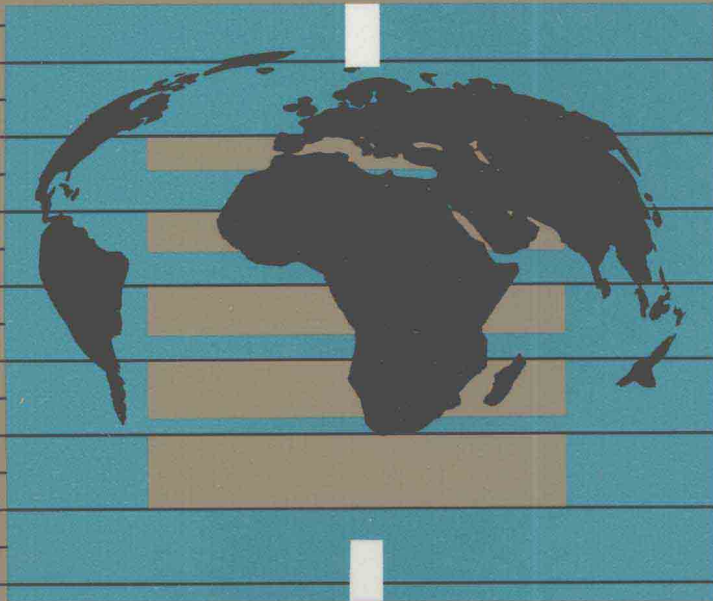


A Guide to World Markets

T H E
WORLD'S EMERGING
STOCK MARKETS

Structure,
Developments,
Regulations &
Opportunities



KEITH K. H. PARK & ANTOINE W. VAN AGTMAEL

EDITORS

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To people I met at the factory of Polycity Industrial, Ltd.
in Dong Guang, China last April. You are the ones
who have made it all happen.

Keith K.H. Park

To my parents

Antoine W. van Agtmael

Preface

Nearly a decade ago, in the introduction to the first book on emerging markets, *Emerging Securities Markets* (Antoine W. van Agtmael, Euromoney Publications, London, January 1984), it was shown “why investment bankers, investors and development experts can no longer ignore emerging markets . . . viewed by many as too small and irrelevant to warrant much attention . . . The frontiers of international investment are beginning to push toward the major emerging markets. . . . This trend is likely to accelerate.” Since then, investing in the emerging markets has gained much respectability from pension sponsors and fund managers. Markets such as Korea, Thailand, Mexico, and Chile are no longer viewed as illiquid and exotic but as markets of the future which are increasingly becoming an integral part of the mainstream of international investment. Today the key question for pension sponsors and fund managers is no longer whether and why to invest in the emerging stock markets but, rather, whether they fall short in their fiduciary duty if they fail to recognize the importance of investing a portion of their assets in these markets.

The 1980s were a decade of dramatic change and growth for the emerging stock markets. They had to endure the global economic recession of the early 1980s, and the emerging markets in Latin America had to overcome a major debt crisis. However, the major economic policy upheavals that embraced more open economies and actively pursued privatization and reliance on market forces brought about an unprecedented economic expansion. During this process, many rising emerging stock markets became widely recognized by local and international investors.

The emerging stock markets should not be viewed as a static universe but as a constantly evolving group of markets. After the tumultuous 1980s, the 1990s will perhaps be less dramatic but far from uneventful. As the economies of the emerging markets continue to grow at a much faster pace than the industrialized economies,

the emerging markets' share of the global stock market capitalization will grow further from about 7% in 1991 to 15–20% by the end of this decade. Moreover, China, India, and Eastern Europe will become active (or, in the case of India, better organized) stock markets for their growing industries and vast populations and will be recognized as the newest frontiers of international investing.

The total investment in emerging markets by international investors, which was a mere US\$500 million in 1984, impressively grew to US\$25 billion in 1991, and is expected to reach over US\$100 billion by the end of this decade. The top 100 companies from the emerging markets will become household names among international investors as they float their new securities in the United States, Europe, and Asia and emerge as significant participants in the global capital markets. In the 1990s, vastly expanded research, truly global brokerage activities, and a proliferation of specialized investment managers will make the major emerging markets more efficient and liquid. In the meantime, a new list of markets will offer barely imaginable opportunities.

This book consists of three major sections. First, the book discusses the opportunities and risks of investing in the emerging markets with a presentation of portfolio management and research techniques. In the second section, individual markets are examined with brief profiles of their major listed companies. The last section of the book compiles articles which discuss the important issues in deciding how to distribute a portfolio across the markets. Despite the investment opportunities, mastering the emerging markets can be an intimidating task. The editors hope this book provides readers with a wealth of factual information as well as the tools to put this knowledge to work.

