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Emerging market equities

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Introduction

- Focus of this presentation is to set out the rationale for a strategic bias toward emerging market equities

Consider the following:

- Definition and structure of emerging markets
- Past performance
- Arguments for and against a strategic tilt toward emerging markets
- Conclusions

Definition and structure of emerging markets

Definition and structure of emerging markets

- “Emerging markets” is a widely used term but with no widely agreed definition
- Has been used to describe countries that have begun to undergo industrialisation and market-based reforms
- In an investment sense we tend to think of emerging markets as any/all of the following (amongst other things)
  - Relatively immature markets
  - Economies likely to experience stronger GDP growth over time
  - Markets where political factors can have a significant impact
- MSCI use the following criteria
  - Sustainability of economic development (GNI per capita threshold)
  - Size and liquidity requirements
  - Market accessibility criteria

Definition and structure of emerging markets

MSCI classification

MSCI International Equity Indices—Country & Market Coverage

Developed Markets

Americas	Europe	Pacific
Canada	Austria	Australia
United States	Belgium	Hong Kong
	Denmark	Japan
	Finland	New Zealand
	France	Singapore
	Germany	
	Greece	
	Ireland	
	Italy	
	Netherlands	
	Norway	
	Portugal	
	Spain	
	Sweden	
	Switzerland	
	United Kingdom	

Emerging Markets

Americas	Europe, Middle East & Africa	Asia
Brazil	Czech Republic	China
Chile	Egypt	India
Colombia	Hungary	Indonesia
Mexico	Israel	Korea
Peru	Morocco	Malaysia
	Poland	Philippines
	Russia	Taiwan
	South Africa	Thailand
	Turkey	

Frontier Markets

Americas	Central & Eastern Europe & CIS	Africa	Middle East	Asia
Argentina	Bulgaria	Botswana[2]	Bahrain	Pakistan
Jamaica[2]	Croatia	Ghana[2]	Jordan	Sri Lanka
Trinidad & Tobago	Estonia	Kenya	Kuwait	Vietnam
	Lithuania	Mauritius	Lebanon	
	Kazakhstan	Nigeria	Oman	
	Romania	Tunisia	Qatar	
	Serbia		Saudi Arabia[1]	
	Slovenia		United Arab Emirates	
	Ukraine			

1. The MSCI Saudi Arabia Index is currently not included in the MSCI Frontier Markets Index but is part of the MSCI Gulf Cooperation Council (GCC) Countries Index.
2. The MSCI Botswana Index, the MSCI Ghana Index, and the MSCI Jamaica Index are currently stand-alone country indices and are not included in the MSCI Frontier Markets Index. The addition of these country indices to the MSCI Frontier Markets Index is under consideration.

Definition and structure of emerging markets
MSCI / FTSE / S&P

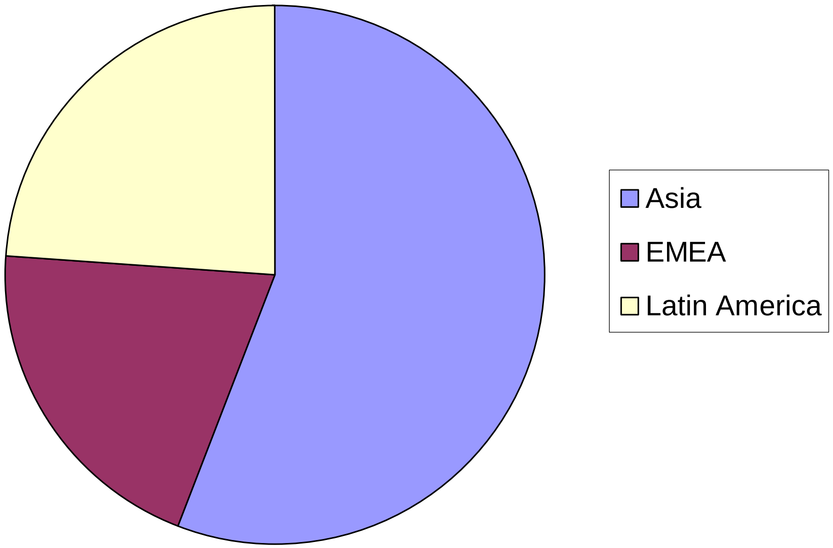
- While MSCI index is the most widely used by managers, FTSE and S&P/IFCI indices are also fairly common
- The construction of the 3 different indices is very similar – at present there are only relatively minor constituent differences between the main index providers
- Clearly index constituents will change from time to time, and methodologies will differ to some extent such that country weights are slightly different

Definition and structure of emerging markets

Country allocation

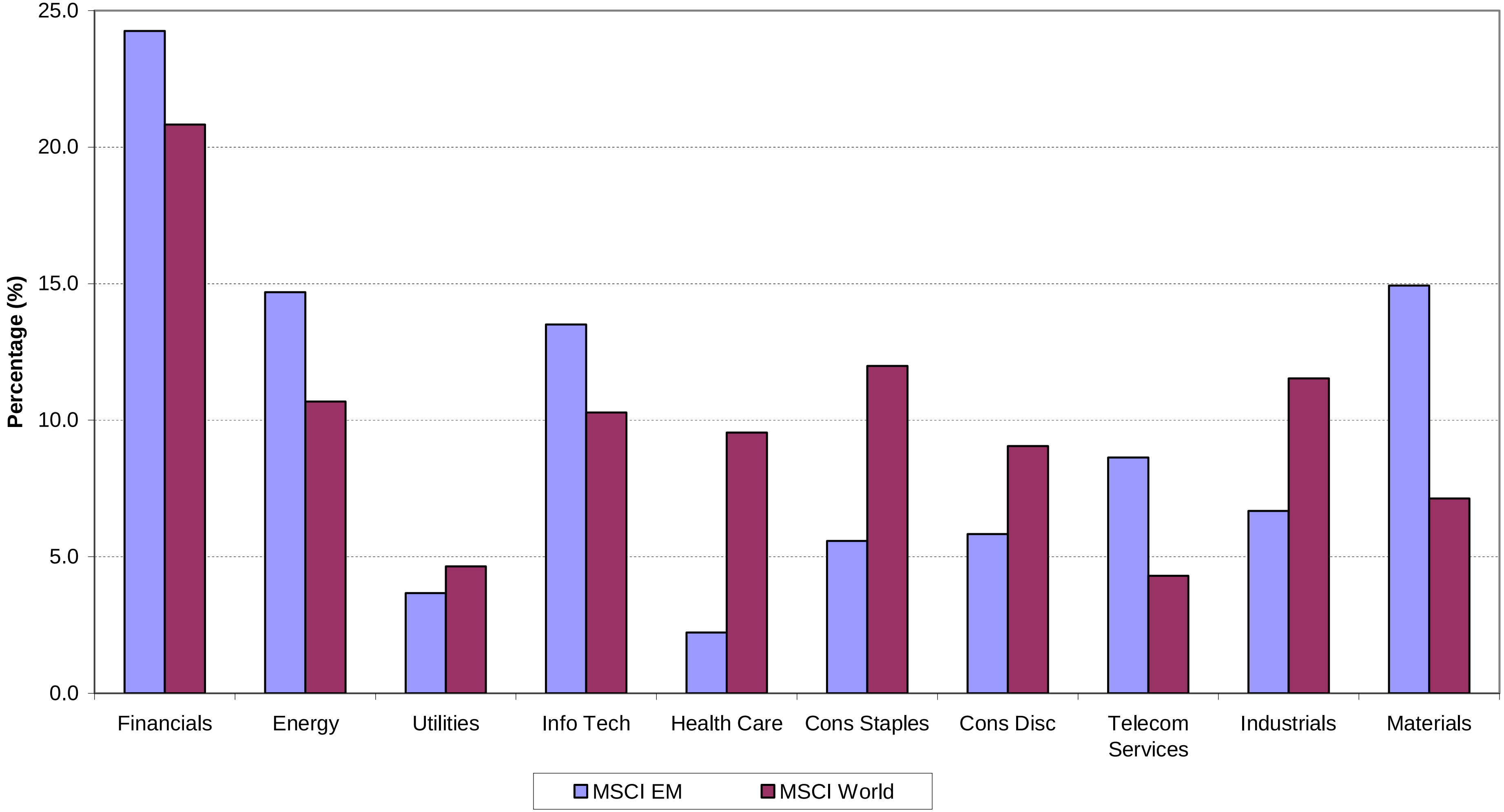
- Composition of emerging markets has changed over time
  - Current breakdown of MSCI Emerging Markets index shown below

