CLIENT **BULLETIN**

Independent Financial Advisors

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Emerging Markets: We should get off the bandwagon

Most of you who were my clients back in 2002 and 2003 have held and may still hold emerging markets stock fund(s). More recently, a number of you have moved into the category through a China fund or a couple of regional Asia funds. In addition, some of you may hold emerging markets funds in your company retirement plan or elsewhere outside of Schwab Institutional.

The purpose of this bulletin is to focus your attention on this investment category, since it has been "shooting out the lights" for over 3 years. In 2003, the average emerging markets fund rose 55.3%; then in 2004 and 2005, increases of 23.8% and 31.6% were seen. No letup is in sight so far in 2006. My recommendation is that we move out of emerging markets at this point and redeploy the cash to developed foreign markets, which are less volatile, more diversified and less frothy.

As most of you know about me, I'm not one to time the markets or jump in and out of sectors and markets. I'm becoming quite concerned, however, about this market. Money flows have surged over the last quarter and the relative performance gap between U.S. and emerging markets appears to be reaching extreme levels. Specifically, over the last 3 years, the emerging markets index has risen 44.5% per year, on average, compared to 17.1% for the S&P 500. Sure, the S&P's performance is strong, but that of emerging markets is huge.

With the surge in flows into the emerging markets, it reminds me of the tech bubble back in the late 1990s and 2000. Everyone began to jump on the bandwagon after they saw how large the gains were. As we now know in retrospect, those large gains were the dying gasp of an overheated market. Everyone who jumped in at the last minute suffered greatly by buying very high and selling low sometime in the next two years of sustained declines.

The reason I got most of you into emerging markets three to four years ago was that I viewed the situation as an attractive opportunity. These markets had just suffered through declines of 26.1% in 1998, 29.6% in 2000 and a combined 8.8% in 2001 and 2002. So valuations were a bargain at the time. Since then, we've reaped ample rewards each year.

But neither this nor any other category of mutual fund can post huge gains and dominate the competition forever. It's important to note that the volatility measure (called standard deviation) of emerging markets stocks is about 60% higher than that of developed market stocks, so it's difficult for investors to use this category effectively.

So just as I did over the last couple of years with two other volatile, cyclical categories, i.e. high-yield (junk) bond funds and domestic real estate (REIT) funds, I'm prepared to say that now is the time to realize our profits in emerging markets funds and wait until the next trough comes along. After all, why be greedy? If we wait too long, history tells us that the bulk of those profits could disappear.

As a final note, this recommendation does not apply to a few of you who have just recently begun sticking your toe into the emerging markets. I've done so on your behalf only with very small amounts, and if those markets drop, it will present us with an opportunity to buy a little more at bargain prices.

I'll be preparing to sell your emerging markets fund(s) over the next couple of weeks, so I'll email or phone you soon to recommend specific changes. As usual, I won't actually make the switch until you feel comfortable.