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Putting *The World's Emerging Stock Markets* together was a task that took more than two years and involved coordination between many people throughout the world. Many thanks must be given to each of the contributing authors for taking time from their hectic schedules, and to Pamela van Giessen and Kevin Thornton of Probus Publishing, Linda Shin of Global Strategies Group, and Yvonne Wise of Emerging Markets Management for their assistance without which the book could never have been completed.

Keith K. H. Park

Managing an investment bank in Thailand opened my eyes to the potential (and volatility) of emerging markets. Working at the Capital Markets Department of the International Finance Corporation, the private sector arm of the World Bank, broadened my outlook. During the past five years as president of Emerging Markets Management, I had an opportunity to utilize all of this experience in managing emerging market portfolios. Everywhere I have had the privilege of working with bright and highly professional colleagues from whom I learned a great deal.

Local participants in many markets contributed chapters for this book. All of them have busy jobs and I am very grateful for the time and effort they devoted. I could not have co-edited this book without the help of several of the members of my team at Emerging Markets Management. Felicia Morrow and Catherine Fry contributed chapters and assisted in turning “Spanglish” into English. Rob Ginis and Stephanie Atkins provided and checked data for many chapters of the book. My executive assistant, Yvonne Wise, coordinated the contacts with authors and the publisher, a difficult task which she handled with her usual efficiency. All of them should share in the credit for this book but only I can be held responsible for whatever errors remain.

I am blessed with a wonderful and understanding family who put up with the many evenings I wrote chapters or edited others. Thanks again, Emily, Jenny and Peter for coping with more absent-mindedness than you deserve.

Finally, this book is dedicated to my parents. They instilled in me the drive to persist and were tolerant of my habit of pursuing untrodden paths. Even years after my mother's death, I often miss her enthusiasm; I feel extremely lucky to have my father's continued encouragement.

Antoine W. van Agtmael

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ENHANCED EFFICIENCY OF GLOBAL PORTFOLIO DIVERSIFICATION THROUGH EMERGING MARKET INVESTING

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Introduction

As the world equity markets become further globalized in the 1990s, the ever-increasing outflow of investment into the international equity markets will continue. According to an estimate by Salomon Brothers, the worldwide investment in foreign shares increased from \$300bn in 1985 to \$1,600bn in 1989, and more than one transaction in every seven in the global equity markets has a foreign investor on the other side. Furthermore, according to the survey of Greenwich Associates, U.S. corporate pension fund managers plan to increase the international equity portion of their total assets to 9.5% by 1993 from the 1990 average of 5.6%, which is an almost 100% increase in just three years. Equity investing has truly become a global transaction. See Table 1-1 for the breakdown of global equity flows in 1989.

The phenomenal growth in international equity investing is fueled by the two distinctive benefits inherent in the investment: 1) the reduction of market risk; and 2) the enhancement of returns.¹ The analysis of risk and return has been the major building block of modern portfolio theory (MPT). An investment which generates superior returns and at the same time reduces the degree of risk intrinsic to the investment, will more than likely attract the attention of prudent pension sponsors. This has been the case for global equity investing.

Table 1-1 Gross Cross-Border Equity Flows, 1989
(U.S. Dollars in Billions)

	Market to					
	U.S.	Japan	U.K.	Continental Europe	Rest of World	Investor Total
Investor From:						
U.S.	—	84.16	83.38	50.35	57.58	275.47
Japan	60.77	—	5.25	8.22	101.99	176.23
U.K.	97.22	76.50	—	109.59	40.82	324.13
Continental Europe	107.08	66.48	28.57	148.98	17.01	368.12
Rest of World	151.77	205.72	24.09	26.12	46.41	454.12
Market Total	416.84	432.86	141.30	343.26	263.81	1,598.05

Source: Salomon Brothers, Inc.

However, the current trends in global equity investing elicit great concern because their long-term impact will be a displacement of the risk/return profile of the investment strategies currently in vogue. Given this concern, investing in the world's emerging equity markets provides a means to insure the efficient risk/return profile of global equity investment. This chapter examines: 1) the long-term impact of the current trends in global equity investing; 2) the significance and benefits of emerging market investing in the overall global equity investment programs of pension sponsors; and 3) the recent developments in the emerging equity markets.

