

# Other Emerging Markets

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One major sin committed by Wall Street (besides creating a financial crisis that put millions out of work and causing untold suffering) is creating not only the illusion of constant growth in emerging markets, but also convincing investors and, sadly, many world leaders, that the asset class is filled with markets that are somehow exactly alike.

As we have seen from the review of the BRIC countries, each of these markets has a common relationship-based structure. This ensures a methodology for analysis. It also creates a framework that guarantees they have several things in common with one or two other countries; however, the list of differences far outweighs the similarities. The main thing that Brazil, Russia, India, and China have in common is a history of socialist policies. But even in this regard, there are vast differences. Russia and China tried very hard to wipe out any form of private enterprise. Brazil and India just tried to suffocate private enterprise with bureaucracy. China is at the center of globalization. India is barely a part of it. Russia and Brazil rely heavily on commodities. China and India mostly consume them. India and Brazil are democratic countries. China is not and has absolutely no interest in becoming one.

Each has a legal infrastructure that has encouraged their relationship-based systems in different ways. China and Russia have arbitrary systems that function at the whim of the elite. India and Brazil have created systems where

the law creates so many obstacles that it prevents itself from serving its purpose. Each of these systems, depending on global economic conditions, can and does enjoy periods of strong economic growth. But none of these periods creates the necessary basis for sustainable economic growth as advertised by the financial marketing mavens. Yet the sales pitch continues.

It is one pitch in a long line of pitches. Before the BRIC countries, there were the East Asian Tigers. These included Malaysia, Singapore, Thailand, Indonesia, the Philippines, South Korea, Hong Kong, and Taiwan. Prior to the Asian meltdown in 1997, these economies were considered paragons of correct economic management. For example, *The Economist* stated that “The gleaming high-rise buildings that fill the skylines of East Asia’s capital cities used to be seen as symbols of the region’s economic success. Malaysians boasted about having the world’s tallest building; Bangkok bankers joked that the crane had become Thailand’s national bird.”<sup>1</sup>

The paths of these economies have been very different. Some went on to shed any trace of developing country status. Singapore has one of the highest per capita GDPs in the world. The average Hong Kong resident makes about the same as the average American. The people of Taiwan are better off than people in the United Kingdom. South Korea is ranked just below many of the EU countries and above others.

In contrast, Malaysia never quite made it. It remains in the mid ranks, about the same as many Latin American countries, and at the same level as poorer eastern European economies. Thailand is also stuck just below the world average. The Philippines and Indonesia remain truly poor, at about the same level as India.

Yet despite the vast differences between these economies, they were and to a certain extent still are lumped into the same category as part of the “emerging market” growth story. However, it should be obvious from the subsequent history of the Asian Tigers that they are quite diverse.

Each and every country in the asset class offers the investor quite distinct risks and opportunities. The one thing that remains consistent, except as a matter of degree, is that all these markets are relationship-based systems and all exhibit the four major factors typical of relationship-based systems we discussed in Chapter 2—the dominance of family-owned companies, large underground economies, corruption, and state-owned companies.

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<sup>1</sup> “Tigers adrift: After three decades of whirlwind growth, many of East Asia’s tiger economies are in the doldrums,” [www.economist.com/node/114999](http://www.economist.com/node/114999), March 5, 1998.

But Wall Street cannot burden investors with something as complex as actual analysis. You can't discuss the differences between all these economies in a sixty-second spot on CNBC. Thus, Wall Street developed short phrases, such as Asian Tiger economies. Asian Tiger economies of course morphed into BRICs. BRICs expanded into the general concept of Emerging Markets and now we have Frontier Markets. Although the concept has evolved, there is one consistent theme.

Starting with Jim O'Neill and the acronym BRICs in 2001 through Thomas Friedman and *The World Is Flat*, the general idea is that the developed world is somehow declining and that rapid and guaranteed growth is only available in emerging markets. This thesis is so attractive that it has been adopted by almost every commentator, fund manager, financial analyst, money advisor, economist, politician, and even some world leaders. But as we saw with Brazil and the Asian Tigers, it simply is not true. Emerging markets can and do grow, often very quickly. Investments made at the right time can make a lot of money. But this is true for almost any stock in any asset class. Like any investment, the reverse is also true. Investments made at the wrong time in the wrong country can be disastrous.

The O'Neills and the Friedmans of this world are very much alive and well, dishing up the same falsehoods. A recent example appeared on the Dow Jones website, MarketWatch. The article concerned some of the world's smallest micro exchanges, including Cambodia, Mozambique, Laos, Cameroon, the Maldives, Cape Verde, Swaziland, Namibia, Libya, Armenia, Tanzania, and Syria. The author's take was that "these bourses hold the biggest potential for trading in and on the future ... I bet these scrappy markets will beat out anything the developed world has to offer. In fact, in the first days after opening, the Laos exchange zoomed more than 80%."<sup>2</sup> Thankfully, he also noted that "It dropped precipitously afterward." I might point out that the Laotian stock exchange has only two listed companies, both state-owned enterprises.

The commentator's thesis was that many of these countries are sitting on most of the world's commodities and large populations of cheap labor. Since labor is becoming expensive in places like China and since China has a constant growing demand for commodities, these exchanges and the few stocks listed on them have no place to go but up. The whole idea is simply absurd.

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<sup>2</sup> Thomas Kostigen, "World's smallest stock exchanges can only go up: Commentary: Resource-rich Africa, Asia should be on your radar," *MarketWatch.com*, [www.marketwatch.com/story/worlds-smallest-stock-exchanges-can-only-go-up-2011-07-22](http://www.marketwatch.com/story/worlds-smallest-stock-exchanges-can-only-go-up-2011-07-22), July 22, 2011.

The assumption is that the labor force is educated enough to make something and is at the end of an infrastructure that actually allows their labor to be part of the global supply chain. The thesis also assumes that China's demand for commodities will continue and that the commodities can be profitably extracted and exported. Sure, Afghanistan has large amounts of copper, gold, and tin; but its links to the global marketplace do not exist nor can they be built any time soon.

These countries are also exceptionally corrupt. For an investor, especially a foreign investor, there has to be a legal nexus between the investment and the investor in order to make money. First, there have to be sufficient property rights to ensure a corporation has actual title to real assets that cannot be taken away at the whim of a faceless bureaucrat (for example, because his mother-in-law needs a new house). The corporation must also be governed by rules that can be enforced by a reasonably honest court within a time frame not measured in generations. The corporation must also be subject to independent, well-financed regulators with sufficient power to force the management of the corporation to actually tell the truth about its assets. In many of these countries, legal protections simply do not exist and there is no reason to believe they will be created any time soon. This hype is simply the stupid and dangerous idea that emerging markets are just mini Wall Streets, each holding get-rich-quick companies with unlimited potential. The only people getting rich are the financial gurus selling this dreck to an unsuspecting public.

With these caveats in mind, the following will be a brief review of many of the smaller emerging markets. I have arbitrarily limited this analysis to the markets large enough to have individual ETFs. As previously stated, the potential distortion of information makes investing in a specific company difficult. Also, it is unwise to invest in general category ETFs, such as BRIC or general emerging market ETFs. Each country in these categories is vastly different, as are their growth rates. Therefore, these funds will not necessarily capture the potential of a given country. Most likely they will only represent the volatility of all the markets. They will do better than developed markets during bull markets and worse in bear markets. Even less attractive would be ETFs based on derivatives rather than on actually holding the shares of a specific index. The derivatives may either exacerbate the fluctuations or make any profit impossible, except over the short term.

Sector ETFs based in emerging markets should be avoided. An example might be emerging market infrastructure. The emerging market infrastructure story is very attractive, but since most of it is dependent upon government programs in individual countries, the differences are vast. Likewise, it

might be best to avoid emerging market ETFs based on commodities. These have names like “emerging market energy fund” or “emerging markets metals.” Again, this seems attractive. Who could not be impressed by an ETF that combines the potential of the emerging market growth story with the current fad for commodities?

The problem with this thesis is that it might harvest the worst of both worlds. The price for the commodity has little to do with where it comes from. It will grow (or not) based on global demand or, recently, global liquidity. But it will not grow based on the conditions in emerging markets. If demand is high for a given commodity, it does not mean the investor will necessarily see the value. The fundamentals of the company supplying the commodity may look attractive, but the actual execution is lacking. Many of these companies in emerging markets, especially in oil, are state-owned companies. The probability that these companies will pass along profits to minority foreign investors is slight.

These ETFs could provide good returns, though, if there are other factors driving their momentum. Recently, the massive liquidity provided by the confluence of the United States Federal Reserve’s unfortunate QE2 program plus a huge flood of Chinese bank loans has given the combined stories of unlimited commodities demand and emerging market growth legs. As a short-term momentum play, these could work; however, investors should keep an eye on the clock and not expect the promised consistent growth will ever materialize.

Other sector ETFs are problematic as well. Most of these include categories I mentioned earlier. They were designed for developed markets but have been slapped on emerging markets without a thought as to whether these categories might perform differently in a different environment. Examples of these types of funds are country- or region-specific funds in a particular sector, such as the financial, consumer, or technology sector. Another type has to do with the size of the company, as in small cap or mid cap, or another characteristic, such as high yield.

