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In-Country Advantage

It's time to tune in to emerging-market funds focused on strong single-nation performers

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Why some emerging-market funds are looking like good investment picks.

Scoreboard | Fund Scope | Cash Track

EMERGING-MARKET FUNDS have had a nice run over the past few years, although lately their returns have been less impressive -- thanks partly to jitters about weakening profit growth, rising interest rates and slowing economic growth in developed countries.

As of April 28, these funds were down nearly 2% in 2005, on average, according to Lipper. That's better than the Standard & Poor's 500's 5.14% loss and the Dow Jones Industrials' 5.95% decline in the same span. But emerging-market funds have notched a notably stronger gain of 21% over the past 12 months. And their three-year annualized gain of 17.09% has handily outpaced the major U.S. indexes.

So what's an investor to do?

Francis X. Claro, who oversees the international component of the **Evergreen Global Opportunities Fund** (ticker: EKGAX), has lightened his emerging-market exposure considerably. It's now about 1%, down from 12% in January 2004. The fund is off around 0.7% this year.

The weighting shift stems largely from Claro's concerns about a slowing economic growth in the industrialized lands, as well as rising interest rates -- factors that can put a crimp in emerging-market countries' exports, the key economic driver.

At the same time, some stocks in countries like Brazil and South Korea sport attractive valuations. "You always have to assess the risk to earnings before going in there," Claro says. "But there are developed markets that have pretty attractive valuations."

That includes Europe, where Claro has increased his weightings recently.

"There's an issue of relative valuation between certain developed and emerging markets," he explains. "At this point, it's tilting in favor of developed markets. Relative opportunities now appear to be more in developed markets."

Although he has divested considerably from emerging markets, Claro does see some opportunities in Brazil, where the overall market trades at about six times forward earnings, he says.

The fund's holdings include **Companhia Energetica de Minas Gerais** (CIG), a utility, and **TIM Participacoes** (TSU), which offers cellular service.

Andrew Clark, a Lipper analyst, sees a strong correlation between 10-year Treasury yields and flows into emerging-market funds. If the 10-year yield closes in on 5%, "you don't necessarily want to take more risk on emerging-market stocks or debt," he says.

The 10-year bond was yielding around 4.20% late last week, down from more than 4.60% in late March. Sure enough, emerging-market funds had net inflows of $370 million in March, versus nearly $1.3 billion in February, according to Lipper.

Clark points out the current merits of individual-country funds. "You don't have diversification, but there are some very good stories out there in terms of domestic economies," he says, citing Brazil and Hong Kong as examples.

Nicholas Smithie, portfolio manager of the **MFS Emerging Markets Equity Fund** (MEMAX), points out that, in the past, the typical trade was to exit emerging markets whenever the Fed raised rates. But this year, even in a rising-rate environment, emerging markets have held up comparatively well. "It speaks volumes that the asset class is being taken a little more seriously by longer-term investors than in the past," Smithie observes.

Says Thomas Melendez, associate portfolio manager of the emerging-markets fund and portfolio manager of the **MFS International Diversification** Fund: "Investors aren't painting all the emerging markets with one single wide brush. They're looking at individual countries."

The fund, which is up 3.18% this year, has overweightings in Latin America, primarily Mexico and Brazil, as well as Israel, Turkey and Russia. It's slightly underweight in Taiwan and India.

The portfolio has de-emphasized technology stocks, while it's overweight in financial services and energy/natural resources. One of its holdings is **Absa Group**, a South African financial-services company in which Barclays reportedly plans to buy a controlling stake.

Bullish though he is on emerging markets, Smithie acknowledges that "people are definitely concerned that the bloom is off the rose." He adds: "A long-term buy-and-hold investor with a diversified portfolio should stay a long-term investor with a diversified portfolio. But it's definitely harder work to make money when rates are rising and profit growth is slowing."

John Chisholm, co-chief investment officer at Acadian Asset Management, says it has been trimming its emerging-markets exposure in the separate accounts it runs for institutional investors. The firm also runs the **Acadian Emerging Markets** Fund (AEMGX), up 4.6% this year.

That weighting shift is partly attributable to what Chisholm and his colleagues sense is an increase in investors' aversion to volatility and risk. At least through the middle of this year, "We still have a fairly cautious view of emerging markets in general," he explains.

"Longer term, emerging markets are pretty attractive," he continues. "Valuations in emerging markets as a group are still fairly cheap, relative to developed markets. And profitability is quite high. Long-term growth prospects are still pretty strong."

Just not in the short term.

Money, Money, Money

Investors poured a lot of cash into long-term mutual funds in the first quarter, albeit less than in the corresponding 2004 period, Financial Research Corp. says.

Long-term open-end funds had net inflows of $75.7 billion, versus $113.8 billion a year earlier. (Financial Research Corp.'s long-term-fund definition excludes money funds.) No doubt, the disappointing first-quarter performance of both stocks and bonds curtailed cash flows.

Los Angeles-based American Funds continued to attract a lot of dough -- $23.6 billion in the quarter, down from $27.6 billion a year earlier. The company accounted for about one-third of all net flows tracked by FRC in the first quarter. What's more, American Funds surpassed Fidelity to become the second-largest fund firm, with $671.8 billion in long-term assets under management. Vanguard topped the list, with $713 billion, and Fidelity was third, with $667.2 billion.

Conversely, Putnam Investments and Janus Capital Group had first-quarter net outflows of $5.4 billion and $4.2 billion, respectively -- but the outflows did slow from the previous year's levels.

"From a category level, investors are being more conservative and tempering their bets," says Owen Concannon, a research analyst at FRC.

The moderate-allocation funds brought in $5.5 billion in March, topping all categories. Life-cycle funds make up the fastest-growing group within this category. Their investment allocations shift, depending on the shareholder's investing time horizon.

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