



MISPERCEPTION
OF RISK
IN EMERGING
MARKETS

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CONTENTS

Executive Summary	4
Introduction	5
Investors Reluctance Factors	6
Psychological Bias	7
Media Coverage Analysis	8
Home Bias	9
Deconstructing Risk Over-Assessment in Emerging Countries	11
Sovereign Risk is Not Corporate Risk	12
Non-Performing Loans Analysis	13
Demystification of Foreign Exchange Risk	14
Conclusion	16
Notes	18
References	19

EXECUTIVE SUMMARY

INVESTORS RELUCTANCE FACTORS

Impact investing in emerging markets is seldom considered as part of an investment strategy. Indeed, the psychological bias of risk aversion, as presented by Daniel Kahneman and Amos Tversky, makes us reluctant to invest in asset classes with high risk/reward ratios, which is often the case with emerging markets. This reluctance is exacerbated by both negative media coverage of emerging markets and domestic biases that reduce our appetite to invest in these markets. However, to fully benefit from global growth, investors should include emerging markets in their strategy, as these markets are expected to support 70% of future global growth.

DECONSTRUCTING RISK OVER- ASSESSMENT IN EMERGING MARKETS

Despite these known factors, many risks are overstated when investing in emerging markets. For example, sovereign risk is not the same as real economic risk. The reaction of sovereign credit default swap (CDS) is often disproportionate to the actual risk of default in the real economy. Contrary to popular belief, the average loan default rate in emerging markets is only slightly higher than in developed markets—a difference of just 219 basis points, according to the World Bank. Symbiotics' track record provides additional evidence to this point, performing well with default rates that are in line with, or even lower than, those in developed countries. Finally, internationalizing a portfolio inevitably involves exchange rate risk as emerging market currencies tend to depreciate against the dollar. However, as emerging market currencies are less correlated to the dollar than developed market currencies, some exposure to these currencies allow investors to diversify their currency exposure.

INTRODUCTION

In 1981, Antoine Van Agtmael, the then Deputy Director of the Capital Markets department of the International Finance Corporation (“IFC”), a subsidiary of the World Bank, proposed the term “emerging market” to replace “third world”, which had a strong negative connotation. According to Van Agtmael, “emerging market” emphasized the opportunities offered by countries such as Brazil and Indonesia. His vision materialized in 1986 when the IFC launched the Emerging Market Fund of the World Bank, the first investment fund for emerging markets, marking a significant milestone in global finance.¹

Despite the IFC’s pioneering initiative, the success of such funds has been mixed. The term “emerging markets” alone has not been enough to convince investors of the opportunities these markets offer. Many investors still perceive these funds as risky and opaque. A crucial contributing factor is that when various asset classes are plotted on a risk-return graph, emerging markets often appear on the far right, representing the highest risk-return pair².

This paper aims to explore the underlying reasons for investors’ reluctance to invest in emerging markets and to deconstruct the specific risks that are most prominently perceived by investors.

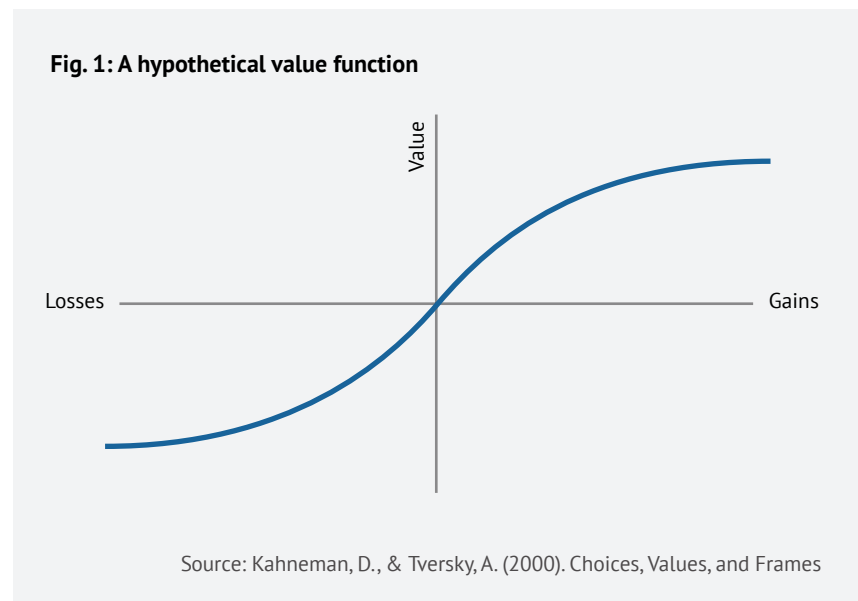
INVESTORS RELUCTANCE FACTORS

PSYCHOLOGICAL BIAS

“Risk aversion in the area of gains is limiting our appetite for emerging markets.”