MSCI Emerging Markets Index



MSCI Emerging Markets Breakdown			
Asia	**55.7**	Turkey	1.5
China	17.9	Poland	1.3
South Korea	12.7	Egypt	0.5
Taiwan	11.4	Czech Republic	0.4
India	7.5	Hungary	0.6
Malaysia	2.7	Morocco	0.2
Indonesia	1.9		
Thailand	1.3	**Latin America**	**23.9**
Philippines	0.4	Brazil	16.9
		Mexico	4.3
EMEA	**20.4**	Chile	1.4
South Africa	6.9	Colombia	0.6
Russia	6.3	Peru	0.6
Israel	2.8		

Definition and structure of emerging markets
Sector allocation



Definition and structure of emerging markets
Frontier markets

- The term ‘frontier markets’ is typically used to describe the smaller and less liquid subset of emerging markets
- Covers less developed parts of Eastern Europe, Asia, Middle East, and Latin America, as well as markets in Africa and the Caribbean
  - These markets constitute close to 5% of global nominal GDP and represent 1% of the global market capitalisation
  - Some of these economies have enjoyed stellar growth over recent years
- Frontier markets have typically been relatively inaccessible to institutional investors
  - However restrictions on foreign ownership have reduced in many cases and liquidity has improved

Definition and structure of emerging markets

Canadian Pension Funds Exposure

- The exposure to emerging markets equity can be obtained directly via an emerging markets equity mandate or indirectly via a foreign developed markets equity mandate
- The table below shows the direct exposure of Canadian pension funds to emerging markets equity:

Fund Assets	% Allocation to EM
$0-$100M	0.2%
$100M-$500M	0.3%
$500M+	0.8%

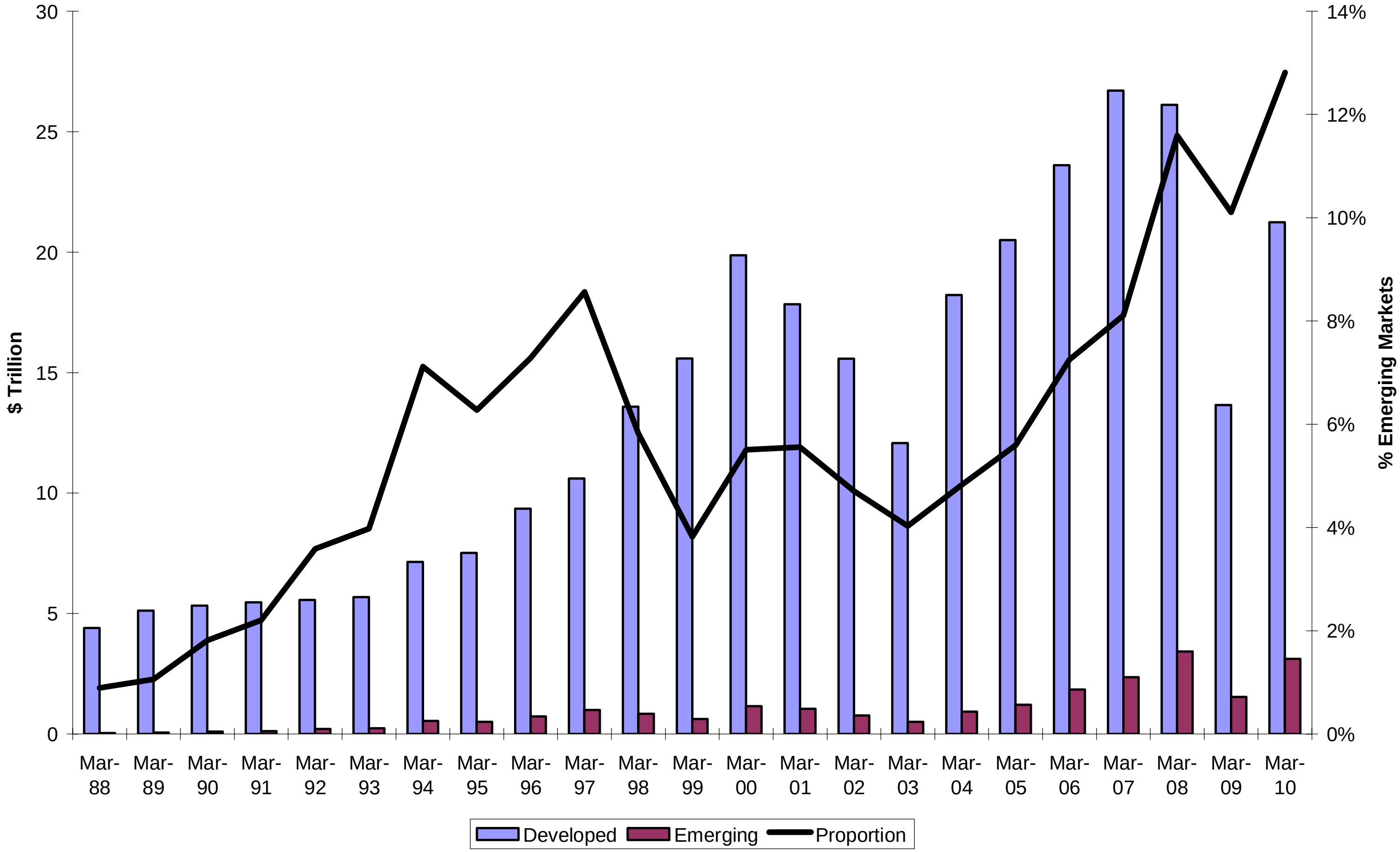
- Canadian pension funds are underweight to emerging markets equity

Source : Mercer survey on Canadian pension funds' asset allocation, 2010

Past performance:
although not a guarantee of
future results…

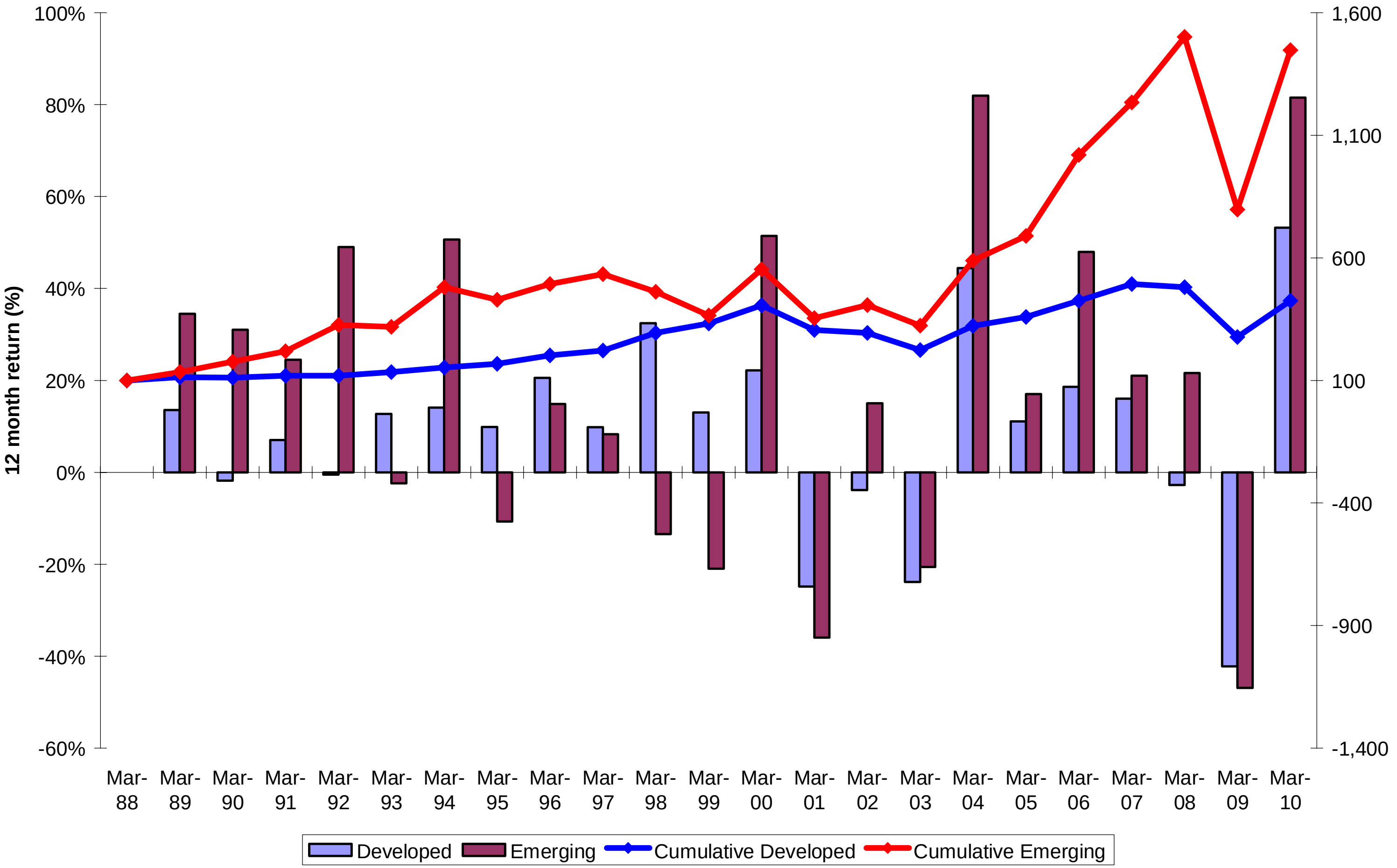
Past performance

- Historically, emerging markets now constitute approximately13% of the MSCI AC World Index (from less than 2%, 20 years ago)