China is an example why these designations are misleading; the financials are all state owned. The intellectual property of a Chinese or Western company with a breakthrough technology would be stolen in about five minutes. Small- or mid-cap companies are family-owned firms with little or no corporate governance and high yield firms could go under at any time with little or no return to bond holders, regardless of a bankruptcy proceeding.

In contrast, country-specific ETFs can capture the growth of a specific market, especially when there is momentum regarding a “story” for a specific

country. Since they contain many different shares, they can act as a buffer against distorted information and flaws in a particular country's or firm's corporate governance. Shorting the ETF can also provide opportunities for a market that has diverged from the mean. The problem with this strategy is that borrowing shares of the ETF for a short position may not be possible.

At the time of this writing, there are approximately 15 emerging market country ETFs. To the best of my knowledge, they are all physical as opposed to synthetic ETFs based on derivatives, so the counter party and other risks associated with synthetic ETFs is not a problem. The list includes:

- Asia: South Korea, Taiwan, Singapore, Malaysia, Indonesia, Vietnam, and the Philippines;
- Middle East: Turkey;
- Africa: Egypt and South Africa; and
- North America: Mexico.

I will briefly review these countries.

## Asia

There is one thing that has created sort of an exception to the diversity among markets in different countries. Although the rules in each Asian market varies widely, as do their prospects for sustainable growth, they all have one thing in common—China.

China is the 800-pound gorilla in the Asian room. Several of these economies were built on export growth models, especially Japan, South Korea, Taiwan, Singapore, Malaysia, and Thailand. Ten years ago, the major market for all these economies was the United States. A slight recession in the United States could have a major impact on these economies. But this is no longer the case.

The main trading partner for all these countries is now China. While China runs large trade surpluses with the United States, it usually runs large trade deficits with these countries. China has had very rapid growth for the past two decades. Most of the worldwide financial community assumes this growth rate will continue, but nothing lasts forever. As previously mentioned, there are very strong reasons to believe China's growth may slow and its economy may stagnate. If it does, the other Asian economies will not be able to avoid a similar slowdown.

## South Korea

South Korea is not really in the emerging market category any more. It has a large and sophisticated market with a market capitalization of about \$1.2 trillion. There is generally lots of liquidity and 800 listed shares. While it is hardly in the same league as Hong Kong or Japan, South Korea is in the top 20. There are rules enforced by an active watchdog, but that is not to say South Korea has not shaken off the hallmarks of an emerging market.

Despite its rather advanced development and firmly entrenched democratic institutions, South Korea remains a very relationship-based system. One doesn't generally think of industrial giants—chaebols such as Samsung or Hyundai—as family-owned firms, but they definitely are. Samsung Group accounts for about a fifth of South Korea's total exports.<sup>3</sup> It is, was, and will be controlled by the progeny of the founder, Lee Byung-chull. The present ruler of the firm is Lee Kun-hee. His siblings either run or are married to people who run some of the largest firms in Korea.

Although Mr. Lee has stated he wants to hire the best minds from all over Korea and the world, important positions in the company go to his children. His son, Lee Jae-yong, is President and COO of Samsung Electronics. His eldest daughter, Lee Boo-jin, is the CEO of a luxury hotel chain and President of Samsung Everland, a theme park and resort operator that is “widely seen as the de facto holding company for the conglomerate.”<sup>4</sup> The company owns about 62 affiliates. With a pyramid structure and numerous cross-share holdings, one study estimated the Lee family exercises voting rights in affiliates that are 17 times greater than its actual shareholdings.<sup>5</sup>

With power, money, and connections, it is hardly surprising chaebol owners are above the law. Corrupt politicians are available to those who can pay. The difference is that the price is higher. The tax evasion rap mentioned in Chapter 2 was not the first time Lee Kun-hee was in trouble with the law. He has also avoided prosecution for embezzlement and bribery. Prosecutors dropped the charges due to lack of evidence and because the statute of limitations had expired. Of course, the journalists who broke the story

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<sup>3</sup> <http://en.wikipedia.org/wiki/Samsung>.

<sup>4</sup> Lee Kun-hee, Wikipedia, [http://en.wikipedia.org/wiki/Lee\\_Kun-hee](http://en.wikipedia.org/wiki/Lee_Kun-hee).

<sup>5</sup> Anna Fifield, “Citizens restless in Republic of Samsung,” *Financial Times*, [www.ft.com](http://www.ft.com), June 9, 2005.

were indicted.<sup>6</sup> It is hardly surprising that South Korea is sometimes referred to as the Republic of Samsung.

The Korean chaebols, at least the ones that survived the Asian Crisis of 1997, are some of the best run and most competitive businesses in the world. But they are still definitely run for the family, not for other shareholders. This means any corporate transparency or corporate governance that would protect shareholders, especially foreign shareholders, is a matter of the ruling family's whim.

The South Korean system has also ensnared direct investors. Lone Star, the American private equity firm, thought it made a killing. It purchased the troubled Korea Exchange Bank (KEB), Korea's sixth largest bank, from the government in 2003 for \$1.2 billion. Lone Star took a big risk buying KEB because no one else wanted in. KEB was insolvent due to South Korea's credit card meltdown, which is now an issue for other emerging markets. Lone Star has been trying to sell its interest in the bank since 2006 without success. It has made two previous attempts to sell the bank, but each attempt ran into all sorts of legal obstacles, including financial regulators and criminal charges. It also ran into difficulties as a result of the public backlash against foreign firms making huge tax-free profits.<sup>7</sup>

## Taiwan

Taiwan is sort of the mirror image of Korea. Its stock market is two thirds the size of South Korea's, but has about the same number of companies. Where Korea is dominated by large chaebols, Taiwan has a very diverse number of smaller entrepreneurial companies. For example, there are 40 banks serving a population of just 23 million. The market has grown more fragmented over the years rather than less. The market share of the top three institutions by assets slid from 31% in 1996 to 23% in 2007.<sup>8</sup>

The Financial Supervisory Commission, the local financial watchdog, has only been around since 2004, but unlike many of its fellow Asian watchdogs, it actually does prosecute those involved in insider trading. Still, with the heavy predominance of family-owned companies, transparency and good corporate governance are difficult to enforce.

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<sup>6</sup> Anna Fifield, "Samsung Chief Cleared in Bribe Scandal," *Financial Times*, www.ft.com, December 14, 2005.

<sup>7</sup> Christian Oliver, "Lone Star struggles with Seoul to shed KEB," *Financial Times*, www.ft.com, August 1, 2011.

<sup>8</sup> Kathrin Hille, "Taiwan's banks feel the heat," *Financial Times*, www.ft.com, July 10, 2007.



Like other emerging markets, the government is heavily involved in the financial sector. It controls a dozen banks, including the six largest. Attempts to streamline and privatize the sector have met with stiff resistance from unions and the public.

The legal system also has its problems. There have been rumors the judiciary is corrupt. These rumors were confirmed by the arrest of three high court judges and a prosecutor for taking bribes to fix the outcome of a high-profile case.<sup>9</sup>

Direct investors have at times had some difficulties with local officials. As a small country, Taiwan is worried its stock market could get hollowed out by foreign buyout firms. The private equity firm Oaktree faced this problem when it tried to buy out Fu Sheng, the world's largest manufacturer of golf club heads. Fu Sheng would have been delisted after the sale. After some delays, the Fu Sheng deal was approved.<sup>10</sup>

Despite the friction, the main issue with Taiwan is its relationship with mainland China. Much of the success of Chinese exporters is not actually due to the Chinese. It is due to Taiwanese-owned businesses that have invested in China. For example, Foxconn is the contract manufacturer for much of the electronics sold under different brands, which may include Apple's iPads and iPods and Nintendo and Microsoft game consoles and laptops. It is a Taiwanese company headquartered in Taipei. The Taiwanese use cheaper Chinese labor. Foxconn alone employs 270,000 people at its factory complex in Shenzhen. But the manufacturing techniques—such as flexible production—that are often credited to the Chinese originate with Taiwanese manufacturers.<sup>11</sup>

However, Taiwanese businessmen often have a much different experience in China than those from developed countries. Because the Chinese know the Taiwanese government treads very softly regarding its relationship with the mainland, the Taiwanese can expect little protection. The result is that these businessmen are often the victims of rapacious government officials. For example, in one case, a Taiwanese businessman found that seven million yuan (\$1.01 million) had disappeared from his Bank of China account. "They told

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<sup>9</sup> "Corruption in Taiwan: Confirming the Worst Suspicions: The arrest of three senior judges sparks renewed debate over corruption," *The Economist*, [www.economist.com/node/16647375](http://www.economist.com/node/16647375), July 22, 2010.

<sup>10</sup> Jessie Ho, "Oaktree allowed to buy Fu Sheng," *Taipei Times*, [www.taipetimes.com/News/biz/archives/2007/07/20/2003370494](http://www.taipetimes.com/News/biz/archives/2007/07/20/2003370494), July 20, 2007.