One of the primary reasons fueling investors' reluctance to engage with emerging markets is risk aversion around potential gains, as presented by Daniel Kahneman (who was awarded the Nobel Memorial Prize in Economics in 2002) and Amos Tversky in their book "Values, Choices and Frames". They argue that individuals generally prefer to avoid uncertainty. The reluctance to invest in emerging markets is therefore exacerbated by this psychological bias.

Kahneman and Tversky argue that the pain of losing USD 100 is perceived as greater than the pleasure of gaining USD 100. To demonstrate this, they conducted a study in which they asked undergraduate students to choose between a certain gain of USD 240 and a 25% chance of winning USD 1,000. The majority (83%) preferred the sure win option, even though rationally the expected value of the second option is higher. Conversely, when this study was repeated by asking students to choose between two losses (one certain and the other uncertain), the opposite phenomenon was observed, i.e. risk-seeking behavior.



These studies allow us to define a value function that is concave for gains and convex for losses. This asymmetric relationship between gains and losses has profound implications for decision making, reinforcing investors' reluctance to invest in what they perceive as risky assets, even if they are more rewarding.

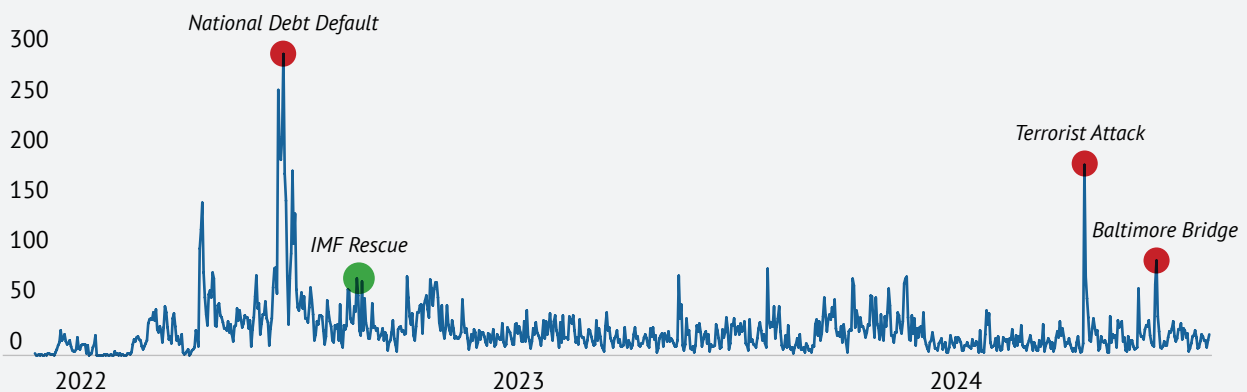
MEDIA COVERAGE ANALYSIS

“The result of this study are unequivocal: Bad news is overrepresented compared to good news.”

When it comes to investing in emerging markets, our psychological bias of risk aversion is constantly exacerbated by unfavorable media coverage. For example, on 15 February 2022, the Financial Times titled its highly popular daily news briefing: "High Risk, No Reward?"³, highlighting the diminishing rewards from emerging markets.

Research shows that this negativity bias has long been prevalent in financial reporting, where negative news often receives more coverage and prominence compared to positive developments. Using the Media Cloud database, launched in 2011 at the Berkman Klein Center for Internet and Society at Harvard University, we analyzed the daily frequency of certain keywords in a selection of newspapers. More specifically, we recorded the number of times a given country was mentioned in relation to the key words found in articles published by the largest national media outlets in the United States, United Kingdom and France. The results of this study are clear: bad news is over-represented compared to good news. We then repeated this analysis for nine different emerging countries to confirm our findings. The chart below shows an in-depth analysis of the results obtained for Sri Lanka, which stands out in a particularly striking manner.

