



ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments



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In This Issue

Fidelity Opens Two Emerging Market Funds

Despite subpar returns, emerging market funds were a bright spot for fund companies in 2011, garnering \$17.5 billion in new assets through the end of November, according to Lipper. Earlier that month, Fidelity introduced two new funds delving into this space: Total Emerging Markets (FTEMX) joins several other new balanced emerging markets funds that offer risk-averse investors a way to invest in the emerging markets, while Emerging Markets Discovery (FEDDX) attempts to provide diversification by focusing on the smaller companies in the segment.

- Fidelity Opens Two Emerging Market Funds
- Emerging Markets on the Rise?
- Fidelity Total Emerging Markets
- Fidelity Emerging Markets Discovery

Emerging Markets on the Rise?

With Europe's sovereign-debt crisis showing few signs of abating anytime soon, and our own deficit issues yielding a debt-to-GDP ratio of 100%, the emerging markets are becoming more attractive for investors looking for an international component to their portfolios if the asset flows quoted above are any indication. Many emerging markets, such as China, have a debt-to-GDP ratio less than half that of our own--China's ratio is around 17%. While that doesn't mean they're less volatile, it does raise the question of how best to define risk. Moreover, demographic trends in many emerging markets are positive, as young, growing and increasingly urbanized populations strive to join the middle class. As a result, many of these nations are enjoying rapid economic growth, especially when compared to the U.S. and Europe.

Despite that robust growth, however, most emerging market mutual funds did not fare well in 2011. For the year, the benchmark MSCI Emerging Markets Index fell 18%. These results are a taste of the risks and sometimes knee-buckling volatility that comes with the territory.

While diversified emerging market mutual funds are generally less risky than funds that focus on a single

country or region, investors need to have a strong risk tolerance when considering funds in this category. Consider Fidelity Emerging Markets, which, over the course of the three years from 2007 through 2009, saw calendar-year returns of 45.1%, -60.8% and 76.0%, consecutively. That's quite a ride. The last two years were tame by comparison, but investors still saw a nearly 40% swing from a gain of 18.2% in 2010 to a loss of 21.0% in 2011.

Emerging markets bond funds are also more volatile than their developed markets counterparts are. For example, Fidelity New Markets Income rose 5.7% in 2007, fell 18.2% in 2008 and rose 44.6% in 2009. While less volatile than emerging market stocks, emerging market bonds are still a far cry from the relative safety of U.S. Treasuries or even investment-grade corporate bonds.

To help reduce the volatility of emerging market investments, many investors employ a "pairing strategy" that combines similar-sized positions in both emerging markets stock funds and emerging markets bond funds or ETFs. Pairing creates a well-diversified emerging markets stake that helps long-term investors hang on during what is often a bumpy ride. In essence, this strategy is similar to the approach of domestic balanced funds that feature both equity and fixed income holdings.

Fidelity Total Emerging Markets

Fidelity's launch of Total Emerging Markets takes that balanced approach to the emerging markets. By investing in a mix of stocks and bonds, the new fund seeks to minimize some of the inherent volatility of this category. The catch is that, like all balanced funds, it may not fully participate in stock market rallies. Of course, it may also suffer less severe losses when stocks decline.

John Carlson, one of our favorite Fidelity managers, serves as lead manager for Total Emerging Markets and is also entirely responsible for the bond portion of the fund. A team of Fidelity's emerging markets sector analysts, including Douglas Chow, Timothy Gannon, Jim Hayes, Per Johansson and Sam Polyak, manages the equity sub-portfolio.

Carlson will continue to manage New Markets Income, as he has done since June 1995. He also manages Advisor Emerging Markets Income, Global High Income and Advisor Global High Income. Previously, he was lead manager for Strategic Income, as well as International Bond from 1998 to 2001. He managed Emerging Markets from 2001 until 2003.

As manager of New Markets Income, Carlson has used

stocks to generate gains in some markets, but has generally allocated less than 10% of the fund's assets to stocks. With Total Emerging Markets, Carlson will have much more freedom to move strategically among asset classes. The fund's neutral asset allocation is 60% stocks and 40% bonds, but Carlson has the leeway to increase equity exposure as high as 80% or as low as 40%.

In a recent interview with our own Jim Lowell, Carlson indicated that, at the outset, he plans to focus on eight of the larger emerging market countries, including Brazil, Mexico, China, Turkey, Russia, South Africa and South Korea. To reduce risk, he intends to avoid large bets on any single country's stocks and bonds.

Under Carlson's leadership, we think that Total Emerging Markets shows promise, and we're intrigued by the fund's balanced approach, something of a recent development in the emerging markets arena.

Fidelity Emerging Markets Discovery

Taking a more aggressive approach, Emerging Markets Discovery is focused on small- and mid-cap emerging market stocks. We see it as both an emerging company and emerging markets play, one which will likely serve investors best when the world markets are steaming full speed ahead, but could lag when they are coasting or slowing down. As such, we think it's worth taking a wait-and-see approach here.

Emerging Markets Discovery is managed by Ashish Swarup, and the posting represents his first lead portfolio management position with the firm (he is also managing an Advisor-class clone). He will also continue to manage the emerging markets assets for Diversified International. Previously, he served as an assistant portfolio manager on Global Emerging Markets for Fidelity Worldwide (FWI). Swarup joined FWI in 2004 as a research analyst covering consumer and diversified stocks in Africa, Eastern Europe, the Middle East and Russia.

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