Current Trends in Global Equity Investing

One major strategy for domestic and international investing increasingly adopted by institutional investors worldwide since the mid-1980s has been passive equity portfolio indexation. According to Birinyi Associates, at the end of 1989, 25.2% of the total U.S. ERISA (Employee Retirement Income Security Act) assets were indexed to major international equity indices such as S&P 500, FT-SE 100, Nikkei 225, or MSCI EAFE (Europe, Australia, Far East) Indices. According to Salomon Brothers, in 1985 only 1.03% of the total pension assets were indexed. In the U.K., according to Greenwich Associates, 8.8% of the total pension assets were indexed as of March 1990. The benchmark indices used for passive management are market capitalization-weighted, and their constituent shares are largely-capitalized, global blue-chip equities.

Furthermore, because the performance of active international fund managers is measured against benchmark market indices such as MSCI EAFE Index, even the construction of active portfolios has been looking more and more like benchmark

market indices. This performance measurement methodology has been steering active managers away from taking risk by holding shares which do not belong to benchmark market indices.

As a result, investments by international fund managers have been mostly concentrated on some 1,000 largely-capitalized, major international shares, which are the constituent shares of S&P 500, Nikkei 225, FT-SE 100 and Eurotrack 100 Indices.² As Michael Howell of Salomon Brothers writes, "it is not difficult to envisage a future characterized by a 'thundering thousand' superleague of global stocks, to rival the 'nifty fifty' of popular growth stocks that dominated the U.S. market in the late 1960s."

Another new investment strategy which emerged in the mid-1980s and maintains its strong presence in the global investment scene in the 1990s is global tactical asset allocation (GTAA). The GTAA fund managers are not concerned with the prospect of individual shares; they base their investment decision instead on the assessment of broad economic conditions and expected currency movements of specific markets. They switch in and out of markets by trading baskets of shares or utilizing index derivatives. This strategy requires the liquidity of shares included in their buy/sell baskets and the availability of index derivatives for their buy/sell baskets. Consequently, the shares eligible for the inclusion in GTAA buy/sell baskets have been largely-capitalized, international blue-chip shares.

In addition to passive indexation and GTAA, international investment managers have been preferring largely-capitalized equities because of the following: 1) their liquidity; 2) the comfort of worldwide name recognition; 3) the efficiency and safety of an already-established international trading structure for the 'thundering thousand' superleague; and 4) the availability of index derivatives which can be used for managing the risk of holding these shares.

Long-Term Impact of Current Trends

The extensive concentration of investment in globally recognized, largely-capitalized, and highly liquid shares is bound to distort the fair valuation of these shares and will result in a periodic correction of their prices. For instance, in June of 1991 the share price of Rentokil, a U.K. pest-control company, jumped over 5% in one day despite no significant improvement in the company's earning prospect except that Rentokil became a constituent share of the FT-SE 100 (Financial Times-Stock Exchange) Index. Had the share of Rentokil been undervalued by 5% or was a 5% premium attached to the share for no substantive reason except that it had just joined the 'thundering thousand' superleague?

Global institutional investors have already seen the consequence of the blind subscription of largely-capitalized MSCI shares. At the end of 1989, according to all three major global equity indices (MSCI World, Financial Times-Actuaries World, and

4 Chapter 1

Salomon-Russell Global Indices), the Japanese market accounted for more than 35% of the world's equity markets. As a result, the capitalization-weighted global portfolios had some 35% of their equity holdings in Japan. However, at the end of 1989, the price/earning ratios of Japanese equities were reaching a breathtaking height of 60. By the end of 1990, the Nikkei Stock Average (Nikkei 225) had fallen some 40% from the previous year end.

Many western institutional fund managers might claim that they did not inflate the valuation of Japanese equities in the second half of the 1980s, but that the speculative frenzy among Japanese investors was responsible for the irrational valuation of Japanese equities. However, this claim would not be consistent with their heavy weighting in Japanese equities in the second half of the previous decade. For instance, as shown in Table 1-1, U.S. and European investors poured \$230bn into the Japanese market in 1989 alone. An overvaluation of largely-capitalized, global blue-chip equities will make it infeasible to achieve superior returns by investing in them.

International investment by U.S. pension sponsors, which was initiated in order to take advantage of market imperfection overseas, has been making global equity markets increasingly efficient. However, the extensive concentration in largely-capitalized, global blue-chip equities will reverse this process and bring back imperfection to market equilibrium. Moreover, a prudent institutional investor cannot claim to have achieved an optimal diversification of market risk by putting 35% of his or her eggs in one basket.

Also, as world economies and financial markets become more and more integrated, the correlations among the "thundering thousand" superleague shares have been rising (Table 1-2). These rising correlations among the major international equity markets will not contribute to reducing the volatility of portfolio.