Fig. 2: Recurrence of the keyword "Sri Lanka" in newspapers



From looking at the chart, we can see that the announcement of the government's default on the national debt (13/07/2022) was widely covered by the media, while the support or even the disbursement of the IMF financial facilities received very little coverage. Other negative events have increased Sri Lanka presence in the media, including a deadly terrorist attack took place on 23 March 2024 and the collision between the Dali cargo ship with the Baltimore Bridge, which was on its way to Sri Lanka.

It is interesting to note that when there is a link between a developed country and a developing country, the media coverage is significant. However, when the news does not directly affect the developed world (as is the case with much good news at the national level), the media tends to show little or no interest in the event.

HOME BIAS

“On average, Swiss investors invest 44% of their portfolio in the domestic market, even though it represents only 3% of the global market.”

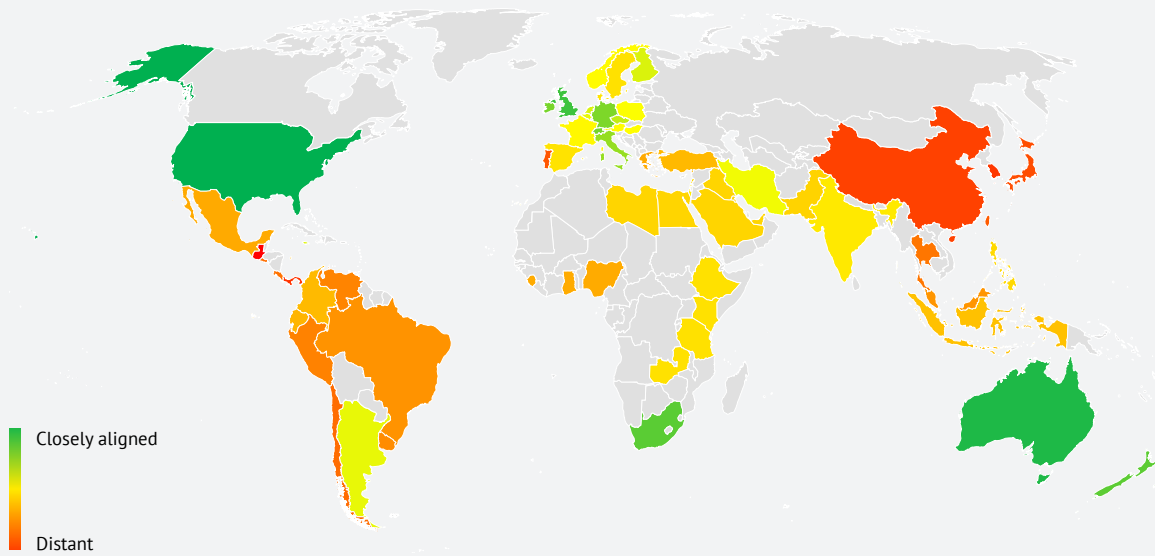
Another psychological element that dampens investors' enthusiasm for emerging markets is the home bias.

Coval's theory of home bias refers to the tendency to favour investments that are geographically close over those that are distant⁴. When he wrote his groundbreaking paper titled "Home Bias at Home: Local Equity Preference in Domestic Portfolios," published in 1999, Coval found that asset managers on average invested in companies that were 184 km closer to them than the average company they could have held. UBS has since published additional data that supports this trend. For example, according to the bank's Chief Investment Office, South Koreans, hold 66% of their portfolio in Korean companies, while the Korean market represents only 1% of the global market. A similar trend can be seen in Switzerland, where 44% of investments are in domestic companies, while the Swiss market represents only 3% of the global market⁵. This shows that average portfolio is heavily concentrated in the domestic market, which increases the domestic risk of the portfolio. In such a scenario, the financial impact of Brexit, for example, would have been felt much more strongly by a British investor than by an American one.

The causes of this home bias are manifold. Some are intrinsically linked to international finance, such as capital controls, unclear or complicated accounting standards for international investments, and the asymmetry of information between domestic and foreign investors. These various causes are relatively quantifiable and rational. However, cultural and behavioral factors also reinforce the home bias.

