Money Wise

Colin Bloodworth breaks down the good and the bad of the world's trading floors

Getting the Most From Markets, Big And Small

An electronic board displaying stock prices in Tokyo, Japan. As part of a major market, companies in Japan are highly regulated and part of a long-established and well-developed body. EPA Photo/Kiyoshi Ota

Last week we identified the three main groupings of stock markets. They were major markets, representing traditional markets such as the United States, Europe and Japan; emerging markets representing countries with relatively young stock markets such as China, India, Brazil, Russia, South Africa, Malaysia, Thailand, Indonesia; and the new kid on the block, new frontier markets; Kuwait, Iraq, Pakistan, Sri Lanka, Mongolia and Vietnam.

With such a wide choice how should we allocate our investment funds, assuming we can? Let's start by looking at the relative merits of each of the groups.

Major markets

Pros: Companies in major markets are more established and highly regulated. They have to conform to corporate laws, rules and regulations that have evolved over many decades.

The New York Stock Exchange was established over 100 years ago. Today, billions of dollars of shares are traded on the exchange every day.

All dealings are transparent and information on the companies is freely available in the public domain. "Blue chip" company shares form much of the backbone of pension funds, not just for their value but also the reliability of their dividends, an essential in ensuring liquidity.

Cons: As companies in major markets have been researched to death it is not easy for stockbrokers or fund managers to identify good investment opportunities. It is more a case of "follow the herd" which can be a safe strategy but can also backfire when everyone gets it wrong. An example was the public offering of Facebook.

The prevailing wisdom was that the share price would surge after the launch but, as it turned out, the price fell almost immediately so investors saw early losses. Even giants can fall as we saw in the case of BP after one incident in the Gulf of Mexico.

Emerging markets

Pros: These markets have offered shrewd investors superlative returns over short periods. As little research had been conducted on companies in those markets there have been rich pickings for those who identified the opportunities. Four countries stand out in particular, Brazil, India and two countries who were once shackled by their anti-capitalist doctrine, Russia and China.

They were recognized by Jim O'Neill, a researcher at Goldman Sachs in 2001, who created the acronym "BRIC." From 2001 through 2010 the MSCI BRIC index rose 424% compared to a rise of only 44% in the MSCI All Country index.

Cons: After an outstanding decade the countries have lost their luster, for the time being anyway. The BRIC index has now trailed world markets three years in a row.

While emerging markets in general did well last year they have witnessed sharp falls in the past, particularly when there is a global crisis. When there is uncertainty in the world investors tend to take risk "off the table" and emerging markets are perceived as higher risk than major markets.

New Frontier Markets

Pros: The wealth enjoyed by both advanced countries and fast-developing countries has not gone unnoticed by those that have been left behind. As a result, many smaller countries are opening up their markets.

Some of them like Iraq, Kuwait, Nigeria and Mongolia offer huge potential with their reserves of natural resources. Astute fund managers are seeking out undervalued companies. Potential returns are very high, particularly if the markets follow the trend of the original emerging markets.

Cons: Political issues will invariably be an area of concern in many of these countries. Levels of corporate due diligence will not be up to Western standards and there may be potential liquidity problems. In the event of a global crisis these markets would feel the greatest impact of any flight to safety.

So where should we place our money?

There is no one-size-fits-all answer. A factor to consider is your nationality and where you eventually expect to spend your investment proceeds so you weight to reduce currency risk.

Precisely where you invest depends on factors such as age, appetite for risk etc. A growth portfolio might have an allocation of 70 — 25 — 5 in major, emerging and frontier markets respectively. If limited funds are available then the solution is to invest in a global fund and let the managers do the allocation.

In any event, stock markets should represent just a portion of your overall assets and if you are likely to need cash in a hurry or are unable to take a medium- to long-term view you shouldn't be in the stock markets at all!

Colin Bloodworth, director of PPI Indonesia, has spent over 20 years in Indonesia. If you have any questions on this or a related subject you can contact the writer at colin.bloodworth@ppiadvisory.com