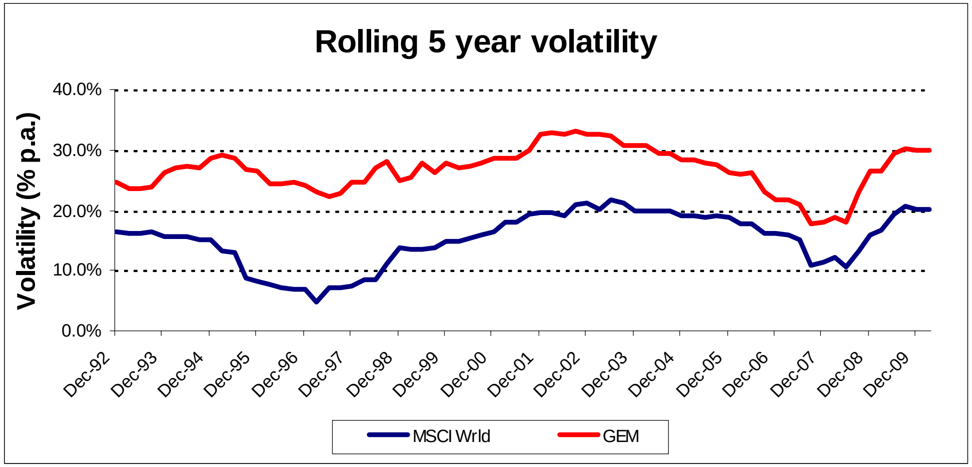
Past performance

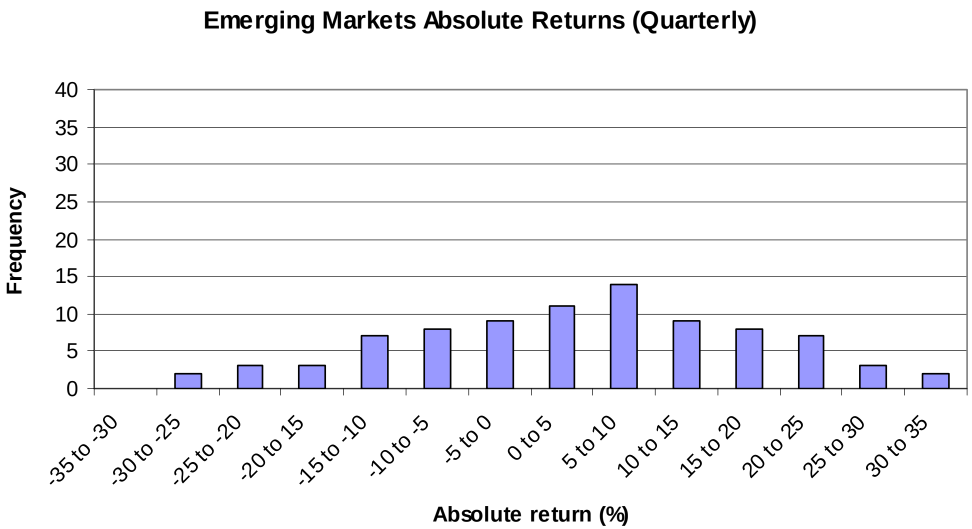
- Past performance of emerging markets over the last 22 years has significantly outpaced that over developed markets (by 5.7% p.a.)



Past performance

- Greater volatility
- Distribution of quarterly returns show a wider range (i.e. fatter tails)





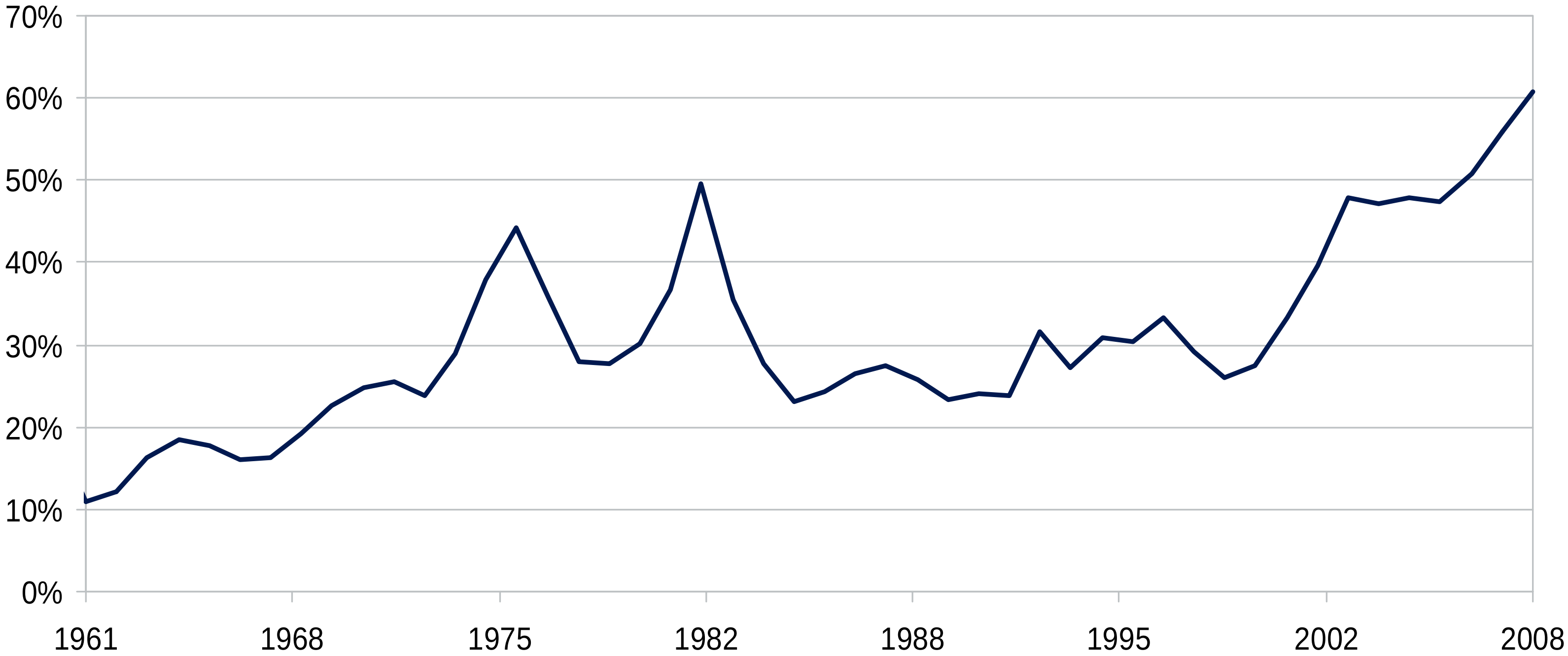
Arguments in favour of a bias towards emerging markets

Arguments in favour of a bias towards emerging markets

- Engine of growth for global economy i.e. global importance
- Attractive investment opportunities for companies located therein
- Demographic factors
  - Population growth
  - Population ageing
- Emergence of a consumption oriented middle-class
- Enormous pool of cheap labour
- Stronger fiscal positions