Heath and Tversky explained in one of their studies that investors feel psychologically more competent in their own market than in international markets. One of the easiest behavioral factors to conceptualize is patriotism, which drives investment in national brands as a gesture of support for the nation. However, Kogut and Singh have highlighted a more novel factor and found that cultural distance has a positive impact on prejudice towards the country of origin. Indeed, the more culturally distant a country is (according to Hofstede's cultural dimensions), the less likely an investor is to place capital there. When looking at the cultural distance between the US and the rest of the world, we see that emerging markets are on average further away than developed countries. This distance negatively affects the willingness of an investor in the Global North to lend money to the Global South.

Fig. 3: Cultural distance from the USA



Sources: Hofstede's Globe © Australian Bureau of Statistics, Geonames, Microsoft, Navinfo, Open Places, Open StreetMaps, TomTom, Zenrin

The reluctance to invest in emerging markets is preventing investors from fully benefiting from global growth. A decision to not invest in emerging markets today means missing out on the estimated 70% increase of global real GDP growth by 2050⁶.

Investors are well-informed and know what they are doing; not participating in most of the growth is not an arbitrary decision, but is based on the pretext of various risks, some of which are overestimated or, and in some cases, misinterpreted. The following section aims to deconstruct some of these risks.

DECONSTRUCTING RISK OVER-ASSESSMENT IN EMERGING COUNTRIES

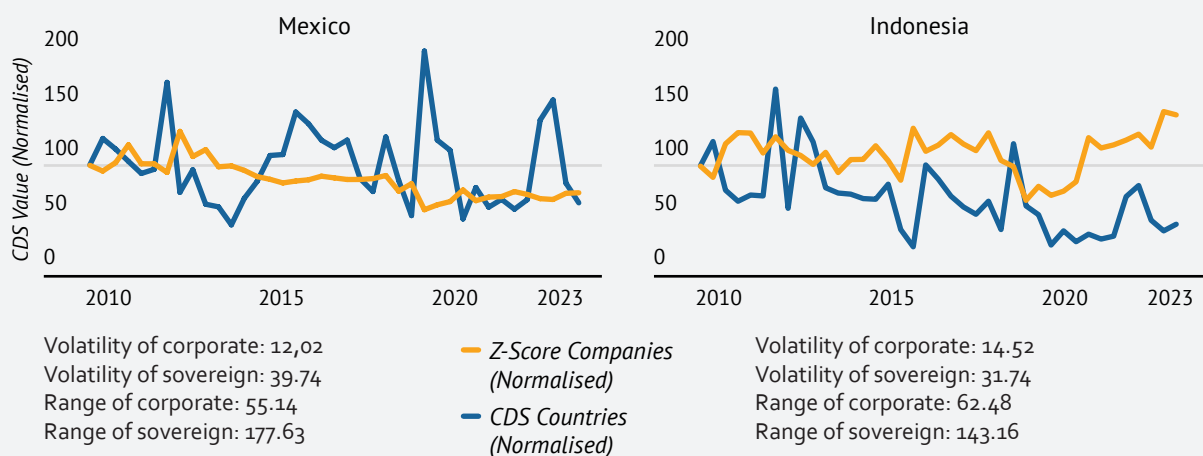
SOVEREIGN RISK IS NOT CORPORATE RISK

"It is therefore inappropriate to use sovereign CDS as an indicator of the default risk of a company operating in the country."

To assess the risk associated with a country, an investor's first instinct is often to look at the level of the sovereign's CDS. However, the CDS does not always reflect the overall economy of a country. For example, when Sri Lanka announced it was defaulting on its sovereign debt, the sovereign CDS soared, and the economy obviously suffered, but it did not come to a standstill. Companies based in emerging markets often implement strategies that ensure considerable stability regardless of the national economic situation. The default risk of a company is therefore not necessarily the same as that of the government. It is therefore inappropriate to use sovereign CDS as an indicator of the default risk of a company operating in the country.

A more precise alternative is the Altman Z-score, introduced by Professor Edward I. Altman in 1968. Unlike the statistical Z-score, which measures how far a data point is from the mean in terms of standard deviations, the Altman Z-score is a financial model that combines several ratios—working capital, retained earnings, earnings before interest and taxes, book value of equity, and sales—to assess a company's risk of bankruptcy. A high Altman Z-score indicates a low probability of bankruptcy, while a low score suggests a higher risk. When applied to large companies in emerging markets over several years, the Altman Z-score shows a marked difference in risk compared to the often more volatile sovereign CDS. The chart below highlights the decoupling between sovereign risk and corporate risk in Mexico and Indonesia. Moreover, a direct comparison of the evolution of sovereign CDS with the level of non-performing loans (NPL) over the same period shows that NPL experience less variation.

