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Time to switch risk labels

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This is an occasional series for individual investors tiptoeing into emerging markets. Today we look at how to evaluate risk.

With two separate trillion-dollar government bailouts in the Western World in as many years, investors might need to rethink their foreign-content risk.

Traditional asset-allocation models that rely on crude distinctions between developed and developing markets look flawed today, and investors who lump developed-market investments into a low-risk bucket and emerging-market investments into a high-risk bucket are out of step with the times.

For example, where would you put an economy with a budget deficit equal to roughly 10% of GDP this year and last and public debt that will rise by half relative to GDP over the next decade? "Definitely high risk," you might say. If that is your answer, what are U.S. equities and bonds doing in your low-risk bucket?

Emerging markets are constituents of the high-risk investing bucket, but they do not appear more risky than the "submerging" markets of United States and Europe. In fact, wholesale label switching might be the best approach.

The IMF predicts public debt in so-called advanced economies will have risen from 70% of GDP prior to the credit crisis to 110% of GDP by 2015. In contrast, public debt in emerging and developing economies will have declined to a mere 30% of GDP by 2015.

This data may come as a surprise to investors knowing full well that governments in both developed and developing economies saw budgetary revenues decline last year, yet spent liberally to offset the effects of falling exports and declining consumer demand on their economies.

One crucial difference between developed and developing country debt-to-GDP ratios is the greater bang for the buck from public spending in emerging markets this year and last. For all the fistfuls of dollars thrown at the problem, advanced economies will grow only 2.3% this year compared with 6.6% growth in the emerging and developing economies, according to IMF estimates.

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For emerging markets and debt, it is a case of rolling stones gathering no moss. Ten per cent annual growth in China means its economy doubles in size roughly every seven years. So, China, and many other emerging markets, will literally grow its way out of any debt burden. Not so the developed nations where high debt levels could keep these countries stuck in a cycle of high interest rates, rising bond yields and weak economic growth.

For its part, the euro region will have seen public-debt ratios balloon by roughly 50% between 2007 and 2015, according to IMF estimates. Moreover, the highly indebted PIGS (Portugal, Ireland, Greece and Spain) are being fitted into a hair shirt of fiscal prudence in exchange for renewed market or government loans. Recessions will be the probable outcome.

Our research shows the BRIC nations (Brazil, Russia, India and China) posed minimal additional risks to a traditional portfolio of Canadian equities and bonds and developed-market foreign content. In fact, a 10% allocation to BRIC investments substantially enhanced annualized returns.

The message is clear: BRIC investments still carry the stigma of high-risk relative to U.S. and international equities, but that antiquated notion needs to kick the bucket.

- Levi Folk is a consultant to Excel Funds, a Toronto-based mutual fund company specializing in emerging markets.

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