Arguments in favour of a bias towards emerging markets
Global importance

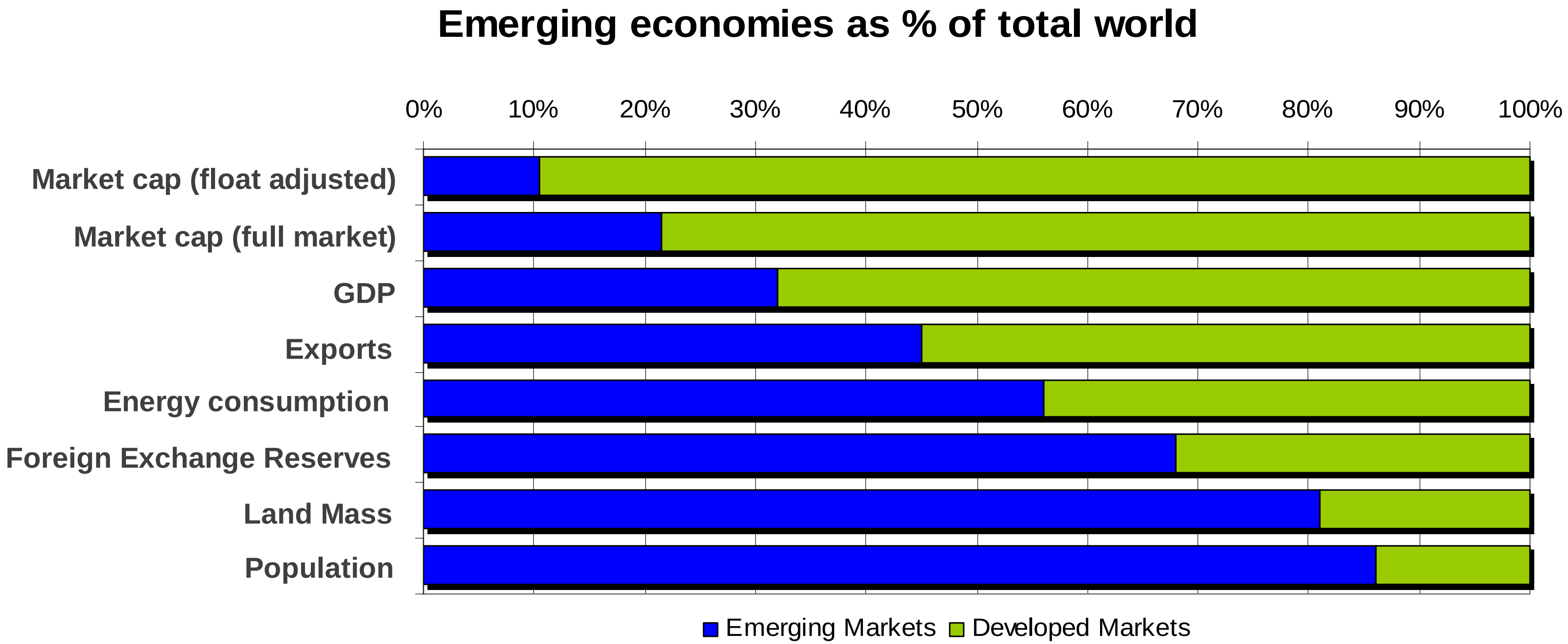
Share of world GDP Growth
(Blended weights, %)



Emerging share of global growth has grown from 20% to around 60% over last 50 years

Source: UBS, Haver, IMF, World Bank. Data to December 2008

Arguments in favour of a bias towards emerging markets
Global importance



Arguments in favour of a bias towards emerging markets

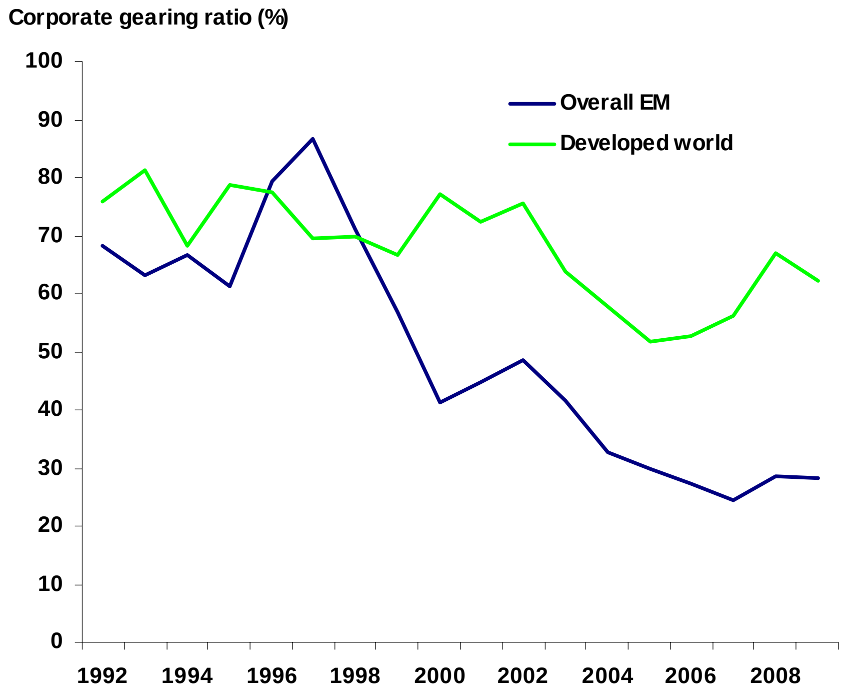
Opportunities for companies

- It is likely that the corporate sector will continue to grow
- The opportunities for both new and existing companies located within emerging markets should exceed the opportunities available to companies focussed mainly on developed markets
  - Developed market companies with a large base of consumers in emerging markets will also have the potential to benefit
- The range of opportunities open to the corporate sector in emerging economies should manifest itself in superior corporate earnings growth
  - A specific allocation to emerging markets may be used to exploit this trend

Arguments in favour of a bias towards emerging markets

Opportunities for companies

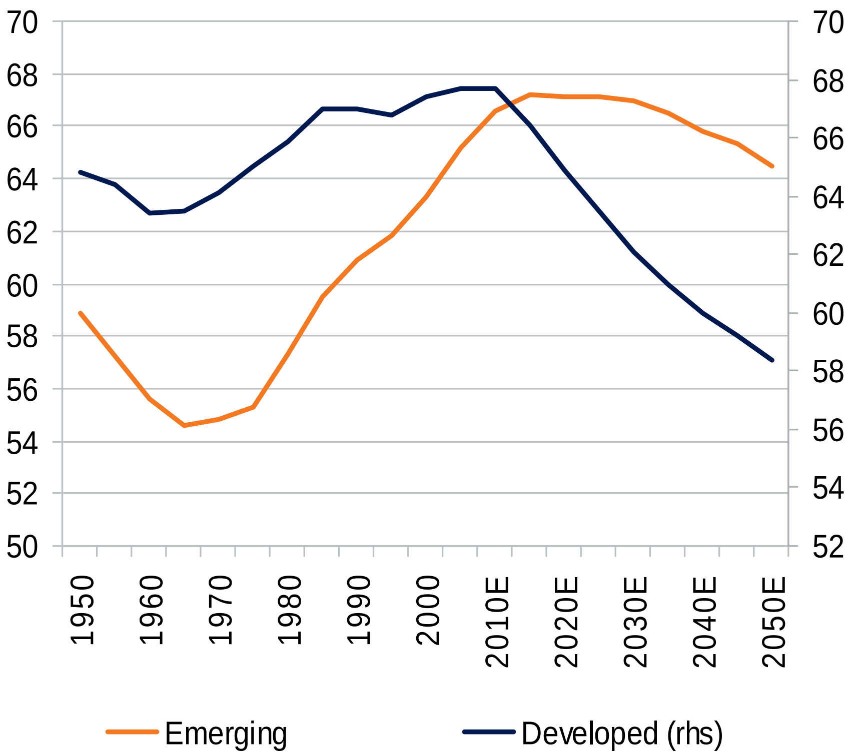
- Are emerging market companies simply using leverage to drive returns?
- Analysis by UBS (shown below) illustrates that corporate gearing ratios in the emerging world are significantly lower
- An up-tick in the level of leverage being used by corporate in the emerging world is likely to be positive for returns



Arguments in favour of a bias towards emerging markets

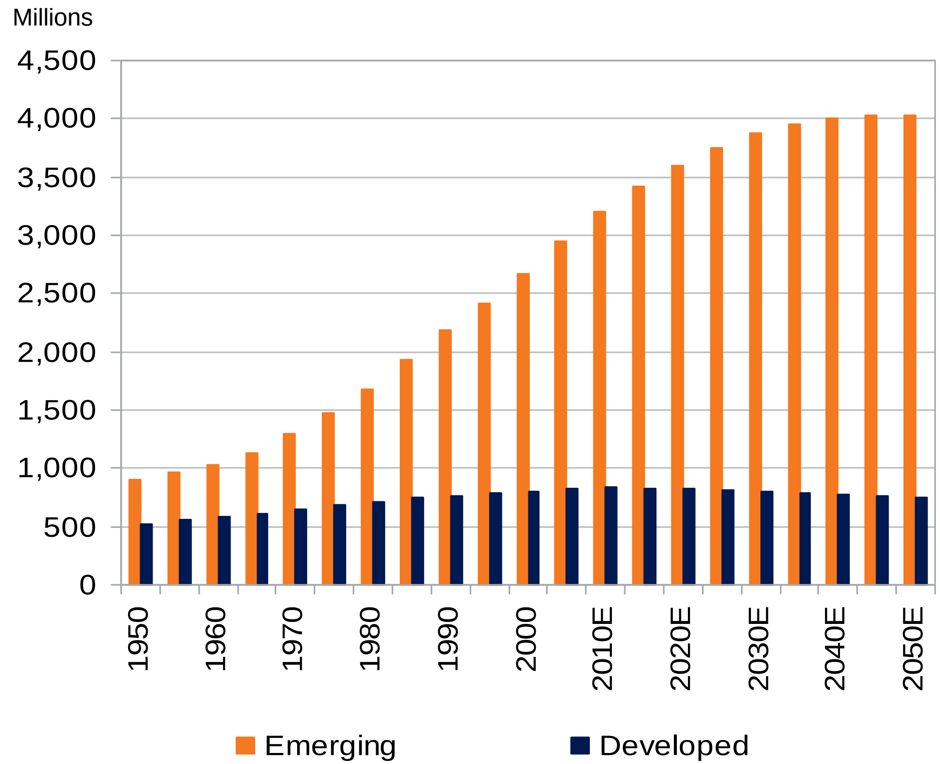
Favourable demographics

EM vs. Developed: Dependency Ratio (15-64 yrs old as % total, 1950-2050e)



Source: Morgan Stanley Research, United Nations World Population Prospects 2005 revision. Data as at September 2009.

