“Principles behind investors’ consideration of investing in emerging markets”

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PRINCIPLES BEHIND INVESTORS' CONSIDERATION OF INVESTING IN EMERGING MARKETS[1]

Abstract

Investors are showing a growing interest in emerging economies due to several compelling characteristics that make these countries attractive for investment. The objective of this study is to examine the factors that motivate individuals to invest in emerging markets. This study employed a quantitative research methodology, specifically utilizing a survey method and online questionnaires to collect data from asset managers in South Africa due to their investment expertise. This group is specifically for a limited number of investors and/or asset managers who have the ability to provide the required information. Data analysis entailed the application of descriptive statistics. The findings revealed multiple justifications for investing in emerging economies, such as higher returns, risk diversification, capitalizing on emerging markets, expanding prospects, maintaining a well-balanced investment portfolio, hedging money, and ensuring anonymity. Among these arguments, only four are crucial when contemplating investment in emerging economies: augmented returns, risk diversification, capitalizing on emerging markets, and expanding prospects.

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JEL Classification B26, D25, E22, G11

INTRODUCTION

Investors have increasingly favored investing in emerging markets in recent years due to the possibility of achieving significant profits and the chance to diversify their portfolios. Emerging markets refer to nations that are currently undergoing fast modernization and are witnessing substantial economic expansion. These markets provide distinctive investment prospects that are uncommon in established markets, rendering them appealing to investors in search of expansion and diversification (Manogna & Mishra, 2021). Traditionally, emerging markets have been perceived as precarious and unpredictable investments because of their political instability, restricted regulatory environment, and currency swings. Nevertheless, in recent times, some developing economies have achieved substantial advancements in terms of economic growth, political stability, and regulatory changes, rendering them more appealing to potential investors. Consequently, an increasing number of investors are seeking to participate in developing economies to broaden their portfolios and take advantage of the possibility of significant profits (OECD, 2022). Emerging markets exhibit a notable pattern of swift economic expansion, which has the potential to provide substantial profits for investors. Furthermore, emerging markets frequently exhibit lower valuations than developed markets, presenting investors with the chance to allocate their investments towards undervalued assets. Investors have the ability to attain

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1 This study is based on the PhD thesis of the corresponding author.

greater returns by investing in emerging economies as opposed to mature ones (Reivan-Ortiz et al., 2023). Investing in emerging economies provides investors with the possibility of achieving substantial profits and accessing chances for diversification. Although investing in these areas carries risks and obstacles, the advantages of being exposed to emerging markets can outweigh the potential disadvantages for many investors. Investors can earn substantial long-term returns by being well-informed and aggressively managing threats to derive gain from the prospects offered by emerging markets (Hussain et al., 2023). Several studies have explored the fundamental factors that motivate investors to consider investing in developed economies (Mai et al., 2023; Renko et al., 2009; Proksch et al., 2018). While there are numerous justifications for investing in mature markets, there has been a scarcity of research undertaken on emerging markets. Therefore, there is a current disparity in the performance of developing markets, which necessitates an examination of this matter and the provision of justifications for investors to contemplate allocating their investments towards emerging markets. Hence, this study holds significant relevance in the context of emerging markets, particularly for investors seeking to engage in investment opportunities.

1. LITERATURE REVIEW

According to Leeds (2015), an emerging or developing market is a marketplace that is sufficiently open to the universal economy, allowing for international trade and granting foreign investors the opportunity to participate in its bond and stock markets. Amadeo (2017) asserts that not all emerging markets possess equal potential as investment locations. Following the 2008 financial crisis, certain developing economies capitalized on the increasing prices of commodities to foster economic growth. Certain emerging countries choose not to allocate funds towards infrastructure development. Instead, they utilized the additional money for subsidization purposes and the establishment of government employment opportunities (Abiad et al., 2012). Consequently, their economies saw rapid growth, leading to increased consumption of imported commodities and subsequent inflationary pressures. Despite the increase in inflation, developing market equities have performed significantly better than United States bonds since the economic crisis in 2008. According to Gundlach (2017), marketplace experts predict that this trend will continue if the value of the United States currency continues to decline. Gundlach (2017) cautions that if investors begin to support emerging market currencies, it is probable that emerging markets will persist in surpassing the United States in terms of performance. Consequently, this presents a favorable opportunity to invest in emerging markets. An appreciating US dollar in relation to foreign currencies is typically considered detrimental to developing markets. This is because it reduces the value of their commodities and increases the burden of their United States currency designated liability (Sanchez, 2017).

