OPINION

Looking for superior returns? Consider investing in emerging markets instead of the U.S.

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The U.S. stock market has been on a roll in recent years. Its performance has outshined that of emerging markets, which have been flat over the last 15 years.

It is tempting to extrapolate that such a gap will continue and even get wider in the years to come. But can this continue in the long run?

Nowadays, everyone is talking about artificial intelligence (AI) and the U.S. market, but when everyone talks about an investment idea at the same time, prices tend to be bid above fundamentals and the risk increases of a bubble developing. AI may supercharge productivity and the economy, but for now this is purely hypothetical.

Nevertheless, it's worth noting that no economy is immune to the business cycle, namely, the short-term fluctuations of business activity around fundamental values, which are driven by human over-optimism and over-pessimism. But even if U.S. economic activity continues unabated, there is no evidence that economic growth will result in rising stock markets.

If we assess economic growth over several decades, one decade at a time, and relate such growth to stock market returns, we will see there is little correlation between economic growth over 10-year periods and stock market returns. In other words, decades with higher economic growth haven't necessarily led to greater stock market returns. In fact, noted investor Warren Buffett has repeatedly mocked those who forecast the economy in order to forecast the stock market.

Moreover, there is enough evidence to show that high-growth companies tend to underperform low-growth companies in the long run. Researchers at the Darden School of Business examined the asset growth of U.S. firms over the last 40 years and compared

the stock performance of high-growth firms with that of low-growth firms over that period. They found that low-growth firms outperformed the high-growth firms by a whopping 22 per cent, on average per year, over the 40-year period. High-growth stocks tend to attract a lot of attention and a lot of trading by investors and thus they tend to become overvalued, leading to low returns going forward – and this may also be true for high-growth countries.

That is, high-growth countries may underperform low-growth countries in the long run, as investors get overoptimistic about growth, falsely assuming high growth rates will continue and, as humans tend to herd, they all make similar investment calls. All this leads them to bid prices above fundamentals.

As you may recall, in the early 2000s no one loved the U.S .market. Everyone was recommending investing in the BRICS bloc - Brazil, Russia, India, China, and South Africa. But which was the best market in the world over the last 20 years? The U.S. market.

In my opinion, superior stock market performance could transfer to emerging markets, but only those with the following characteristics.

First are emerging markets that have a more diversified economy, as opposed to markets where growth depends on resources. Resources are very volatile, have shown no clear upward trend in the long run and will ultimately be depleted.

Second are emerging markets which have a more democratic government or are moving in that direction. This reduces the possibility of an uprising, revolution or confiscation of private property.

And third are emerging markets that have population growth and a growing middle class, with governments that are willing to make investments in education and innovation.

Mexico and India are two countries, for example, that have these favourable characteristics.

In general, emerging markets, especially the smaller ones, should play a key role in everyone's portfolio as they tend to have lower correlation to the rest of the world than developed markets. This gives investors greater diversification benefits.

But make no mistake: There are many risks lurking in the background of emerging markets. They are macro and micro – political, economic and social, as well as management quality, accounting clarity, reliability of numbers and auditor experience, corruption both political and corporate, corporate governance issues, poor regulation, foreign exchange risk, liquidity risk, thin trading problems that adversely affect risk measures, and so on.

Most of the above company-specific problems can be avoided by investing in country-specific emerging market indexes as opposed to individual stocks – and that would be my advice for retail investors.

Alternatively, a less-risky option for retail investors may be to invest in Western companies that carry a large portion of their business in emerging markets. Especially for small, risk-averse investors with fewer resources and know-how, this may be the best way to capture the opportunities of emerging markets and avoid potential problems.

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