Equity Overview with Chuck Gibson, Emerging Markets 101

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C. Austin Fitts: Welcome to The Solari Report. This is our quarterly equity overview with Chuck Gibson. Chuck is a person who needs no introduction on The Solari Report.

We've had a great series for the equity overview so far this year. Over the last twelve months, we've talked about the long-term bull market in bonds, when it's going to turn and what that will mean to the equity markets.

Chuck also did it a great Solari Report on market cycles. We went back and looked at the market cycles in the U.S. market. Then we did a great one on why dividends matter.

Now we're going to turn to the emerging markets. The emerging market's behavior this year vis-à-vis the developed markets has been very interesting. So I am very pleased we could do this topic at this time. So, Chuck, welcome to The Solari Report for Emerging Markets 101.

Chuck Gibson: Thank you. It's, as always, great to be here.

C. Austin Fitts: So lead us through your analysis. You've prepared a great analysis with ten charts, which will be up on the blog post. We're going to integrate them in with the video so people can also listen to this in video form and watch the charts as we go. So take it away.

Chuck Gibson: Okay. When we brought this up as a subject, the first thing I thought I knew to do was to come up with a definition of what the emerging markets are.

C. Austin Fitts: Good luck.

Chuck Gibson: Yes, exactly. Unfortunately what I found out is that this is easier said than done. The term emerging markets has now been around for almost 25 years, and has come to define a wide swath of the world undergoing rapid economic change. Right now, dozens of countries fall under this label even though they are evolving at their own pace and with their own twists on their economic development.

So let me give you a quick little history. The term "emerging markets" first appeared in the early 90s, and it's now widely acknowledged and used not just in the financial world. Prior to that, these countries were commonly referred to as either underdeveloped, or LDCs, which is lesser-developed countries, and the slightly derogatory third world.

It's easy to find lists of emerging market countries, but it's hard to find a single agreed upon definition of what they are. The big four emerging markets that originally came out were referred to as the BRICS, which was an acronym that stood for Brazil, Russia, India, China and South Africa. Since then, that list has expanded. Let's take a look a chart number one, which comes from MSCI. This is their latest list of who they consider is an emerging market country.

C. Austin Fitts: I hate to make it more complicated. I saw the headlines yesterday. Somebody has come up with "BRITs". So they've replaced China with Taiwan.

Chuck Gibson: Okay. That has expanded and included other countries; it's gone. Everybody uses the acronym now, so it's interesting. If you look, there are a variety on this list. You see China, Chile, South Africa, Hungary, Mexico, and et cetera. But given the diversity of the economies that you see here, you can see how coming up with one definition to cover that wide range is going to be difficult.

C. Austin Fitts: Right. I often talk about G20 versus G7 or G8. The difference from – the 12 or 13 from the seven or eight – the 20 is that they often pick up a lot of the BRICs. So, it's another way of framing that is in the basket.

Chuck Gibson: What we see here is – and so I thought that another way to maybe describe what the emerging markets are – is just simply all those other countries that are not considered developed.

C. Austin Fitts: Right.

Chuck Gibson: Well, by developed I mean the major European countries plus the United States, Canada, Japan, Australia, and New Zealand.

But after thinking about it, I came to the conclusion that that really isn't particularly useful since it doesn't really help narrow down the scope. Basically every other country in the world would then be considered emerging, so I thought forget that idea.

C. Austin Fitts: Let me just make one other comment because the other term I do use for subscribers is "frontier markets."

Chuck Gibson: Okay.

C. Austin Fitts: So there is the Wild West of the emerging markets, if you will, which is the frontier markets.

Chuck Gibson: Well, it's interesting you brought that up. I had a chart I was going to bring up and that was going to give you a little insight as to the frontier markets. I didn't do that because I wanted to keep it as simple as possible because once again, there was no clear definition of what a frontier market is. There are some countries that one might consider frontiers, and some that one might consider emerging.

C. Austin Fitts: Right.

Chuck Gibson: So, rather than looking for a definition, I gave up and I thought that maybe a more useful way to look at this is to see if there was some common key attribute that all these countries shared. So let's just take a look at some of those. First off, is increasing foreign investment. The emerging markets tend to see strong foreign investment as hot money chases opportunities in growth.

