Emerging Markets Dugout Speech

[Address by David A. Salem to the Endowments and Foundations Symposium]

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Thanks George. I'm honored to be here, and I'm especially honored that many of you who have heard talks I've given in the past have decided to listen to me again. As some of you know, although I've spent my entire career in the money management business, if my talent had been even remotely commensurate with my love of the sport I would have played baseball rather than managed money for a living. Happily for me, money management demands less innate talent than baseball, and it has reasonably flexible hours, thus permitting me to keep up with what's happening in baseball even though I no longer play the game myself. Those of you who've heard some of my past talks should be thankful that I have time to follow baseball reasonably closely, because if I didn't I wouldn't have a fresh supply of baseball anecdotes with which to illustrate some of the points I'd like to make about financial markets in general and emerging markets in particular.

Before I get into the substance of my prepared remarks, let me say a word or two about the background materials for this session that you've all presumably received. In addition to a bulleted outline of my talk, the handout includes a brief monograph on emerging markets that my organization published not too many moons ago. There are two reasons why I've chosen to distribute the monograph: first, because it contains some interesting facts and figures about emerging markets that, while now a bit dated, are illuminatng to any of you who are new to the business; second, because the monograph discusses in detail an important issue that I have time to discuss only summarily here today.

The issue is whether emerging markets are a distinct asset class, worthy of inclusion in an endowment or foundation's long-term policy mix. My current view is that they are not, because they do not satisfy fully the three key tests for determining whether specified assets merit a permanent place in an institution's so-called policy portfolio. To be sure, emerging markets probably satisfy the first test, which is simply that the asset in question be available in sufficient quantities to justify the time and effort required to gain exposure to it. And emerging markets probably also satisfy the second test for determining whether assets merit inclusion in a so-called policy portfolio, namely whether they produce competitive rates of return to tax-exempt investors. The third test is more problematic, because it focuses on the extent to which the asset in question provides meaningful diversification relative to the rest of one's portfolio, and I'm not at all sure that emerging markets taken as a group pass this test. Indeed, I'm pretty sure they flunk it, or at least that is what the available data suggest [pause]: when so-called developed markets perform extremely well, so-called emerging markets tend to do relatively poorly, but when developed markets perform very poorly, emerging markets perform even worse. In academic parlance, emerging markets have all too often displayed a bear market beta greater than one and a bull market beta less than one. With respect to emerging markets' correlation or so-called r-squared with major developed markets, the data are very unstable, but in general correlations have been trending upward, and the dividing line between developed markets on the one hand and emerging markets on the other has become increasingly blurred.

Of course, given the proven tendency of markets to begin behaving in a highly unpredictable manner at the precise moment in time when quant jocks think they've got things all figured out, I wouldn't be in the least bit surprised if so-called emerging markets essentially decoupled from developed markets, and especially from the U.S. market if it finally begins producing minimal or negative real returns. As any monetarists in the room can attest, an important reason that U.S. securities markets have produced such unexpectedly high returns in the 1990's is because many foreign central banks, especially Japan's, have elected to offset what would otherwise be strong upward pressure on their home currencies by accumulating massive supplies of American dollars. I have no idea when the rest of the world will decide that it's had its fill of U.S. dollars, but the day foreign absorption of U.S. dollars peaks is the day that many emerging markets will likely decouple from the U.S. market, with ugly consequences for U.S. stocks and bonds and with potentially fatal consequences for money managers who've hedged the foreign currency risk inherent in their non-U.S. portfolios by shorting emerging currencies against the dollar.

U.S. investors are currently accumulating foreign stocks at the rate of about $90 billion per annum, with roughly 20% flowing into emerging markets. At present, U.S. investors own approximately $400 billion of foreign stocks, which is about 5% of the total capitalization of U.S. stocks. If, over the next five years, this roughly 5% allocation to foreign stocks rises to just 7%, which is an extremely conservative assumption, the amount of money flowing out of U.S. stocks and into emerging markets will easily surpass the $23 billion annualized rate achieved in 1993. You can quibble with the numbers, but the policy implications seem unarguable: a lot of money is going to flow out of domestic securities and into emerging markets in coming years, and it behooves all of us to think carefully about how the endowments and foundations with which we're associated can profitably exploit this trend.

