Emerging Markets Investing Redefined

Strategy for Investing in a Volatile Asset Class

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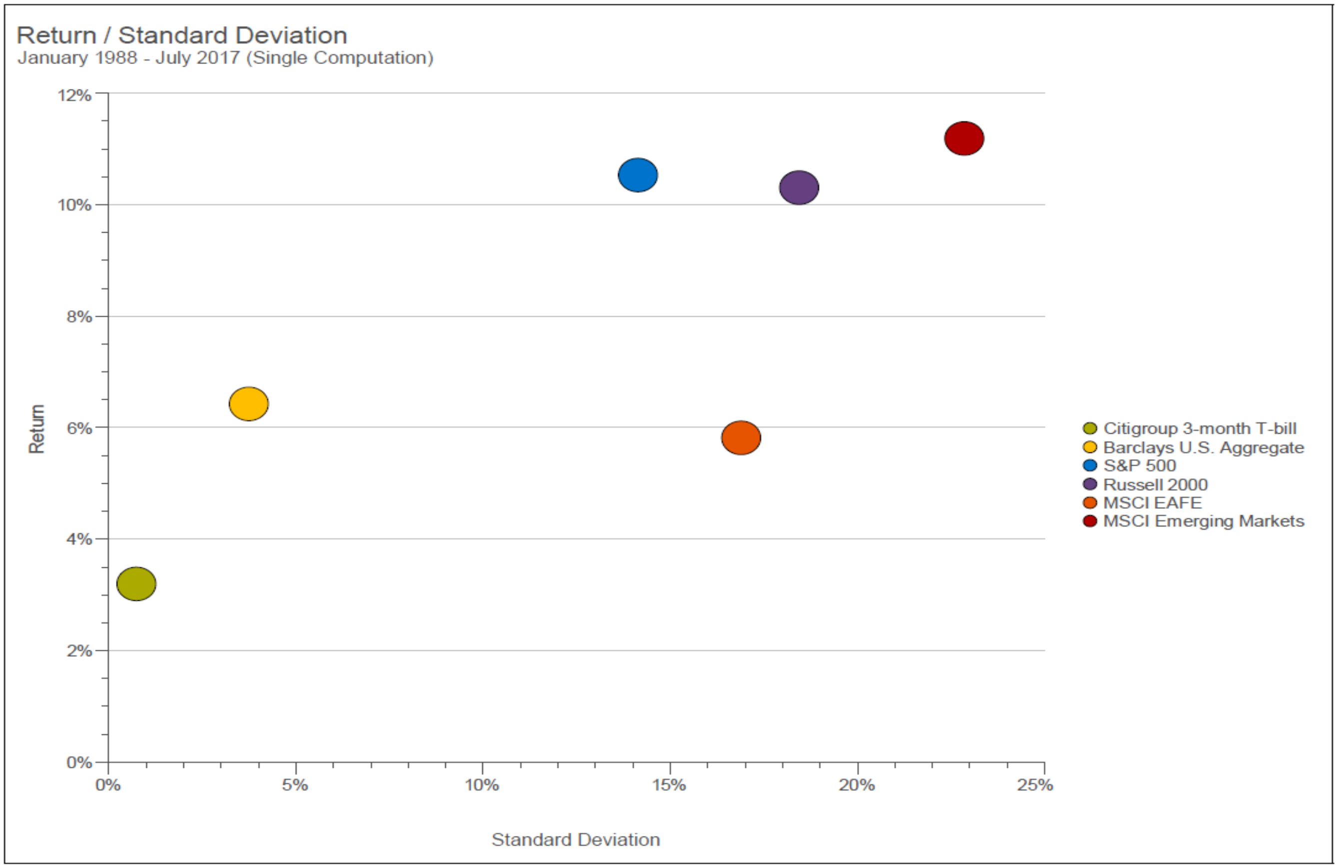
Investing in a Volatile Asset Class

In a world of low yields and sluggish growth in most of the developed world, many consider emerging markets investing an outlet for those seeking growth of assets. However, it is also widely known that investing in emerging markets is a venture fraught with risks.