<sup>11</sup> "Schumpeter: Bamboo innovation: Beware of judging China's innovation engine by the standards of Silicon Valley," *The Economist*, [www.economist.com/node/18648264](http://www.economist.com/node/18648264), May 5, 2011.

me I had never deposited seven million yuan in my account,” Peng said. “Apparently, someone inside the bank took the money—even some people from within the bank told me that.”<sup>12</sup>

It is not uncommon for Taiwanese businesses to suffer all sorts of expropriations, from real estate to intellectual property. The head of Taiwanese electronics giant Hon Hai Precision Industry Co. Ltd. criticized Warren Buffett’s investment in the Chinese battery maker BYD, which Hon Hai sued for intellectual property violations.<sup>13</sup> Taiwanese businessmen are fair game because they know if they complain too loudly, they will be arrested. So, often they just flee and don’t return.

Taiwanese direct investment in China is important for two reasons. First, investing in China through Taiwanese businesses substantially lowers the risk for foreign investors. As Chinese, the Taiwanese definitely have the advantage over Westerners doing business in a relationship-based system. Relationships in China can and do go back many generations. Despite the divide between the People’s Republic of China and the Republic of China, the cultural and familiar ties are exceptionally effective. Second, the experiences of Taiwanese businessmen in China serves as a warning about what exactly the Chinese bureaucracy can do to businesspeople when they think they can get away with it.

## Hong Kong

Like South Korea and Taiwan, Hong Kong cannot exactly be considered an emerging market. Unlike Korea and Taiwan, it is not included in the MSCI Emerging Markets Index. Still, it is, outside China itself, the largest exchange in Asia. It is also intimately tied to companies in China, which is a problem.

The widely derided British Empire did leave two gifts of immeasurable value to many of its former colonies—the English language and a good legal system. The English language, thanks to the United States and the Internet, has become the lingua franca of global trade. Elite education in many former British colonies is always in English. The same is true for many emerging markets that were never colonies at all. High-end London real estate owes part of its stellar value to the promise of high-level exclusive English language education that appeals to billionaires from many countries.

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<sup>12</sup> Loa Iok-sin, “Government accused of failing investors in China,” *Taipei Times*, [www.taipetimes.com/News/taiwan/archives/2011/09/08/2003512753](http://www.taipetimes.com/News/taiwan/archives/2011/09/08/2003512753), September 8, 2011.

<sup>13</sup> Annie Huang, “Taiwanese tycoon challenges Buffett’s investment,” *AP*, [www.taipetimes.com/News/biz/archives/2009/05/05/2003442820](http://www.taipetimes.com/News/biz/archives/2009/05/05/2003442820), May 5, 2009.

The British legal system has helped the tiny city states of Hong Kong and Singapore to become the global entrepôts they are today. But a legal system is dynamic. It is subject to government whim and the government of Hong Kong is China. The leaders in Beijing, like leaders everywhere, are not keen on limits to their power and the laws of Hong Kong are definitely a limit.

When the Hong Kong exchange was limited to Hong Kong companies only (those registered in Hong Kong and subject to Hong Kong jurisdiction), the value of the excellent Hong Kong legal system was evident. Although heavily controlled and influenced by local tycoons, they had enough sense to keep the corruption under control. These tycoons didn't want to cheat shareholders too much because they realized the value of the brand.

Originally, the only way to invest directly in China was to invest in the so-called red chip companies. These were some of the largest state-owned firms in mainland China and were listed in Hong Kong. The Chinese, unlike the Russians, knew that if they were going to raise large amounts of foreign capital, they would have to be sure that shareholders were treated properly. The Russians were very short sighted and greedy. They didn't care and were happy to steal anything they could. The Chinese were more farsighted, which paid off both for the investors in the red chips and for the China brand. The red chips appreciated rapidly from 2002 to 2007 and shareholders profited handsomely, unlike shareholders of the Russian firm Yukos, who got nothing.

The listing of the red chip firms also yielded fabulous wealth for Hong Kong. Besides being the middleman for Chinese manufacturing firms, it became a financial capital in its own right. Its exchange is listed as the sixth largest in the world, with listings for over 1,448 companies.

But success has come at a price. The Chinese feel it is inevitable that investors will want to invest in China no matter what. The China brand is not as significant as it once was, especially for smaller players. The economic incentives to make a quick fortune are overwhelming. The 2008 crash certainly didn't help because it convinced many Chinese and their leaders of the inevitable domination of their system. So the constraints are coming off. Huge companies, such as the state-owned Chinese banks, are still careful at least to look solvent, but smaller firms, such as Sino Forest, don't really care. The reputation of the Hong Kong market as a safe place to invest is beginning to tarnish.

It is not that the Hong Kong legal watchdogs do not do a good job, but there are limits. One such limit is that one of the stock exchange regulators is not an independent government agency. The Hong Kong Exchange is pri-

vately owned and to a large extent self-regulated. This is an enormous conflict of interest. In contrast, the Securities & Futures Commission does do a good job, especially recently. Since 2008, it has actually started to enforce Hong Kong's insider trading rules and has had convictions. It even hired an ex-pat British regulator who "hopes to raise the independence of the regulatory world." He added that "the feeling was that a local is more susceptible to pressure from China."<sup>14</sup>

The real problem with Hong Kong has to do with jurisdiction. The law stops at the border. If a Hong Kong regulator wants something from the mainland, they have no way to get it. For example, Asia Aluminum, Asia's largest manufacturer of aluminum-extruded products, got into trouble after the 2008 crash. On February 13, 2009, it made a tender offer to buy back all its outstanding bonds, which had an aggregate face value of \$1.2 billion USD. They offered 27.5 cents on the dollar for the senior bonds and 13 cents on the dollar for junior debt. The holders of the bonds would have none of it. They thought they could do better in court. After all, the company was registered in Hong Kong, although its assets were on the mainland.<sup>15</sup>

The creditors sued in a Hong Kong court to force Asia Aluminum into bankruptcy. On March 16, 2009, a Hong Kong court appointed the corporate restructuring firm Ferrier Hodgson as Asia Aluminum's provisional liquidator after the buyback offer was rejected by bondholders. Ferrier Hodgson got nowhere. It finally had to accept a bid by an unknown company named Golden Concord, whose management included unidentified Asia Aluminum executives. Golden Concord offered 20 cents on the dollar for the senior bonds and only one cent on the dollar for the \$800 million worth of junior bonds. The Hong Kong receiver had no choice but to accept the offer.<sup>16</sup>

## Malaysia

Alexis de Tocqueville, one of the world's most insightful political commentators, observed that the French Revolution did not occur because the French people were poor. It occurred because people were getting rich and wanted to protect their newly won property rights from the government. This is

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<sup>14</sup> Henny Sender, "Hong Kong taps Alder for securities regulator," *Financial Times*, [www.ft.com](http://www.ft.com), July 29, 2011.

<sup>15</sup> Peter Stein and Laura Santini, "Asia Debt Holders Squirm," *The Wall Street Journal*, [www.wsj.com](http://www.wsj.com), August 25, 2009.

<sup>16</sup> Ibid.

the problem in Malaysia. As the large, well-educated minorities get richer, they have more of an incentive to challenge an entrenched system.

Since the country gained independence from Britain in 1957, it has been ruled by a governing coalition led by the United Malays National Organization (UMNO). The country is divided along ethnic lines. Of a population of 28 million, the Muslim ethnic Malay population makes up the majority; however, there are large ethnic minorities. Ethnic Chinese make up 23% of the country and have dominated Malay business. Indian minorities make up 7% and are well represented in the professions.

To protect the poorer, less-educated majority, ethnic discrimination was enshrined in the country's 1957 constitution. After riots in 1969, Malays were given additional perks. These include privileged access to public-sector jobs, university places, stock market IPOs for their companies, and government contracts. The result was corruption. The combination of what is basically a single-party state that favors one group, together with a heavily commodities-based economy, has resulted in certain people having connections to the ruling UMNO party.

This is particularly the case with judges. In 1988, the courts ordered UMNO's dissolution. The long serving UMNO prime minister, Dr. Mahathir (1981–2003), took revenge. He had the constitution changed to strip the courts of their independence from government and sacked the head of the Supreme Court and five other senior judges. Since then, the courts have been subject to politicians. Last year, the opposition circulated a video clip of a top lawyer apparently boasting of his ability to fix judicial appointments.<sup>17</sup>

The combination of discrimination and corruption led to one of the largest street protests in years. On July 9, 2011, the independent group known as Bersih—the Malay word for “clean”—organized a street protest of 20,000 people that was met by the police bearing water cannons and tear gas. The present government has promised reform of the electoral laws, the repeal of the hated Internal Security Act, and more press freedom. However, since the ruling party has a high approval rating, the changes are not guaranteed. It will be difficult to revoke the privileges of the Malays and their champion, UMNO. Until such time, Malaysia will not achieve its true potential.

