Emerging markets in your portfolio

How to make a sensible decision about a great opportunity

If you're investing for growth you will, at some point, need to think about emerging markets. That's because this dynamic group of countries – which includes Brazil, Russia, India, China and many others – has become the growth engine of the global economy.

Granted, an investment in emerging markets shouldn't be taken lightly. The opportunities are great but emerging market stocks tend to be more volatile than their counterparts in developed markets.

Nonetheless, more and more investors are looking for ways to diversify their portfolios to include emerging markets. In this article, we outline a sensible way to invest in this fast-growing area while maintaining the total risk in your portfolio at a reasonable level.

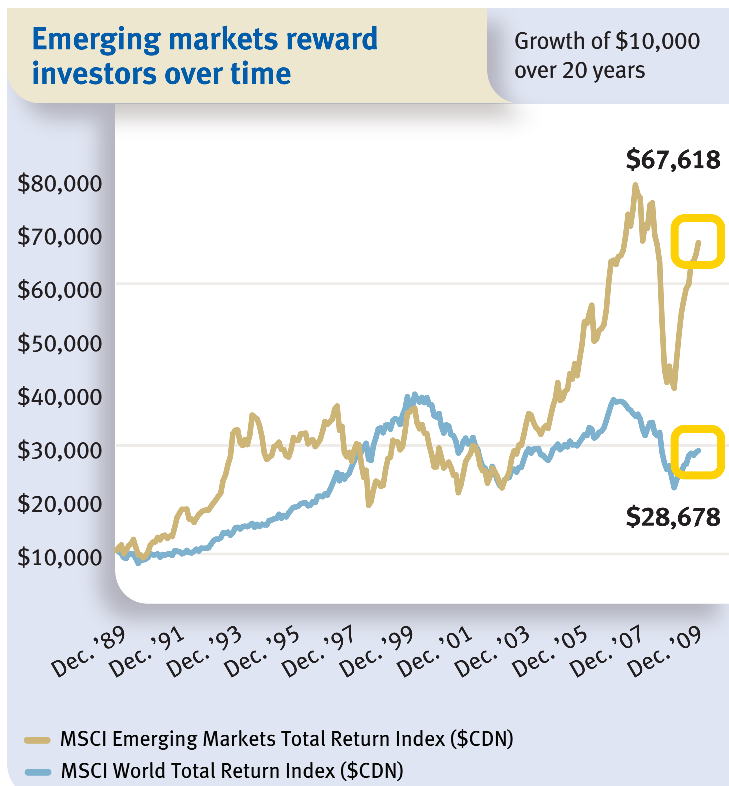
Why emerging markets make sense

Fuelled by a strong desire for economic expansion, many emerging markets are increasingly opening their doors to foreign investment; shifting to more democratic and free-market societies; developing trading relationships with the rest of the world; and, in the process, unleashing the economic drive of young, skilled and highly motivated workforces.

Not surprisingly, these economic improvements have led to two decades of rapid economic growth and strong returns for emerging market stocks, which have outperformed those of developed markets.

It pays to take a measured approach to emerging markets exposure

Emerging market stocks have outperformed those of developed markets over 20 years, but investors have still had to live through some dramatic ups and downs. While developed market stocks have seen their fair share of good and bad times too, emerging markets tend to have bigger price fluctuations and greater political, economic and regulatory risks than developed markets. The good news, though, is that you can limit these risks by taking the following steps to conservatively add emerging markets to your portfolio.



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How to add a sensible amount of emerging markets to your portfolio