With that incredibly long wind-up, let me turn to my agreed-upon topic for today, which for lack of a better title has been dubbed "a report from the emerging markets dugout." Those of you in the room who follow the investment cooperative that I head might reasonably question whether I'm qualified to offer any useful guidance to the rest of you on emerging markets: the plain truth is that our own emerging markets fund has been a real disappointment, not only to the foundations that have invested in it but to those of us sitting in the dugout doing what we can to make it a winner rather than a loser. The cruel irony is that the emerging markets portions of our International and Multi-Asset Funds have performed extremely well, and the discussion that follows draws heavily on the peculiarly varied experience we've had as an organization investing in so-called emerging markets.

Naturally, I've come up with a baseball anecdote to illustrate the most important lesson that I personally have learned about emerging market investing since TIFF commenced operations a few years ago — an anecdote about the great Joe Dimaggio. Those of you fortunate enough to have watched Dimaggio play know that, like all great hitters, he was extremely precise not only in his movements on the field but in his thinking about the game. This precision came to the fore one day when Dimaggio rebuked a radio announcer for having exclaimed over the air that a gifted outfielder was, quote, "off with the crack of the bat." A good outfielder, Dimaggio reminded the play-by-play man, should be in motion long before the sound of ball meeting bat reaches the outfield. I mention this story not only to hedge against the possibility that I was invited to speak for my presumed expertise in baseball, as opposed to investing, but also because Dimaggio's strategy of getting to the right spot on the field at the earliest possible time seems to typify much of the conventional thinking about what it takes to do well investing in emerging markets. The question I want to focus on today is whether this strategy makes sense, or whether there are other, potentially more profitable, ways to invest in so-called emerging markets.

Since you're all seasoned investors, I'm not going to burden you with a description of conventional approaches to emerging markets. Nor will I argue that a Dimaggio-like strategy of racing to where the action is as rapidly as possible cannot succeed in emerging markets — obviously it can. The question I want to focus on is whether emerging markets strategies that require investors to act even before they hear the sound of bat meeting ball have a higher probability of success than strategies entailing indolence if not outright sloth. After all, despite his legendary success as a hustler on the field, Dimaggio had considerably less success off it, especially in the realm of romance. Indeed, when the news leaked out that Dimaggio's much-publicized marriage to the voluptuous but hard-to-satisfy movie star Marilyn Monroe was breaking up, one baseball writer quipped: "It just goes to show you — no one can be a master of two national pastimes."

Turning back to investing, I want to spend the rest of my prepared remarks defending two specific assumptions that underlie our evolving approach to emerging markets: first, the marketing claims of most emerging markets specialists notwithstanding, playing emerging markets the way Dimaggio played the outfield is not a good idea; second, conventional notions to the contrary notwithstanding, there is no material difference between the principles that animate successful efforts to invest in emerging markets and the principles that animate successful efforts to invest in other markets.

By way of defending the first assertion, let me tell a brief story about my favorite ballplayer of all time, Carl Yazstremski. Although most of the baseball stories that creep into my speeches involve events that occurred long before I crossed the threshold of baseball consciousness in the early 1960's, my favorite story about Yazstremski is based on an incident that I actually witnessed first-hand, and that stands in sharp contrast to the mindset inherent in Dimaggio's comments that I recounted a minute ago.

Those of you who've had the good fortune to visit the world's most hallowed ground in baseball, namely Fenway Park in Boston, know that its most distinctive feature is the so-called Green Monster — a high wall that runs from the left field foul pole to center field less than 320 feet from home plate. Before his legs gave out and the Red Sox moved

Yazstremski from left field into first base, Yaz was a Gold Glove-winning outfielder, and a genius at converting the Green Monster from a liability for the perpetually weak-pitching Red Sox into a distinct asset.