This is sad because there is so much potential. Malaysia ranks a respectable 56 on the Transparency International's corruption index,<sup>18</sup> a rating that is

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<sup>17</sup> “The winds of change: Could the opposition take power after 51 years?” *The Economist*, [www.economist.com/node/11294789](http://www.economist.com/node/11294789), May 1, 2008.

<sup>18</sup> [www.transparency.org/policy\\_research/surveys\\_indices/cpi/2010/results](http://www.transparency.org/policy_research/surveys_indices/cpi/2010/results).

above Thailand's, but below Taiwan's, which is 33, and Korea's, which is 39. It has also received a reasonably good grade from the World Bank's Doing Business Index. It ranks as having one of the best environments for doing business among the emerging markets. It ranks at 18.<sup>19</sup>

Malaysia is a predominantly Muslim country, but some of the more conservative strains of Islam, such as Wahhabism and Salafi, have not been successful. As a result, Malaysia enjoys a more moderate and tolerant religious climate. This has helped it not only as a destination for Muslims from stricter countries but also as a budding financial capital.

As of 2009, Malaysia ranks third behind Iran and Saudi Arabia in terms of Sharia-compliant banking assets (\$86 billion) and third behind Bahrain and Kuwait for the number of Islamic banks (53). Malaysia also issues large amounts of Sharia-compliant securities. Many so-called *sukuk* bonds are issued by Malaysian companies; 58% of the total outstanding corporate bonds are *sukuk*. Malaysia's total outstanding *sukuk*—both public and private—amounts to \$66 billion or 62% of global outstanding issuance. The financial sector has the advantage of being both broad and varied, with large-scale banking, Islamic fund management, and capital markets activity alongside the conventional financial sector.<sup>20</sup> Malaysia is also rich in commodities, so the global slowdowns, particularly the slowdown in China, will impact its economy.

## Thailand

Like Malaysia, Thailand has become a battleground for the winners and losers in rapid growth. Since the military coup in 2006, the fight has been between the older elites, represented by the yellow-shirted nationalists dominated by the Army, and the Bangkok old guard. In opposition are the red-shirted populists led by the party of the former Prime Minister, Thaksin Shinawatra. In this near-civil war, the red shirts have come out on top in the form of Thaksin's younger sister, Yingluck.

But political dissonance is not Thailand's only problem. Like Brazil, there are limits to Thailand's emerging market story. During the 1990s, Thailand might have been able to claim to be a destination for low-cost labor. Prior to 2005, their labor costs were higher than China's. China surpassed them, but it is of little benefit. Their labor costs are more than double those of Vietnam or the Philippines, to say nothing of India or Bangladesh.

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<sup>19</sup> [www.doingbusiness.org/rankings](http://www.doingbusiness.org/rankings).

<sup>20</sup> Kevin Brown, "Malaysia: Rules and tax breaks boost innovation," *Financial Times*, [www.ft.com](http://www.ft.com), December 7, 2009.

Countries such as Korea, with better and more sophisticated institutions and educational systems, have been successful at moving up market, but not Thailand. Because the country has a relationship-based system, its businesses cannot adapt. Joe Studwell is the author of the superb *China Dream*. In his 2008 book, *Asian Godfathers*, he describes the region's business scene as "dominated by old-fashioned, mediocre, sprawling conglomerates, run at the whims of ageing patriarchal owners. These firms' core competence, such as it is, is exploiting their cozy connections with governing elites. Their profits come from rent-seeking: being handed generous state contracts and concessions, or using their sway with officialdom to keep potential competitors out. If they need technology, they buy it from abroad."<sup>21</sup> It's hardly surprising the Bangkok business community would battle rural populists to maintain their advantages.

Thailand remains the second largest economy in South East Asia after Indonesia. Through investments by Toyota and Ford, Thailand has developed a large automobile industry. Manufacturing contributes 43% of the GDP but only employs 14% of the labor force. Thailand has also been successful in developing medical tourism and the largest tourist industry in South East Asia. Still, like other emerging markets, Thailand remains heavily dependent on agriculture, which employs almost half the work force but only contributes 8.4% to the GDP.

The United States is Thailand's largest trading partner, but China is now number two. The Thai economy was hurt by the slowdown in the United States, but China picked up the slack. A slowdown in both China and the United States could not be good. Unlike Malaysia, Thailand is not blessed with a natural resources cushion.

## Vietnam

Vietnam and financial marketers like to sell the country as the "new" China. In other words, Vietnam is the quintessential emerging market story, being a poor country like China was twenty years ago and with the same growth potential. Potential investors are supposed to look at Vietnam and assume it will inevitably grow as fast as China. In Hanoi, the government tries to en-

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<sup>21</sup> "The tigers that lost their roar," *The Economist*, [www.economist.com/node/10760174](http://www.economist.com/node/10760174), February 28, 2008.

courage potential multinational corporations to adopt a “China plus one” strategy, sourcing products both in China and Vietnam.<sup>22</sup>

Like China in the 1990s, low wages have certainly helped Vietnam grow. Since the 1990s, per capita has risen tenfold to well over \$1,000 per person.<sup>23</sup> Vietnamese low-cost manufacturers have been able to attract a significant share of the footwear and furniture business, much of which used to be in China.

Also like China, Vietnam is still very much a Communist country. The fact that its stock exchange index is called Ho Chi Minh ought to say something. It has tried to mimic the Chinese model of export-based growth, but does not really understand the model very well. They are in good company. Neither did the Chinese.

The Chinese like to believe it was the state and state-owned businesses that were the source of its success. Actually, it was a combination of foreign and local private firms that did the trick. The Chinese are now reversing the process by setting more barriers for both types of firms. Still, there was one thing the Chinese did get right. The various regions of China competed for foreign firms by trying to provide the best infrastructure.

Vietnam has not made sufficient investments in its infrastructures and its bureaucrats stifle private enterprises trying to export. Instead, the government funnels cash to big, state firms that, like their Chinese counterparts, are morphing into large diversified conglomerates without focus or core competencies.

Both Vietnam and China have a special fondness for the Korean chaebols. The idea of keeping the national wealth in a few easily watched and controlled mega firms with the ability to compete globally is exceptionally attractive to party apparatchiks. But they forget the chaebols are family-run firms whose owners have a keen interest in growing the business, not using it as a parking spot for rent-seeking government officials. These firms are run by often corrupt political appointees whose only aptitude is making good party connections. Vietnam ranks at 116 on Transparency International’s corruption index. The result is that these large state-owned firms, whether in China, Russia or Vietnam, are going nowhere except toward insolvency.

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<sup>22</sup> “Vietnam’s economy: Plus one country: Cheap labour will not yield gains for ever. But what comes next is unclear,” *The Economist*, September 2, 2010.

<sup>23</sup> *Ibid.*



A good example is the Vietnamese state ship-building firm Vinashin, which raised about \$1 billion from international investors in 2007. Its total debts are more than \$4 billion and it almost collapsed while expanding into non-core activities. In December of 2010, it failed to make a \$60 million payment on a \$600 million debt. When the creditors asked for a meeting, the company responded they would be happy to meet, just not at the present time.<sup>24</sup>

Some of the firm's creditors include hedge funds. They are getting impatient and have resorted to a very Western remedy—lawyers. They are trying to exert legal pressure through the courts. Vietnam does have a bankruptcy law that seems to conform to international standards, but law is only a piece of paper. An independent judiciary is something that is simply not in the vocabulary of high officials in any communist country and it is unlikely to rule against a state-owned company. The hedge funds apparently understand their chances of a successful legal solution are slim, a realization which is a little late for some of their investors.

Still, the lack of reform that makes Vietnam a poor investment for indirect investors could help direct investors looking for cheap labor. Lack of sustainable economic growth will mean wages will no doubt remain quite low for the foreseeable future.

## Indonesia

If there is one country that deserves to be the object of international investors, it is Indonesia. As far as potential, it far outweighs a country like Russia and has many more possibilities than South Africa if for only one reason—its size. Indonesia is the fourth largest country in the world. Yet with all its population, its economy only ranks at 18, below that of the Netherlands.

Besides a large population, Indonesia is also blessed with many natural resources. It is a large regional producer of oil and natural gas and is comparatively close to the huge Chinese market. In addition to hydrocarbons, it has large reserves of tin, natural gas, nickel, timber, bauxite, copper, fertile land, coal, gold, silver, and other things many Asian countries want, but don't have.

Also, unlike many other emerging markets, Indonesia is actually a democracy that has made an effort at real reform. This process has been far from easy. Since the fall of the dictator Suharto 13 years ago, there have been

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<sup>24</sup> Ben Bland, "Vinashin: a tough lesson," *Financial Times*, <http://blogs.ft.com/beyond-brics/2011/03/07/vinashin-a-lesson-for-investors-and-government/#ixzz1Z5H8Dah8>, March 7, 2011.

some questionable moments. However, the election of President Susilo Bambang Yudhoyono wasn't one of them.

President Yudhoyono has instituted some major reforms, including tax, customs, capital market development, and supervision reforms. Good fiscal and monetary policy has created a stable environment and the banking system was overhauled after the 1997 meltdown. Even in 2009, when much of the world was contracting, Indonesia was expanding at over 4%.<sup>25</sup> Even the stock market reached a new all-time high.

