

# Does Investing in Emerging Markets Still Make Sense?

## ACADEMIC PERSPECTIVE

Whether from a 14% loss of value in Argentina's peso following President Mauricio Macri's unexpectedly poor performance in party primaries or further weakening of China's onshore renminbi after another round of tariffs on U.S. imports, signs of the high-risk nature of investing in emerging markets (EM) are all around us.

For seasoned EM investors, these events may look like routine market turbulence. Maybe the turbulence is worth enduring for the additional diversification or the boost in return that tends to go hand in hand for global investors participating in such markets? Maybe it is not the political economic uncertainty as much as the binding institutional constraints that hold back investors from more active engagement in emerging markets. These constraints include restrictions on market access, operational inefficiencies, weaker corporate governance systems and limits on legal protections for minority investors. Indeed, emerging markets have been a core component of many investors' portfolios because these very institutional constraints have tended to hold those markets back from fully realizing their economic growth potential and thus fully converging with the rest of the developed markets world.

More market watchers these days are questioning whether convergence is really happening. These experts point to forecasts of slowing economic growth, receding foreign direct investment flows, declining labor market productivity, ballooning non-financial sector debt, and even trend reversals, like reshoring, that disrupt the trade and global manufacturing supply chains that have sustained emerging markets for so long.

Investors evaluating emerging markets as an asset class size them up relative to their full investment opportunity set. Recent research in finance highlights some of the drivers behind capital allocation across countries and allows us to put emerging markets into better context. It matters how you access emerging markets and who you are.



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## UNDERSTANDING INDUSTRY FAMILIARITY

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A recent study by McGill University's David Schumacher examines the holdings of over 2,000 international mutual funds around the world with the goal of understanding what researchers call the "foreign bias puzzle."<sup>1</sup> It is a close cousin of the "home bias" puzzle, which asks why investors systematically forego the benefits of international diversification by investing disproportionately in the stocks of their home countries.

The foreign bias, by extension, asks why investors mandated to pursue opportunities abroad inexplicably favor the stocks of countries more geographically, institutionally or culturally proximate when the real economic benefits often lie well beyond.

Schumacher's hypothesis is that it is all about information. And specifically, information about the industries that constitute these overseas markets. He offers evidence

that about half of the foreign bias puzzle can be tied to how international mutual fund managers overweight industry sectors in target countries that are comparatively large in their domestic market. Funds managed out of Switzerland overweight non-Swiss pharmaceutical stocks by 1.1% relative to the global benchmark index, while funds managed out of the U.S. overweight technology stocks by 1.8% relative to the benchmark.

The research argues that this perceived industry-information advantage persists over time and it is just as robust among investments targeting emerging markets as those in developed ones. Well-diversified passive strategies tend to avoid these biases because their allocation to countries is not driven by their portfolio managers but by the size of each market in the global market portfolio.

## KNOWING FOR WHOM EMERGING MARKETS REALLY MATTER

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So much of what we understand about the home-bias and foreign-bias puzzles, particularly as it relates to emerging markets as targets of opportunity, arise from country-level analysis of foreign holdings, trades and return performance. Naturally, we wonder about country-level attributes, such as the quality of corporate governance systems, level of stock market development and foreign investment restrictions. But are some investors more susceptible to those home/foreign biases than others? Data limitations have often hampered the ability of researchers to do a deep dive into such a question; we need granularity practically at the individual or household level to get at it.

A recent study by Geert Bekaert, Kenton Hoyem, Wei-Yin Hu and Enrichetta Ravina breaks through the impasse with an analysis of international equity allocations of 3.8 million individuals across 296 different 401(k) plans.<sup>2</sup>

They uncover just how much personal characteristics, such as age, salary and wealth, play a role in their asset allocation decisions. Higher salaries, more education and higher house values are associated with higher international allocations, especially to emerging markets. For example, shifting the proportion of people with a bachelor's degree or higher from the 5<sup>th</sup> to the 95<sup>th</sup> percentile of the distribution is associated with a 1.54% higher international allocation. Even more intriguingly, the researchers find the zip code in which an investor lives and even the firm she works for can matter. Peer effects matter, too. Zip codes with a higher percentage of the population born in foreign countries have higher international allocations, even after controlling for the wealth and house value per zip code. This provides another boost to the idea that greater familiarity and perhaps more information and awareness because of *who you are* and *where you are from* matter as investors pursue opportunities in complex emerging markets.