The cleverest move I ever saw Yaz make as an outfielder was the day he responded to a high fly ball that was clearly headed for the Green Monster, if not beyond, by remaining completely still. The reason he did this is because the preceding batter — who was the swiftest but not necessarily the smartest player in the league — had just reached second on a stolen base. Seeing that Yaz was comfortably camped under what, despite initial appearances, was evidently merely a routine fly ball, the base runner quite naturally held his ground at second base. Those of you who are smiling know the rest of the story: as the ball went soaring over his head, Yaz whipped around, caught the ball as it caromed off the Green Monster, and hurled a perfect strike back to the shortstop, transforming what should have been an RBI double into a measly single with one of the fastest runners in baseball held transfixed at second base. In other words, instead of taking the growth investor's approach and leaping into action at the earliest opportunity, Yaz took the value investor's approach and waited for others to make a misstep before acting decisively in his own favor.

Having tipped my hand with respect to the question that I know all of you came here to ponder — namely, whether Carl Yazstremski was indeed as clever a player as Joe Dimaggio — let me turn to a related question that is as controversial in investment circles as it is in baseball circles, namely whether the designated hitter rule makes sense.

For those of you unfamiliar with American baseball, a designated hitter is a player who — sometimes by choice but more typically by necessity — plays a highly specialized role, batting for his team's pitcher when the pitcher's turn at the plate arrives. A lot of people think that the designated hitter rule adds much needed excitement to what they regard as an otherwise pretty dull sport, but those of us who take a more traditional view think designated hitters are unnecessary at best and foolish at worst. Of course, the same thing can be said of emerging market specialists: speaking from personal experience, I can tell you that they certainly make life more exciting for those of us who supervise institutional funds, but whether they actually merit a permanent spot in an institution's manager line-up is very much an open question.

My own view about emerging markets is that the best way to make money investing in them is to do what some baseball managers do when deciding which player should serve as their designated hitters: instead of hiring expensive specialists whose consistency at the plate is far from assured, they round out their line-ups with players whose potential contributions to the team go beyond an occasional home run or extra base hit. I have to admit that I am far more skeptical about emerging markets specialists today than I was a mere five years ago, because back then emerging markets were in fact what they no longer are, namely a diverse collection of largely uncorrelated securities. I have no idea whether correlations among emerging markets will fall back to their earlier levels or continue their seemingly inexorable rise, but I will say this: if recent trends continue and emerging markets become even more highly correlated, I doubt that many truly superior investors will become emerging market specialists, because they can make more money and garner more glory as generalists, just as baseballers can make more money if they can field as well as hit.

Putting the same point somewhat differently, even if those of us who serve as the investment equivalent of a baseball team's general manager are able to gain exposure to emerging markets through one or more of the many firms that specialize in such markets, it's not at all clear that we should willingly pursue such a course, especially when doing so forces us to retain rather than delegate responsibility for determining how much of our portfolios should be allocated to emerging markets at any given point in time. At the risk of stretching my baseball analogy past the breaking point, I'll note that if general managers could indeed play the game at the very highest levels, they would take the field themselves and put their high-paid players on waivers. Of course, the reason that you don't see a bunch of pot-bellied executives playing major league baseball is because they recognize that, however much baseball experience they've accumulated and however much fun it might be to try, they are singularly ill-equipped to play the game at the highest levels and win. By relying primarily if not exclusively on specialists to provide their funds with exposure to emerging markets, plan sponsors are playing a game that few if any of them are equipped personally to play and win, namely gauging the attractiveness of emerging markets relative to competing alternatives.

Nor are emerging market specialists necessarily better equipped to outperform emerging market benchmarks than firms whose purview extends beyond developing countries. If emerging markets formed a closed system in which it was possible for a specialist to outperform a mutually-agreed-upon benchmark only by inflicting losses on other specialists, then the argument that designated hitters are the key to success in emerging markets would be more sound. But the gravamen of the argument in favor of emerging markets as choiceworthy places to invest is that trade and capital flows are becoming increasingly globalized, and it is hard to reconcile this cardinal attribute of contemporary economic life with a designated hitter approach to investing, especially with respect to emerging market stocks.