But the reforms have not been sufficient to deal with Indonesia's number one problem—corruption. The crony capitalism that was institutionalized under Suharto is difficult to eradicate. Indonesia remains one of the most corrupt countries in the world. It ranks at 110 on Transparency International's corruption index. The only thing good about this low ranking is that it is better than other emerging markets, such as Russia, Vietnam, and the Philippines. Indonesia also does not do well in terms of investment climate. It ranks only 121.

Reforms are never guaranteed. The present trajectory could easily go the other way. In 2010, the effective Corruption Eradication Commission came under attack by senior prosecutors and police and the reform-minded finance minister, Sri Mulyani Indrawati, was removed from office.<sup>26</sup> The wealthy and powerful families who run Indonesia's relationship-based system have learned how to manage its democracy as easily as they learned to manage the dictatorship.

The good news is that in 2011, 28 current and former lawmakers were sentenced to prison for accepting bribes. While this sounds like evidence of corruption, the fact they were arrested at all is major progress for an emerging market.<sup>27</sup>

The other problem for Indonesia is the curse of oil. Indonesia not only has oil, but much of the recent boom has been fueled by coal—to say nothing of gold and all its other natural resources. The pernicious effects of a natural resources bonanza without strong institutions to control it allows for a constant and never-ending gravy train of patronage to an ever-expanding band of government rentiers. An example is that despite this vast natural

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<sup>25</sup> Anthony Deutsch and Henny Sender, "Indonesia: Regional economic boom," *Financial Times*, [www.ft.com](http://www.ft.com), June 7, 2011.

<sup>26</sup> Ibid.

<sup>27</sup> "Indonesia's politics, Corruption everywhere," *The Economist*, [www.economist.com/blogs/banyan/2011/09/indonesias-politics](http://www.economist.com/blogs/banyan/2011/09/indonesias-politics), September 2, 2011.

wealth, Indonesia has an infrastructure that is far worse than even Brazil's. According to a government study, there is a need for \$150 billion in physical infrastructure, including roads, sea and airports, electricity plants, and bridges by 2014. But Indonesia can only seem to find a third of that in its limited state budget.<sup>28</sup>

For direct and indirect investors, Indonesia certainly does show the promise of an emerging market. Besides all the natural resources, it also has a rising middle class that now numbers about 50 million. But despite a population where the median age is under 30 and literacy rates are close to 90%, Indonesia has lagged behind in manufacturing, another aspect of the curse of oil.

In 2011, the commodities cycle and the problems in China do not bode well for Indonesia's continued growth. Indonesia is definitely a country to watch. As a democracy, it has the potential to solve its problems; but it also has the same potential to stagnate.

## The Philippines

In September, 2011, the Manila stock exchange became the best-performing exchange in Asia. Of course it was up only 2.5%, which is more of a statement of the emerging market bubble than the quality of the shares. According to a report by the Asian Corporate Governance Association in 2010, the Philippines had the weakest corporate governance standards of 11 Asian markets.<sup>29</sup>

It is not only that the Philippines has the least developed market in Asia, but that it is getting worse. The report stated the country's absolute score for corporate governance fell 13%. Said the *Financial Times*, "The Philippines clearly went backwards over the past few years under the previous administration. Corruption levels appear to have risen, political interference has increased"<sup>30</sup>

But the Filipinos didn't get the hint. The performance of the Philippines market since 2009 has been excellent. It has risen 150%. According to Val

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<sup>28</sup> Anthony Deutsch and Henny Sender, "Indonesia: Regional Economic Boom," *Financial Times*, www.ft.com, June 7, 2011.

<sup>29</sup> Roel Lindingin, "Corruption and weak rules: not enough to shake investors' faith in the Philippines?" *Financial Times*, <http://blogs.ft.com/beyond-brics/2010/09/24/corruption-and-weak-rules-not-enough-to-shake-investors-faith-in-the-philippines/#ixzz1ZA97VSd5>, September 24, 2010.

<sup>30</sup> Ibid.

Antonio Suarez, the CEO of the Philippine Stock Exchange Inc., “investors have overwhelmingly given their stamp of approval on the Philippines by rewarding the market now.”<sup>31</sup>

Apparently, he has a short memory. In 1999, a stock-rigging scandal almost caused the collapse of the market. The stock, BW Resources, increased 5,000%. An investigation by the chairman of the Securities and Exchange Commission was stopped by then President Joseph Estrada. Allegedly, the biggest shareholder in BW Resources, Dante Tan, was a friend of the president.<sup>32</sup> Of course, the scandal sent prices plummeting and Dante Tan, although charged, was never convicted.<sup>33</sup>

The problems experienced by the Philippine Stock Exchange are hardly surprising. The Philippines, ranked at 134, has one of the worst scores on Transparency International’s corruption index. It also scores near the bottom of the World Bank’s Doing Business index.

The Philippines is the emerging market poster child for the effects of bad government. The economic situation and growth prospects in the Philippines are so bad that its major export is its people. About a tenth of the population work abroad and remittances make up about 11% of the economy.<sup>34</sup> And yet the stock market performed very well, often because the remittances encouraged consumption, which created the illusion of sustainable growth.

This again is a warning about emerging markets for both direct and indirect investors. There are profits to be made, but time horizons have to be kept short. There is no possibility of sustainable growth and the connection between an investor and his money could be very tenuous.

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<sup>31</sup> Josh Noble, “Asian markets: Philippines now year’s best performer,” *Financial Times*, [www.ft.com](http://www.ft.com), September 19, 2011.

<sup>32</sup> “The Philippines: Imperfecto,” *The Economist*, [www.economist.com/node/277539](http://www.economist.com/node/277539), January 27, 2000.

<sup>33</sup> “Dante Tan cleared of BW mess,” *Manila Standard*, [www.manilastandardtoday.com/insideNation.htm?f=2010/august/2/nation4.isx&d=2010/august/2](http://www.manilastandardtoday.com/insideNation.htm?f=2010/august/2/nation4.isx&d=2010/august/2), August 2, 2010.

<sup>34</sup> Banyan, “The Philippines and its remittance economy, People, the Philippines’ best export,” *The Economist*, [www.economist.com/blogs/banyan/2010/02/philippines\\_and\\_its\\_remittance\\_economy](http://www.economist.com/blogs/banyan/2010/02/philippines_and_its_remittance_economy), February 9, 2010.

# Turkey

Turkey in many ways is one of the real stars among the emerging markets. From March 2009 to November 2010, the iShares MSCI Turkey Index Fund increased over 300%! Currently, though, Turkey may not be the best place to invest. The central bank's unorthodox cut of interest rates to lower capital inflows may backfire and result in higher inflation. Yet, it should still be high on any list of emerging market countries for investors.

It is not that Turkey does not have its share of problems. The constant running sore of the situation with the Kurds is one major issue. But Turkey's democratic system has shown enormous resiliency. It appears it has been successful in finally keeping the military out of politics and in the barracks.

Prime Minister Recep Erdogan, along with his "mildly Islamist" (whatever that means) AKP party, has transformed Turkey. According to one Western diplomat, "What he has accomplished in this country is astonishing."<sup>35</sup> Erdogan has in the past shown some authoritarian tendencies. The police in Turkey have a habit of arresting journalists and even Nobel Laureate authors, but the recent elections helped to curb such behavior. Erdogan and the AKP won the election in 2011 with over 50% of the vote. What they did not win was the right to change the constitution alone.

Turkey has been a candidate for membership in the EU since 2004. The accession process has basically gone nowhere due to hesitation on the part of France and Germany, but the process has still been a roaring success. The process requires the candidate country conform its laws to those of the European Union. Erdogan used this as an excuse to reform Turkey, widening freedom of expression and minority rights while curbing the power of the military. In addition, he made many other reforms possible, thus facilitating business. Turkey ranks at 65 on the Doing Business index, which is below most of Europe and the United States, but far above the BRICs and even Italy and Greece.

The rise of the AKP has also represented a major power shift. Turkey used to be controlled by a more secular clique in Istanbul. The base of the AKP is the entrepreneurial middle class of central Anatolia. It is more socially conservative and religiously observant than its sophisticated city cousins, which has had an effect on corruption.<sup>36</sup>

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<sup>35</sup> David Gardner, "Turkey: Eyes on a higher prize," *Financial Times*, [www.ft.com](http://www.ft.com), June 9, 2011.

<sup>36</sup> *Ibid.*

One of the earliest election promises of the AKP was to clean up politics as part of their moral religious emphasis. They have done a reasonable job. In 2004, Turkey ranked 77 on the corruption index, tying with Egypt and Morocco. Turkey has risen to 56 to tie with Malaysia, while Morocco has fallen to 85 and Egypt still further to 98. This certainly has made doing business easier and more transparent.

