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Wrong Time to Abandon Emerging Markets?

Adviser sees the 'best returns of any asset class' in the next three years

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As emerging-markets stocks lost value in late August, Jamie Jackson, an investment adviser in Chicago, was watching for an opportunity to buy.

"Over the next three years, these markets are going to produce the best returns of any asset class," says Mr. Jackson, managing principal at investment-advisory firm **Stairway Partners LLC**.

In the near term, he says, emerging countries face challenges to growth, especially as China's economy slows down more sharply than people had expected. But even if China's economy grows at less than 7% a year, emerging-markets securities likely will produce better returns than other investments, Mr. Jackson says.

He didn't buy during the recent market volatility, but says he will if the broad emerging-markets index falls another 20%. Last year, Stairway boosted the allocation to an emerging-markets fund by two percentage points, to 11%, for clients who can handle moderate risk.

In this column, we feature model portfolios from investment advisers. Stairway Partners, which was founded in 2004, manages around $425 million in assets for wealthy individuals and some pension plans and endowments.

To make investment allocations, the team at Stairway estimates potential returns from various asset classes over a period of three years or longer. If an investment is trading cheaply compared with what the advisers expect it to return, they buy, and vice versa.

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Last year, the advisers felt that an index of emerging-markets stocks was cheap compared with expected returns from the underlying stocks, so they added to it. Mr. Jackson says that buying when the markets are volatile, as they have been recently, carries the risk—in Wall Street parlance—of "catching a falling knife," as prices could keep declining. But he says being too picky about the right entry point could mean missing out on a potential early rally.

Here, Mr. Jackson shares a portfolio suitable for someone who can handle moderate risk. The portfolio gained 8.7% annually over the five years ended June 30. This is after Stairway's investment-management fee, which is a maximum of 0.75%.

Dividing Up the Money

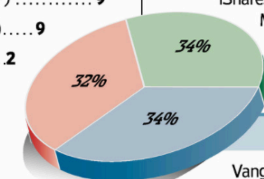
A model portfolio of Stairway Partners

U.S. STOCKS 32%

SPDR S&P 500 ETF (SPY)	**12%**
iShares Russell 1000 Growth ETF (IWF)	**9**
iShares Russell 1000 Value ETF (IWD)	**9**
iShares Russell 2000 ETF (IWM)	**2**

FOREIGN STOCKS 34%

iShares MSCI EAFE ETF (EFA)	**18%**
iShares Core MSCI Emerging Markets ETF (IEMG)	**11**
Vanguard FTSE Europe ETF (VGK)	**5**



BONDS AND CASH 34%

Vanguard Total Bond Market Index (VBMFX)	**10%**
Vanguard Short-Term Investment-Grade (VFSTX)	**9**
Vanguard Short-Term Government Bond (VSBSX)	**6**
Cash	**9**

Note: Retail-share classes shown here though advisers often use cheaper institutional-share classes.

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U.S. STOCKS

SPDR S&P 500 ETF: Advisers believe that despite recent market declines, U.S. stocks are trading at slightly higher prices compared with the companies' expected earnings. As such, they haven't made any changes to this allocation.

ISHARES RUSSELL 1000 GROWTH ETF and **ISHARES RUSSELL 1000 VALUE ETF:** These funds are owned to give advisers the flexibility to tilt the portfolio toward fast-growing or "growth" stocks and cheap or "value" stocks, depending on the valuation of these investment styles. At the moment, valuations of both styles are similar, so the allocation is equally divided.

ISHARES RUSSELL 2000 ETF: Advisers cut back on their allocation to small-company stocks two years ago because they appeared to be expensive, and had moved the money partly to large U.S. companies. "That's been helpful," says Mr. Jackson, because small stocks have been hit harder than larger stocks since they sold.

FOREIGN STOCKS

ISHARES MSCI EAFE ETF: Stairway advisers increased the allocation to this fund last year, because they believe that earnings of companies in Europe and the U.K. are likely to start picking up, and their stocks are cheap compared with what they could return in the coming years.

VANGUARD FTSE EUROPE ETF: This fund was bought last year to gain additional exposure to Europe and the U.K.

BONDS

Advisers believe that the Federal Reserve is likely to raise its benchmark interest rate by half a percentage point this year. When interest rates rise, bond prices decline, and the team at Stairway expects a slightly negative return from bonds in the coming quarters.

VANGUARD TOTAL BOND MARKET INDEX: Some of this fund was sold last year, as advisers moved money to cash and short-term bonds, which are less sensitive to interest-rate increases than longer-term bonds.

VANGUARD SHORT-TERM INVESTMENT-GRADE: Advisers bought this fund, which buys short-term bonds, to replace a fund that owned medium-term bonds, which would likely lose more value when interest rates rise.

VANGUARD SHORT-TERM GOVERNMENT BOND: This fund was bought partly with money from the sale of high-yield, or junk, bonds, which advisers felt had become expensive last year.

CASH: This allocation has gone up over the last year as advisers became more "defensive" in their debt allocation. "We'll happily buy the bonds back when they get back" to fair value, says Mr. Jackson. However, that could take a while, he says.