So let's take a look at chart number two here. This shows capital inflow into the emerging markets. Just to make sure everybody understands, capital inflow is the amount of private money flowing into a region. So what you can see on this yearly chart is the mount of money on the vertical axis, and how it has moved into each of the emerging market regions by year.

It's clear to see this huge ramp of money flowing into the emerging markets that occurred from 2002 into 2008, and why the emerging markets did so well during that period. Since the 2008 and 2009 recovery, you can see the money did come back, but it's basically been flat since then. So another common theme that you would see is that these economies are in transition.

Emerging markets are often in the process of moving from a closed economy to a more open economy, which creates an immediate opportunity for growth. So let's take a look at the growth in chart number three. What you see here is a chart of global GDP growth by year, split between the developed markets, which are in blue, and the emerging markets that are in orange.

There are a lot of swings that you can see in the absolute value of the growth here, but that's not what's important here. What you really should be focusing on here is the fact that the size of the emerging markets, in orange, is expanding and the developed markets, which are in blue, are shrinking.

C. Austin Fitts: It's amazing when you spend time in one of these markets. So which has the strongest growth rate in this chart? The emerging markets, on average, have four to six percent?

Chuck Gibson: Yes.

C. Austin Fitts: Four to six percent. But if you go to a place where they're the strongest, like in China when it can be above 12 percent, it's amazing to be in that place because it's just…

Chuck Gibson: Hustle and bustle, and everybody is moving.

C. Austin Fitts: If you've ever heard the Grateful Dead song, *Truckin'*, everybody is going at that beat. Whenever somebody in the United States says, "I'm really depressed;" I said, "Hey, go plop down in the middle of Indonesia. You'll cheer up."

Chuck Gibson: One of the other common themes, of course, is that they have young and growing populations.

C. Austin Fitts: Right.

Chuck Gibson: Emerging markets often have younger populations, which are capable of spurring strong economic growth by replenishing aging workers, and also consuming goods and services. You can see this is reflected in chart number four, which shows the working age population of the emerging markets, which are in blue, and the developed market, which is in black.

You can see from this chart, it's very clear that the emerging markets have a huge advantage when it comes to the working age population as compared to the developed markets. So, clearly, the more non-working age population a country has, the greater their GDP is required to support those, rather than actually using that productivity towards economic ventures.

C. Austin Fitts: Right.

Chuck Gibson: Japan is a good example of that.

C. Austin Fitts: Right.

Chuck Gibson: Okay. One other thing that we can see, within all the emerging markets, is that they have, at some stage or other, an undeveloped infrastructure. I don't have a chart for this, but there are some pretty good facts here.

C. Austin Fitts: The way to understand this is you beam down into Zürich, and everything is perfect, and then you beam down into New Delhi, and you see an entire economy trying to race far beyond its roads, its bridges, and its tunnels. It's painful because an economy full of dynamic growth could be so much more successful if somebody would just sit down and fix the postal system.

But it doesn't happen. *The Economist* did a large piece earlier this year hen India turned down, laying out the long-term infrastructure needs that India had to attend to if it wanted its stocks to go back up.

Chuck Gibson: Funny you brought up New Delhi. I don't watch too much TV, but this really stuck with me. Some people were in India, and what they showed was the electrical lines and the telephone lines are just hanging from buildings everywhere. There is no post like we have to hold these things up.

It's just mass confusion. How anybody knows where what goes if they need to work on it, has got to be one of the hugest mysteries that there are in New Delhi.

So, anyway, the emerging markets are often in an early stage of building infrastructure.

While this means there is often penned up demand for government spending to help spur that growth, the flipside of course means that there are higher costs and less efficiency for businesses until they actually create that infrastructure.

A key long-term driver for infrastructure demand is urbanization. It's expected that the urban population of the emerging markets will increase by a massive 2.6 billion people from 2010 to 2050. As these people move to cities across the world, the infrastructure companies will need to be able to provide those essential services like water, power, and highways, which act as a foundation for the long-term successful growth.

One other thing is that the governments also understand that infrastructure is critical to the development of their economy. Countries like China and India have both budgeted to spend over a trillion dollars in their respective five-year plans going forward to invest in infrastructure.