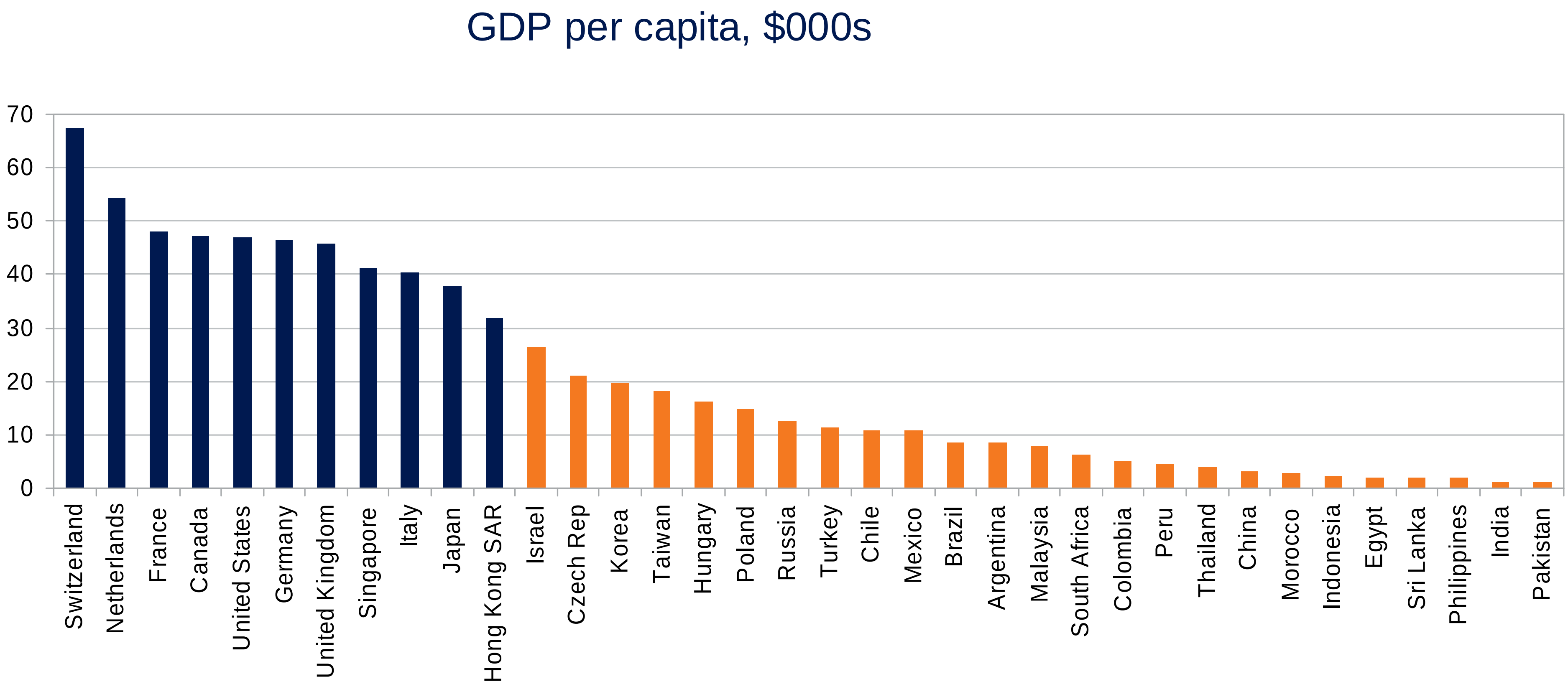
Working age population, 15-64 cohort



Source: UN, Morgan Stanley Research. Excludes the least developed sub-Saharan African countries. E= UN Estimates. Data as at September 2009.

Arguments in favour of a bias towards emerging markets

Potential for growth in domestic demand



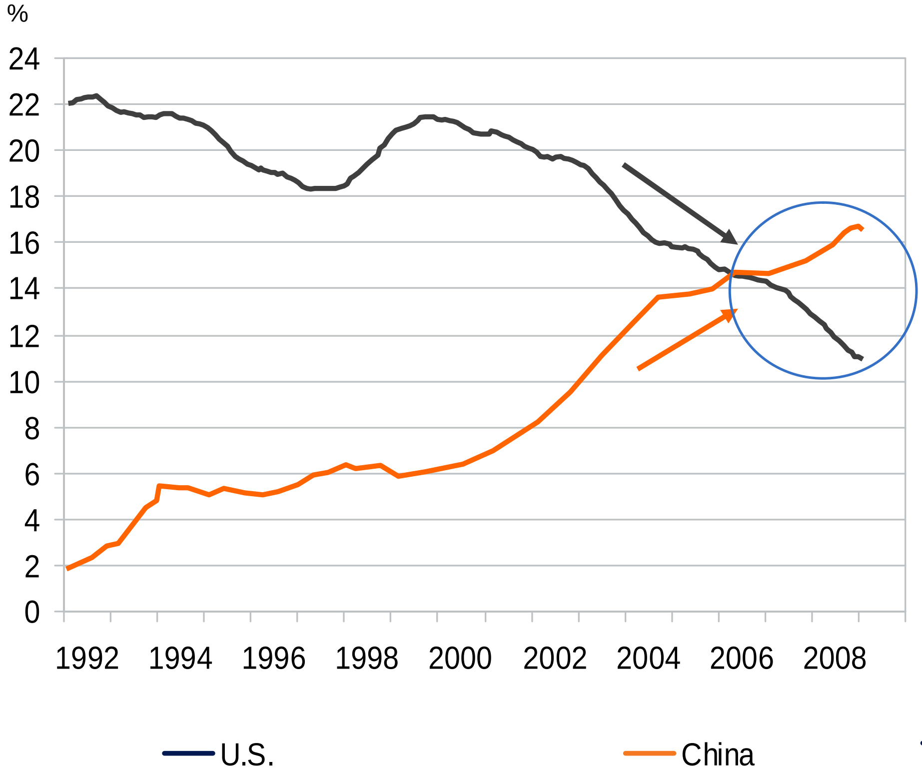
Emerging markets have low but fast growing GDP per capita

Source: IMF

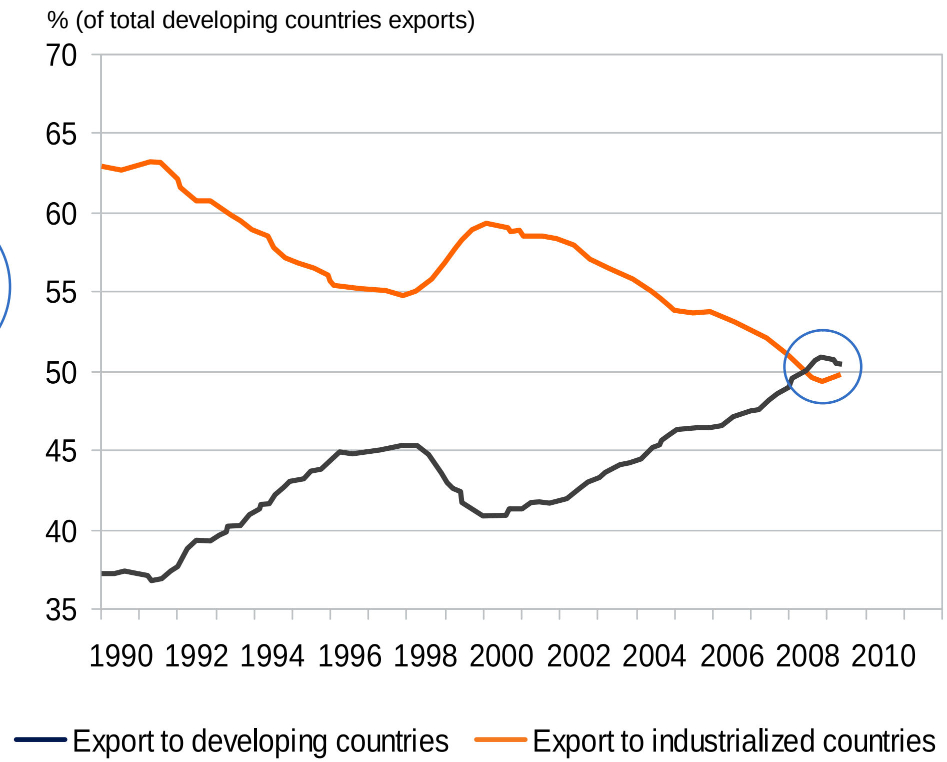
Arguments in favour of a bias towards emerging markets