Fig. 4: Comparison between sovereign CDS and corporate Z-Scores*



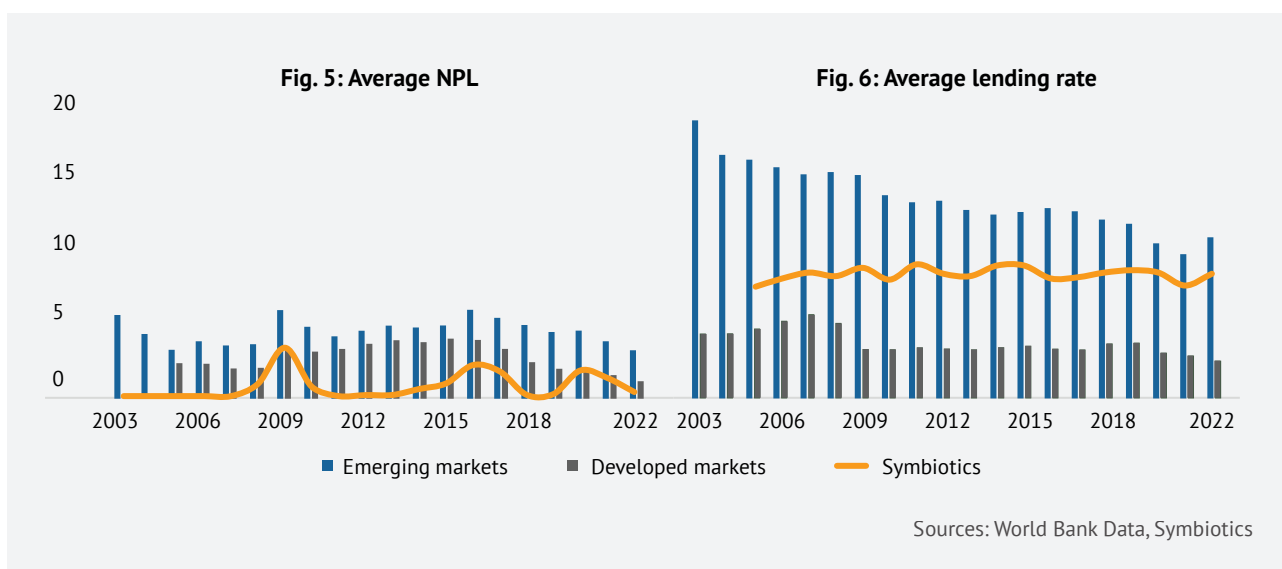
* Z-Score as per Altman's method.

Source: Bloomberg data

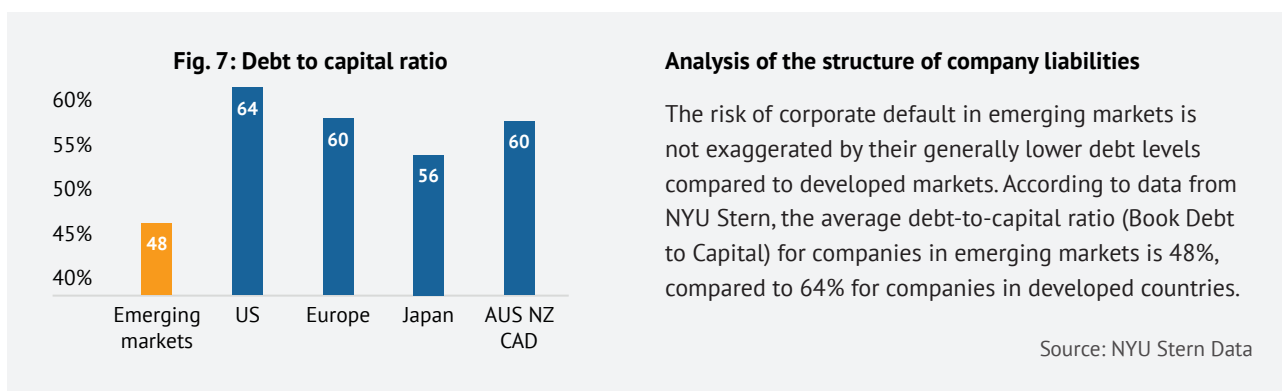
NON-PERFORMING LOANS ANALYSIS

“The average interest rate differential between developing and developed countries, at 889 basis points, offsets this NPL difference.”