Standard financial theory states that the higher the risk, the higher the reward. An investor willing to take on volatility or the potential for losses should be compensated for accepting that risk.

Perhaps no asset class exemplifies this trade-off more than [emerging markets](). Since MSCI started tracking emerging markets in 1988, the asset class has clearly had highest returns and biggest risks of any of the major asset classes.



Source: Zephyr StyleADVISOR

Why Invest in Emerging Markets?

The advantages of emerging markets are well known. Frequently cited are such strengths as:

- Higher upside potential
- Demographic trends favoring emerging markets over many developed countries
- Bourgeoning middle class and consumerism in emerging markets
- Growing share of global GDP
- Wealth of commodities and resources in emerging markets

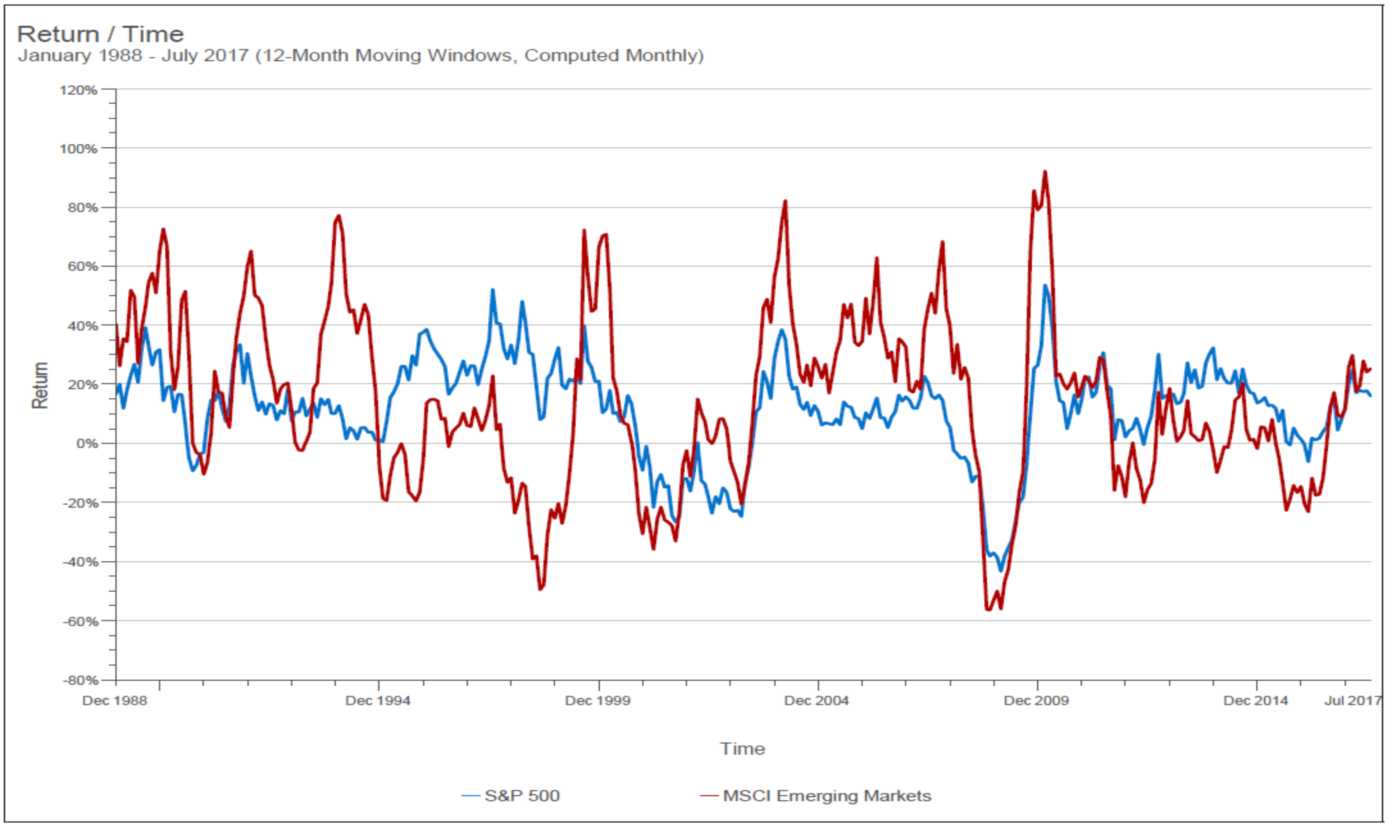
- Diversification benefits to traditional portfolios

