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Emerging markets: Near the point of maximum pessimism?

By Brian Jacobsen, Ph.D., CFA, CFP®, Chief Portfolio Strategist

Summary

- The trickier and more relevant question than what has happened in the emerging markets is what *will* happen?
- Some positive changes are taking place in most, though not all, emerging markets countries.
- Investors should ask themselves if they can identify the risks, if they can understand the risks, and if they are paid to own the risks.

The famous investor and philanthropist Sir John Templeton said, “Invest at the point of maximum pessimism.” That might be where we are with emerging markets stocks.

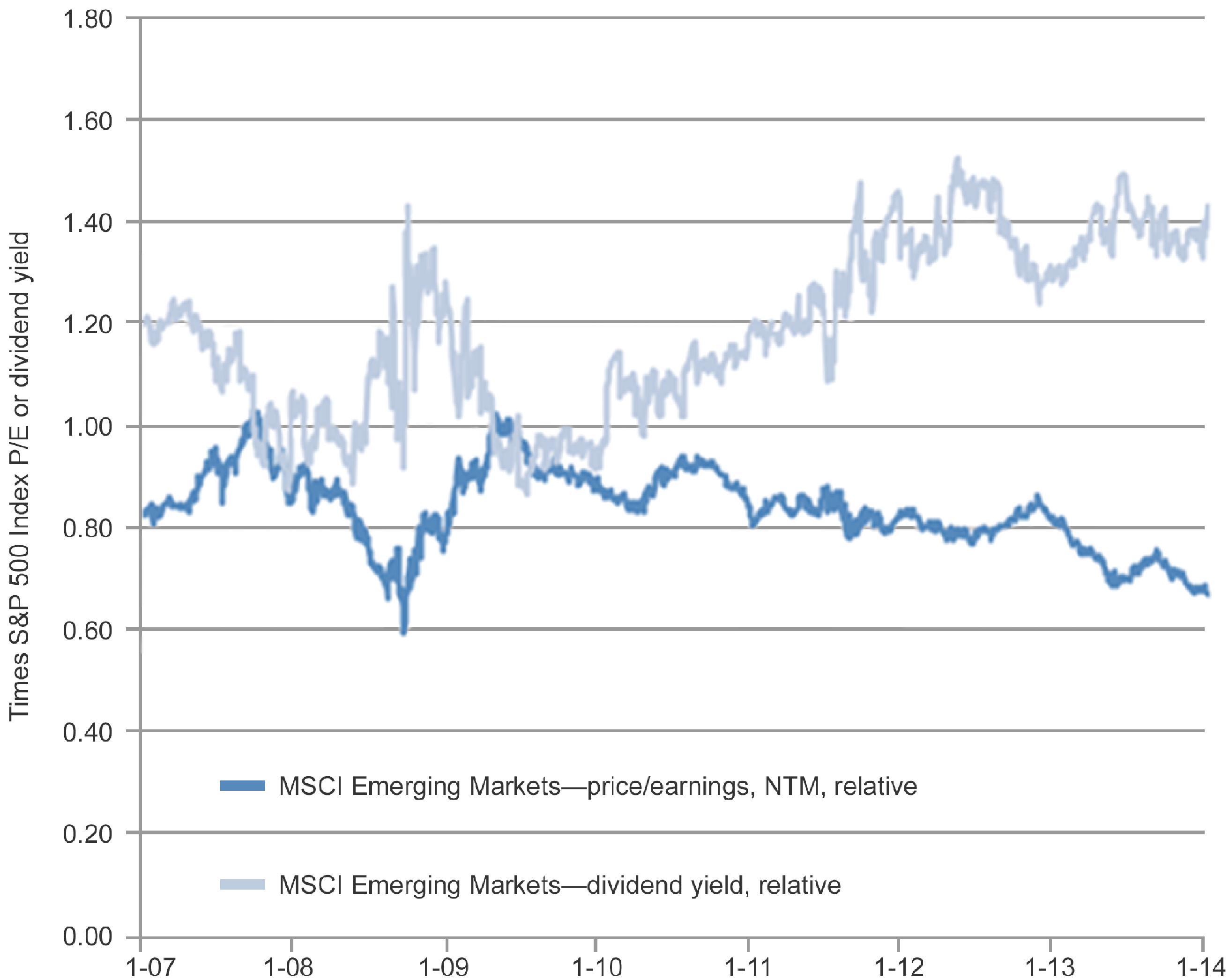
When investors talk about the emerging markets, you need to ask which countries they’re referring to. I generally use the MSCI list, which does not include Argentina or Ukraine, which are hotbeds of problems. For emerging markets where U.S. investors can actually invest, I think companies are looking pretty cheap, and it’s likely too late to try to underweight them. The trickier and more relevant question than what has happened in the emerging markets is what *will* happen?