Potential for growth in domestic demand

Share of emerging markets* exports



GEM Exports by destination



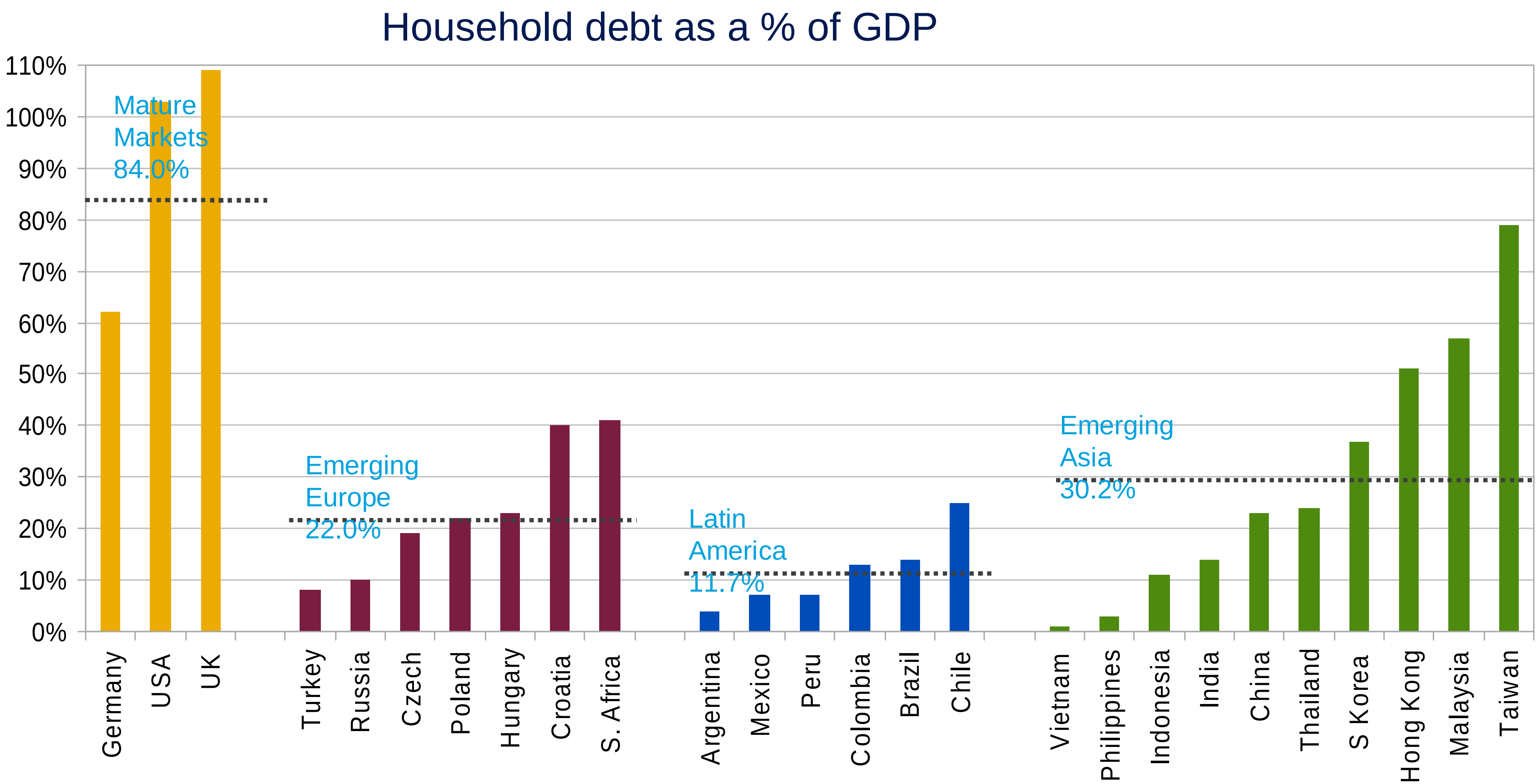
Reduced reliance on US growth

Source: BCA Research April 2009.

* Includes Brazil, Chile, Turkey, Taiwan, Korea, Thailand, Singapore, Malaysia, Indonesia, Philippines and India

Arguments in favour of a bias towards emerging markets

Potential for growth in domestic demand



Potential for rises in household leverage to further support consumption

Source: IMF, Morgan Stanley Research. 2007 data.

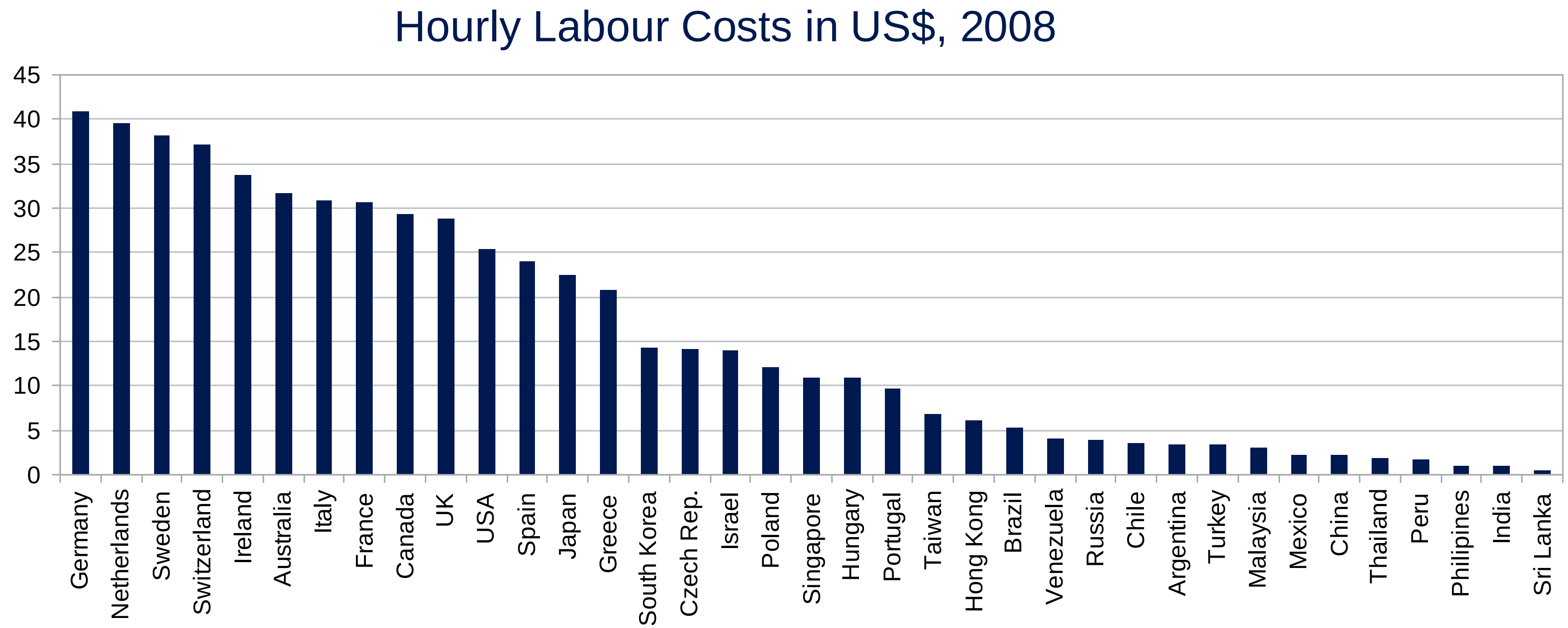
Arguments in favour of a bias towards emerging markets

Potential for growth in domestic demand

- Emerging economies exhibit:
  - low and rising GDP per capita
  - a reducing reliance on growth in the developed world, and
  - relatively low levels of household leverage
- The increasing importance of growth in the domestic demand base in emerging markets should be supportive to:
  - Corporate earnings growth for industries focussed on domestic consumption
  - Sustained growth and a weaker link with developed markets
    - Although this does not necessarily imply a decoupling from developed markets