C. Austin Fitts: Right.

Chuck Gibson: One of the other common themes is growth of consumption. The emerging economies, historically, have tended to focus on producing goods to be shipped abroad to wealthier countries. While this is great, initially, because it creates a foundation for their fledgling economy, doing so makes them subject to the vagaries of the developed world economies.

C. Austin Fitts: Right. That's part of what we've seen over the last year. Europe is China's largest customer. Europe's economy slowed down, and China experienced a huge shift in exports and demand.

Chuck Gibson: Yes. It's really hard to shift your economy as fast as they needed to because of the slow down of Europe. So this is, as you've mentioned, recognized by the emerging markets already, and their models are moving towards this economy that is more dependent upon domestic consumption, rather than exports.

C. Austin Fitts: Right.

Chuck Gibson: If you look at chart number five, this shows two pie charts of global consumption. The first pie chart on the left is for the decade of 2000-2010, and the one on the right is actually the current decade, which projects forwards to 2020. I'm going to use G7 as a reference there. It's the pie piece that's in yellow. Both charts are broken up into the G7 and the rest of the world, which is split up between the red, which are the BRITs, and the rest of the world, which are in blue.

C. Austin Fitts: Right.

Chuck Gibson: What you can see from the decade from 2000-2010, G7 drove consumption growth with 60 percent of the total of all demand. Whereas in the current decade, it's estimated that will drop to 28 percent, which is a dramatic halving of the growth.

C. Austin Fitts: That is an enormous drop.

Chuck Gibson: In ten years, it's huge. One really positive thing that comes to mind is the emerging markets in their position with regards to low debt levels. So thanks to their robust growth and spending restraint, many of the emerging market governments and their corporations have healthy balance sheets; healthy as compared to the developed world. In addition, the citizens of emerging markets tend to also have low debt levels and high savings rates.

C. Austin Fitts: Right.

Chuck Gibson: That also obviously bodes well for future spending.

C. Austin Fitts: So, in many ways, they are really much more financially sound that the developed world.

Chuck Gibson: Correct. Now, take a look at chart number six. This is simply a snapshot of deficits. On the left side, we have plotted debt as a percentage of GDP, so that's the vertical axis, and on the horizontal axis, we showed deficit as a percentage of GDP.

What you really want to take out of this is that the majority of the developed world is centered on the far upper right-hand corner of this chart. That's because they have a large deficit and a large government GDP, whereas the emerging countries are all bunched in the lower left-hand corner reflecting much smaller deficits and debts.

C. Austin Fitts: Well, there's another way to look at it, though, and that is the developed world is getting goods and services from the emerging markets, and giving them crappy paper back.

Chuck Gibson: Sometimes you have to do that to move forward. All right. I've got two more for you. Finally, what we have is productivity. What we know is that productivity in the emerging markets has greatly lagged and it tends to lag less than the mature economies. So better infrastructure and technological advance in the emerging markets will significantly boost productivity, which of course is a major factor in a sustainable growth model.

One of the productivity advantages that the emerging markets do have though, is labor. If you look at chart number seven, what this shows is labor growth across the world. The red line, which is the emerging markets, has far outpaced the mature economies, which are in blue, and that's been going on since the mid 90s.

One of the other interesting tails on this chart is while the growth has been spectacular for the emerging markets, it's really topped out in 2006. What we're starting to see is that it's starting to decline, but it's still two times greater than the growth of the rest of the world.

C. Austin Fitts: It's very interesting how you measure productivity because we think of the U.S. system as having fraud problems. When you get Chinese financials, it can be the Wild West.

You don't have that infrastructure of regulatory compliance that you do in the developed world and it makes it unnerving to deal in those environments. So productivity can be a funny thing. The other thing is it's a lot easier to implement certain kinds of new technology in a country that's a blank slate.

Chuck Gibson: Yes. Use telephones as an example: you have the infrastructure of the landlines, which when you didn't have that in the emerging markets they can go right to cell phones and they bypassed us in no time flat.

We're trying to live within the infrastructure we have.

C. Austin Fitts: Right. So there is leapfrogging going on.

Chuck Gibson: Absolutely. So the last one I have, I think is actually your fun little chart. It's chart number eight, and I think it's from *The Economist*, which shows the emerging market world share of different things. So it's nothing really of major significance other than I thought that bringing this here is pretty interesting and its kind of fun.