Cerutti et al. (2015) identified five universally accepted emerging market attributes. Firstly, their per capita income is below the average. The primary defining feature is low income, as it serves as a catalyst for the subsequent attribute of quick growth. The third trait, high volatility, directly results from rapid growth. High volatility arises due to three causes: geological catastrophes, foreign value surprises, and internal strategy uncertainty (Kuepper, 2016). An essential feature of an emerging market is its dependence on substantial investment capital for growth. Successful investments in emerging markets can result in quick growth, hence generating a high return on investment for investors.

Multiple justifications exist for allocating funds to developing markets (Gough, 1998). Nevertheless, a primary incentive for investment in developing economies ought to focus on safeguarding resources instead of the pursuit of financial gain (Swart, 2011). A rationale for safeguarding possessions should be grounded in the tenets of prudent investment, which dictate that assets should be shielded prior to implementing strategies for generating additional wealth (Gough, 1998). Swart (2011) argues that it is reasonable for different investors to invest in emerging economies. While this may be seen as trendy by some, it is considered a necessary condition for individuals with stable work or sufficient financial resources.

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Diversification is considered a crucial necessity in successful investing, as it is a fundamental premise. Diversification, geographic spread, enhancing returns, currency hedging, confidentiality, increased investment opportunities, and a balanced portfolio are factors that are commonly considered compelling rationales for investing in emerging markets.

Diversification refers to the strategic allocation of resources to minimize vulnerability to any specific asset or risk (Swart, 2011). One often-used strategy to achieve divergence is to mitigate threats or impulsiveness by allocating investments over a range of different resources. Variation allows guarantors to mitigate possibilities by allocating investments across many markets, including together established and developing economies. Developing economies are characterized by their great exposure and tendency to experience significant fluctuations, whereas developed markets have the potential for more stable and consistent growth (Mack, 2014). Investors seeking growth can meet their needs without taking on excessive risks by maintaining a combination of high-risk and low-risk market exposures (Qian, 2016).

Investment planning should incorporate diversification, which can be achieved by spreading investments across several currencies, investment vehicles, or markets (Mack, 2014). It is important to carefully evaluate the dangers of limiting investments just to the local market. The volatility of domestic market currencies in relation to currencies of other emerging and developed markets serves as an incentive to allocate investments in alternative markets and currencies. The subsequent part examines the rationale behind investing in emerging economies, focusing on their geographical expansion.

Geographic spread refers to the practice of investing in many countries at different stages of their growth cycles. Allocating investments across multiple economies is considered a strategy to mitigate fluctuations in returns (Du Preez, 2005). Leveling out gains is achieved by pooling reserves from markets with different growth measures. There is a wide range of venture commodities offered that are not provided locally. Investing abroad expands the scope of investment alternatives accessible to the investor (Mack, 2014). When an investor invests in many emerging markets, they diversify their investments geologically and are not restricted to the domestic market. Hence, the investor has the option to invest in various exchanges, stock instruments, and markets where the most favorable prospects for a profitable return are available (Qian, 2016).

Allocating the investments of an investor across various industries, systems, and securities can result in a substantial increase in the total return on their investment portfolio, assuming they make informed judgments (Qian, 2016). Asset managers must consider the investor's profile before choosing an emerging market portfolio. It is recommended to strive for a portfolio that is well-diversified, consisting of a combination of stocks, bonds, cash, and other investment assets. The investor's risk tolerance and their short-, medium-, and long-term financial goals should decide the allocation (Mack, 2014). Investors who meticulously choose emerging market assets have the ability to enhance the overall return on their investment portfolio because of the wider array of investment options that are accessible. The next section focuses on currency hedging as a rationale for investing in emerging markets.

Inflation has greatly affected investors' attitudes toward investing. However, increasing global investments have the capacity to produce returns that exceed inflation. Investing in foreign currencies has the potential to provide increased profits and capital appreciation. This can mitigate any depreciation in the local currency and, subsequently, the value of domestic investments. Consequently, the proportion of risk to return in a collection of investments is expected to enhance.

