Emerging Market Bonds

248% Profits on the Best Asset Class Of the Last 10 Years
An Investment U White Paper Report
By the Investment U Research Team

Consider this remarkable fact: Over the past 10 years, emerging market sovereign (government) bonds handily outperformed not only U.S. corporate bonds, but the S&P 500 equity index as well.

Yet surprisingly, emerging market bonds represent a conservative asset class over the long term, offering a stellar risk/ reward ratio and excellent diversification benefits.

Consider this about emerging market return growth: from 1994 through May 2004, J.P. Morgan's Global Emerging Markets Bond Index rose 248%, which compares quite favorably to a return of less than 102% for U.S. corporate junk and investment-grade bonds and a gain of 193% for the S&P 500.

Such out-performance is more than trivial; it's remarkable. More importantly for investors, you'll realize that this performance is far from over. In fact, it's just getting started. Many of the fundamental forces that will soon cause investors to flock to emerging market funds are now taking center stage, as this report will illustrate.

In the following report, we'll share with you critical reasons why we think emerging market bond funds will continue to outperform virtually every other asset class. We'll also identify an investment that lets you take advantage of this enormous potential while sidestepping much of the risk usually involved.

But before laying out the investment opportunity, let's first understand how we got here. It's certainly been a rough ride for emerging market bonds over the past 10 years, but they still managed to prevail. Quite a mind-boggling feat actually, which makes today's case for these international bond funds even more compelling once you read about the six powerful fundamentals currently lining up for this asset class.

Emerging Market Bonds' Early-Life Crisis

In looking back, it's hard to believe how emerging market bonds performed so well, as the past 10 years were littered with some of the most market-wrenching financial crises in recent memory...

As the mid-1990s drew near, Mexico shook up Latin markets as its currency crashed — along with its bonds — in what became dubbed the ***"Tequila Crisis."*** A few years later it was Asia's turn. Asian currencies, bonds and stocks throughout the region tumbled one after another, beginning with Thailand.

The negative ripple effect from the Asian crisis spread to Russia next, which subsequently defaulted on its debt and devalued its currency. Then Brazil became infected the following year when it was forced to abandon its fixed exchange-rate system and let its currency "float" (i.e., move freely in the foreign exchange market) against the world's other currencies. (Though "float" is somewhat of a misnomer as the Brazilian real quickly sank like a rock.)

As if these crises weren't enough, Argentina earned top billing not long after as the largest defaulter in bond market history. The event renewed jitters among Latin investors. As Yogi Berra would have said, "It's déjà vu all over again."

Argentina's woes then turned all eyes on Brazil as investors questioned the country's ability to service its debt. Foreign investors were stampeding out of the Brazilian market as fears mounted that a market-"unfriendly" president looked set to take the helm and, once in power, would default — or would be unable to prevent a default — on the country's debt.

With all the negative media hype over the emerging market crises throughout the years, people now assume that these markets are a horrible place to invest. Quite the contrary is true, as you'll soon see.

Tough Love: The Free Market Has No Mercy

"How could the market be so ruthless? We don't deserve to suffer such a setback. We're victims of a grand conspiracy." Such howls rang hollow as one crisis after another ripped through many emerging markets throughout the past decade. While global investors are not immune to herd-like mentality from time to time, much of the fallout from these financial crises was well deserved.

Remember that many of these markets had only recently adopted free-market policies, some as late as the early 1990s. You could say that they were just "getting their legs."

Given that these markets were new to such a liberal system (hence the term "emerging"), it should be no surprise that major neophyte mistakes were made.

Add to this the fact that these countries have money thrown at them when they open their markets... only to have it taken back just as quickly if improprieties as suspected... and you have quite a painful learning curve.

But as they say, two steps forward and one step back. This is a natural process.

So after all the shocks of the past 10 years, how do the prospects for emerging market bonds look for the next 10? Amazingly well, actually, once you understand why:

- Newly restructured emerging-market economies
- Surviving the brutal learning curve
- Globalization as market monitor
- Today's favorable risk/reward ratio
- A low interest rate/low inflationary environment, and
- Optimal dollar diversification.

Let's look at each more closely...

