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## Markets & Investing

# Why the phrase emerging markets no longer applies



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INSIGHT

The term emerging markets is obsolete. They represent half of the world's economy; their financial markets are large and liquid, with volatility, corporate governance and government policies very similar to those of developed markets. The traditional distinctions between emerging and developed markets, once pronounced, have disappeared.

Because of their high growth rates, emerging markets are now too large to be ignored. On a purchasing power parity basis, China's gross domestic product is larger than Japan's, India's is larger than Germany's and Russia's is larger than the UK's. The BRICs (Brazil, Russia, India and China) are as large as developed Europe. Surprisingly, the rest of the emerging markets (ex-BRICs) collectively command a greater share of the global economy than the US.

Even though emerging markets have very large economies, the common misconception is that they have fairly small, illiquid and volatile financial markets. This is definitely not the case. Because of faster economic growth, the out-performance of their financial markets in the past decade and the fact that many private and government-owned companies

have recently been publicly listed, the market capitalisation of emerging markets has grown considerably and in total now represents 30 per cent of world market capitalisation, as much as the US. China now has a larger market cap than Japan. South Korea and Taiwan, two emerging industrial powerhouses, together have a larger market cap than Germany, and Brazil has a larger market than Australia.

Liquidity in these markets has also increased dramatically in recent years. So far in 2009, Chinese exchanges have traded more than the NYSE, South Korea more than France and India more than Canada.

Another argument against

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emerging markets is that they are too volatile and have unstable, unpredictable governments that leave them susceptible to coups or revolutions. In reality, however, volatility levels in emerging markets now nearly match those in developed markets. Even in the extreme market environment of 2008, emerging markets and developed market volatilities were very similar. So in terms of size, liquidity and volatility, emerging markets are on a par with developed markets and should not be discriminated

against because of antiquated notions around these criteria.

Another popular knock against emerging markets is their reputation for poor corporate governance and less market-friendly government policies.

These criticisms are no longer warranted. Not only have emerging markets risen to higher corporate governance standards, but developed markets' aura of quality in this area has also diminished considerably. Enron, Parmalat, WorldCom and Countrywide represent only a handful of examples in this regard.

Further, while the west lectured Asia and Latin America in the 1990s on government policy best practices, the reverse is occurring now as the US and Europe create a striking display of inconsistent and erratic policies often favouring special interests. The handling of, and policies surrounding, Lehman Brothers, Railtrack, GM, Fannie Mae, Northern Rock and Opel are just some recent case studies to ponder.

There is, however, one measure that highlights a clear and continuing distinction between emerging and developed markets: growth.

In the period 2003-2009, sales for "Emerging Markets, Inc" (an aggregation of publicly traded companies in emerging markets) grew 11 per cent annually versus 5 per cent for "World, Inc".

We believe that this differential in growth will continue for three main reasons:

the differentials in GDP and population growth will be maintained for the foreseeable future; many emerging markets' basic needs have not yet been met, so starting from a lower base, consumption and investments

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will continue to grow faster; and from a risk standpoint their companies were and continue to be less leveraged, with higher interest coverage ratios than those in developed markets.

In fact their coverage ratios have improved significantly as interest rates in emerging markets have come down dramatically.

Emerging markets should matter a great deal for all investors, now and for the rest of our investing lives. Yet today they still represent only 12 per cent of the MSCI All Country World Index, while representing 30 per cent of the world's market capitalisation, 50 per cent of the world's economy and the world's best growth prospects. Investors focusing on benchmarks will miss this opportunity.

The end of emerging markets is here. Investors who don't catch on to this reality risk being left behind.

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