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Financing Emerging Market Growth

The best long-term growth story over the next decade may be found on far distant shores. With Pacific Rim, South American and Eastern European cultures and economies building and/or evolving, investment opportunities abound. With those opportunities, obviously, come risks.

Ask an investor about investing in emerging markets and most will think of emerging market stocks. That same investor, however, would be overlooking another potent class of emerging market assets, namely, emerging market bonds.

It wasn't long ago that many investors viewed emerging markets as simply too risky for their portfolios--even those with a growth orientation. 2008 was just the latest in a string of nasty reminders of the risks inherent in fast-growing economies and markets.

But that was stocks. What about bonds?

While the sovereign debt of several European Union nations has been dramatically downgraded amid questions of fiscal health, and worries over several states in our own Union persist it's worth noting that many emerging markets nations enjoy healthy balance sheets born of relatively strong and growing economies. Several of these countries' bonds are rated at or just below "investment grade."

Investors have taken note of these shifting fortunes; not just by buying emerging market stock funds, but also funds that invest in emerging market debt. Over the past 12 months, investors added the tidy sum of \$14.3 billion to emerging markets bond funds according to one Morningstar report.

But we don't believe that investing in emerging market bonds, or stocks, should be done in a vacuum. We think a move we call a "pairing strategy", holding similar-sized positions in emerging market stock and bond funds, or ETFs, is a smart, risk-adjusted way to access these fast-growing markets. Pairing enables you to create a well-diversified and more balanced emerging market stake which we think will reward long-term investors down what is certain to be a long and

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bumpy road.

A Record of Solid Long-Term Results

Just as the U.S. government issues Treasury bonds to finance its operations, countries like Brazil, Russia, and Mexico issue debt in their own local currency or in U.S. dollar-denominated bonds. Emerging market bond funds invest primarily in the sovereign, or government bonds of developing nations; bonds issued to finance the extraordinary infrastructure growth demands that rapid expansion imposes. One of our favorite veteran emerging market bond managers, John Carlson of Fidelity New Markets Income (FNMIX), has been in the emerging market trenches since 1995. He likes to remind emerging market stock investors that 'if you like the stocks, you'd better like bonds, too.'

According to Morningstar, the emerging markets bond fund category delivered average annual returns of 7.7% for the three-year period ended March 30. That outpaced returns for emerging markets stock funds, which averaged 2.1% during the same period. By comparison, over the five-year period, emerging markets stocks outperformed emerging market bonds (8.6% vs. 7.6%).

Over the long haul, however, emerging markets bond fund shareholders have enjoyed solid returns with a lot less volatility. For example, while the MSCI Emerging Markets Index plummeted a stomach-churning 53% in 2008, the JP Morgan Emerging Market Bond Index Global fell just 11% during the same period. When compared to other fixed-income asset categories, however, the volatility of emerging markets bonds is second only to corporate high yield, or junk bonds.

Lessons Learned the Hard Way

As the market for emerging markets debt has developed and grown over the past 25 years or so, there have been several crises along the way that have tested investors' faith. In 1997, a widespread problem among Asian banks led to the so-called "Asian Contagion." In 1998, Russia defaulted on its sovereign debt. More recently, Argentina and Ecuador defaulted on their bonds. Each crisis had its roots in debt financing, which became problematic when global financial institutions reversed the flow of capital into developing nations.

Yet, as the market for emerging market debt has matured, central bankers around the world have implemented reforms. Countries that were extremely risky in the past, such as Brazil, now have independent central banks, floating currency policies, and fiscal restraint which investors believe reduces or mitigates some of the problems endemic to investing in Brazil in years past.

And balance sheets look pretty strong. The average debt-to-GDP ratio for countries within the emerging markets universe

is 33%, while for developed market economies it is close to 100%. Today, approximately 60% of emerging markets sovereign debt is considered investment grade, up from only 10% a decade ago.

Why the dramatic turnaround? Many developing nations have taken advantage of a huge run-up in commodity prices, such as oil and precious metals, to build sizeable cash reserves. These reserves made it easier to weather the 2008-2009 global credit crisis. As a lender of last resort, the International Monetary Fund has also helped prevent the type of catastrophic chain reactions that have marked previous crises.

Consider the progress that Brazil has made in just a few years. In 2001, after the country came close to defaulting on its international debt, the IMF stepped in and extended support. Thanks in part to a surge in commodity prices, Brazil paid off its IMF loans in 2005 and is now enjoying a resurgent economy. Its debt is now rated as investment grade by Moody's Investors Service (Baa3) and Standard & Poor's (BB+).

Will the Good Times Continue?

Despite great progress in recent years, most emerging markets debt still entails higher credit risk than bonds issued by more economically developed nations, recent problems in Greece, Ireland, and Portugal notwithstanding. Even in countries where the sovereign debt is rated investment grade, such as Brazil and Mexico, government bonds tend to be on the lower end of the investment grade scale.

Emerging markets debt funds also expose investors to currency risk, depending on the type of debt a fund owns. Some emerging market bond funds invest a portion of their assets in foreign bonds that are issued in local currencies. These bonds carry more currency risk (the risk that shifts in foreign exchange rates may undermine the dollar value of overseas investments). These countries may have difficulty repaying their local currency debt if the value of their currency declines dramatically against the value of the U.S. dollar. On the other hand, funds that invest in U.S. dollar-denominated bonds are more sensitive to interest rate fluctuations in the U.S.

On the plus side, economic growth rates in emerging markets are forecast to outpace those in developed markets for some time to come. Just consider the explosive growth in China, India, and Brazil over the past decade. As these economies grow, there will be additional middle class consumers generating higher tax revenues for their local governments, the need to issue bonds will decline, and existing emerging market bonds will become more valuable as supply is constrained.

In the past, emerging markets bond yields were substantially higher than those of U.S. Treasuries, to compensate investors for their elevated credit risk. As those risks have receded, so

too have yields on emerging market bonds. In fact, high interest rates were a major contributor to the substantial total returns enjoyed by emerging market bond fund shareholders over the past decade. If current patterns hold, investors may not enjoy the same rates of return in the decade ahead.

If the global economy catches fire, interest rates rise, and inflation surges, emerging market bond prices will not be immune. They will fall just as U.S. bonds would fall. However, the higher coupon rates on these bonds will provide some cushion, especially when compared to other, lower yielding types of bonds.

Additionally, because many developing countries are rich in commodities and natural resources, their economies may benefit if investors turn to these countries' bonds for inflation protection.

As we size up funds in this space, we believe that a highly skilled and experienced fund manager is critical for investment success. John Carlson (mentioned above) has managed Fidelity New Markets Income through the asset class's infancy and has learned valuable lessons along the way.

Also, investors should also pay close attention to a fund's exposure to local currency risk. Some funds, such as Fidelity New Markets Income Fund, invest primarily in dollar-denominated debt, while others may allocate more assets to local currency bonds.

While emerging markets bond funds have racked up impressive returns over the past decade, investors should not become complacent about the risks. That said, these bonds may provide attractive total returns and provide additional diversification benefits as well as helping long-term investors stay the volatile course toward what we view as likely rewards.

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