Arguments in favour of a bias towards emerging markets

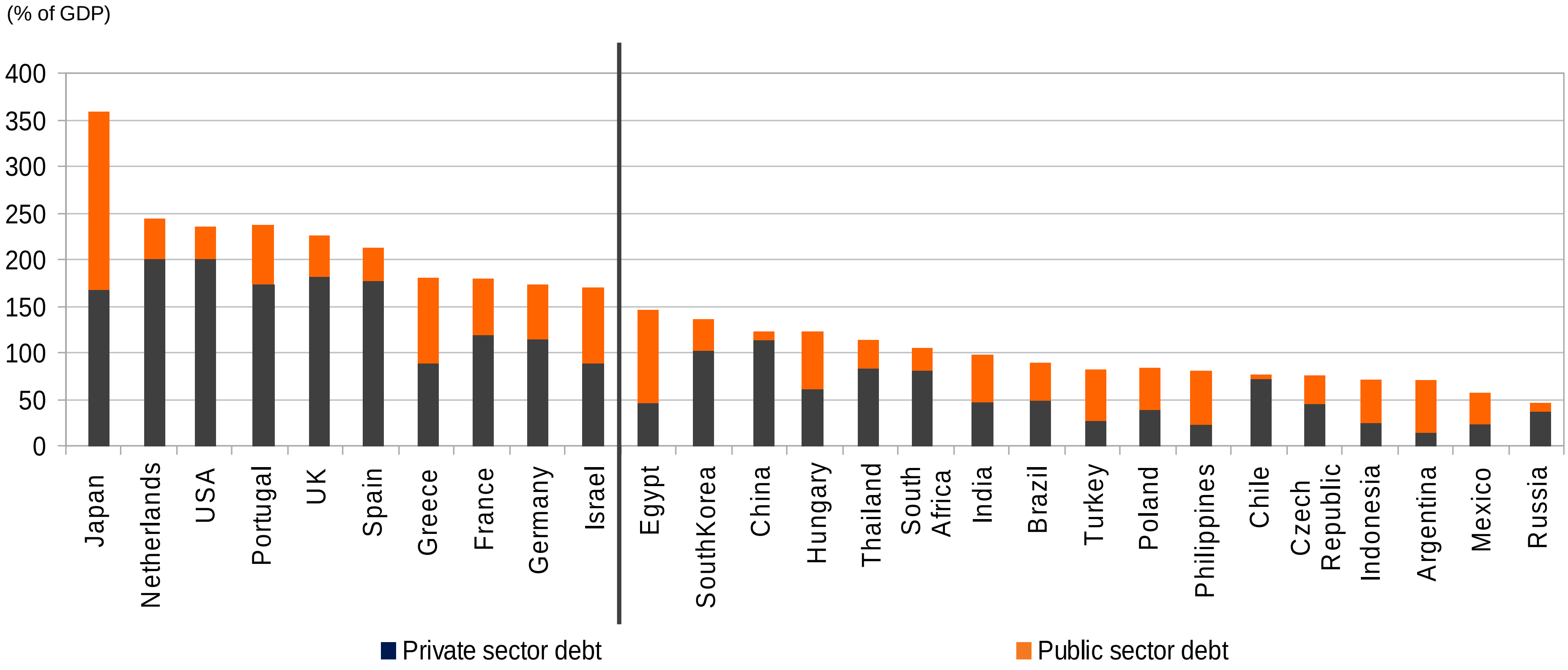
Highly competitive labour costs



Source: EIU Estimates, December 2008

- The labour cost advantage gives companies based in emerging markets a competitive advantage
- Developed market companies are forced to rely on improvements in productivity

Arguments in favour of a bias towards emerging markets
Stronger fiscal positions



Source: IMF, CIA World Factbook, Eurostat, ING. Data to Dec 2007

Arguments in favour of a bias towards emerging markets

Stronger fiscal positions

- Stronger government balance sheets provide the following benefits:
  - Government ability to support and cushion their economies from recessions, mitigating to some extent the negative impact on the corporate sector
  - Stronger fiscal positions are likely to be supportive for emerging market currencies (although there still remains the risk of short term volatility)

Arguments against a bias towards emerging markets

Arguments against a bias towards emerging markets

- Stronger GDP growth does not necessarily imply stronger stock market performance
- Volatility in emerging markets tends to be greater
  - Political risks, currency crises, contagion across markets
- Correlation with developed markets has been increasing over time
  - Diversification benefit does not seem as great as it has in the past
- Higher transaction costs and lower liquidity
  - Lower liquidity itself leads to volatility

Arguments against a bias towards emerging markets

- Currency risk is difficult to hedge
- Company management arguably more variable in quality and less focussed on shareholder wealth creation
- Standards of investor protection trail those in developed markets
- SRI concerns

Consider each of these in turn …

Arguments against a bias towards emerging markets

GDP growth and market performance

- Academic studies looking at many markets over long time periods show no positive correlation between per capita GDP growth and real stock returns
  - J Ritter (2004)
  - Dimson, Marsh and Staunton (2002)
  - These studies argue that although consumers and workers may benefit from economic growth, owners of capital do not necessarily benefit
  - In addition, anticipated returns deriving from stronger expected economic growth may be (more than) priced into the market

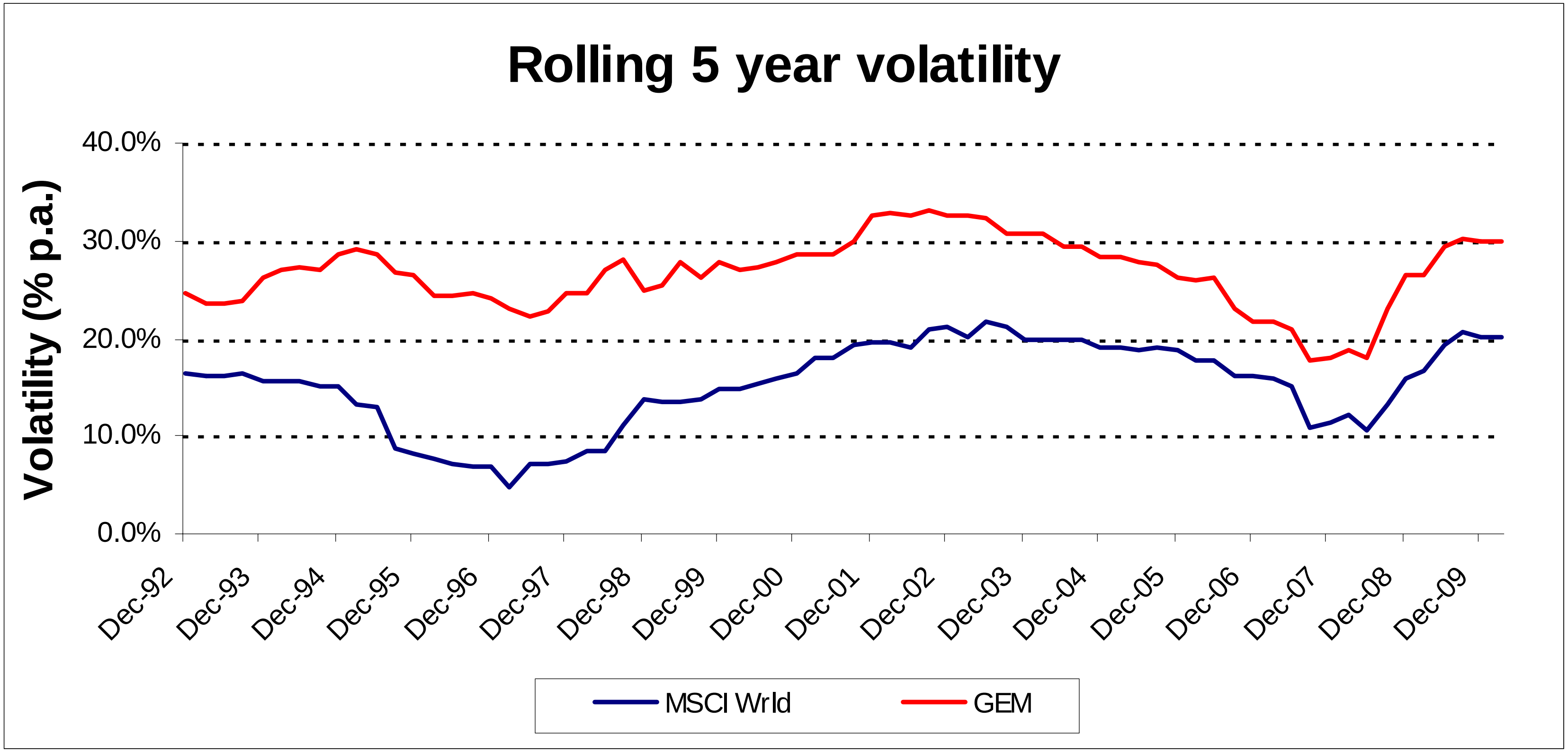
Arguments against a bias towards emerging markets