Many offshore jurisdictions have the added benefit of enacting secrecy legislation that guarantees strict confidentiality in business and financial matters (Qian, 2016). Any breach of this secrecy could lead to substantial consequences. For example, breaching banking secrecy refers to the action of disclosing customer identities or divulging information about an investor's identity (Mack, 2014). This anonymity does not mean that only unscrupulous investors should participate in offshore investments. Offshore legislation allows for the disclosure of an individual's name when there is undeniable evidence of drug trafficking, money laundering, or other illegal activities (Hyman, 2006). The subsequent section highlights the improved investment opportunities as a justification for investing in emerging markets.

Investing in offshore markets provides enhanced opportunities since investors can distribute assets across many countries, products, and industries (Hyman, 2006). The available alternatives consist of foreign currency fixed-term bank deposits, foreign government and corporate bonds, as well as shares on various stock exchanges and foreign venture capital (Mack, 2014). Allocating investments among different opportunities will offer comprehensive exposure to varying levels of risks and returns. Internationalized investments provide a reduced level of risk and increased rewards over an extended period of time. The next section focuses on the idea of a well-diversified investment portfolio as a justification for allocating funds to emerging markets.

A balanced portfolio is distinguished by its heterogeneous assortment of investments, encompassing stocks, bonds, real estate, and other assets. The short-term performance of offshore assets may not continuously exceed that of a domestic investment portfolio. According to Solnik and McLeavey (2003), a well-diversified investment portfolio with significant offshore risk exposure is anticipated to consistently achieve higher returns compared to a portfolio that solely focuses on domestic risk exposure over an extended period of time. An offshore portfolio may outperform a domestic portfolio due to the weakening of the local currency relative to other major currencies.

Therefore, although a domestic investor may suffer financial loss or receive minimal returns due to a single catastrophic event, an offshore investor may witness profits in Russia that offset any negative impact from a tragedy in Brazil. Moreover, investors benefit from the volatility of different asset classes and economies. The idea of retaining all assets in a single currency is challenging to justify in a world where traditional boundaries are being eliminated (Swart, 2011). Investors who make informed selections when investing in foreign markets have the opportunity to enhance the total return of their investment portfolio while reducing the overall amount of risk involved. Du Preez (2005) suggests that choosing the right currency, market segment, geographical region, and asset class can lead to a balanced portfolio.

Investors allocate capital to emerging markets for several reasons, either singly or in combination. Irrespective of an individual's financial situation, risk tolerance, or reasons for investing in emerging economies, it is crucial for investors to have a thorough comprehension of the facts and inherent risk factors connected with these markets. Each investment option entails a certain degree of risk, hence it is crucial for investors to evaluate and comprehend the risks and potential rewards in advance, in order to guarantee that the investment corresponds with their objectives. Investors should determine their risk and return preferences, as well as their risk tolerance, based on their investing objectives.

This study aims to analyze the underlying reasons that drive investors to consider investing in emerging markets.

2. METHODS

This study utilized a conclusive research design. Gaudet and Robert (2018) categorize decisive investigations into two distinct types: descriptive and causal. Out of these choices, the type of study being discussed is descriptive. Descriptive research is a type of conclusive study that primarily seeks to offer a comprehensive and detailed description of something, usually focusing on its characteristics or functions. Descriptive research includes both cross-sectional and longitudinal designs. This study utilized a cross-sectional design, which entails collecting data from a certain sample of population elements just once. The researcher opted for quantitative research in this study to achieve objectivity by utilizing a structured questionnaire to get information from the participants (Gaudet & Robert, 2018). The survey method was deemed the most appropriate for the current inquiry. According to Leedy and Ormrod (2018), surveys are a technique used to collect data from one or more groups of persons. These data often pertain to their characteristics, opinions, at-

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titudes, or past experiences and are organized in a tabulated format. The research region was selected as South Africa since it is one of the countries in Africa with a burgeoning economy, which makes it a magnet for a significant number of investors. Considering the goals of this study, a questionnaire was chosen as the optimal tool for gathering data. After evaluating the advantages and disadvantages of alternative survey delivery methods, a web-based questionnaire was selected as the most efficient tool for collecting data.

