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Dubai Dents Emerging Markets ETFs

By John Spence

Investors have piled into exchange-traded funds that track hot-performing emerging markets this year, but the tremors from Dubai's debt scare provide a clear warning of this volatile sector's risks.

So far this year through October, investors pumped a net $13.2 billion into diversified emerging markets ETFs, according to the latest data from investment researcher Morningstar.

Among mutual funds, the category is a top performer for 2009: Diversified emerging markets stock funds have gained over 70% for the year-to-dated period ended Dec. 1.

"Before the reality check delivered by Dubai World ahead of the Thanksgiving holiday, investors were sticking to their recent strategy of building up their exposure to commodities, emerging markets and short-term developed market debt with an eye to limiting the impacts of dollar weakness and market volatility," said EPFR Global in its Dec. 1 flow update.

Year-to-date flows into emerging markets stock mutual funds climbed to $58.6 billion, it said. Investors have also been putting money into emerging markets bond funds.

"These flow numbers clearly don't reflect the shock delivered by Dubai World's request for a debt freeze, so it won't be a surprise if next week's numbers look a lot different," said Cameron Brandt, senior analyst at EPFR Global.

"But, with a lot of sidelined money looking for an entry point, it also wouldn't be that surprising if emerging markets and sovereign debt funds attract more money before the year is out," Brandt said.

'Knee-Jerk Reaction'

ETFs have given individual investors liquid access to emerging markets, slicing the asset class down into individual countries and even so-called BRIC and frontier-markets funds.

One of the largest ETFs is iShares MSCI Emerging Markets Index Fund (EEM), which holds nearly $40 billion in assets. The fund has more than doubled over the past year with a 105.3% return for the 12 months ended Dec. 1, according to Morningstar. Its five-year annualized return was 44.8%.

The emerging markets ETF has actually held up surprisingly well in the aftermath of conglomerate Dubai World seeking to delay debt payments for at least six months. The firm has liabilities of nearly $60 billion. The emerging markets ETF lost about 4% on the Friday after Thanksgiving as U.S. markets reacted to the news, but has bounced back on hopes the debt problems will be contained and that Dubai won't default.

The situation in Dubai is a reminder that while emerging markets can post big rallies, they are susceptible to equally dramatic sell-offs, and debt and currency shocks.

The Dubai situation is a signal that investors can't blindly rely on governments to bail out troubled companies, said Alec Young, international equity strategist at Standard & Poor's Equity Research.

The "knee-jerk reaction" to a credit scare is an "aversion to riskier assets" such as emerging markets, Young said. Yet the United Arab Emirates, of which Dubai is one, comprise a tiny slice of emerging markets. Countries like Brazil, China, Russia and India constitute a much larger piece.

Despite the big rally in emerging markets this year, Young said emerging markets valuations are "still reasonable" and that the asset class is bouncing off a low base after 2008's credit carnage.

"We still like the emerging markets story," said Young, who added a diversified approach like an indexed ETF makes sense for the volatile sector. "We think emerging markets will cool off and won't be as strong as this year. But we still think emerging markets will do well and outperform developed markets in 2010."

Momentum And Volatility

Over the past decade, more individuals have invested in emerging markets with the lackluster performance of U.S. blue-chip stocks, said David Kreinces, portfolio manager at ETF Portfolio Management LLC.

The firm recommends clients generally keep between 5% and 10% of their core portfolio in emerging markets for diversification purposes. He said emerging markets have performed well lately due to the strength in commodities, weakness in the dollar and concerns over growing U.S. deficits to fight the recession.

Dubai is a "distraction" from the emerging markets trend rather than an "endemic problem," Kreinces said. "The Dubai debt problem isn't a reason to cut back exposure to emerging markets."

However, he said investors need to realize that emerging markets have a lot of momentum right now, which usually means more volatility. Therefore, investors may want to build a position over time, rather than investing a lump sum all at once.

"This equity class contains heavily concentrated industry bets that should be understood before investing," said Morningstar ETF analyst Bradley Kay in his latest report on iShares MSCI Emerging Markets Index Fund. "It is heavily driven by international commodity prices, especially those of oil, natural gas and steel."

The fund is one of many ETFs that follow emerging markets. Kay said a diversified option that offers lower fees is Vanguard Emerging Markets ETF (VWO), which has an expense ratio of 0.27%, although it also has lower trading volume.

Middle East ETFs

Aside from broad-based emerging markets funds, there are also ETFs that track the Middle East, and some invest in the United Arab Emirates.

However, the funds are very small with thin trading volume, so it doesn't appear that ETF investors were hurt too badly by Dubai stunner.

ETFs with significant exposure to the United Arab Emirates include Market Vectors Gulf States Index ETF (MES), PowerShares MENA Frontier Countries Portfolio (PMNA) and WisdomTree Middle East Dividend Fund (GULF). The WisdomTree ETF had a 16.4% allocation to the UAE as of Dec. 1, for example. All three ETFs fell in the days following Dubai's debt jolt.

"One thing worth noting is that, overall, these funds are relatively small in terms of assets under management, averaging around $10.5 million," wrote Morningstar head of ETF analysis Scott Burns in recent commentary posted on the firm's Web site.

"So we don't expect this to cause widespread problems in the portfolios of U.S. ETF investors," Burns said. "Still, this highlights once again the risks with 'frontier' market investing."

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