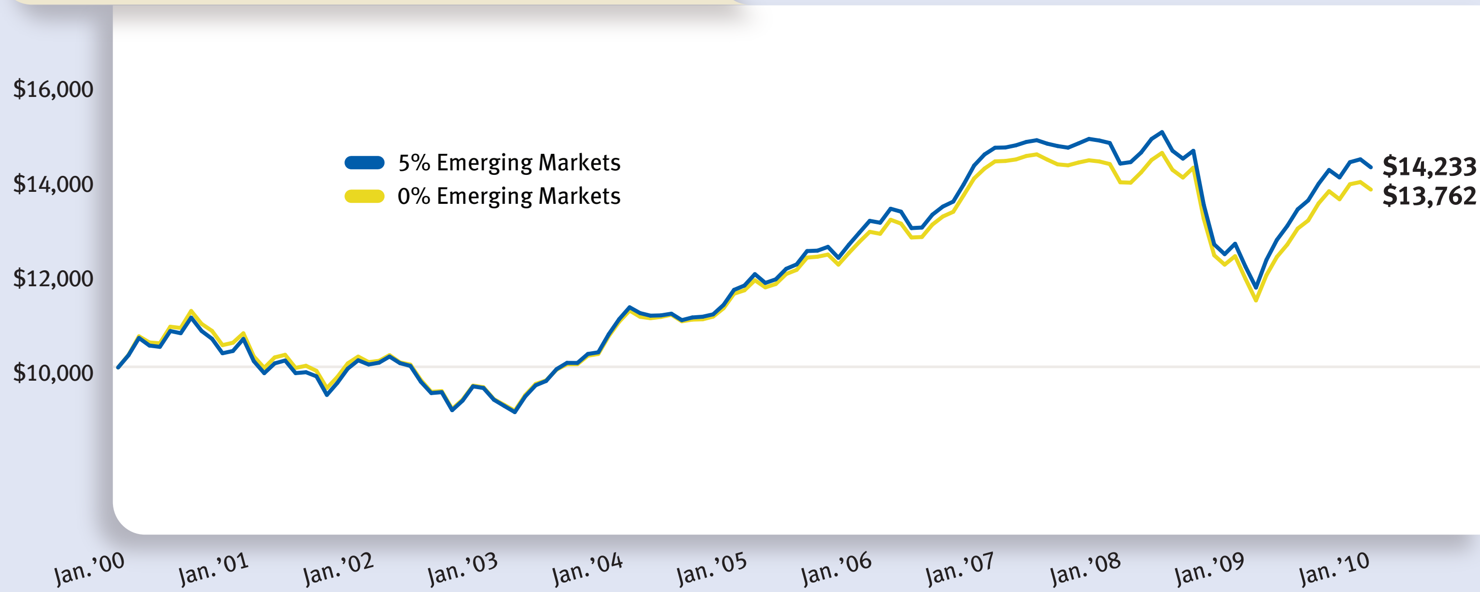
1. Start small

The first key to adding emerging markets to your portfolio is to start with relatively small amounts. This allows you to minimize risk and potentially improve returns.

But emerging markets should only be considered after you determine your risk tolerance level and the corresponding mix between stocks and bonds in your portfolio. For instance, if you fit a balanced investment profile – with 45% fixed income and 55% equities – you might consider allocating 5% of your equity holdings to emerging markets. But if you have more aggressive growth objectives that call for a higher allocation to equities, you could consider allocating up to 10% of your portfolio to emerging markets.

The chart below shows how adding a small amount of emerging markets to a hypothetical balanced portfolio would have improved returns over the past 10 years without significant added downside risk.

Adding small amounts of emerging markets improves returns with little additional risk



Asset Class	Index (in Canadian dollars)	Weighting 0% EM	Weighting 5% EM
Cash	CIBC WM 91 Day Treasury Bill	5.0%	5.0%
Canadian Bonds	DEX Universe	40.0%	40.0%
Canadian Equities	S&P/TSX Composite TR	20.0%	18.3%
U.S. Equities	S&P 500 TR	20.0%	18.3%
International Equities	MSCI EAFE GR	15.0%	13.3%
Emerging Markets	MSCI EM GR	0.0%	5.0%

The hypothetical returns above track the performance of a $10,000 investment from January 31, 2000 to January 31, 2010 based on returns on these indexes, rebalanced monthly.

2. Invest regularly

Consider building up your emerging markets exposure gradually instead of making a single lump sum investment. Because of the higher level of volatility in emerging market stock prices, several small investments made over time (i.e., "dollar cost averaging") may help smooth out the inevitable ups and downs.

To do this, divide your allocation to emerging markets into several smaller amounts that you'll invest at different times. For example, if you decide on an allocation of 5%, divide that into five parts and invest 1% of your portfolio in emerging markets in each of the next five months.

3. Use a diversified fund that covers all emerging markets

To access the full range of opportunities, it's best to use an investment, like the RBC Emerging Markets Fund, that has the flexibility to invest across various emerging markets instead of a fund that invests in just one country (i.e., an India or China fund) or a small group of countries (i.e., Brazil, Russia, India and China or "BRIC" as they're collectively called).

By investing in a more diversified fund, you'll reduce the risk of being too focused on a small number of stocks and industries. A more diversified fund also gives you more investment opportunities than a fund that is limited to just a few countries.

4. Rebalance regularly

The fourth key to including emerging markets in your portfolio is to rebalance frequently. This is another way to take advantage of the ups and downs of emerging markets – and all the other investments in your portfolio, for that matter.

To do this, set a regular time to review your portfolio (at least once a year) and at that time make any changes that are needed to bring your investments back to your target allocations to bonds, cash, Canadian stocks and foreign stocks in both developed and emerging markets. Alternatively, you could consider investing in a diversified fund or investment program that automatically rebalances your holdings for you.

Talk to your advisor

To discuss opportunities in emerging markets and how to include emerging markets in your portfolio, please talk to your advisor.

Your advisor will help you find the right allocation to emerging markets and help you reposition your portfolio accordingly. For more information on the case for investing in emerging markets, please see our publication *Global Emerging Markets – Investing Beyond Our Borders*.

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