So just for example, you can see that 85 percent of the world's population is contained within the emerging markets. Eighty percent of the world's mobile phone subscribers, mobile phone subscribers, are within the emerging markets.

C. Austin Fitts: Right.

Chuck Gibson: They consume 70 percent of the world's steel consumption, and they are 50 percent of the world's exports and 30 percent of the world's consumer spending.

C. Austin Fitts: Wow.

Chuck Gibson: There are a bunch of other things that are really interesting here, but there are a couple of things that I found that I would love to have added to this chart. One of them is that the emerging market consists of 75 percent of the world's landmass. Finally, and this is really relevant to investors, is that they only account for 12 percent of the global equity market capitalization.

C. Austin Fitts: Right. I remember in 1991, Richard Breeden, who was the head of the SEC, asked me to be on the emerging market taskforce. It was a taskforce that the SEC put together to teach all the emerging market countries, one-by-one-by-one, how to start stock markets. Truly global equity markets are a relatively new phenomenon.

I'll never forget in 1997, I was in Shanghai. Deng had just died. I was coming into a university in Shanghai, and you had 50 people sitting around in the guardhouse listening to this portable radio. The guy who was with me, who was a PRC citizen, said to me, "What do you think they're listening to?" I said, "Are they listening to news of Deng's death?" He said, "No, they're listening to the first day of the Shanghai stock market."

Chuck Gibson: Oh really?

C. Austin Fitts: Twenty years ago, none of these countries had real stock markets. Not to say that they didn't have companies that publicly traded, but in terms of real markets, they really didn't have financial markets. What we are watching is an explosion of securitization, both the equities of companies and debt, throughout the emerging markets.

What I didn't understand until you did the presentation, I think it was two quarters ago, was how few global investors are equity investors. So this is still very new, where we are seeing equity markets developed throughout the world, it still hasn't really happened yet. The sovereign wealth funds, the institutional investors are investing, but the average retail investor really hasn't become an equity investor yet. What happens when and if that happens?

Chuck Gibson: Right. It'll just explode.

C. Austin Fitts: Right.

Chuck Gibson: I don't know if people know this, or most people might not know this, but you cannot invest directly in the China stock market. You can invest in a China ADR within the United States.

C. Austin Fitts: Right.

Chuck Gibson: Or the other alternative is to invest in Hong Kong, which invests in the China stock market. But they haven't opened their market for the rest of the world to come in and invest.

C. Austin Fitts: Right. If you invest, you have to invest in non-voting shares. They are very big on the A-share/B-share model.

Chuck Gibson: So with that as a backdrop, what we know is that for the last two decades the emerging markets have generated some of the most exciting global economic opportunities. As economies in Asia, Latin America, and Eastern Europe begin to grow and outpace the developed countries, combined with new economic reforms and trade levelizations, this opened the door to western investment.

C. Austin Fitts: Right.

Chuck Gibson: So in the meantime, increasing urbanization and the emergent middle class gave rise to a new generation of consumers who had strong demands for goods and services, and the infrastructure development is needed to support their lifestyles. As a result, investors during this period of time have been able to enjoy a period of exceptional returns.

C. Austin Fitts: Right.

Chuck Gibson: As a growth investor, because that's what we are, it kind of makes you giddy. It seems like this is a slam-dunk for investors, doesn't it?

C. Austin Fitts: Well, you're talking about investment, which is impacted by fundamental cycles, but it's also impacted by currency fluctuation. If you've ever seen an investor who is really pleased because they had great dividends from emerging markets companies - they are getting great dividends.

Suddenly the dollar swings the other way, the price of their stock gets cut in half and their dividends get cut in half. It can be a very gut wrenching experience. That's one of the reasons since the 2008 scare, a lot of investors are a little bit more nervous about moving back into the emerging markets.

Chuck Gibson: Absolutely. That leads right into what I want to talk about next, which were the risks that are associated. It sounds really good of what this thing provided you, but one example of one of the risks – well, let's go through a couple more to see.

C. Austin Fitts: The Wild East is not everything it's cracked up to be.

Chuck Gibson: Well, it might or it might not be. Let's let the listeners make that call. So as you brought up, the first important thing is the currency risk. Anytime you invest in an international market, investors face the risk that the exchange rate will move in a favorable or unfavorable direction, right?