From a valuation perspective, the emerging markets complex is at a 33% discount relative to the S&P 500 Index. For perspective, in 2007, it was at a 13% discount. Political issues in Argentina, Turkey, and the Ukraine are tarnishing the other emerging markets countries.

The changing composition of the emerging markets indexes

From 2007 to 2013, the dividend yield of the MSCI Emerging Markets Index increased relative to the S&P 500 Index’s dividend yield. So, investors aren’t just paying for growth, they are also getting income (see chart below). This may reflect the changing composition of the emerging markets indexes as well as changes in the countries themselves. At the beginning of 2007, the financials sector was the biggest sector of the MSCI Emerging Markets Index, at 20.92% of the index compared with 22.44% of the S&P 500 Index. As of the beginning of 2014, financials made up 26.26% of the index, while the S&P 500 Index’s financials exposure declined to 16.13%. Although the MSCI Emerging Markets Index has gotten a bit more concentrated in the financials sector, it has become more diversified in terms of the exposure to any one company’s stock. In 2007, the largest holding made up just under 4.5% of the index (a Russian oil company). In 2014, the largest holding was 3.74% of the index (a Korean electronics company).

Investors aren't just paying for growth, they are also getting income



Source: FactSet

In terms of country exposure, the index has also changed over time. This highlights why I think investors should be careful about blindly following an index. In the MSCI Emerging Markets Index, the largest country exposure is China, at 19.76%. Don't get me wrong, I like China as an investment destination, but a lot of the index exposure is in China's banking industry, and I don't have an optimistic outlook for that industry. I'm more optimistic about telecommunication services, industrials, energy, consumer staples, consumer discretionary, and health care (pretty much everything except banks and materials).

Positive changes in most, though not all, emerging markets countries

Some positive changes are taking place in most, though not all, emerging markets countries. Mexico is opening up and reforming the regulation of many of its markets. Chile, Colombia, Mexico, and Peru have created the Pacific Alliance, a trade bloc eliminating tariffs on a majority of trade among the countries. India's central bank is gaining credibility in fighting inflation. Brazil's central bank also appears to be moving in the right direction with inflation and currency. Despite being a basket case, even Argentina is beginning to make some small improvements in the way it officially calculates and reports inflation.

There will always be risk. Investors should ask themselves if they can identify the risks, if they can understand the risks, and if they are paid to own the risks. The currency and political issues are identified, understood, and well compensated in quality companies. Quality means companies that have good corporate governance and consistently generated operating cash flows. A lot of those companies are out there, but you have to dig through a bit of rubble to find them.

Bottom line? When investments are on sale, I think it's time to start increasing, not decreasing, exposure.

Dividend yield is a financial ratio that shows how much a company pays out in dividends each year relative to its share price.

Price to Earnings (P/E) is the price of a share of a stock divided by earnings per share, usually calculated using the latest year's earnings.

The Morgan Stanley Capital International (MSCI) Emerging Markets Index is a free float-adjusted market-capitalization-weighted index designed to measure the equity market performance in the global emerging markets. The index is currently composed of 21 emerging markets country indexes. You cannot invest directly in an index.

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