The optimal method chosen for this inquiry was deliberate non-probability sampling. The decision was taken due to the study's requirement for data that is explicitly derived from a selected target group. This group is exclusively for a select category of investors and/or asset managers who have the capacity to give the necessary information. The asset managers were the most strategically positioned respondents to provide the requisite information. According to the Financial Sector Conduct Authority (FSCA) (2019), there were a total of forty-four licensed Collective Investment Schemes (CIS) operating in emerging countries. The asset managers responsible for these schemes were highly competent in offering insights into the risks they evaluated for investors in emerging markets. As a result, a letter of invitation was sent to these asset managers, asking them to take part in the study. These asset managers are at the forefront of investing and have a pivotal role in the global financial landscape. Therefore, the intended sample size will include all 44 asset managers in South Africa who hold a license from the FCSA to participate in trading activities inside emergent markets.

The study also considered the importance of validity and reliability. A pre-test was conducted to evaluate the validity, reliability, objectivity, and generality of a preliminary questionnaire. The pre-test was undertaken in partnership with a statistician, asset managers, and prominent researchers from the University of South Africa who have specialized knowledge in the areas of finance, investments, and risk management. This study investigated the degree to which the content of the study accurately represents the intended construct. Content validity refers to the extent to which a measurement accurately represents the specific content area it is designed to measure (Howell et al., 2005). The study employed content validity as the most appropriate form of validity, as the questionnaire created for the study sought to evaluate the attitudes and opinions of emerging market investors about a specific set of identified emerging market risks. The experts have confirmed that the questionnaire used in this study is valid in terms of its content and meets the norms of academic research. A reliability assessment was performed utilizing Cronbach's alpha coefficient to ascertain the questionnaire's dependability.

A total of 44 questionnaires were distributed to asset managers in South Africa, 33 of which were returned, yielding a response rate of 75%. All the surveys received were suitable for analysis. Data analysis entailed the application of descriptive statistics. The SPSS software is employed for the analysis of data imported from a LimeSurvey.

3. RESULTS

The respondents for this study were asset managers in South Africa. Most respondents were males (64%), and 36% were females. Most respondents were between the ages of 31 and 35 (40.3%) and 26 and 30 (34.4%). The majority of respondents had less than 5 years of experience (70%) as an asset manager, while 30% of respondents had experience of more than 5 years. In terms of duration at the company, the majority of respondents had less than 3 years (52%), while 48% had a duration of more than 3 years. Most of the respondents had a postgraduate qualification (64%), while 36% had a bachelor's degree.

A reliability test was conducted to assess the questionnaire's internal consistency and reliability. Hence, the coefficients were calculated for each of the underlying factors discovered in emerging markets. The Cronbach's alpha coefficients are presented in Table 1.

Table 1. Descriptive statistics and internal consistency reliabilities

Items	Results
Average inter-item covariance	0.034456
Number of items in the scale	46
Scale reliability coefficient	0.761

Table 1 shows that the scales have an alpha coefficient of 0.761, indicating a high level of dependability. This is considered acceptable as the minimum acceptable score is 0.6. De Souza and Dick (2009) caution that any coefficient alpha values below 0.6 are not deemed acceptable in statistical analysis.

Figure 1 visually represents the assessments of the justifications for investing in emerging countries as reported by the respondents.

Figure 1 highlights many reasons for making investments in emerging markets. The rating for investing in emerging markets for the purpose of risk diversification is as follows: 52% of the participants unequivocally concurred that the major reason for investing in emerging economies was risk diversification. In addition, 36% of the participants agreed to some degree, while 12% agreed to a lesser degree. When assessing the enhancement of returns as a reason for investing in emerging economies, 58% of the participants absolutely concurred, 30% concurred to some degree, and 12% slightly concurred. The response suggests that the main objective of asset management is to maximize investment returns. When assessing the impact of market exploitation on investment decisions in emerging markets, 40% of the participants expressed complete agreement, 36% expressed agreement to a certain degree, 21% expressed partial agreement, and 3% did not express any agreement. Despite the ongoing global crisis, the BRICS countries have observed substantial growth in their developing industries, leading to an increase in investment opportunities. When assessing the appeal of investment opportunities as a reason for investing in foreign nations, 46% of the respondents completely agreed, 42% agreed to a certain degree, and 12% agreed to a limited degree. The respondents evaluated the act of maintaining a balanced investment portfolio as a reason for investing in emerging markets in the following manner: Based on the data presented in Figure 1, it can be observed that 30% of the participants fully agreed, 40% agreed to a certain degree, 27% agreed to a limited extent, and 3% did not agree at all. A hedge fund is a financial instrument that pools funds from accredited or institutional investors to invest in a wide variety of assets, utilizing advanced techniques for constructing portfolios and managing risks. The respondents evaluated the use of hedge funds as a driving factor for investment in emerging nations in the following manner: 18% of the participants expressed complete agreement, 33% expressed partial agreement, 37% expressed limited agreement, and 12% expressed no agreement. Based on the data shown in Figure 1, the survey results indicate that just 6% of the respondents strongly agreed on the significance of secrecy in investing in emerging nations. 30% agreed to some degree, 40% agreed to a certain amount, and 24% did not agree at all. The response suggests that secrecy is not always the main reason for investing in emerging markets.