Volatility and correlations

- The volatility in emerging markets tends to be greater
  - Exposed to political risks, currency crises, contagion across markets
- The higher level of volatility is arguably part of the reason to expect an additional premium for investing in emerging markets
- The correlation with developed markets has been increasing over time so the diversification benefit does not seem as great as it has in the past
  - Emerging markets still offer some diversification

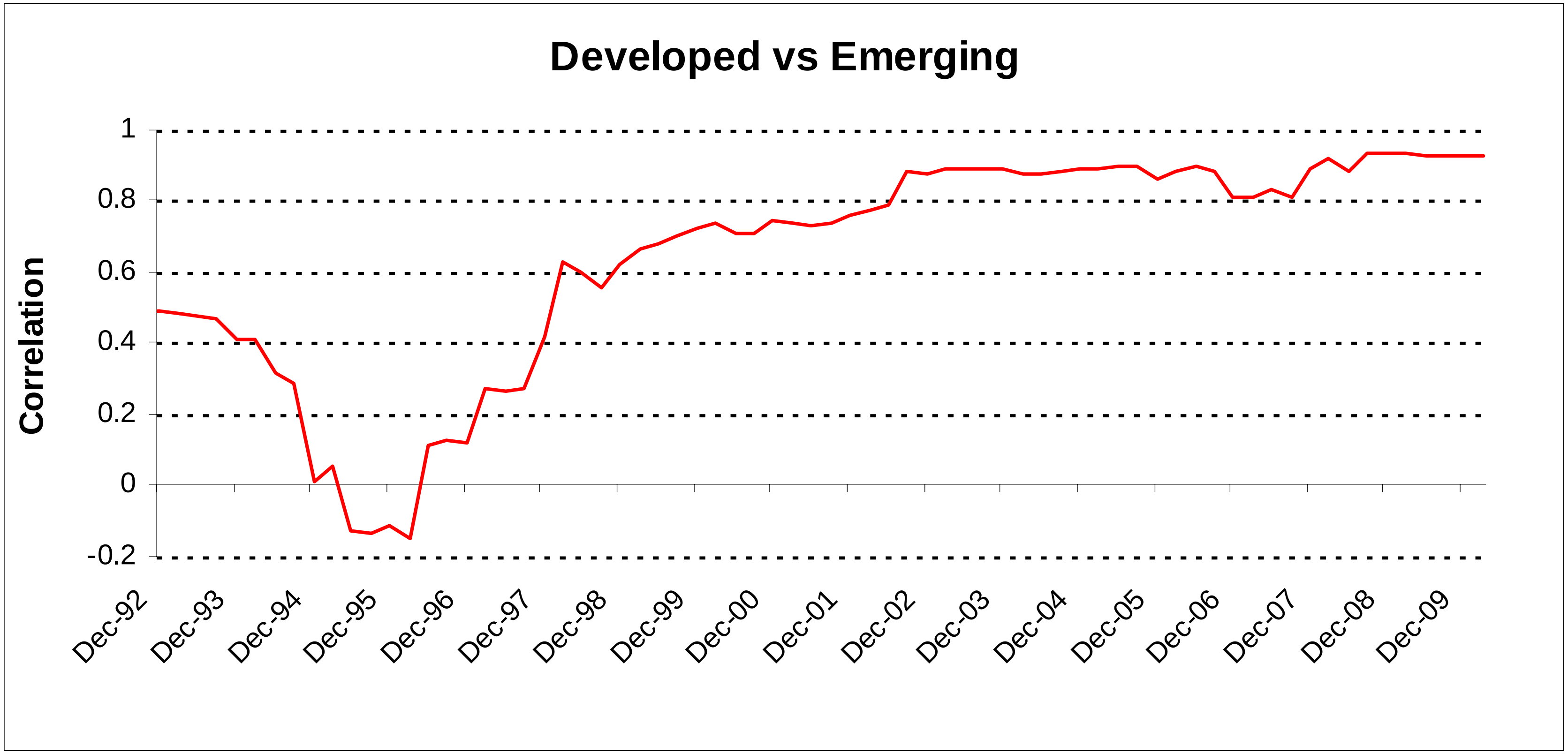
Arguments against a bias towards emerging markets

Volatility and correlations



- Consistently higher levels of volatility experienced in emerging markets

Arguments against a bias towards emerging markets
Volatility and correlations



- From 2002 onwards, the rolling 5 year correlation between developed and emerging markets has been above 0.8
- May or may not be indicative of a trend

Arguments against a bias towards emerging markets

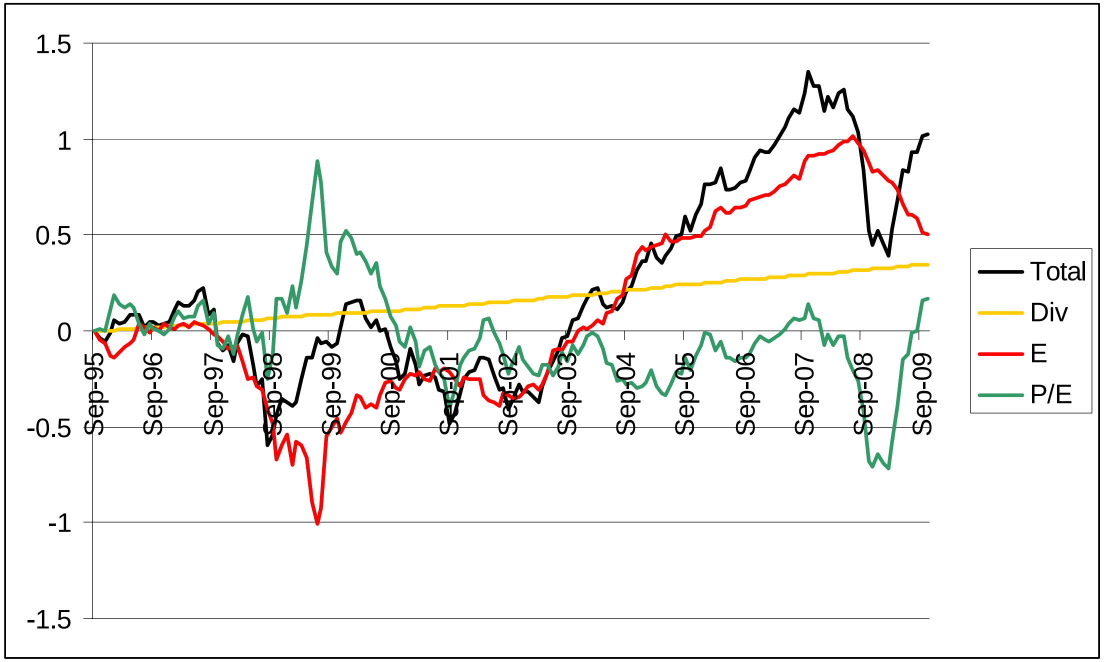
Transaction costs

- Higher transaction costs
- Lower liquidity

- While true this does not provide a strong argument against investing in emerging markets unless liquidity is a key concern

Arguments against a bias towards emerging markets
Valuation

- Has the strong performance over recent years been driven by P/E expansion?
- The chart below shows a decomposition of emerging market returns over the last 15 years into dividends, earnings and valuation
  - The driver of emerging market performance over this period has been **earnings**



Source: Schroder

Arguments against a bias towards emerging markets

Currency risk

- Currency risk is difficult to hedge
- Many commentators believe emerging market currencies to be undervalued on a PPP basis
- Factors in favour of EM currencies include:
  - Balance of payments generally positive (and superior to developed world)
  - Large foreign currency reserves available to support currencies
  - Governments of EM economies have become more adept at controlling inflation
  - Currencies in developed economies under pressure because of weakened economies
- Some active managers incorporate currency views within their approach
- However this should be kept under review and is clearly a risk to be aware of when investing in emerging markets

Arguments against a bias towards emerging markets

Corporate governance concerns

- Corporate governance concerns include: quality of company management, investors protection and SRI issues (amongst other things)
- Positive changes in these areas have been occurring and are likely to continue to do so over time
  - These issues contribute to part of the risk premium to be expected from emerging markets
  - The use of skilful active managers should help mitigate these risks
- Mercer carried out a study for IFC (the private arm of the World Bank) looking at the incorporation of sustainable investment factors in the investment process used by emerging market equity managers
  - Considerabe growth of sustainable investment processes
  - Corporate governance is now a well-understood concept in emerging markets

Conclusions

Arguments for and against a bias towards emerging markets
Conclusion

- In favour of a strategic overweight to emerging markets on the basis of the fundamental factors likely to support strong earnings growth for companies in these economies
  - The main caveat to this is that consideration of market valuation at the point of making any (increase in) allocation to these markets will be important
- Be aware of increased risks and specific issues
- Any allocation will need to be considered within the context of the wider growth portfolio and as part of the overall strategy

Questions?