財務管理論叢 第3卷 第2號 (1996.10)

International Emerging Markets

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Today as we look at the emerging markets, one factor becomes readily apparent--emerging markets have become an increasingly important element in the international financial markets. Regardless of where a financial professional's activities are concentrated, whether it may be in corporate finance, banking, counter trade, foreign exchange and custody, agency brokerage, trading or fund management, the modern financial professional may find himself or herself working in part or even entirely on emerging markets.

Just a few years ago, the emerging markets fund manager guru, Dr. Mark Mobius of Franklin/Templeton Fund Management, launched his emerging markets funds for Templeton and today his emerging markets funds amount to over US$6 billion in scale. Dr. Mobius' funds have generally performed quite well and that good performance has no doubt been very useful to Templeton in enabling the company to attract additional funds from investors for new Templeton funds as well as for their existing portfolio of funds. In short, Dr. Mobius and Templeton have a good track record to run on. In the highly competitive world of fund management, a good track record is of paramount importance.

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Lest anyone think that I am advertising for Templeton, let me assure you that this is not the case. There are of course many excellent fund management companies and fund managers involved in the emerging markets. I simply chose Dr. Mobius and Templeton as a representative example.

Given the size, scale and frequency of the transactions involving the emerging markets today, it would seem to be highly appropriate for us to revisit the basic premise of investment in emerging markets, e.g. that the essential equation here is that the emerging markets investment paradigm is one where high risks bring high rewards. But as participants in emerging markets as financial professionals, and indeed sometimes as investors ourselves, we certainly have the right to question the veracity of the emerging markets investment paradigm that high risks equal high rewards. In fact, it sometimes seems to me that high risks equal no rewards but rather losses instead!! A few examples may serve to illustrate my point.

First, although the world's largest market, New York, has reached record heights this year, some of the developing markets have encountered difficult times. According to the 17 October 1996 edition of the Far Eastern Economic Review, in the 3rd quarter of this year the Karachi market lost over 18% of its value, Bombay over 15%, Bangkok nearly lost 12% and Seoul was down over 4%. Of course, some fortunate investors always or rather often outperform the market averages but for those with index tracking investments, a declining market portends losses. Imagine how disappointed some international investors must be who have invested recently in these developing markets in anticipation of investment outperformance compared to investments in developed markets when in fact the opposite has proven to be the case--developed markets have been winners and some emerging markets have been losers!

Of course, if we look more closely at the markets we see that the picture is not always so clear. Yes, the markets in the U.K. and the U.S.A. have done well this year but Tokyo, although it has been up somewhat, cannot be said to be having a good year. But since the beginning of the year, Bombay is up over 120% and Taipei has gained over 26%. The attraction of markets capable of such performance are obvious, but given what has happened to the Bombay market recently, so are the dangers.

It may be useful then to consider some of the things that could account for the volatility of the emerging markets. Many of the risks encountered by investors in the emerging markets are well known. Much has been said about market risks, such as low capitalization levels, which in turn often means thin trading volumes, which often leads to wide fluctuations in share prices. Economic risks: inflation, interest rates, GNP growth, per capita income growth, wage levels and so forth all need to be tracked and analyzed. Then there are the business risks, e.g. the risks of investing in companies where managements and employees may be inexperienced and encounter problems developing their companies. Many companies in emerging markets have only been recently established and the executives in charge may not have a high level of experience, either in the industry or in management. Often too, companies in emerging markets have difficulty in obtaining or developing technologies. Rather than listing all the general aspects of investing in the emerging markets, it may be more illustrative to highlight some of the actual investments that are currently available.

By way of example, I have obtained a recent prospectus for a fund composed of companies in Russia. The prospectus outlines the following types of risks: political, economic, regulatory, volatility and illiquidity, disclosure, accounting practices, tax system, currency risk, securities market risk, registration and

securities custody, environmental risk, corruption, crime and conflicts of interest. Each of these risks in the Russian market is explained so that the investor can obtain a clearer picture of some of the potential dangers of investment in a newly emerging market such as the Russian market. But of course, despite these risks, the international merchant bank that was launching the fund was not attempting to frighten investors and prevent them from buying shares in the fund. On the contrary, the merchant bank that prepared the prospectus was strongly urging investors to buy the fund.

Interestingly, after warning investors of the risks the merchant bank then proceeded to give investors some information on the particular companies that the fund managers had targeted for inclusion in the fund's portfolio. For each company in the supplemental prospectus, a brief summary of the company's activities, its strengths, risks, financial position and share price trend was provided. For example, the "strengths" of one company were listed as "Good quality oil although no benefit comes to the company under current transportation procedures" and "disclosure improving." These were the only items concerning the company that were listed as "strengths." Under the "risks" category, the following items about the same company were listed: "high production costs, the holding company has an unclear strategy and relatively poor financial position." In another case, another oil company's only strength that was listed was that it was "relatively cheap." Among this company's risks were listed a "high level of debts, substantial investment still required to improve pipelines, poor history of shareholder relations and poor environmental performance."