Ooi Kok Lang (a Malaysian researcher) demonstrated in one of his studies that the level of NPLs serves as a red flag signal for investors⁷. However, contrary to common beliefs, the NPL level for emerging countries is not dangerously high but rather reasonable. World Bank data clearly supports this: in 2022, the average NPL in developing countries was only 3.42%, 219 basis points higher than in developed countries. Nonetheless, the average interest rate differential between developing and developed countries, at 889 basis points, offsets this NPL difference. Although emerging markets are riskier than developed markets, as evidenced by the higher NPL levels in developing countries, this risk is mitigated by significantly higher average lending rates in these countries.



One of the reasons for this lower-than-expected NPL ratio may be that companies in emerging markets are restricting their borrowing policies given the high cost of debt.



DEMYSTIFICATION OF FOREIGN EXCHANGE RISK

There are several aspects to diversification. The first underlying principle is the law of large numbers, i.e., a wide range of different asset classes, a significant number of different companies and geographical diversity to avoid the detrimental effects of home bias. However, diversification is not just about the law of large numbers. Investing in a broad basket of assets may give the appearance of diversification, but if they perform exactly the same, it is as if there is no diversification at all. Hence the importance of low correlation between different investments.

Any geographically diversified portfolio is subject to currency risk. The key to managing currency risk is to look at the correlation between the different currencies in which we invest. Investing in a number of highly correlated currencies will increase our exchange rate risk, while a low correlation will act as a brake.

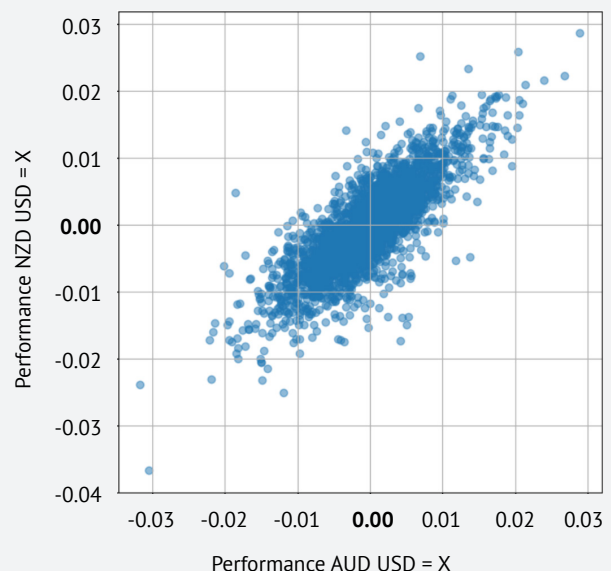
In this analysis, it seems particularly interesting to compare the currency correlation of emerging and developed countries against the dollar in order to assess the exchange rate risk.

Methodology

This study compared the daily returns of two currencies against the dollar. The Pearson correlation coefficient was calculated to determine the degree of correlation between the two currencies. A coefficient close to 1 indicates a positive correlation, while a coefficient close to -1 indicates a negative correlation. Conversely, a coefficient closer to zero indicates no correlation.

For example, the correlation between the daily returns of the AUD-USD and NZD-USD pairs is high, meaning that the New Zealand dollar and Australian dollar appreciate and depreciate at the same time.

