FINANCIAL TIMES

Emerging stocks offer better returns and less risk

Burton G Malkiel

Investment allocation among different asset classes and national markets is the major determinant of a portfolio's return.

While correlations have increased between different national markets, there have been vast differences in the performance of those markets. In the years ahead, three important factors are likely to have a large impact on the performance of the stock markets in different countries.

These are: the debt levels of both governmental and private units which will play an important role in the ability of different economies to sustain growth; demographic trends which will have a strong influence on the ability of a national economy to generate non-inflationary growth; and the end of cheap, abundant resources which will cause an increase in their value and favour economies of nations relatively rich in those resources. Investment policy has paid too little attention to these crucially important long-run trends.

Let's look at debt first.

According to the International Monetary Fund, the G20 advanced economies had a debt-to-gross domestic product ratio of more than 100 per cent in 2010. By 2015, that percentage is projected to rise to 125 per cent. And these debt burdens represent only the tip of the iceberg. In countries such as the US, the debt of government-sponsored entities and state and local governments is more than double the federal debt burden. Moreover, the calculation does not include the vast unfunded liabilities for programmes such as Medicare, Medicaid, and Social Security. Nor does it consider personal debt, which more than tripled during the housing bubble of the early 2000s.

In contrast, public debt levels are less than one-third of GDP in emerging markets and are projected to decline to only one-quarter by 2015. Moreover, unfunded liabilities there are tiny compared with the developed world, and household balance sheets are healthy.

Debt at the levels currently existing in the world's developed economies has historically been associated with lower long-run capital accumulation, poorer

productivity growth, and lower levels of real economic growth. Debt levels also constrain the flexibility of fiscal policy and risk a full-scale economic crisis.

Demographics also favour emerging markets.

Demographers use a simple statistic – the dependency ratio – to measure the youthfulness of a country's population. The ratio of retirees to workers is rising sharply in the developed world. By 2025 there will be as many non-workers as working population in Japan. Italy, Germany, and France will have almost one non-worker for every worker. Demography interacts with debt levels by placing larger burdens on entitlement spending and significantly reducing growth rates. Yet in Brazil and in Southeast Asia, dependency ratios will remain low. In India, dependency ratios will actually fall over the next two decades. Even in China, with its one-child policy, the ratio of retirees to the working age population will be less than 30 per cent in 2025.

Finally, the period of abundant natural resources and falling prices is over.

The world is using up its natural resources at an alarming rate. Our supplies of hydrocarbons, metals, land, and water are finite. It is very probable that in the long-run the (inflation-adjusted) prices of commodities will rise. This creates excellent long-term investment opportunities in companies and countries with abundant natural resources – not only oil and metals, but also arable land and abundant water.

Debt, demography, and diminishing natural resources have already engendered a major shift in the growth of different economies. The developed economies with unsustainable levels of both governmental and private debt and with ageing populations will inevitably experience slower growth and poorer performance. The equities of emerging economies with more favourable debt levels, demography, and abundance of natural resources will benefit relative to countries less favourably situated.

Valuations in these and other emerging markets are approximately the same as those in the developed world, which has far poorer growth possibilities. Certainly, many of these emerging economies carry with them a considerable amount of political risk. But different risks, and possibly even greater ones, face developed economies such as those in the US, Europe, and Japan.

The question for investors is whether enough of their equity portfolio is allocated to emerging markets or to companies in developed markets that

derive most of their sales and earnings from their activities in the most rapidly growing regions of the world.

I believe an examination of most portfolios would indicate that they are severely underweighted to the most dynamic growth economies of the world.

Burton Malkiel is Professor Emeritus of Economics at Princeton University and the author of 'A Random Walk down Wall Street' and 'The Elements of Investing'