One last remark to the current trends in global equity investing is that despite the high liquidity of the global superleague shares, institutional investors are locking themselves into an investment position the unwinding of which will become more and more difficult and costly. Some large U.S. pension sponsors each own 1% or even 2% of a largely-capitalized company. Moreover, all pension sponsors together own a sizeable stake of the company's total capitalization. For instance, pension sponsors own 75% of the outstanding shares of Chase Manhattan Bank.

The 1% shareholder of a large corporation usually finds the liquidation of its position quite expensive. Given this, it will be almost impossible for the 75% shareholder (that is, the pension fund community as a whole in the case of Chase Manhattan Bank) to unload its holding. In his 1991 article in *Harvard Business Review*, *Reckoning With the Pension Fund Revolution*, Peter Drucker estimated that pension funds would have to invest \$100bn to \$200bn in new resources each year in the 1990s. Pouring more and more pension contribution into a limited universe of equities will result in a poor liquidity and diversification of portfolio.

As the 1990s continue, global equity investment has reached a juncture where the assessment of the current investment strategies is necessary. Institutional investors need to broaden their universe of global equity investment in order to insure the adequate diversification of global equity investment programs and to achieve the superior returns from them. The second-tier, small-capitalization shares of established international equity markets should be screened, and the newly-emerging equity markets tapped.³ Here, the rising importance of emerging market investment programs to pension sponsors and other institutional investors is apparent.

Diversification of Risk Offered by Emerging Market Investment

As the world economies become increasingly interdependent, the correlations among the major equity markets have been rising. Consequently, the effectiveness of diversification of portfolio via global equity investing has been somewhat reduced. However, the emerging equity markets still remain lowly correlated with the established equity markets of the world. As shown in Table 1-2, the average correlation coefficient of MSCI EAFE Index (which is a composite index for 20 established equity markets of Europe, Australia, and the Far East) with the United States, United Kingdom and Japan is close to 0.48.⁴ The correlation of MSCI EAFE Index with IFC Composite Index (which is a composite index for the world's 21 emerging equity markets) is 0.27.⁵ The correlation coefficients of MSCI EAFE Index with IFC Asia Index is 0.26, and with IFC Latin America Index, 0.20. Table 1-3 lists correlation coefficients among the constituent countries of IFC Composite Index.

Because of the low correlations between the emerging and established equity markets, the further diversification of a global portfolio (which presently invests only in the established markets) by including the emerging markets will enhance the effectiveness of risk reduction. For a detailed modern portfolio theory (MPT) discussion of correlation and risk reduction, see Appendix at the end of this chapter.

Table 1-2 Correlation Coefficients of Established and Emerging Markets

	EAFE*	USA	UK	JAPAN
EAFE	1.00	0.44	0.50	0.49
USA	0.44	1.00	0.82	0.24
UK	0.05	0.82	1.00	0.20
JAPAN	0.49	0.24	0.20	1.00
EAFE	1.00	0.44	0.50	0.49
IFCC**	0.26	0.36	0.41	0.32
IFCA**	0.20	0.35	0.40	0.37
IFCL**	0.26	0.30	0.25	0.17

*MSCI EAFE (Europe, Australia, Far East) Index

**IFC (International Finance Corporation) Composite, Asia and Latin America Indices

Source: International Finance Corp.

Enhancement of Returns Offered by Emerging Market Investment

The economies of the emerging markets are still in the early stage of modernization and industrialization and have been growing robustly—like teenagers who outgrow their pants every month. In Asia, countries such as Thailand, China, Indonesia, and Malaysia have emerged as new NICs (Newly Industrialized Countries), and are expected to repeat the impressive growth of Asia's four dragons (Taiwan, Korea, Hong Kong, and Singapore) in the 1980s. Latin American countries, such as Chile and Mexico, have been effective in reducing their external debts and controlling high inflation rates, setting the stage for achieving vigorous growth in the 1990s and beyond.

The earning growth rates of companies in the emerging markets have been higher than those of mature companies in the developed markets resulting in faster rising share prices for the emerging companies. For instance, a telephone company in Mexico has neither superior products nor better management than telephone companies in the developed markets. It will take more than a decade for that company to compete against its counterparts in the industrialized economies. However, as the Mexican economy expands robustly, the demand for telephone lines in Mexico are much higher than in the developed markets where most households have already equipped themselves with telephone lines. Consequently, the growth prospect for a Mexican telephone company is much brighter than its counterparts in the developed economies. This growth prospect has been influencing the movement of the emerging stock markets and will continue to do so. As shown in Figure 1-1, a number of the world's emerging equity markets significantly outperformed MSCI EAFE Index during the six-year period between 1984 and 1990.