MVCM White Paper Series

Outcome-Oriented Thinking

Emerged Markets, Emerging Opportunities

What do the following statistics have in common?

- 98% of total geographic land mass
- 95% of total labor force
- 98% of total proven oil and natural gas reserves
- 76% of total electricity consumption
- 80% of total real (purchasing power parity) GDP

Answer: they are all statistics for which the following statement is true – *exists outside of the United States*.

Now consider another statistic:

- Maximum 15% of permitted investments

Same answer as above: *exists outside of the United States*, as per the typical investment policy statement of a US-domiciled individual or institutional investor.

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The world has emerged faster than our understanding of the world's markets has emerged. At MV Financial Group we think that we are entering a new chapter – Phase III, if you will – of the post-World War II globalizing trend.

Phase I was what we call the *Age of Globalism*. This phase, more or less running from the mid-late 1940s to the mid 1970s, was one primarily of man-made creations to reconstruct the world after the destruction wrought by two world wars and a global depression. The World Bank, the International Monetary Fund, and the attendant mechanics of international finance agreed to during the Bretton Woods conferences ending in 1944 were the efforts of people – heads of state and ministers of finance and other pillars of the Great and Good – brought together for the noble purpose of laying the infrastructure for the ensuing Marshall Plan and other edifices of the world's economic renaissance. For a brief shining moment the world came together and helped bring about a quarter century of shared growth and prosperity.

Phase II was the *Age of Globalization*. Unlike global*ism*, global*ization* was an organic phenomenon – not the deliberative creation of good men with good policies but a disruptive tsunami unleashed with the marriage of Moore's law to financial market liberalization.

Intel co-founder Gordon Moore's observation in 1965 – that the number of transistors on an integrated circuit for minimum component cost doubles every 24 months – became shorthand for the geometrically explosive power of modern computing. At the same time the coordinated efforts of governments to honor their Bretton Woods financial obligations began to strain under the weight of cross-border trade and finance. The system finally collapsed irretrievably in 1971 during an otherwise unremarkable televised Sunday address when US President Nixon announced the removal of the obligation to redeem international holdings of US dollars at the fixed rate of $35 per ounce of gold. Fixed rates and market controls were out, floating rates and electronic quote systems were in. The Eurobond market, started as a US tax dodge in 1963, began a trajectory that would go from $24 billion in 1970 to $8,833 billion by 1991.

This tsunami then spread to places where markets had long been absent. In China Mao's Little Red Book gave way to a new maxim "Getting Rich is Glorious". In Eastern Europe "security" walls crumbled and securities exchanges lit up for business. Emerging markets, as they became commonly known, were now a part of *New York Times* columnist Tom Friedman's aptly-named Flat World.

Except that the term "emerging market" has become a misnomer and this brings us to Phase III, the *Age of Global Capitalization*. In the preceding Age of Globalization money from developed countries increasingly raced around the globe into and out of "emerging" opportunities – in the form of both portfolio investment (into stocks, bonds and the like) and direct investment (into whole companies). Much of this capital – and particularly that of the portfolio investors – was not in it for the long term but ready to repatriate to the home country when times got tough. Hence the frantic race for the exit in places such as Thailand, Russia and Argentina when things got dicey there at various times in the 1990s.

Global capitalization is something else entirely. It's about individual countries and regions mobilizing their own capital sources – domestic and regional savings from increasingly wealthy business and consumer populations. In other words, capital locations are becoming more closely correlated with manufacturing, service and consumer locations. The light-speed improvements in technology and the widespread adoption of global regulatory standards will mean that more good companies – not only the very largest with Level III ADR programs on the New York Stock Exchange – will be able to tap into their own increasingly robust domestic capital markets to raise money for growth.

Of course Phase III is not going to replace Phase II overnight. The world never works in such a way that one era ends with a closing bell and another begins with an opening bell. But consider the following:

South Korea and Israel are part of the MSCI Emerging Markets Index(SM) but have higher real *per capita* GDP than Greece, listed on the MSCI EAFE® index of developed markets. The Czech Republic, whose economy just 18 years ago languished behind the Iron Curtain, has a higher *per capita* GDP than Portugal. Taiwan – another country on the EM Index – ranks higher by this measure than EAFE member Spain.

Or consider this: for the period October 2001 – October 2006 the average annual standard deviation (a common measure of investment risk) of the MSCI Malaysia stock index was lower – at 14.7% - than those of Italy (16.5%) and the Netherlands (19.2%). By the same risk measure China (20.8%) was lower than Sweden (23.7%). Oh – and just a fraction higher than our own US NASDAQ index, which had a standard deviation of 20.5% for the same time period!

And yet the artificial divide persists in the minds of most. You often see something like the following in an investment policy statement: "Up to 10% of the portfolio may be invested in developed international markets, while a maximum of 2.5% may be invested in emerging markets". The fact that Taiwan, with a *per capita* GDP of $27,500 and Pakistan, with $2,400 of GDP per head, are both constrained by this 2.5% suggests there is a major asymmetry in our investment markets today. To put it another way, risk in the international marketplace is being mispriced.