4. DISCUSSION

The primary reasons include diversification of risk, augmentation of returns, market exploitation, expanded investment prospects, portfolio balance, hedge fund utilization, and confidentiality. The respondents significantly prioritized risk diversification as the primary motive for investing in emerging economies. Risk diversification is the

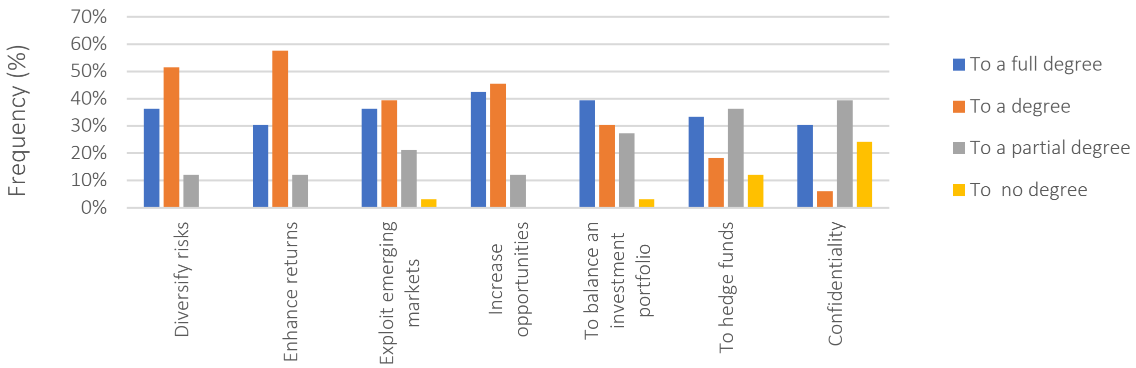

Figure 1. Reasons for making investments in emerging markets

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act of spreading out risk across many areas to reduce the negative effects that could arise from being exposed to a particular factor (Clarke, 2017). Diversification is a strategy used to reduce risk by including a wide variety of investments in a portfolio. A diversified portfolio is formed by combining many asset types and investment vehicles in order to mitigate the risk associated with any single asset or risk (Clarke, 2017). Therefore, it may be deduced that investors should utilize a strategy that reduces risk by allocating investments among a wide range of financial instruments, industries, and other categories. The ultimate objective of risk diversification is to maximize profits by distributing investments across different portfolios that would demonstrate unique reactions to a specific event. Therefore, it can be deduced that the spreading out of risk is a compelling reason for investing in emerging markets.

Asset managers primarily aim to employ strategies that grant them access to particular types of investment opportunities, with the goal of enhancing the performance of their portfolios (Clarke, 2017). The evaluations from the respondents validated the previous citations, as they unanimously agreed that the key impetus for investing in emerging economies was to enhance returns. Therefore, asset managers must strive to reduce costs whenever possible, find the most dependable and profitable sources of revenue, and mitigate liability and risk.

Market exploitation, as defined by Bodie et al. (2018), is the process of actively pursuing and obtaining new knowledge and abilities that go beyond the investor's current product market. The respondents had different viewpoints on using markets as a motivating factor for investing in emerging markets. This corroborates the current corpus of literature, which posits that individuals possess diverse predilections for investment yields, and therefore, a solitary investment technique or locale would not be universally appropriate for all investors. Therefore, investors should give priority to what is most beneficial to them with respect to their investment objectives. Therefore, it can be deduced that the utilization of markets is a contributing element to investing in emerging markets. The next section examines the justification for investing in emerging markets, specifically highlighting the increasing abundance of investment prospects.