The AKP have also helped streamline the banking system. Ten years ago, there were more than 80 banks. Today, there are about 40, with the top seven banks controlling 80% of the banking sector's assets of about \$626 billion. They are stronger, with an average 19% capital adequacy ratio at the end of 2010 and are more profitable, with 16% return on equity for the sector.<sup>37</sup>

The failure to gain EU membership has had one promising effect. Turkey is now looking east, not west. The problem with relationship-based systems is that you need relationships. Turkey is a Muslim country with good diplomatic relations with most of the Muslim countries in the region. Its businesses have good contacts and longstanding experience in these areas. When you do business with a Turkish company as a direct investor, the process is subject to the more developed and reforming legal infrastructure of Turkey. The political instability of the Middle East can be a real nightmare for any company; therefore, it is better to work with a partner who knows the territory. Turkey has always been a bridge between east and west. Its present success has made this an excellent time to take advantage of its connections.

## Egypt

As one of the largest countries and markets in the Arab world, Egypt is potentially a high-growth country. Certainly, reforms over the past few years have borne fruit, at least for the well connected. But revolt has changed everything and economic reform will not be easy.

The Middle Eastern countries have the largest proportion of young people in the world—38% of Arabs are under 14.<sup>38</sup> However, this is a detriment rather than an asset because an extremely high proportion of the population is unemployed. The frustrations of jobless young men were no doubt the origins of the Arab Spring. They could challenge entrenched regimes because

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<sup>37</sup> Lex, "Turkish banks: not for the faint-hearted," *Financial Times*, [www.ft.com](http://www.ft.com), June 9, 2011.

<sup>38</sup> "Self-doomed to failure: An unsparing new report by Arab scholars explains why their region lags behind so much of the world," *The Economist*, [www.economist.com/node/1213392](http://www.economist.com/node/1213392), July 23, 2009.

they had nothing to lose. But creating jobs in an unstable environment will be harder still.

Many of the jobs in Egypt were provided by the public sector. In 2007, Egypt's civil service was about seven million<sup>39</sup> strong in a country with a population of about 80 million. Much of the country's businesses were successful due to the patronage of the Mubarak regime. Other countries have shown that these connected businesses and the families that control them have remarkable resiliency. Even after a change in regime, they are typically managing to make their peace with or even control incoming politicians.

The new voters have been left out of the loop for so long that they will no doubt want a redivision of the spoils and their newly elected politicians will want to make them happy. Thus, the state may expand, not retreat. Add a little fiscal irresponsibility and there may be a mess.

Egypt may improve in time. If it is fortunate enough to elect the right leaders who can actually build institutions, Egypt could prosper; otherwise it is a country to be avoided.

## South Africa

South Africa has recently been designated (or capitalized) by financial marketing departments as the S in BRICS. It certainly has potential. Based on GDP, it ranks at number 26 in the world. Most investors would look at its vast mineral wealth. It has 90% of the world's known platinum reserves, 80% of the world's manganese, 70% of the world's chrome, and 40% of the world's gold, as well as a large amount of coal.

From October of 2008 to July of 2011, the two ETFs for South Africa have doubled. The stock market index has risen 70% over the same period, but it dropped 40% in 2008. The stock market is also the largest in Africa, one of the largest of the emerging markets and one of the most sophisticated. It should be. Unlike some of its emerging market cousins, which have been in existence for less than two decades, the Johannesburg Stock Exchange has been around for more than a century. It has had an insider trading law for many years and actually enforces it.

South Africa also has a number of world-class corporations. For example, SABMiller, founded in 1885, is one of the largest brewers in the world. It sells more than 200 beer brands in over 75 countries. South Africa has 18

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<sup>39</sup> "Waking from its sleep," *The Economist*, [www.economist.com/node/14082930](http://www.economist.com/node/14082930), July 23, 2009.

“African champions” in the Boston Consulting Group’s list of 40 fast-growing African companies with global ambitions.<sup>40</sup>

South Africa is best described as a first-world and a third-world country all in one.<sup>41</sup> Over 50% of its citizens live below the poverty line and its GINI coefficient is the second highest in the world. Few of its citizens benefit from the geologic bonanza. Its unemployment rate is officially at 25%, but it could be as high as 40%. Unemployment falls unequally on the black and the young. Over 50% of South African blacks aged 15 to 24 are unemployed.<sup>42</sup> Not a single net job has been added since the end of apartheid.<sup>43</sup>

The manufacturing sector, which has created so much employment in Asia, is quite small in South Africa, at only 13.3%. With high unemployment, labor costs are quite low, but the education system is woefully inadequate and there is a shortage of skilled labor. In addition, the infrastructure is often poor and the currency strong, which deters foreign investment.

Unlike the other BRICs, South Africa has a small home market. It has a population of just 50 million, behind Italy and ahead of South Korea. But like Turkey, it does have something else. It is a country with a reasonably sophisticated legal system and connections across a vast continent that pays scant deference to law. This allows partnerships between western companies with more sophisticated technologies and South African companies that understand the territory. For example, Blue Label Telecoms, which sells pre-paid tokens, has formed relationships with tribal chiefs and popular gospel singers to help sell its products. SABMiller makes cheap beer in Uganda with local ingredients. Caterpillar has teamed up with the South African company Barloworld, and Microsoft with Blueworld, to reach African markets.<sup>44</sup>

The South African combination of local knowledge and contacts together with South African legal protections allows both direct and indirect investors to realize the potential from emerging markets. The vast possibilities of Africa can be exploited and the rewards of these risks kept.

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<sup>40</sup> “Long walk to innovation: South Africa has been slow to innovate. That may be changing,” *The Economist*, [www.economist.com/node/21528612](http://www.economist.com/node/21528612), September 10, 2011.

<sup>41</sup> Ibid.

<sup>42</sup> “Jobless growth: The economy is doing nicely—but at least one person in three is out of work,” *The Economist*, [www.economist.com/node/16248641](http://www.economist.com/node/16248641), June 3, 2010.

<sup>43</sup> “Long walk to innovation: South Africa has been slow to innovate. That may be changing,” *The Economist*, [www.economist.com/node/21528612](http://www.economist.com/node/21528612), September 10, 2011.

<sup>44</sup> Ibid.



There are two issues, though. First, like many Asian countries, China has overtaken America, Japan, Germany, and Britain to be South Africa's biggest trading partner. South Africa has done very well in the China- and liquidity-fueled commodities boom, but as China slows, that boom will most likely turn to bust. Part of the boom is the gold bubble. South Africa is no longer the world's largest producer. It is fourth behind China, Australia, and the United States. But gold does earn over \$62 billion in foreign exchange and is the second largest export after platinum. As the gold bubble deflates, so will this income.

The second problem is the same as in the Arab countries. A large unemployed pool of young men is subject to populist impulses. This is certainly true of South Africa where Julius Malema, the rabble-rousing, racial epithet-spewing leader of the ruling African National Congress's Youth League, talks about nationalizing large parts of the economy and taking over white-owned farms without compensation, a radical solution that has ruined Zimbabwe.

Like Singapore, South Africa is fortunate to have a legacy of British legal infrastructure. If South Africa can capitalize on the protection of property rights yet use its skills as a dragoman between the world and the relationship-based systems of Africa, it will indeed become very successful. If not, it will simply stagnate.

## Mexico

Mexico, like other emerging markets, is a prisoner of its geography and history. Its geography has placed it in proximity to an enormous market, which has at different times been either an enormous benefit or a curse. The country has had a series of very poor governments. Most recently, the one-party state, dominated by the Institutional Revolutionary Party (PRI), has given way to a far more competitive democracy. Mexico's relationship with the United States and participation in the North American Free Trade Agreement has given it access to a very large, very rich market. However, it also has given it paralyzing drug wars.

The PRI granted favors that allowed different groups to skim off large parts of the country's wealth. This includes not just monopolists such as Carlos Slim, but certain unions that have done very well.

For example, Mexico's teacher's union, the National Union of Education Workers (SNTE), is the single biggest union (of any sort) in Latin America, with more than 1.2 million members. It is run by Elba Esther Gordillo,

known as “La Maestra” (“The Teacher”). Ms. Gordillio has done very well from favors. She owns mansions in Mexico City and California. Her property also includes a private jet and she sports \$1,200 shoes and a matching \$5,500 purse. Thanks to the lessons taught by Ms. Gordillo, Mexico’s education system performs on a par with the schools in Jordan, which is half as rich. No one messes with The Teacher because she controls a million or so votes.<sup>45</sup>

Another sacred cow is Pemex, the state-owned oil company. On March 18 of every year, the country celebrates the 1938 move to nationalize it. They should hold a day of mourning instead. Like other oil-producing countries, the income from oil makes up a large percentage of the government’s income (over a third). But like Venezuela, the lack of investment and foreign know-how has resulted in falling production, from about 3.4 million barrels a day in 2004 to just 2.6 million today.

Pemex may not be contributing as much as it did to the Mexican treasury, but it is helping someone else. The real beneficiary of its largess is its union. It has over 140,000 employees, far more than is reasonable or even sane, and they are paid very well.

It was hoped that the end of the PRI’s monopoly on power would also lead to reform, but so far this has not been the case. The first non-PRI president, Vicente Fox, attempted a reform agenda that was supposed to include tax reform, labor law reform, and even a new private investment in the oil sector, but nothing was achieved.

