



The Case for Emerging Markets

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Strap yourself in, close your eyes, and clench your teeth. It's time to invest in emerging markets.

U.S. stocks are still overvalued; the fear of rising interest rates is making high quality bonds less attractive. So what should investors do? We believe one area to be invested in now, as evidenced by our entry into these positions in the first quarter, is emerging markets.

In 1993 **Fidelity Emerging Markets** returned 82% as the U.S. and other developed markets were rebounding from the recession of the early 90's. We are near that stage in the cycle again. As the U.S. and other global economies recover from this recession, we believe emerging markets will again offer investors sweet rewards. Why? Emerging market economies, including Latin America, Southeast Asia, and Russia, rely heavily on exporting commodities to developed nations. Small increases in demand by developed nations, often lead to enhanced growth for developing markets.

Another factor supporting a rise in emerging markets stocks is rock-bottom valuations. After a multi-year slump, emerging markets hit a 16-year low relative to the S&P 500, based on price-to-book value and price-to-earnings ratios. We have already had a nice rally in emerging markets since September, but valuations are still at a multi-year low.

While emerging market investments are inherently higher risk, investing a small portion of your portfolio in emerging markets equity or income funds can actually reduce overall volatility in your portfolio. In recent years the real diversification benefit of investing in developed foreign markets has been called into question as these markets have increasingly moved in line with the U.S. market. Emerging markets exhibit a lower correlation with the U.S. markets than developed foreign markets, owing in large part to the often independent political and economic risks surrounding each country.

One interesting observation made about emerging market risk recently is that related to the Enron scandal. For years, U.S. stocks have enjoyed a premium over much of the rest of the world, in part because of stricter corporate governance and accounting standards in the U.S. that seemed to offer investors some guarantee that their stocks wouldn't blow up in scandal. In some cases, the price discount between similar U.S. and emerging market companies was as much as 50%, in part to compensate for weak bookkeeping standards abroad. But that discount is now being reconsidered following revelations at Enron, as well as questions about balance sheet maneuvers by other major U.S. corporations. In the wake of all this, emerging markets don't seem quite so risky after all.

For more aggressive investors we recommend **Fidelity Emerging Markets**, **Templeton Developing Markets**, or **UAM Acadian Emerging Markets** for equity exposure to these markets. For more conservative investors we recommend **Fidelity New Markets Income** or **PIMCO Emerging Markets Bond**. In all cases, however, we suggest keeping these positions at 5% to 15% of your portfolio, with 20% a maximum.