Fig. 8: AUD USD = X vs NZD USD = X



Source: Bloomberg data

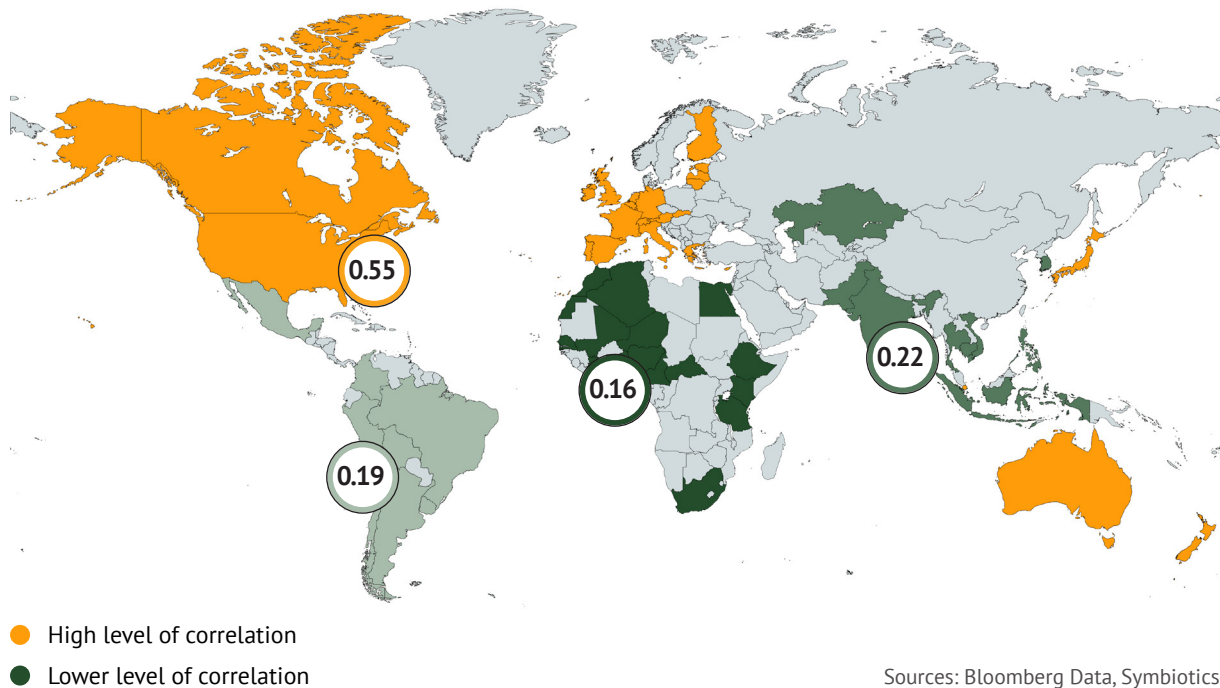
“In general, the average overall correlation coefficient for all emerging markets is 0.1275, indicating a particularly low positive correlation.”

The analysis of exchange rate correlations for emerging markets provides interesting insights into the financial dynamics of these economies. In general, the average overall correlation coefficient for all emerging markets is 0.1275, indicating a particularly low positive correlation between the exchange rates of various emerging market currencies against the US dollar. This low average correlation suggests that emerging market currencies do not move in tandem and may be influenced by country-specific factors such as monetary policy, domestic economic performance or commodity price fluctuations, which differ from country to country.

In comparison, the results for developed markets show a much higher average coefficient (0.5524), making it clear that developed market currencies exhibit more synchronized movements. This can be explained by greater economic and financial interconnections, as well as more harmonized monetary and economic policies.

From this perspective, one can assert that to achieve satisfactory diversification in emerging markets, exposure to emerging market currencies acts more as insurance than a risk.

Fig. 9: Average correlation coefficient between currencies by continent



CONCLUSION

In this paper we explored the multifaceted reasons behind investors' reluctance to engage with emerging markets, including psychological biases such as risk aversion and home bias, and the reinforcing role of negative media coverage. These biases often lead to an overestimation of the risks associated with emerging markets, such as perceived high volatility and economic instability. However, the analysis presented demonstrates that the risks of emerging markets can be more nuanced. Sovereign risk does not necessarily reflect corporate risk, and companies in these regions often display resilience independent of their national economies. Additionally, concerns about foreign exchange risk can be mitigated through careful diversification, as emerging market currencies often show low correlations with each other, providing a natural hedge.

Additionally, while NPL levels in emerging markets are higher than in developed markets, the differential is often offset by significantly higher returns, which can compensate for the elevated risks. The misconception that emerging markets inherently offer a poor risk-return profile overlooks the potential benefits of these markets as a key component of a diversified investment strategy.

Finally, we believe that the reluctance to invest in emerging markets is not always grounded in objective analysis but is often shaped by psychological biases and misinformation.

By demystifying these risks, investors can better assess the true potential of emerging markets and make more informed decisions that could unlock substantial growth opportunities. The findings suggest that a more balanced approach, considering both risks and rewards, is essential for investors seeking to benefit from the dynamic growth of emerging economies.



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