But let's assume — for purposes of discussion only — that we've decided to follow the designated hitter rule — that we've decided to make a focused commitment to emerging markets. The task we now confront is how to choose among the many available specialty firms — a task made more daunting in recent years by the development of subspecialists within what was already a highly specialized area: firms whose reach is limited to a single region, if not a single country — the investment equivalent, if you will, of a designated hitter who takes to the plate only when a right-handed knuckleballer is on the mound and the wind is blowing left to right.

Now don't get me wrong: if you're going to follow the designated hitter rule, you might as well extend whatever logic underlies it to the ultimate extreme and carve the developing world up into multiple parts, assigning each part to a subspecialist chosen for its presumed capacity to outperform the narrow universe of securities constituting its benchmark. I don't know any major institutional funds that have taken the idea of emerging markets specialization to this logical extreme, but I suspect that regional and even single country mandates will become increasingly popular in coming years, especially with respect to the countries that dominate emerging markets benchmarks, namely Brazil, Korea, Malaysia, Mexico and South Africa. Again, it's an open question whether any truly superior investors will choose to build their careers around a subspecialty that could disappear overnight if the market on which they focus graduates from emerging universes into developed ones. I myself am skeptical that specialty managers can add enough value within their respective spheres to offset the drag on total fund results that inevitably accompanies the shift of country allocation decisions away from full-time money managers and back toward institutional owners — away, in other words, from the players on the field and back to the those of us sitting in the dugout, or — what's worse — back to the general managers sitting in their skybox seats, far removed from the action on the field.

I'm also skeptical that plan sponsors can avoid the problem I've just described by hiring one of the quasi-huge firms that hold themselves out as specialists not in a particular emerging economy or region but rather in emerging markets generally. As per usual, I tried to conceive a way to illustrate this point with a baseball analogy, and the best I could do was to invoke the unhappy precedent of Moe Berg, a light-hitting but deep-thinking catcher whose intellectual accomplishments included a law degree from Columbia University, mastery of several languages — including Sanskrit — and moonlighting as a wartime spy for the United States and its Allies on German nuclear capabilities. Needless to say, the less-bookish athletes that Berg played with weren't much impressed by Berg's intellectual gifts. Indeed, after one of Berg's especially weak outings at the plate, one of his teammates muttered: "Moe can speak twelve languages but he can't hit in any of them."

To say that the large specialty firms that today dominate the emerging markets landscape can speak multiple languages, but can't hit in any of them, is an unfair generalization, of course, but one does have to wonder how they can succeed at doing something that their developed market counterparts have such extreme difficulty doing well, namely integrating timely top-down allocation decisions with shrewd bottom-up stock picks while simultaneously developing in-house or obtaining from outside vendors the trading savvy and back office expertise that are absolutely critical to success in emerging markets. As is always the case in the money management business, it's hard to know whether the quasi-huge firms I'm talking about have voluntarily chosen to be all things to all people, or whether their clients have unwittingly forced them to build excessively large bureaucracies by threatening to take their emerging markets business elsewhere if the specialty managers they employ don't hire at least one in-house specialist for each of the countries in which they invest. Of course, once a large bureaucracy is in place, one needs to pay for it, and the only way to do that is to grow assets under management at a rate that is at least commensurate with growth in the bureaucracy itself.

There is, of course, an alternative to the Moe Berg approach to emerging markets — what, for lack of a better term, I'll call the Dizzy Dean approach to such markets. For those of you whose educations inexcusably omitted study of America's pastime, Dizzy

Dean was hugely talented at hurling a baseball the requisite sixty feet and six inches with frightening accuracy, but he was singularly unskilled at just about everything else, including especially public speaking. This was most unfortunate, because Dizzy's skill as a pitcher made him a role model of sorts for a whole generation of adoring schoolboys, all of whose teachers were greatly distressed by Dizzy's awful grammar, to say nothing of his predilection toward fast living. To his lasting fame if not also credit, Dizzy made no effort whatsoever to remedy his grammatical deficiencies. Indeed, in response to repeated complaints that his awful grammar was setting a bad example for schoolchildren, Dizzy had this to say, quote: "A lot of folks that ain't saying 'ain't', ain't making as much dough as me."

