The Best Way to Play Volatility in Emerging Markets

Description

George Iwanicki, **J.P. Morgan Asset Management's** emerging markets macro strategist, has recently come out in favour of emerging markets, suggesting some of the hardest-hit economies in the developing world have bottomed out, providing investors with real value at a time when there's very little here in North America.

The problem for most retail investors is that the volatility present in emerging markets is much higher than what we're used to in Canada and the U.S., making it awfully difficult to pull the trigger.

But there's a solution.

New York–based Ben Carlson, director of Institutional Asset Management at Ritholtz Wealth Management, recently looked at the annual returns and volatility of the S&P 500, Russell 2000, and MSCI Emerging Markets Index between 1988 and June 30, 2016.

1988-2016	S&P 500	Russell 2000	MSCI Emerging Markets	Equal-Weig
Annual Returns	10.2%	9.8%	10.6%	11.0%
Volatility	14.3%	18.6%	23.2%	16.8%

Source: Ben Carlson's blog: "A Wealth of Common Sense"

While emerging markets delivered the highest annual returns, those returns came with much greater volatility (60% higher than the S&P 500; 25% higher than Russell 2000). To solve this problem, Carlson equal-weighted each of the indexes, rebalancing them annually.

Now, here's the interesting part. If you simply average the annual returns and volatility for the three indexes, the annual return and volatility over 29 years would be 10.2% and 18.7%, respectively. The equal-weighted portfolio, on the other hand, would have delivered an annual return 80 basis points higher with a 190-basis-point reduction in volatility.

Abracadabra! You have a portfolio you can stomach while pushing the envelope when it comes to returns. It's a win/win scenario.

How do you do it using ETFs? The simple answer: Buy the ETFs that correspond to the three indexes and rebalance each January.

For example, by size, you would buy the **BMO S&P 500 Index ETF** (TSX:ZSP), **iShares U.S. Small Cap Index ETF** (TSX:XSU), which is hedged to the Canadian dollar, and **iShares MSCI Emerging Markets Index ETF** (TSX:XEM). Canadian investors, quite rightly, might like to add the **iShares S&P/TSX Capped Composite Index Fund** (TSX:XIC) to the portfolio.

Now, if you want to construct a true equal-weighted portfolio, I'm afraid you are out of luck.

That's because according to ETF Insight, there are 17 equal-weighted ETFs listed on the TSX, but none for emerging markets. In the U.S., Guggenheim Investments has one that can get the job done: **Guggenheim MSCI Emerging Markets Equal Country Weight ETF** (NYSEARCA:EWEM)—but even there, the countries themselves are equal-weighted, but the stocks within those countries are cap-weighted.

With ETFs growing in popularity, one can only hope the manufacturers on both sides of the borders can address this obvious gap in the marketplace.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:XIC (iShares Core S&P/TSX Capped Composite Index ETF)

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