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Emerging markets a source of stomachaches for advisers

But investors still poured money into the funds in the second quarter

By **Sue Asci**
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Some financial advisers are still cautious about emerging markets despite the fact that investors poured an estimated $4.3 billion into the equity-fund sector in the second quarter and the opinions of leading fund managers, who say future growth potential is outside the United States.

Wealth is moving away from the United States, Mohamed El-Erian, co-chief executive and co-chief investment officer of Newport Beach, Calif.-based Pacific Investment Management Co. LLC, said in an interview last month at Morningstar Inc.'s investment conference in Chicago.

Emerging economies are contributing to global growth at higher rates, he said.

That growth has delivered comparatively good returns.

As of July 9, diversified emerging markets had an average one-year trailing return of -8.69%, a three-year trailing return of 23.21% and a five-year trailing return of 25.73%, according to Chicago-based Morningstar.

The returns far exceed those of the Standard & Poor's 500 stock index during the same time. The index produced trailing returns of -18.75% for the one-year period, 0.89% for the three-year period and 4.43% for the five-year period.

Still, many advisers aren't jumping on the bandwagon, despite clients' enthusiasm.

Clients don't typically call about shifting investments, but they have been asking about emerging markets, said Steve Medland, partner and principal at TABR Capital Management LLC of Orange, Calif., which manages $155 million in assets.

"The contrarians in us make us kind of nervous when people start asking. Some people are basing their investment decision on old news," Mr. Medland said.

"It could be just at the point where the market has reached its potential or is becoming overvalued," he said. "We are proceeding with caution."

His clients' exposure to emerging markets is limited to about 10% to 15% of a portfolio, Mr. Medland said.

"From a diversification standpoint, it makes sense to have exposure to this market," he said.

While billions flowed into emerging markets since January, on a monthly basis, the numbers have been choppy. April and May tallied cash inflows in the billions, but June saw outflows.

And although all equity markets took a hit this year, some areas fared better than others.

For instance, Latin American funds returned -3.77% for the year to date through July 9, compared with -15.23% for the S&P 500.

But diversified emerging markets posted a return of -16.62% and the Pacific/Asia region returned a dismal -28.45%.

The performance ups and downs make some advisers leery.

Clients should have a small exposure to emerging markets, said Joseph Alexopolous, principal of Aequitas Wealth Management LLC of Los Angeles, which manages $18 million in assets. "It ranges from 2% to 4% of the entire portfolio,"he said.

"It's not that we don't believe in them or that the values aren't good, but it's done too much too quickly," Mr. Alexopoulous said.

And he isn't confident that emerging market investments can keep up the pace.

"It's very reminiscent of the [technology] boom of the late 1990s," Mr. Alexopoulous said.

Emerging markets can be difficult to wrap one's arms around, as they react to global trends differently, Mr. Medland said.

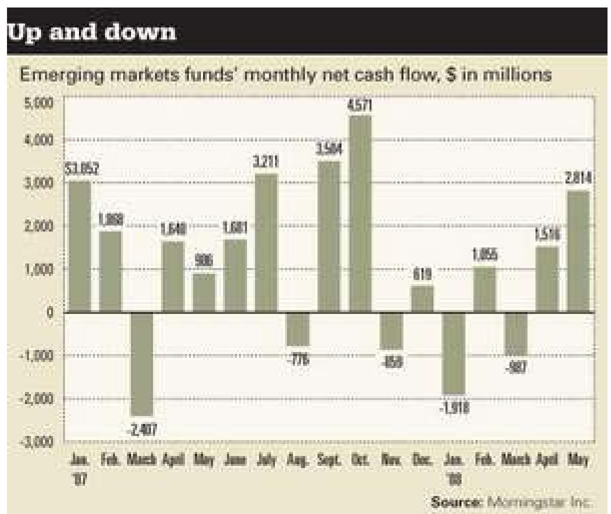
"China is more dependent on oil right now than other less-developed countries," he said. "Higher oil prices may end up really hammering China, and other countries may not be as affected."

As the United States becomes a smaller percentage of the world's economic output, interest is rising in overseas investing, said Mark Berg, president of Timothy Financial Counsel Inc. of Wheaton, Ill., established in 2000 as a fee-only firm.

And yet emerging markets shouldn't represent more than 5% of a portfolio and even less for those who are conservative or retired, he said.

'RISKY SECTOR'

"It's a very risky sector," Mr. Berg said.



"There is political instability," he said. "You're dealing with Third World countries and small companies."

Others think it is time to embrace investing in emerging markets more boldly.

International investments should comprise about 40% of a portfolio and of that portion, 15% to 20% should be in emerging markets, said Bill Carter, founder of Carter Financial Advisory Services of Dallas, which manages $800 million in assets.

"We are going to have to look at this thing different than in the past," he said. "I think we are going to be diversifying to a greater degree than we've ever done."

Clients should have exposure to emerging markets but expect volatility, said Marjorie Determan, owner of Financial Strategies of Northern California in Nevada City, Calif., which oversees $60 million in assets. She said her firm recommends that clients' portfolios have about 8% or 9% in emerging markets.

"There's a lot more internal growth that can happen that has already happened in the developed markets," Ms. Determan said.

Fund managers maintain that there is a great deal of potential.

Much of the strong performance of Latin American stocks has been commodities-based and generated by Brazil, said Sophie Bosch, country specialist for Latin America and portfolio manager of JPMorgan Latin America Fund (JLTAX). The fund is part of JPMorgan Asset Management Holdings Inc., a subsidiary of the New York-based JPMorgan Chase & Co.

The collective GDP of Latin American countries is expected to grow over the long term. Ms. Bosch said she expects to see better performance among small- and mid-cap companies.

Taiwan has also fared well, said Sharat Shroff, co-lead manager of the Matthews Pacific Tiger Fund (MAPTX) and co-manager of the Matthews India Fund (MINDX) and Matthews Asia Pacific Fund (MPACX). The three are offered by Matthews International Capital Management LLC of San Francisco.

But growth in China and India may become more moderate beyond this year, Mr. Shroff said.

Health care has held up. The next growth areas in China and India could be consumer staples and goods such as mobile telecommunications, Mr. Shroff said.

The Laudus Mondrian Emerging Markets Fund (LEMIX) has also been overweight in Taiwan this year, said David Hogan, a client portfolio manager at San Francisco-based Charles Schwab Investment Management who oversees the relationship with Laudus Investment Partners Ltd. of London.

But some managers are optimistic across the board.

There is broad-based growth po-tential, said Patricia Ribiero, portfolio manager for Kansas City, Mo.-based American Century Investments' Emerging Markets Fund (TWMIX).

"The drivers of growth globally are still emerging markets," she said.

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