C. Austin Fitts: Right.

Chuck Gibson: So, for example, you brought up the stock example where you didn't get hit on, not only in the gains that you're seeing, but also in your dividends. The foreign currency in which you invest in is dominated and declines in value relative to the dollar. It could reduce your gains and potentially magnify losses.

C. Austin Fitts: Right.

Chuck Gibson: You brought up a point that I really didn't consider during this. If you're buying an investment for a dividend, a lot of people are going to be more patient to be able to have the swings in the price if they continue to get that dividend. But that dividend now becomes an element that is no longer as attractive as it was, then people get nervous and they want to bail out.

C. Austin Fitts: Right.

Chuck Gibson: Another risk that we need to consider is inflation. A mix of strong economic growth and insufficient monetary strain really can result in high inflation, a problem that's regularly cropped up in the emerging markets. Runaway inflation and policymakers are used to combat these things to devalue. What they can do is to devalue their currencies, which can hurt profit margins and abruptly slow economic growth.

C. Austin Fitts: Right. It's interesting. If you're an investor in the United States and you're used to investing domestically, you're investing in an economy that controls the world's reserve currency.

Chuck Gibson: Yes.

C. Austin Fitts: When you invest in a variety of emerging markets, you're investing in economies that are the mercy of the larger currencies. It's a very different competitive position.

Chuck Gibson: Yes. Another thing is capital market inflation. You have risk of excessive capital flows chasing a limited supply of financial assets, and this is the old too much money chasing too few of goods or services, and that has created in the past, bubbles.

C. Austin Fitts: Right.

Chuck Gibson: If not bubbles, it can create significant declines very quickly.

C. Austin Fitts: Right.

Chuck Gibson: Another thing is institutional risk, and you kind of touched on this. In the emerging market, we have accounting rules, whether they follow them is another thing. They don't have necessarily the rules, standards, and the regulatory framework that we've seen mostly in the advanced world economies.

C. Austin Fitts: You do not have, within the culture, within the people, the managerial infrastructure that you do in the developed world.

Chuck Gibson: Absolutely. That's another risk that one takes while investing there. And liquidity; this is a real sensitive subject to me. But the emerging markets typically have a much lighter trading volumes, and a small number of participants than you do have in the developed market. So this creates a risk that investors wishing to sell will not be able to find somebody to buy their shares at a specific price, right?

C. Austin Fitts: Right. This one is very hard for me because most of the companies that find to be have excellent management and products and services; they're stock is not liquid.

Chuck Gibson: Exactly. It's great. You can say, "Well, I'll buy it and I'll just hang onto it forever," but good luck trying to get rid of it if you need to. There are two more here, and one of them I had to do some research on in case it came up. It's something called the "middle income trap". I didn't know what this was. Historically, it's shown that almost all high growth countries that are transitioning from lower income to middle income have experienced a major growth slowdown, as their economies have gotten larger and more complex, and their living standards have risen.

C. Austin Fitts: They plateau.

Chuck Gibson: They plateau, and it's like they have to consolidate. It's like a stock going up. It has to consolidate before it makes its next move up. Then, finally, there are the political risks that are associated with the emerging markets.

C. Austin Fitts: Right. One of the things we've seen is there have been a lot of political risks in the emerging markets since 2010. As Europe is working out, and now as we have the US budget issues, you see the developed world calling capital home.

If you look at the politics of the G20, the G12 or 13 have been flexing their political muscles, and G7 has been saying, "What G7 giveth, G7 can taketh away."

So we have seen a real tug of war going on It's part of the consolidation of a new sort of rebalancing of the global economy. Power swings to the emerging markets, and the G7 asserts its authority and it swings. Right now, we're in a situation where it's swinging back. It's just part of the pendulum swinging back and forth as we rebalance.

I don't think it's permanent. We have G7 saying they're going to target the tax havens. That's a lot of capital, and that capital can swing the world markets in lots of funny directions.

Chuck Gibson: That's interesting you bring that up because I think it's in chart number ten or nine, whatever, a couple ahead of us here. That'll just reemphasize the point you just made in terms of it quantifies it. It's amazing what has happened because of this.

C. Austin Fitts: It's amazing. Well, don't count G7 out.

Chuck Gibson: No.