Very few people argue against the upside potential of emerging markets. And yet in spite of these advantages many investors tend to shy away from emerging markets. Overall, emerging represents only 3% of U.S. mutual fund assets (according to a recent Calamos study). For many investors, the risks of emerging markets outweigh the rewards.

What are the Risks?

No doubt about it, the risks are real. Political risk, economic risk, currency risk, and market risk are all present in emerging markets. These risks occasionally manifest themselves in higher volatility and large sell-offs.

The chart below illustrates both the highs and lows of investing in emerging markets in the form of rolling, one-year returns.



Source: Zephyr StyleADVISOR

Investor Conundrum: *How does one maximize the potential of emerging markets, while minimizing the risks?*

Given the dim outlook for a traditional 60/40 balanced portfolio, emerging markets are one of the few assets with the upside potential to meet the return needs of an investor.

The Defining Risk in Emerging Markets

Swan believes it has a unique solution that can maximize return and minimize risk of emerging markets. It is the same strategy that has been successfully applied to U.S. Large Cap equities for 20 years: the Defined Risk Strategy (DRS). The DRS was built around the idea that the biggest risk to an investor's wealth is the large scale, systematic sell-offs that occasionally befell the markets.

Emerging Markets Investing Redefined

The DRS directly hedges against bear markets via long-term put options. Not only are the put options designed to protect during a bear market, the puts are also designed to be a source of capital for re-investing into the markets when the markets are trading at a discount after a large bear market sell-off.

By re-hedging and re-investing after a bear market sell-off, Swan believes the DRS is superior to market timing. One of Swan's core beliefs is that it is difficult, if not impossible to call the tops and bottoms of markets and to build a successful long-term strategy by timing the markets. This truth is especially relevant in emerging markets. As seen in the previous graph, emerging markets are noted not only for their steep declines but also for their very sharp rallies. In other words, if your timing is slightly off and you miss the rally, you miss big.

Below is a table showing the returns of emerging markets coming off the bottom. The first two columns specify a market sell off and the date of when the rally started. The middle column shows the 12-month return if someone had perfect foresight and bought at the bottom of the market. The fourth column is the impact of missing the first month of the rally and the final column shows the 12-month returns if the first three months of the rally are missed.

Market Event	Start of Rally	12-month Returns if…		
		"Perfect Timing"	Miss by one month	Miss by three months
Russian Default/LTCM	**9/1/1998**	**72.28%**	**56.52%**	**45.49%**
Dot-Com bear market	**4/1/2003**	**82.16%**	**53.59%**	**33.51%**
Credit Crisis	**3/1/2009**	**92.14%**	**81.55%**	**22.72%**
Debt downgrade/Euro crisis	**10/1/2011**	**17.33%**	**2.98%**	**18.63%**

Source: Zephyr StyleADVISOR

We believe the above information simply reinforces the importance of Swan's motto: "Always Invested, Always Hedged."

We also believe that our approach to managing risk in emerging markets is completely unique. By hedging against bear markets and seeking to generate cash flow through option premium, we believe we have fundamentally changed the risk/return profile of emerging markets.

Click to find out more about the [Defined Risk Strategy applied to Emerging Markets](), or call 970.382.8901.

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About the Author:

Marc Odo, CFA®, CAIA®, CIPM®, CFP®, Director of Investment Solutions, is responsible for helping clients and prospects gain a detailed understanding of Swan's Defined Risk Strategy, including how it fits into an overall investment strategy. Formerly, Marc was the Director of Research for 11 years at Zephyr Associates.

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