The point I'm driving at is that fielding a team laden with high-priced talent may be a sufficient condition for success in emerging markets, but it is arguably not a necessary one. As with developed markets, if the objective is to achieve truly superior returns, without regard to such silly distractions as standard deviations or r-squareds, there's nothing to be gained from trying to play all aspects of the game better than one's competitors. The better course is to play one or at most a few aspects of the game so much better than anyone else that you still come out ahead, despite the conscious forfeiture of opportunities along the way. Those of you who followed America's pastime in the 60's and 70's know that the quintessential baseball example of the strategy I've just described was the cagey manager of the World Champion Baltimore Orioles, Earl Weaver. Instead of attempting to remedy obvious weaknesses in the Orioles' line-up through trades that might disturb the team's happy karma, Weaver chose to leave his team as is while doing everything in his power to make sure that the Orioles played as many games as possible on a field well-suited to its particular skills. More specifically, Weaver would spend hours with the Orioles' chief groundskeeper telling him precisely how high to cut the grass in various parts of the ballpark — close-shaven down the third base line to exploit Brooks Robinson's lightning-quick reflexes, but overgrown like a shag rug down the first base line to accommodate the Orioles' lumbering first baseman Boog Powell, and so on. All perfectly legal stuff, of course, although — as is too often the case in our profession — baseballers aren't much interested in the nagging question of whether what's legal is also ethical.

Weaver himself had an especially difficult time distinguishing between legal and ethical standards of conduct, my favorite example being a crucial home game that the Orioles played against the New York Yankees toward the end of the 1978 season. The weather was foul in Baltimore, and Weaver sank into a particularly foul humor when the Yankees erased a three to nothing Baltimore lead by exploding for five runs in the top of the seventh inning. Before the Orioles could bat in the bottom half of the seventh, heavy rains drenched the field, forcing a delay. Normally, when the umpires halt a game due to rain, the grounds crew rushes on to the field and covers it with a tarp as soon as possible. But with the Yankees having taken the lead in the top of the seventh, Weaver knew that his only hope for a victory was a rainout, so he passed word to his faithful grounds crew that they should take their sweet time covering the field, and that they should make sure to direct any rain that collected on the tarp on to the playing field, rather than on to foul territory as was customary. Naturally, the game had to be called, and since the Orioles didn't get to bat in the seventh inning, the score reverted back to the last complete inning, enabling the Orioles to win, three to nothing.

I don't mean to be too harsh on Earl Weaver, who was usually pretty discreet about cheating, which put him into stark contrast with one of the toughest pitchers his Orioles routinely faced in the World Series, the Dodgers' Don Sutton. Upon reading rumors in a Baltimore paper that he was doctoring the baseball with a quote, unquote, "foreign substance", Sutton exploded in rage. "That's not true at all," he fumed. "The label says that this here jar of Vaseline was made right here in the United States."

As you can tell, I have an essentially unlimited supply of baseball anecdotes to draw from, but a limited supply of truly novel ideas that can help you make money investing in emerging markets. Obviously, the folks who make their livings investing exclusively in emerging markets have an interest in promoting the view that generalists are as ill-equipped to invest in emerging markets as Don Sutton is to be editor of the Oxford English Dictionary, but I'm not at all convinced that they're right. Nor am I convinced that the superior growth prospects that make emerging markets so appealing to many investors justify a growth- as distinct from value-oriented approach to such markets. One of the biggest ironies of all about emerging markets is that the companies that dominate most emerging country indexes are utilities, banks and resource-related companies, which are hardly the stuff of which money management legends are made. Indeed, precisely because so many managers apply growth-oriented approaches to non-U.S. markets in general, and to emerging markets in particular, I favor tilting the line-up heavily in favor of value managers, especially those pursuing a strictly bottom-up approach based on rigorously objective cross-border comparisons similar to those that underlie successful value-driven approaches to developed markets.