C. Austin Fitts: That's what we used to say on Wall Street looking at that chart, "Wow, that's real power."

Chuck Gibson: So this is their risk. What we've done is we've put together a list of some pros, and then we talked about the cons. Now that we have a framework for risk and reward, let's take a look at where we are today briefly.

C. Austin Fitts: Okay.

Chuck Gibson: Since the U.S. stock market bottomed in 2009, an investment in the collective emerging markets has gone nowhere; it's flat, while the S&P has doubled. Here we are, the United States stock market has doubled. Is that because we have such a far under evaluation in 2009 that the S&P was so far undervalued that it had to revert back to the mean, or this because of what you said, political risk and flexing muscles?

C. Austin Fitts: Well, there are two issues. One is after we came out of the lows in 2008-2009, the two were tracking together. Emerging markets and North American equities were tracking up. It's really just been at the beginning of 2012, we've just seen a huge split. Part of it is G7 calling the capital home.

The other question is: How dependent are the emerging markets on the commodities markets? As commodities have fallen, the emerging markets have gotten slaughtered. Part of it is Europe is not buying, so China doesn't make, so they don't buy from Brazil. The question is whether what we call the commodity super cycle is over.

Chuck Gibson: One other thing that I therefore thought is that when you have an out performance, a consistent out performance in a sector or a region, and it's clearly identifiable. Then you start to see the herd to start to move towards that and ignore the things that are a value.

So part of that is a whole conglomeration of all these things. Part of it is because of the fact that if you are looking at where to invest your money, and you've got money due right away, most people look behind them and see what has performed best over the last period of time. The developed world, the United States, has done unbelievably in comparison. So that's where the money tends to flow.

C. Austin Fitts: Right.

Chuck Gibson: That, too, is a pendulum and it may swing at some point in time too. Well, we know it will swing.

C. Austin Fitts: We were hoping you would tell us exactly when.

Chuck Gibson: Oh, of course. So the United States stock market has doubled. Let's take a look at why the emerging markets haven't done as well.

So the first reason is growth. This was the whole discussion and value that the emerging markets bring. The backdrop of the long-term is very positive with a developed world attempting to rebuild their collective balance sheets, and no longer providing this endless demand for emerging market experts. So the days also of China's double digit GDP growth are gone.

C. Austin Fitts: Right.

Chuck Gibson: Now, not that seven percent is anything to sneeze at, but they were 10, 12, 13 percent, and now they're at seven percent. Now, is that going to reassert itself? It's going to be hard.

C. Austin Fitts: Right.

Chuck Gibson: Additionally, what you tend to see is that the emerging markets, as a whole, were really dependent upon the Chinese growth engine, so poor performance has been driven because of China.

Also, if you look at India, their growth has halved, and even worse, Brazil is only up one percent.

C. Austin Fitts: Right.

Chuck Gibson: Another reason is liquidity. What happened was as the United States interest rates continued to fall, what you saw was that to counter the first dot-com slump, and then the financial crisis of 2008. What that did was it fueled a carry trade for investors. What that means is that investors are borrowing cheap U.S. dollars, and going in and chasing higher yields, whether they be yields in emerging market debt or in equities. Now with interest rates starting to rise, that whole argument…

C. Austin Fitts: The whole carry trade reverses.

Chuck Gibson: If it's reversing, it's changing direction.

C. Austin Fitts: Right.

Chuck Gibson: One other reason I think is unfortunate is they seem to be a victim of their own success. So their governments are trying to walk this fine tightrope. On one hand, they're trying to contain the inflation, and on the other hand, they're trying to keep growth at a satisfactory pace.

As such, most of the emerging markets companies have also issued their analyst profit expectations for the last five quarters. Also what we can see is that the expansions of the economies in China and Brazil have been slowed to their weakest point since 2009.

So you have this trend that was positive, that has slowed down.

C. Austin Fitts: So if you're the president of Brazil, you're having a very bad year because there is no growth and your citizens are mad. In the meantime, the president of the United States is listening to your phone calls. You're just having a really bad year.

Chuck Gibson: If you're in Brazil, the other thing that would really bother you is that you didn't do so well in the World Cup.