Clearly, if the two companies that I have just described are to form a substantial element of the fund's investment assets, then the overall risks of investment might seem to outweigh the advantages. On the other hand, there are

obviously many, or at least some investors who are willing to accept the risks. In fact, some investors are so eager to put their savings into emerging market funds that they will even invest in country funds where the country targeted by the fund does not even have a stock market!

A case in point would be the Templeton Vietnam Opportunities Fund, a US$100 million fund approved for sale in the United States. Dr. Mobius and his colleagues launched this fund in 1994 with the objective of investing in Vietnamese companies that would be listed on the Vietnamese Stock Exchange when the stock exchange was launched. Although the Vietnamese authorities had stated their intention to launch a stock exchange in 1994, thus far no exchange has been launched, and so about half of the Templeton Fund's assets remain in U.S. Treasury bills with much of the remainder invested in Asian companies doing business in Vietnam. This information came from the October 19th-20th edition of the International Herald Tribune, which also explained what Dr. Mobius' investment criteria is for investing directly into Vietnamese companies, since the U.S. Securities and Exchange Commission has said that by October of 1997 the fund must have at least 65% of its assets invested in Vietnam or the fund must change its name from the Vietnamese Opportunities to something else, or the fund will have to liquidate.

Interestingly, despite the pressure on him to find Vietnamese investments soon, Dr. Mobius is maintaining a strict investment criteria. Since there are no listed companies in which to invest in Vietnam, Dr. Mobius is looking for Vietnamese companies that have foreign partners already and which may be willing to let the Vietnamese Opportunities Fund take a minority shareholding. Although many executives have asked him to invest in their companies, Dr. Mobius has established the following investment guidelines for his fund. First, the target

investment company must have "an experienced and successful venture partner, complete government licenses in advance and a defined mechanism to get his investors' capital out."

I have met Dr. Mobius many times and he has indicated to me as well that even if there is an excellent business opportunity or company in which to invest, he will not make the investment if there is no clearly defined mechanism in place for the subsequent sale and recovery of the invested capital and capital gains. Thus, to him, the most important risk in may ways is the liquidity risk. Nevertheless, despite the absence of a stock market and the implied guarantee of liquidity, Dr. Mobius hopes that he will be able to find appropriate investments in Vietnam.

Given all of these obvious difficulties, what is it that continues to make investors around the world so interested in the emerging markets? I would suggest that the investors are encouraged by the impressive results that they see from investments made in some of the emerging markets. Leaving aside the question of the risks and difficulties and looking just at the returns of investments in these emerging markets, one can say that in many cases the returns have been very impressive.

Again, going by information provided in the 17th October 1996 edition of the Far Eastern Economic Review, we can easily see how impressive some emerging markets investment returns have been. The Genesis Malaysia Maju fund, for instance has had a five year return on investment in excess of 278%. The HSBC GIF Hong Kong Equity fund boasts a five year return of nearly 242%, whilst the GT ASEAN A Share fund has had a return over five years in excess of 106%. Certainly investment yields on such a scale would be difficult to achieve in developed markets and thus they tend to attract the attention of investors. There

is no absolute certainty of course that the investment future will reflect the past but there are probably many committed emerging markets investors who believe that it will.

Finally, I would like to touch on the Korean market. Most South Korean funds five year performances, as listed in the Far Eastern Economic Review article, were negative. In recent years the Korean market has been disappointing most of the time. Foreign investors and domestic investors have often lost money on their investments in the Korean market. I would like to advance one possible reason for the underperformance. In my view, the Korean market has been and still is too dependent upon the individual investor rather than the institutional investor.

One fund manager quoted in the Far Eastern Economic Review had this to say: "I would say that local investors tend to make markets more volatile because in general, in my experience, they are much more interested in punting on speculative stocks." I could add that in my experience, much the same could be said in reference to the Korean market where we often hear such expressions as "individual stocks" or "asset shares" or "M&A related shares" and so on. Many such shares are recommended to local individual investors regardless of the financial positions or business circumstances of the companies, which may be quite serious. To most foreign institutional investors, investment into such shares would be quite speculative and they are unlikely to make such investments.

To conclude, I would say that for a market to leave emerging status and enter developed status, the speculative element regarding the market's performance must be greatly reduced. Although Korea is not yet at that stage, I hope it soon will be.