the still distinct risk/return characteristics of developed and emerging market investments that produce the diversification benefit of including both within a globally diversified investment portfolio. Though most often the focus of emerging market investing is on

³ Eric Dutram, "Does South Korea Belong in your Emerging Market ETF" *ETF Database* (March 2011)



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equity investments, the emerging debt market has evolved to the point where it now presents an exciting new diversification opportunity. In 2012, DiMeo Schneider & Associates, L.L.C. will introduce emerging market debt within our 10-year capital market assumptions and model the asset class within our updated 2012 Frontier Engineer™ software.

Please contact your DiMeo Schneider & Associates' consultant to learn more about the differences in developed and emerging markets or to discuss the introduction of emerging market bonds to your portfolio. In addition, we recently posted a new research paper, "Emerging Market Bonds: An Asset Class Primer" within the research tab of our website, www.dimeoschneider.com.