Fox’s successor, Felipe Calderón, is probably the better politician, but his razor-thin victory in the 2006 presidential election did not give him a sufficient mandate. Also, the President’s party does not control the legislature and after 2009, the PRI gained a plurality; thus, getting anything accomplished is difficult.

The result has been stagnation. According to Transparency International’s annual corruption perception index, Mexico ranked 58 in 1999 but by 2010 it had fallen to 98. Also in 1999, the World Economic Forum ranked Mexico at 34 on its competitiveness index. In its 2011–2012 ranking, it comes in at 58, just above Turkey.<sup>46</sup>

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<sup>45</sup> T.W., “Mexico’s teachers’ union: An expensive handbag fight,” *The Economist*, [www.economist.com/blogs/americasview/2011/07/mexicos-teachers-union](http://www.economist.com/blogs/americasview/2011/07/mexicos-teachers-union), July 7, 2011.

<sup>46</sup> Adam Thomson, “Mexico: Downward drift,” *Financial Times*, [www.ft.com](http://www.ft.com), June 29, 2010.

This is a perfect example of one of the central myths of emerging markets. This is the myth of continuing reform. Emerging markets have done very well thanks to reform. It has brought millions out of poverty, but there is no political or economic reason why reform should continue. On the contrary, there are many reasons why it should reverse. As Mancur Olson pointed out, as the pie gets bigger, power players such as Carlos Slim, the SNTE, or the PRI all want larger pieces and they have the power to stop the pie from growing.

Mexico also has another headwind—China. Many other emerging markets have done very well from the boom in China by selling commodities. Not Mexico. China is a direct competitor in terms of Mexico's role as a manufacturing base for the United States. Mexico's share of US imports fell from 11.2% in 2000 to 10.7% in 2006.

Since the bottom of the market in 2009, indirect investors have done rather well in Mexico. The local stock index has outperformed the S&P 500 most of the time. The most likely explanation is that the Mexican exchange has benefitted from the momentum associated with other emerging markets. Momentum and "stories" are both powerful forces. However, the reverse is also true. As with other emerging markets, the Mexican Bolsa can be far more volatile than its developed-market counterparts. As the cycle turns, the market can go a lot lower.

This no doubt will be helped by the usual issues with corporate governance. Mexico shares with other emerging markets the habit of neglecting to prosecute those involved in insider trading. Although insider trading has been outlawed since 1975, no one was formally accused of insider trading until 2002.<sup>47</sup> With the lack of good corporate governance and the distortions from failure to provide accurate and timely information, ETFs are no doubt the best way to invest indirectly in Mexico.

As for direct investors, the relationships between many US citizens of Mexican descent and Mexicans go back generations. For once, investors from the United States have a distinct advantage over investors from other developed markets. The Americans know the territory.

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<sup>47</sup> Juan J. Cruces and Enrique Kawamura, "Insider Trading and Corporate Governance in Latin America: A Sequential Trade Model Approach," [www.udesa.edu.ar/files/Public/Doc/Eco/DOC86.PDF](http://www.udesa.edu.ar/files/Public/Doc/Eco/DOC86.PDF), November 30, 2005.

## Frontier Markets

The marketing campaign led by the “Mad Men” of Wall Street has been very successful in selling both the BRIC countries and emerging markets. It has created untold profits for all sorts of investment and financial firms, to say nothing of the quantity of conferences and even academic papers. But to repeat the success, one needs a new product and Wall Street has one.

The new asset class is called Frontier Markets. The idea is to get in on the ground floor of the “new China.” Even the venerable *Financial Times* describes these markets as “a lot like emerging markets a generation ago.”<sup>48</sup> So these assets are being sold as a chance to get in on the ground floor of a no-lose growth story.

A good example of frontier markets is the MSCI Frontier Emerging Markets Index of 26 countries, which basically includes every market not part of another index. A little more discriminating is the selection of the ever-inventive Goldman Sachs. Imaginatively called the Goldman II, these countries include South Korea, Mexico, Indonesia, Turkey, the Philippines, Egypt, Vietnam, Pakistan, Nigeria, Bangladesh, and Iran.

Attempting to replicate the success of the BRIC brand are the CIVETS. These include Colombia, Indonesia, Vietnam, Egypt, Turkey, and South Africa. The choice of the civet, a mammal, might be accurate. The civet is known for two things, creating very expensive coffee by ingesting and excreting the coffee bean and possibly being the source of an interspecies virus known as severe acute respiratory syndrome (SARS).

Despite the odd names, there is some truth to the Frontier Market “story.” In the last six months of 2010, the MSCI Frontier Markets Index did outperform the emerging markets by gaining 16.5% compared to 12.3%. Of course, this is a rather recent phenomenon. After doing quite well from 2003 to mid-2008, frontier markets collapsed. Like all markets, frontier markets did recover, but until recently they underperformed not only the emerging market index by 27%, but the S&P 500 as well.

In terms of economic growth, these markets are very attractive, with some of the fastest growing economies in the world. Their debt burden is often lower than both emerging and developed markets. Their growth seems generally to have a lower correlation to both emerging and developed markets and at 13 times earnings, their equities seem quite cheap. Besides, they all have growing populations with young cheap labor.

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<sup>48</sup> Lex, “Frontier markets,” *Financial Times*, [www.ft.com](http://www.ft.com), December 21 2010.

But the happy talk only goes so far. There is another side to the story. First, other than marketing, the grouping of frontier markets has no purpose. To place countries as different as Kuwait, Argentina, Bangladesh, Kenya, and Estonia in the same group is simply silly. These countries, their markets, economies, and growth prospects have really nothing to do with each other.

Many of the problems for investors in these countries are similar to those in other emerging markets, except on a larger scale. Their legal infrastructures are exceptionally economically inefficient, if they exist at all. Many have high levels of political instability and some are nearly failed states. According to Transparency International's corruption index, some countries in this group, such as Qatar and Estonia, rank fairly high (19 and 26, respectively). However, most do not. Few rank even in the top 100. Countries such as Bangladesh, Nigeria, and the Philippines are all tied at 134.

Like many emerging markets, Frontier Markets are dominated by state-owned and family-owned companies. According to one ranking by the Asian Corporate Governance Association, their corporate governance is rather low. Indonesia and the Philippines ranked at the bottom for Asia, with scores of 40 and 37, respectively. In contrast, Singapore has a score of 67 out of 100.

Their labor forces are young, but sadly their economies are often growing too slowly to provide jobs. Unemployment rates among younger workers are often as high as 40%. Education does not seem to help. According to the IMF, the unemployment rate in Egypt, Jordan, and Tunisia exceeds 15%, even for workers with a tertiary education.

Also, the growth assumptions may be dependent on some potentially short-term effects. For example, the African investment story is based on a belief that Chinese demand will continue. According to recent research at the IMF, the quantitative monetary easing (QE2) in the United States has transferred itself almost completely to emerging markets.

The result is often highly volatile markets. Presently, Chile, Peru, Indonesia, the Philippines, Sri Lanka, Taiwan, and Thailand are all at or near all-time highs. In the past, many of these markets have dropped by enormous amounts. In 2008, Egypt dropped 60%. While this was similar to the S&P 500, its recovery is not. While the S&P 500 was only 17% off its all-time high in early 2011, Egypt is still 36% below its peak. Kuwait has recovered only 4% since 2008 and is still 54% off its all-time high. Saudi Arabia reached its peak in 2006. Even after five years, it is trading at only 35% of its peak.

While the promise is there, it is exceptionally important for investors to make sophisticated distinctions between these markets. Strategies that might be applicable to more developed markets have no use in frontier

markets. And as always, new highs should be a signal for caution rather than the promise of greater profits.

## Emerging Market Bonds

In the fall of 2010, the United States Federal Reserve started a process of quantitative easing known as QE2. It had and most likely will continue to have many unfortunate and unintended consequences. The idea behind QE2 was that it was supposed to drive US interest rates so low that investors would seek higher yields by investing in riskier assets. In this regard, it did accomplish its goal. With interest rates for US government and corporate bonds at all-time lows, investors went looking for higher yields. No doubt the Federal Reserve thought investors would confine their search to the United States. They were wrong. They didn't. In a globalized world, investors looked everywhere, often in all the wrong places.

Emerging market sovereign debt quite recently seemed to involve quite a bit of risk. After all, investing in debt or fixed income investments is supposed to be a conservative investment without either risk or the volatility of equities. Emerging markets are supposed to involve a great deal of volatility, currency, and political risk. How could they become so respectable? One word—Greece.

In contrast to Greece and many of the other Eurozone basket cases, the balance sheets of many emerging markets look quite strong. While both Italy and Japan have debt to GDP ratios above 100% (almost 200% in the case of Japan), the debts of Brazil, Turkey, Mexico, Poland, and even South Africa are all below 50%. Tony Crescenzi of PIMCO put it very simply, "Investors are asking themselves, 'Would I rather lend money to nations whose debt burden is worsening, or to nations where it is improving?'"<sup>49</sup>

Not only are the balance sheets often stronger, the yields are as well. As of October 2011, the yield for ten-year bonds from Mexico is 6.01% and for Brazil it is 11.61%. Ten-year bonds in the United States are yielding only 2.16% and Japan's ten-year Japan Government Bonds (JGBs) yields only 1.02%.