C. Austin Fitts: Right.

Chuck Gibson: Then finally the fourth reason and this is what I talked about before; investors, as a whole, appear to be more cautious since the 2008-2009 crisis. So the risk premium for the emerging markets investments has increased, and, as such, that money is actually sticking closer to home.

Why? It's easier to monitor. It's more transparent. And, quite frankly, investors seem to be turning a blind eye to that proven successful investment strategy in a diverse location. Instead, what they were doing is concentrating on what's hot.

C. Austin Fitts: Well, the question then is where is the opportunity because when I look at the quality of investments and management teams in some of the emerging markets I'm very impressed. Can I turn to your chart nine?

Chuck Gibson: Sure.

C. Austin Fitts: If you look at your chart nine, if I can find a great management team and a good company with strong markets, it's basically trading at a PE average of 14, while I have to pay 24 for that same income in the US market. So I can basically buy a dollar of income for $14.00 that is just as good as paying for $24 for in the North American market. Why would I do that?

Chuck Gibson: Right. Exactly. You don't have to worry about currency risk in the United States market, I look at this as very akin to what happened. It's not quite as bad. The valuations are compelling in the emerging markets such that it is similar to what happened in the United States in 2009 at the bottom.

C. Austin Fitts: Right.

Chuck Gibson: So at some point in time, and it may have already started, there is going to be some accumulation of the smart money and it's going to be moving back into that market because of the overvaluation in the United States stock market.

C. Austin Fitts: Now, but here's the thing. In the last quarter, they have moved up a little bit, so maybe it's turned. If you look at, again, what G7 is talking about doing in terms of the tax havens, and if you look at the politics going on now between the G20 and the G7, it says to me that the war is not over.

Chuck Gibson: No. The other thing that is driving this is the dollar. We've drawn a line in the sand right where we're at today, and I think that what the emerging markets do is going to also be driven by what the dollar does, as such, if the dollar falls, you would expect commodities to get back in vogue, and then, therefore, the emerging markets to be much more attractive.

C. Austin Fitts: Right. That's going to hammer U.S. equities.

Chuck Gibson:. Yes, potentially.

C. Austin Fitts: I got to the point where I think of this all around Starbucks. If the price of coffee goes up and the cost of borrowing money goes up, Starbucks earnings goes down. It's all very simple.

Chuck Gibson: Well, I mean that chart you brought up, chart number nine, that's a value investor's dream.

C. Austin Fitts: Right.

Chuck Gibson: But the problem is you've got this conundrum that we've got going on.

C. Austin Fitts: We've got this war going on.

Chuck Gibson: Exactly. That leads me to chart number ten, my final chart. So what you're looking at in this is the flow of money year-to-date. On the far right-hand column it says, "YTTD", the flow of money year-to-date into global equities. What you see is that, in total, there was 160 billion dollars year-to-date that flowed into global equities.

Now that sounds good. But what you also see, which is not so good, is that all of that flowed into the developed market. In addition, more flowed into the developed market as it pulled eight billion dollars out of the emerging market.

C. Austin Fitts: So its net pulls from the emerging markets.

Chuck Gibson: Net pulls from the emerging markets into the developed markets. So my feeling is until that changes, you need to minimize your exposure to the emerging markets because money flowing into a place or a thing is what's going to drive prices higher.

C. Austin Fitts: Right.

Chuck Gibson: So I feel that there is no real compelling reason right now, yet, to be first to the party into the emerging markets.

C. Austin Fitts: Right. But it's certainly something to watch very closely.

Chuck Gibson: Absolutely.

C. Austin Fitts: The other thing I will say is when you focus on great companies and finding great opportunities in great companies, you just never know. You and I can sit here and say, "We want nothing to do with this market," and the next day, we find a great company.

Chuck Gibson: Absolutely. We have done that.

C. Austin Fitts: Yes, we have.

Chuck Gibson: So just to wrap this up, I think in the end and over the long haul, investing is finding out about those growth areas. It's finding those growth prospects, and the growth prospects of the emerging markets going forward are very compelling. But as with any growth prospect, there is always a myriad of risk for one to contend with.

So the one thing I feel comfortable saying though is that no matter how much the emerging market grows, whether that's up or down, it will continue to grow. I believe that there is a very high probability that it's going to be significantly in excess of the developed markets.