1) The Maturation of Market Economies

Despite all the financial traumas, emerging market bonds still managed to cross the finish line well ahead of the pack. How could this be?

First and foremost, diversification — the heart of modern portfolio theory — acts as a shock absorber. Higher reward compensating for higher risk combined with a long-term time horizon has also done its part. Misperception in the market also plays a role: Bad news hangs thicker and garners more attention than good news and often clouds the bigger, and brighter, picture. The emerging-market story does have a bright side.

But perhaps the most important reason for such a stellar performance is rooted in the free-market economic framework adopted by emerging markets over the years. In fact, access to the global capital markets would not be possible without this commitment to capitalism.

And without access to the world's investment funds, most countries wouldn't have the wherewithal to compete in a globalized world.

But here's where resiliency and comeback stories are made possible. The powerful forces of global investors may knock you down hard when you misbehave. But they'll be the first to lend a helping hand once you've learned your lesson, dusted yourself off, and demonstrated a genuine interest in playing the game right the next time around.

2) Bittersweet Market Medicine

One learns the most through traumatizing adversity, and most of these countries — though not all — have fortunately embraced their lessons with humility. The medicine was harsh and tough to swallow, but swallow it they have.

Many of the imbalances built up during the irrationally exuberant times have now been unwound. Broadly speaking, government and corporate debt have been brought under control while exchange-rate policies are more sensible.

You could say that a more responsible mentality has taken hold.

Fiscal prudence and monetary discipline are the new government mantras. The cut-off of easy money has starved the irresponsible, wasteful and/or excessively speculative mentality that existed to varying degrees in both the public and private sectors.

The long run is now the preferred time frame for all parties. Change and adjustment are never easy, but the reward is indeed sweet, and not just for the emerging markets but for the world at large.

Welcome to the new environment called globalization! It may seem overly harsh and competitive at times, but rest assured that it's for your own good... and the world's. But to stay one major step in front of the investment crowd, you need to have a better understanding of globalization and how it's transforming the market.

3) The Globalization Train: Either You're Aboard or You're Not

Globalization has shifted into overdrive ever since the Berlin Wall fell in 1989 — an event that has proven to be the catalyst for the globalization trend. Marking the end of the Cold War, the dismantling of the Berlin Wall foreshadowed and symbolized the removal of protective walls around many economies worldwide.

With free-market capitalism having proven itself as the best economic system from which to raise living standards (central planning under communism, socialism and fascism failed miserably), many countries around the world have climbed aboard the globalization train. And the ticket price includes throwing open a country's doors to world trade and — especially for emerging markets — plugging into the world's capital markets for desperately needed emerging market funds to kick-start growth.

In other words, countries can either climb aboard the globalization train or eventually end up like North Korea. No more hiding behind protective walls that only lead to steady economic deterioration and eventual impoverishment. Exposure to world competition and the global market toughens up countries, not just a bit, but a lot. Of course, the more a country is willing to embrace globalization's tough-love process, then the better off it'll be in the long run.

Fortunately, the belief in open markets and economic freedom as the optimal economic platform has survived several heart-pounding tests. Despite the emerging market financial crises of the

1990s, the grueling worldwide economic slowdown of the past three years, and the 9/11 terrorist attacks, the globalization train still remains largely on track. Indeed, capitalism has become deeply imbedded as the only viable system.

Globalization enhances and distributes opportunities like no system before it. Entrepreneurs and businesses of all stripes, not just politically or socially connected ones, are given free reign and have a more equitable chance in tapping investment funds, as meritocracy now rules. Yet by doing so — and as more and more countries hop aboard — global competition heats up tremendously, pushing everyone to improve while at the same time providing a necessary disciplinary force.

Thus, unbiased global competition imposes unprecedented pressure on a country's private businesses to perform or fall by the wayside. Survival is at stake. If a country's domestic companies can't produce what the market wants at the right price, then you can be sure that another country's can.

In the long run, this pays dividends as companies are forced to shape up, become more productive, and meet the global market's demands. The world benefits from greater wealth creation, more choices and improved standards of living, which leads to a more peaceful world. After all, you're not likely to pick a fight with your neighbors when you're too busy working, making money and enjoying life.

View the Emerging Market Bonds report as an HTML file.

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