How can reality and perceptions be so far out of synch? Aren't asymmetries or anomalies like this arbitraged away by market efficiencies even with the slightest discrepancy between value and price? True enough in most cases. If some news comes to light that could affect the value of a Pepsico or a General Electric it's likely to be incorporated into the stock price almost – if not precisely – at the instantaneous moment such news is released. Hedge funds make a living every day by scouring over every nook and cranny in the market to "arb out" a fleeting value anomaly.

But we are talking about something else entirely – not fleeting but structural – built into the system. Some thirty-odd years ago a portfolio manager named David Dreman scratched his head in puzzlement wondering why so much investment money always went into stocks with high price multiples when it seemed that value stocks, i.e. cheaper out-of-favor names with low price multiples, seemed to consistently outperform their growth counterparts. Well, to this day value continues to consistently outperform growth over mid to long time horizons, and David Dreman is still making money from his observations way back in the days of the Vietnam War and Woodstock, back when the "Nifty Fifty" were the stocks getting the breathless media coverage that would later be lavished on the Dot-com Darlings.

What Dreman and others observed was the strength of psychological, behavioral tendencies to fly in the face of rational expectations. Growth stocks were sexy stories – neat technologies and colorful brands surrounded by hype and media buzz. Value stocks were boring stories with company names of which many people had never heard. An entire school of financial theory grew around the compelling evidence that "behavioral finance" was in fact a dominant force in the investment world. The Nobel Prize for Economics in 2002 was awarded to one of its leading proponents, Daniel Kahneman. Perhaps Economic Man – the old-school shorthand for rational, value-maximizing decision-making – was being replaced by Behavioral Woman – making decisions based on a combination of factors and emotions not necessarily to her optimal financial advantage.

What does this digression have to do with our discussion on international markets? Everything, actually. We believe that a variation of these behavioral quirks is at play in explaining why we in the US are so reluctant to allocate more of our portfolios to international and particularly so-called "emerging" equity and fixed income opportunities.

In essence, the world may be flat but we in the US still have difficulty visualizing it. Relatively few of us can comfortably grasp and define the nuances of what economics, politics, social trends, domestic life and individual tastes are like in different parts of the world. How many of us know that some the world's most innovative gene therapy solutions for certain types of cancer can be found in research centers located in Poland? Perhaps more of us know by now that the voice at the other end of the phone when we call about our mortgages is probably sitting somewhere in India. But do we grasp how urban professionals in South Asia are making their own financial decisions about pension plans, car loans and bathroom fixtures? Do we care, particularly?

Maybe we do care – but perhaps through the prism of resentment that others in the world are profiting from the loss of jobs and opportunities in the US. That unfortunately is a subject for a whole different kind of article – but it is undeniable that a robust middle class is a growing fixture in many, many parts of the world. Middle class individuals and families need and want things – material things certainly but also security and a better life for their children. And a key success factor for any economy with a growing and self-enriching middle class is a vibrant domestic capital market – thus the Age of Global Capitalization.

This is simply the age-old recipe of mobilizing available financial resources to redeploy into economic growth opportunities that benefit the community. The first "emerging market" in the post-World War II period was Japan. What was Japan's success engine? The post office, of all places. From the earliest post-war days people in this devastated country could put their few hard-earned yen into a savings account at their local post office, which would pay them a very modest but stable rate of interest. Does that sound quaint? Well, Japan Post, the public corporation that now runs the postal savings system, today has assets under management of approximately *$2.1 trillion*. Quaint, indeed.

Domestic capital markets are coming to take many shapes and sizes – from the Polish pension investment system to microfinance lending in places like Bangladesh and Pakistan, the Tel Aviv Stock Exchange to the Ukrainian corporate bond market. As the technology to support these domestic markets and the regulations governing them converge to global standards more and more international companies and opportunities are coming on-line. And because our old friend Moore's law is still at work, the cost-efficiency of accessing this increased supply of offerings is becoming much more advantageous.

So if all this is true, why do we still think US investors will opt more for NASDAQ than for China? Like David Dreman we think much of it is about behavioral heuristics – the same reasons that cause investors to keep coming back for whatever version of Dutch tulips or the Nifty Fifty are in vogue rather than the boring old value stocks that offer better returns over the long term. "China" as an abstract concept or a tourist destination may be exotic and interesting, but how many people know or care what Wuhan Steel is? (Answer: the third largest steel manufacturer in the country that supplies a third of the world's steel, based in industrial Hubei Province, hundreds of miles away from Beijing's Forbidden City or Shanghai's Bund). Russia, most of us know, is the land of Tolstoy and Tchaikovsky. It also houses the world's largest producer and exporter of natural gas (Gazprom) that is methodically acquiring energy companies all across Europe with names like *Slovensky plynarensky priemysel*. What perky commentator on CNBC is going to pronounce that in the same breath as "Google"?

In other words, boring old out-of-favor companies in Laos or Latvia can be value anomalies as much as boring old out-of-favor companies in Lubbock or Louisville still are making money for US contrarian investors. The question is simply "when", not "if". The question is "where are the opportunities", not "will there be opportunities". It's a great thing in this business when an asymmetry presents itself that is structural, not fleeting, and therefore can be realized through an intelligent, carefully executed strategy rather than seat-of-the-pants tactics. These opportunities don't come along every year or even every ten years. And these opportunities certainly do not come without risk. But to us at MV Financial Group it is, to repeat, a question of "when", not "if". Why not now?