C. Austin Fitts: Right.

Chuck Gibson: So, as such, for those investors who are willing to assume the risks, they understand them, they have a long-term time horizon, and they are willing to live with the inherent volatility, the potential reward suggests that you really do need to have a portion of your investments focused on the emerging markets.

C. Austin Fitts: Right. I remember reading one investment advisor who advised basically that you should look at the global GNP, and you should allocate your portfolio according to the global GNP. Which would be very difficult because despite their growth as part of the global GNP, the emerging markets are still only 12 percent of the equity flows. That's going to be tough to do.

One thing I wanted to bring up is that when you start to look at investing in the emerging markets, you're really, in most cases, forced into mutual funds or ETFs or certain kinds of vehicles. Often times these markets don't have a lot of liquidity.

Chuck Gibson: Correct.

C. Austin Fitts: If you limit yourself to ADRs, which are the stocks traded on the U.S. markets, you're going to miss a lot of the great opportunities. Also, frankly, in some of these markets, you want somebody who is totally expert at that place because it takes very specialized knowledge to monitor. So often times, I think particularly for retail investors, you want to come in following somebody who's focused on that market.

Chuck Gibson: Absolutely. You said it ever since I've known you, "boots on the ground makes a huge difference to understanding what you're investing and where you're investing it." As much as we would love to be able to say that we're experts on understanding the emerging markets, I can't say that I have any edge over somebody that is actually sitting there immersed in it day-to-day.

C. Austin Fitts: It was really funny. My first year at Dillon Read, they used to send the first-year associates off to annual meetings. So I went to the annual meeting of Colgate/Palmolive, who was a big client. The whole board was like 70 years old and they were all men. They showed the products in a video, and it was all women buying stuff.

I came back and the officers said, "What do you think?" I said, "Until they put Erma Bombeck on the board, sell Colgate." Sure enough, the stock dropped significantly. That was my first lesson. When you could still get in to corporate buildings, I'd go ride up and down in the elevators and talk to people and do all sorts of things to get inside and see what the companies were like. I think you really have to be there.

Well, Chuck, any other summary thoughts you want to add?

Chuck Gibson: We did a reasonable job of framing the pros and the cons. What I don't want anybody to walk away from here is that, as with any investment, and emerging markets is one, you need to also be very aware and concerned with the point at which you enter. So I'm not saying to anybody, "This is the time to go enter the emerging markets," even though the argument for the valuations is compelling.

C. Austin Fitts: Right. You need to watch the PEs.

Chuck Gibson: You need to watch the PEs. Those PEs can become a lot lower than what they are today. You can see a PE, instead of 12, down at ten. I'm not saying that's what's going to happen, but I'm saying as long as there's a trend, follow the money. That's really the key. The problem is it's really hard to find that data. When you do find it, it's typically a year or so later.

C. Austin Fitts: Right. Although, I have to say that I think the charts in this presentation are very helpful, and from them you can start to think about how you want to follow the analytics.

Chuck Gibson: Absolutely.

C. Austin Fitts: The other thing I do want to say is I find looking and studying the emerging markets to be one of the most hopeful things I do. This may be tangential to what investors are interested in, but every day, day after day, you look at amazing teams of people who are doing important and interesting things.

We're in a mature economy. When you study what really dynamic management teams are doing, they're things you would have never thought of. So one of the things I keep mentioning to everybody is, Jack Ma started Alibaba in 1999. It was worth zero. Today, they're talking about doing the IPO at a valuation of $70 billion. That's a pretty dynamic company.

Chuck Gibson: Yes.

C. Austin Fitts: So you see these amazing things going on, and it reminds you that the world is full of opportunities. It's one of the things I love because I will say these markets are a little bit wild for me sometimes, but they are very, very interesting.

Chuck Gibson: Yes. That enthusiasm comes across greatly. I find that very helpful for me because I'm not as optimistic as you are. I tend to see things more negatively. You keep mentioning if there are seven billion people waking up every morning, moving and going to work, and hustling and bustling, it's hard for things to collapse. You know what? It's going to be hard to change the flow of seven billion people all at once.

C. Austin Fitts: Right. Well, that's it for our equity overview this quarter. I can't wait to hear what you're going to have for us next quarter.

Chuck Gibson: Well, thank you. It was great being with you.

C. Austin Fitts: Okay. Bye.