All participants agreed that the main reason for investing in emerging markets is to increase investment opportunities. Teso et al. (2019) contend that assets in emerging markets will exceed those in established markets, with Asia exhibiting the most auspicious prospects. The above information is derived from Bloomberg's comprehensive poll conducted in 2019, which involved 57 investors, strategists, and traders from around the world. The study aimed to gather their forecasts for the year 2020. In December 2019, the total worth of stocks and bonds in emerging markets exceeded $25 trillion, surpassing the combined economies of the United States and Germany. Therefore, it seems that emerging markets continue to offer better investment opportunities in comparison to mature ones. Therefore, it can be deduced that the increase in investment opportunities is a significant factor in choosing to invest in emerging economies.

The essential factor to consider while investing in emerging markets is a well-balanced investment strategy. A balanced investment strategy entails the amalgamation of investments in a portfolio with the objective of attaining equilibrium between risks and returns. Typically, balanced portfolios can achieve diversification by distributing assets across equities and bonds (Aven, 2015). The respondents reached an agreement that diversifying an investment portfolio is a motivating factor for investing in emerging markets. Including developing economies in an investment portfolio is essential since it is necessary to have exposure to these nations in any investment portfolio.

The majority of respondents concurred that investing in emerging markets serves as a means to hedge funds. There is a substantial rise in the inclusion of hedge funds in individual financial portfolios since the start of the twenty-first century. The document can be considered a contract between a proficient fund manager, sometimes called the general partner, and the investors also referred to as limited partners, who together contribute their cash to the fund. Hedge funds strive to maximize investor profits while limiting risk and are generally considered to be more aggressive, risky, and exclusive than mutual funds. Therefore, hedge funds are not recommended for all investors, especially those who are not inclined to take risks. Hedge funds should be seen as a substantial risk element to consider when making investments in emerging countries (Saunders & Cornett, 2018).

The consideration of confidentiality was a motivating factor for investment in emerging countries. However, it is worth noting that only a small number of respondents agreed with this notion. Confidentiality pertains to the practice of withholding the specifics of contracts commonly used in negotiations prior to entering into agreements concerning distribution, licensing, technological transfer, franchise, manufacturing, joint ventures, mergers, and acquisitions (Gitman et al., 2016). According to Chapman (2013), secrecy is a reciprocal understanding that may entail the exchange of sensitive material in advance.

Investors consider multiple factors when making investments in emerging markets. This study identified risk diversification, return enhancement, market exploitation, increased investment opportunities, portfolio balance, hedge funds, and confidentiality as significant factors to consider.

CONCLUSION

The objective of this study was to analyze the reasons for making investments in emerging markets. Investors mostly allocate their assets to emerging markets due to a variety of reasons or a convergence of factors. Each investor or potential investor must adhere to their individual investing objectives, as there is no universally applicable investment that can meet the requirements of all investors, and no individual can utilize all investment vehicles to accomplish their goals. The response suggests that the prioritization of reasons for investing in emerging economies can be determined based on the average response. The study revealed seven reasons for allocating resources to emerging markets, including higher returns, risk diversification, capitalizing on emerging market potential, accessing new opportunities, maintaining a balanced investment portfolio, hedging money, and ensuring confidentiality. Out of these reasons, there are four that are particularly significant when considering investing in emerging economies: increased returns, risk diversification, capitalizing on emerging markets, and expanding prospects. This study emphasized several elements that should prompt investors to consider investing in emerging economies. Nevertheless, it is imperative to recognize the presence of potential hazards and obstacles. Emerging markets often encounter political and economic volatility, leading to volatile asset values and substantial investment losses. Additionally, emerging economies may lack the regulatory framework and transparency commonly found in mature markets, which can present difficulties for investors in assessing risk and making educated investment decisions. Hence, it is recommended for investors to consider these aspects in addition to the potential risks and challenges associated with the particular investment. Therefore, this study has provided a significant contribution to the current understanding and has presented new insights into the underlying factors that drive investors to consider investing in emerging countries.

The primary constraint of the study is that it exclusively focused on South African asset managers as the target group. Nevertheless, it was acknowledged that asset managers based in South Africa, given the literature's validation of similar risks, obstacles, and investment conditions across all BRICS countries, would sufficiently represent asset managers from other developing economies. Furthermore, it is important to note that the data collection occurred at a given moment, which means that the variables, responses, and findings may only be applicable to that particular time frame.

AUTHOR CONTRIBUTIONS

Conceptualization: Jethro Godi.
Formal analysis: Jethro Godi.
Investigation: Jethro Godi.
Methodology: Jethro Godi.
Writing – original draft: Jethro Godi.
Writing – review & editing: Jethro Godi.

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