## THE COMING WAVE OF EMERGING MARKETS-BASED INVESTORS

So much of our focus targets investors in developed markets pursuing opportunities in emerging markets. It turns out that EM-domiciled investors are now playing an increasingly prominent role as portfolio and foreign direct investment (FDI) outflows are rapidly gathering momentum. From 2000 to 2018, foreign exchange reserves held in EM central banks grew by over \$5 trillion, with the People's Bank of China driving about half of this increase. According to the International Monetary Fund's Coordinated Portfolio Investment Survey, overseas holdings by emerging market-based investors exploded from less than \$100 billion in the early 2000s to nearly \$1 trillion today.

Do these ever more influential EM-based investors—what my Cornell University colleagues, David Ng and Eswar Prasad, and I call “the coming wave” in a forthcoming article—reveal the same unexplainable home- and foreign-bias tendencies as their developed market-based counterparts?<sup>3</sup> Or, do they pierce the veil of these many problems related to corporate opacity, accessibility constraints and political instability by stepping into other emerging markets with more gusto? Not so much, it turns out. Our research shows that they appear to be even more susceptible to the same kind of heuristic biases relying on information readily at their disposal.

## THE BOTTOM LINE EMERGING MARKETS STILL DO MAKE SENSE

EM investing is not getting any easier, and it still requires a disciplined framework to understand the transparency of the institutions that anchor these markets. However, convergence is unlikely to be played out anytime soon, the diversification benefits continue and there are many other reasons why pursuing opportunities in emerging markets still makes sense. Given the heightened flows from investors in emerging markets toward developed

Our research measured these relationships by evaluating the intensity of historical FDI and trade flows between the home (developed market) and destination (EM) countries from the 1990s. It turns out that a long-standing relationship between Malaysia and the U.K.—with business contacts and investment relationships secured along the way—is associated with significantly higher investment allocation to the U.K. from new Malaysian-based investors today. To further demonstrate the power of these relationships, we show that EM-based investors' allocations to developed destination markets are guided by the existence of subsidiary locations in emerging markets of the parent investment firm and even to other emerging markets by the location of other foreign subsidiaries of the same parent company. For developed market investors who are now increasingly competing with EM investors for investment opportunities in these same target countries, it is clearly important to be aware of the factors driving their foreign allocations, especially as they go beyond traditional drivers of global diversification.

markets, there is likely more integration ahead. Awareness of the global diversification opportunities that greater integration bears out will be a key success factor. What's the big takeaway? For many equity investors, exposure to developed and emerging economies through a globally diversified portfolio likely remains a sensible means of accessing these opportunities.

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### Glossary

**Central bank.** Entity that oversees a nation's monetary system.

**Foreign direct investment.** An investment made by a firm or individual in one country into business interests located in another country. According to the International Monetary Fund, direct investment reflects the aim of obtaining a "lasting interest," which implies the existence of a long-term relationship between the direct investor and the direct investment enterprise and a significant degree of influence on the management of the latter.

**Foreign exchange reserves.** Assets that central banks hold on reserve in foreign currencies to back liabilities and influence monetary policy.

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### Endnotes

<sup>1</sup> David Schumacher, "Home Bias Abroad: Domestic Industries and Foreign Portfolio Choice," *The Review of Financial Studies* 31, no. 5 (May 2018): pp. 1654-1706, <https://doi.org/10.1093/rfs/hhx135>.

<sup>2</sup> Geert Bekaert, Kenton Hoyem, Wei-Yin Hu, and Enrichetta Ravina, "Who is internationally diversified? Evidence from the 401(k) plans of 296 firms," *Journal of Financial Economics* 124, no. 1 (April 2017): pp. 86-112, <https://doi.org/10.1016/j.jfineco.2016.12.010>.

<sup>3</sup> Andrew Karolyi, David Ng, and Eswar Prasad, "The Coming Wave: Where Do Emerging Market Investors Put Their Money?" forthcoming in *Journal of Financial and Quantitative Analysis*, (2020).

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