But what are the risks? First, there is the currency risk. In the past, unstable emerging market economies produced high inflation and volatile currencies. Often, they would borrow in dollars, which caused a crisis if their currencies fell. Today, the situation may be reversed. The credit ratings of many

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<sup>49</sup> "In a hole: Stagnation, default or inflation await. The only way out is growth," *The Economist*, [www.economist.com/node/16397098](http://www.economist.com/node/16397098), June 24, 2010.

emerging markets are good enough to allow them to borrow in their own currencies.

The currency risks have also changed. Much has been written about the undervalued renminbi; it is not alone. *The Economist's* most recent Big Mac index, a measure of currency valuations according to purchasing power parity, showed that several emerging markets, including Mexico and Indonesia, have substantially undervalued currencies.<sup>50</sup> In contrast, the Brazilian real is the most overvalued currency. So there is potential for both currency gains and losses depending on the country.

Inflation has always been a headache for emerging markets. Governments would often follow unsustainable development and social programs financed by international borrowing and printing money. Again, it appears the situation is reversed, as central banks in developed countries follow extraordinarily loose monetary policies to avoid a nasty recession. But appearances can be deceiving. Since the crash, the booming economies of the emerging markets have caused several countries to have rather resilient inflation rates that have so far resisted interest rate hikes. As of October, 2011, India's inflation rate is almost 10%. China's reported rate is 6.1%, although it is likely much higher. Brazil's inflation rate is 7.31%. The rates of all three countries are still rising.

There are other problems as well, including trying to determine the risk. The Greek crisis was certainly exacerbated by dodgy accounting. According to Pierre Cailleteau of Moody's, a rating agency, "the state of public-finance accounting is extremely rudimentary relative to private-sector accounting." Greece is subject to EU rules, has a democratic government, and a free press. Even so, they distorted their numbers. Greece's budget issues were discovered when the newly elected Socialist government revealed a double-digit deficit in October of 2009, a deficit that was almost three times the previous forecast. It wasn't a mistake. The Greek bean counters had been at this game a long time. According to Eurostat, the European Union statistical agency, Greece distorted its numbers to get into the EU in 2001.<sup>51</sup>

Governments make laws, but they do not necessarily have to obey them. Investors always have to remember the agencies that compile statistics are controlled by governments and do not really have to answer to anyone.

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<sup>50</sup> "The Big Mac index: Currency comparisons, to go," *The Economist*, [www.economist.com/blogs/dailychart/2011/07/big-mac-index](http://www.economist.com/blogs/dailychart/2011/07/big-mac-index), July 28, 2011.

<sup>51</sup> Kerin Hope, "History of statistics that failed to add up," *Financial Times*, [www.ft.com](http://www.ft.com), September 30, 2011.

Other legal institutions that allow for access to accurate information simply do not exist in many emerging markets, so the optimistic numbers may only give the illusion of solvency. The reality may be quite different.

It is not only information about governments that creates risk in emerging markets. It is the governments themselves. According to a recent study, increased government interference in the economies of developed markets has resulted in less efficient use of resources. For each percentage point increase in the share of GDP devoted to government spending, growth was reduced by 0.12–0.13% a year.<sup>52</sup> Emerging markets such as India, China, and Russia are dominated by government. In all these countries, the government sector is over 50% of the economy. Therefore, the present fiscal situation could change rapidly.

In fact, it is already changing. Due to demand, emerging market corporate and sovereign bonds have been issued at a record pace. They are 10% above 2009, itself a record year. This new debt may cause problems because of the nature of debt itself.

In game theory, a debtor's best move is not to pay back the creditor. Debtors do so for only two reasons, the law and reputation. An enforced law can require a debtor to repay. Without the law, creditors must rely on reputation. If a debtor earns a bad reputation, then they cannot borrow in the future.

The problem with sovereign debt is that governments make the law, so collecting from defaulters like Argentina has been exceptionally difficult. Usually, when a country defaults, the restructuring is basically dictated by the defaulting state. Creditors take the deal, often because there are no alternatives.

Certainly, sovereign debt from emerging markets carries associated risks, but government is government. The debt is issued by a country, which can't really just disappear. In time, most sovereign defaults are worked out. However, such logic is not always convincing. Tom Becket, chief investment officer at PSigma Investment Management, states "I think people are probably giving emerging market governments too much credence in their ability to manage their way through potential financial crises. I would still much rather

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<sup>52</sup> "The unkindest cuts: Many countries face the difficult choice of upsetting the markets or upsetting their voters," *The Economist*, [www.economist.com/node/16397086](http://www.economist.com/node/16397086), June 24, 2010.



invest with high quality emerging market companies and their management than with the politicians of certain emerging market countries.”<sup>53</sup>

With such faith and with mounting risks associated with government bonds in developed markets, emerging market countries and corporations were able to issue more debt than ever before. In 2010, they issued \$151 billion dollars in dollar-denominated debt, more than in any other year.<sup>54</sup>

China was a preferred destination for yield-seeking investors. In 2010, Chinese companies raised three times more money from bonds as they did from equities. The sales continued to break records this year. Chinese corporate yuan-denominated bond sales totaled over 100 billion yuan (\$15.2 billion), up 60% over 2010. Dollar-denominated bonds did even better. Chinese companies also broke records, with sales of \$33 billion.<sup>55</sup> Chinese real estate developers alone have sold more than \$19 billion in recent years.<sup>56</sup>

Now, many of these bonds are beginning to go bad. The Chinese property developers are some of the first to go. Many took on enormous debt to take advantage of the real estate boom. In the past month alone, prices for these bonds have fallen 22 cents on the dollar as default risks rise.<sup>57</sup>

In the past, Chinese state banks would sometimes step in and buy foreign bonds. For example, Greentown China Holdings Ltd. avoided a default in 2009 by paying off \$400 million of its foreign bonds. They raised money through lightly regulated Chinese trust companies. This exit strategy is probably closed. China’s banking regulator has been cracking down on trust companies’ loans, specifically loans to Greentown.<sup>58</sup>

The foreign bond holders of Greentown were lucky to receive their investments back. Investors in Asia Aluminum were not so lucky. Asia’s largest

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<sup>53</sup> Tanya Powley, “Opportunities remain in emerging markets,” *Financial Times*, www.ft.com, October 13 2011.

<sup>54</sup> David Oakley, “Emerging market dollar issues soar,” *Financial Times*, www.ft.com, September 1, 2010.

<sup>55</sup> Henry Sanderson and Will McSheehy, “Bond Sales Beat Stocks in Busiest Start to a Year on Record: China Credit,” *Bloomberg*, www.bloomberg.com/news/2011-01-23/bond-sales-beat-stocks-in-busiest-start-to-a-year-on-record-china-credit.html, January 24, 2011.

<sup>56</sup> Robert Cookson, “Chinese property boom starts to wobble,” *Financial Times*, www.ft.com, September 29, 2011.

<sup>57</sup> Ibid.

<sup>58</sup> Laura Santini, “Greentown Buys Back Its Foreign Bonds: Property Firm Uses Loans to Pay Off Investors as China Relaxes Restrictions.” *Wall Street Journal*, online.wsj.com/article/SB124155359838788625.html, May 6, 2009.

manufacturer of aluminum extruded products paid only 20 cents on the dollar for the senior bonds and only one cent on the dollar for the \$800 million worth of junior bonds. An attempt by a Hong Kong bankruptcy court to liquidate the company's assets to get a better deal failed.

The problems are not just limited to China. Some Russian bond holders are beginning to worry. This year, the Russian ruble was the fourth best performer against the dollar. The combination of high yields and potential currency appreciation was irresistible. Many local Russian companies were happy to take advantage of this opportunity to issue international bonds denominated in rubles. It sounds like a good idea, unless problems develop. The market is illiquid, shallow, and new, so it will be more vulnerable to sell-offs than the dollar-denominated or local ruble bond markets.

The potential for trouble came in the recent example of the Bank of Moscow, a bank we discussed in Chapter 6. The Bank of Moscow is Russia's fifth largest bank, whose shareholders include Goldman Sachs and Credit Suisse. VTB, the state-controlled lender and Russia's second largest bank, recently bought 46.5% of the bank. What it found on the bank's books caused a scandal. There was a \$14 billion hole in its balance sheet and questionable loans worth billions of dollars to businesses related to Bank of Moscow senior managers. This was bad enough. The real problem was that not only was the Bank of Moscow's \$2 billion in foreign currency bonds placed in question, but so were \$8 billion of VTB's own foreign currency bonds.

Many larger corporations in emerging markets are either state owned or have close ties to the government, which may not favor bond holders. Stiffing foreigners in pursuit of domestic policy goals is a time-honored practice.