4 Reasons To Buy, Not Sell, Emerging Markets

[I always find it amazing how little you hear in the news and other media about asset classes with recent poor performance. Asset classes like gold and emerging markets had a rough year last year, especially in comparison to US stocks. But that's exactly the reason you may have bought them in the first place. In my February column for [Physicians Money Digest](), I write about why I'm going to be buying some more Emerging Markets stock with this month's 401K contribution.]

People are apparently pulling money out of emerging market (EM) stocks like crazy. As of the end of January, EM funds had 13 consecutive weeks of outflows—the longest losing streak in 11 years.

While there is some data supportive of momentum investing, this seems a whole lot more like the old buy high/sell low behavior that smart investors are supposed to be avoiding. A review of the historical records supports this.

There were heavy outflows in 2008 and 2009, just in time to miss the 78% returns in the last 3 quarters of 2009 and the 19% returns in 2010. By the beginning of 2011, inflows were quite positive (I wonder why), and EM lost 18% that year. By the end of the year, money was flowing out of the fund, just in time to miss the 18% return in 2012. Now, with EM losing 4% in 2013 (while the S&P 500 returned over 30%) and another 4% so far in 2014, is there any surprise that money is flowing out like a fire hose?

This is classic performance chasing: a childish way to invest and the reason why investors underperform the funds they invest in by such a large margin. In fact, the more volatile the fund, the greater the difference between the returns of the fund and the returns of the investor’s dollars in that fund.

EM is a volatile asset class, but I’m buying, not selling, for four different reasons.

1. Emerging Markets are a good investment
EM stocks (think China, Brazil, India, South Africa, Russia, Mexico, Malaysia and similar countries) have provided solid returns for decades.

The Vanguard Emerging Markets Index Fund, my vehicle of choice for this asset class, has an annualized return of 6.7% per year for the last 20 years, enough to turn a $100,000 investment into $366,000. Returns for the last 10 years have been 9.3%, about 2.5% better than the US stock market.

Although the future is impossible to predict, especially in the short term, long-term future returns also look bright for this asset class, according to experts like global investment firm GMO, which predicts 6.8% annualized, after-inflation returns over the next 7 years, and *Forbes* columnist Rick Ferri, who predicts 7% returns after inflation over the next 30 years.

By comparison, their predictions for US stocks over those time periods are -2% and 5% respectively.

Clearly, EM stocks have a place in the portfolio of the long-term investor.

2. Emerging markets zig when US and other developed markets zag

The whole point of including different asset classes into a portfolio is to have some that, at any given time, are doing well while others do poorly. Diversification not only within an asset class, but also among asset classes serves investors well. Unfortunately, correlations between asset classes have been rising in recent years, which is a bad thing for the diversified investor.

However, EM stocks provide more diversification to a US-centric portfolio than most other stock asset classes. The Vanguard 500 Index Fund (US stocks) and the Vanguard Emerging Markets Stock Index Fund have a correlation of only 0.78, lower than the correlation with the developed market economies of Japan and Europe (0.86,) small-value US stocks (0.96), and small international stocks (0.85).

3. Emerging market stocks are on sale

In many ways, EM stocks are on sale. With similar long-term returns to the more developed markets in the US, Europe, and Japan, EM stocks missed the run-up seen in US markets over the last 13 months. While the S&P 500 is up over 30%, EM stocks are down about 8%.Although you can't predict when it will occur, reversion to the mean is a well-proven historical phenomenon. Valuation metrics bear this out. Price-to-earnings (P/E) ratios for EM stocks (~10) are not only low compared to their historical values, but they are very low when compared to US P/E ratios (~15).Another valuation measure, the price-to-book ratio (P/B), is below 1.5: a crisis valuation level. The P/B has only been that low during the Asian financial crisis, during the 9/11 terrorist attacks, and during the 2008 global financial crisis. When compared to the US market P/B (currently 3.5), EM stocks look incredibly cheap. Of course, that does not mean EM stocks won't get cheaper, but the long-term outlook seems awfully good.

4. My investing plan calls for it

My written investing plan calls for 5% of my portfolio to be allocated to EM stocks. Since these stocks have done poorly lately, I'm below my target ratio. Thus, it is time to buy some more.

Designing and following a written investing plan allows you to invest unemotionally. It forces you to buy low and sell high. Investors following a written investment plan don't have to know or care what the P/E ratios are, what the P/B ratios are, or what experts think EM stocks are going to do in the future. They only need to know whether or not their portfolio allocations are aligned with the investment plan, and they can figure that out with a calculator in 5 minutes once a year.

These four reasons demonstrate why my 401(k) contribution this month will be used to purchase EM stocks. Develop a written investing plan and follow it if you want to have success in reaching your investing goals.

Among commonly used stock portfolio building blocks, only REITs have a lower correlation with the S&P 500, and just barely at 0.74. While it would be great if all of these asset classes were completely uncorrelated or even negatively correlated, there's no doubt that when it comes to correlations between your asset classes, that 0.78 is a whole lot better than 0.96.

Do you hold EM in your portfolio? Why or why not? What do you think of their recent underperformance and possible future performance?