The problem with such an approach, of course, is that it tends to entail a large degree of benchmark risk, which is off-putting in the extreme to some plan sponsors. Why these folks are obsessed with tracking error on the measly three to five percent of their assets that they've allocated to emerging markets is beyond me, but I hope and pray that they'll maintain this obsession for the remainder of my career, because if they act more sensibly they'll make it that much harder for the rest of us to earn adequate returns. In this connection, let me record my amazement at how few plan sponsors are utilizing what strike me as the two most sensible ways to invest in emerging markets: one, an equally-weighted index fund; and two, a portfolio that invests exclusively in closed-end country funds trading at attractive discounts. I don't have time, at least in my prepared remarks, to flesh out these two ideas, both of which are admittedly sounder in theory than they are in practice. But I do wish that someone, somewhere, would attempt to run an equally-weighted emerging markets index fund with a serious amount of money, because it would be interesting to see whether trading costs would consume as large a fraction of the return advantage that disciplined rebalancing provides as I fear it would, namely 100%!

With respect to the second strategy — investing exclusively in closed-end funds trading at a discount — I regard it as, essentially, a legalized form of cheating, analogous to Earl Weaver's sculpting the grass in his home ballpark to exploit other boundary conditions that he could not, or would not, alter. Or perhaps a better baseball metaphor for the closed-end strategy I favor is the anecdote about Carl Yazstremski with which I began these remarks. Instead of leaping into action at the earliest possible opportunity, Yazstremski's genius as a fielder and, I might add, as a hitter, lay in delaying decisive action for as long as possible, a strategy that might have made Joe Dimaggio's marriage to Marilyn Monroe more satisfying, at least for Marilyn! Of course, it is precisely the opposite mindset — the unwillingness of retail investors to wait for shares in newly created closed-end funds to trade at something below net asset value, which most closed-end fund inevitably do — that makes the continued creation of fresh supplies of such funds a near-certainty, especially in emerging markets. Again, my own hope is that the unwashed masses will never adopt a Yazstremski-like approach to investing, because if they do the number of closed-end funds created each year will shrink at a more rapid rate than that at which even the swiftest outfielder races to snag a well-struck fly ball. That would be unfortunate, because open-endings, mergers, and other factors reduce the total supply of closed-end funds by a frustratingly large percentage every year, making life difficult indeed for those of us who think closed-end strategies are the most intelligent way to make money investing in emerging markets.

As a closing aside, let me note that one reason I favor closed-end funds in an emerging markets context is because such funds are much freer than their open-end counterparts to take meaningful positions in private companies, which is an attractive proposition given the large gap between public and private market values that has opened up in some emerging markets in recent years, the Philippines being just one obvious example. A related reason that I favor closed-end funds is because their acquisition at substantial discounts provide a large margin for error in case one's judgments about relative value prove mistaken. An analogy in the baseball world would be the strategy pursued by the Cleveland Indians' brilliant general manager Pat Hart, who stunned the baseball world in the early 90's by offering a number of promising but essentially unproven minor leaguers or rookies long-term employment contracts. In a world where only the most proven players commanded long-term contracts, Hart's strategy was as radical as it was sound: it was sound because the salaries he had to pay the young players in question were small enough that he could afford to have several of them bomb out. In the event, most of them proved to be stars, if not superstars, including Charles Nagy, Albert Bell, and Carlos Buerga, who now labors for the New York Mets. I've tried to persuade Pat Hart to give up baseball and go into the even more obscenely compensated profession of money management, but he says he won't change jobs without a long-term contract, which remains as rare in the money management business as it was in baseball when Hart initiated a paradigm shift in player relations just a few years ago.

There are no time clocks in baseball, but there are emphatically limits to how long I'm supposed to talk here today, so before I breach those limits I had best duck back into the dugout. Thanks for being such an attentive audience.