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EMERGING MARKETS EQUITIES: AN INTRODUCTION

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Market Overview

The term "emerging markets" refers to a group of countries defined by the International Finance Corporation (IFC) on the basis of GNP per capita.[1] The idea of investing in the equity markets of such countries was stimulated by the creation of a $50 million emerging markets fund in 1986, funded by the IFC and 11 other investors to encourage private market economic development.

Investing in Emerging Markets Equities

Given the volatile history of the asset class, does a policy allocation to emerging markets make sense? Investors have generally added emerging markets to their policy mix on the basis of two fundamental assumptions:

1. **Rapid GDP growth will translate into higher equity market returns than those of developed markets with substantially lower expected GDP growth, which will in turn compensate investors for the greater risk they incur in these markets.** In fact, analysis of GDP growth rates and equity market performance across many countries shows little correlation between the two. Strong and steady GDP growth does, of course, create an economic climate in which equities can thrive; however, a country that has enjoyed rapid GDP growth in recent years is like a fast-growing company—investors may extrapolate this recent growth into the indefinite future, and bid up the price to levels that discount the presumption of continued success, leaving no room for disappointment. The key to successful investing in emerging markets is therefore to invest in countries with good long-term prospects when they are selling at relatively *low* multiples. In short, higher prospective GDP growth alone is an important but not a sufficient condition, and must be related to the multiple at which that growth is priced. Further, investors must determine whether they prefer to invest in emerging markets equity or debt; in other words, whether it is better to be paid as a lender or an owner.

2. **Although more volatile, emerging markets equities have relatively low correlations with those of developed markets and therefore provide some portfolio diversification benefits.** Except in short-term periods of crisis, like October 1987 and August 1998, when all equity market correlations tend toward one, this thesis has proved correct. Consequently, a modest allocation to emerging markets equities should result in higher total portfolio returns with no increase in aggregate risk.

As for diversification—many investors who understand and embrace the theory of diversification become disillusioned with its practical reality when they realize it means they may be losing money in some markets even as they are doing well in others, or that in periods of crises, all markets move down together.

[1] The World Bank characterizes economies as low-, middle-, and high-income. Low- and middle-income economies are sometimes referred to as developing economies, and are those countries in which most people have a lower standard of living with access to fewer goods and services than do most people in high-income countries. The low-income countries are denoted by average annual per capita income of $785 or less, and middle-income countries, between $786 and $9,365. There are currently about 125 developing countries with populations over 1 million; their total population is approximately 5 billion.

Few investors, in other words, regard negative returns when developed markets are booming as confirmation of the wisdom of investing in emerging markets for the purpose of portfolio diversification.

If superior GDP growth and portfolio diversification are inadequate foundations on which to build a case for investing in emerging markets, what are the reasons for doing so? Most critical, obviously, is whether one can expect the emerging markets to deliver the high relative returns in the future that they have during certain periods in the past.

Among the more important of these conditions are:

- Reasonable and improving market breadth and depth.
- Reasonable equity market valuations.
- Stable macroeconomic and political environment.
- Stable currency.
- High levels of sustained GDP and GDP/capita growth.
- Steady increases in productive capacity and high levels of capacity utilization (so that capital can be profitably invested).
- Improved equity market transparency, banking and capital markets regulation, and legal infrastructure (e.g., effective and enforceable bankruptcy laws).
- Competitive advantages for locally based emerging markets companies, (e.g., low labor and capital costs).

Market Breadth and Depth

Increased market breadth and depth is important for investors because narrow and concentrated markets are more volatile and less liquid. Despite the very high volatility of individual markets and the increased correlation of markets and regions at times of crisis, the greater breadth and depth of the emerging markets as a whole suggests the probability of declining volatility over time. Furthermore, the indices are not overly concentrated relative to developed markets, with the top ten stocks of the IFC Index composing a similar percentage of the overall index as do the top ten stocks in the S&P 500. Still, within individual markets the top ten stocks typically constitute over 50% of the investable market and represent the bulk of that country's investable universe. Further, emerging markets indices *are* overly concentrated by country, while the asset class' inherent volatility means the best- and worst-performing global markets in any given year are typically from emerging (rather than developed) markets. Thus, to some degree emerging markets managers will be labeled geniuses or idiots based solely on the performance of, say, Korea, which in turn depends on one or two large companies (Samsung, for example) for the bulk of *its* returns.

Even more to the point, the bulk of the IFC Index tends to be concentrated in relatively few economic sectors (manufacturing, transportation, communications, utilities, finance, and real estate). As large segments of the economy, such as privately held or state-owned companies, are added to the pool of publicly traded issues over time, market breadth and depth should continue to improve. In the meantime, however, investors should recognize that despite the fact there are large areas of these economies that foreign

investors are unable to access, they should nonetheless attempt to ensure that their portfolios are reasonably diversified by country, by economic sector, and by exposure to specific risks like rising U.S. interest rates or declining commodity prices.

Political and Economic Stability

History indicates that high levels of economic growth and positive conditions for equity investment are not sustainable without a stable macroeconomic and political environment. Any broad statement about the macroeconomic and political conditions of developing countries would clearly require a fistful of caveats for individual nations. Nevertheless, one can say that the macroeconomic policies and political environments of *most* (not all) developing countries have steadily improved over the past several decades, although some (particularly those in Latin America) seem unable to shake their socialist tendencies. Still, most emerging economies today are much more open to outside competition and capital flows than in the past. These changes have in turn acted as catalysts for positive developments such as privatization programs, and have also contributed to important international trade agreements such as NAFTA and Mercosur, although progress on dismantling trade barriers remains agonizingly slow. In addition, increased competition and better economic policy management have in some cases led to the dismantling of previously protected inefficient industries and companies. Finally, many emerging economies have substantially improved their finances, moving from current account deficits to surpluses, shoring up foreign exchange reserves, and increasingly replacing US$-denominated debt with local currency paper. Countries that have made such improvements should be able to better weather a global financial slowdown and/or financial crisis than in the past, when most countries carried heavy debt loads denominated in US$. In short, such countries are unlikely to get caught in the vicious cycle in which capital flows out of a country beget further outflows, with falling currency values driving up debt service costs, and frequently pushing the government to impose capital controls and/or currency pegs.

Currency Instability

Indeed, currency instability has historically added an element of risk to emerging markets investing that was not previously fully appreciated. Some of that risk has been mitigated by the improvements discussed above, but officials must be careful not to settle for short-term fixes (such as currency pegs and capital controls) that tend to be damaging in the long run. While pegs can stabilize growth, inflation, and markets in the short term, they cannot be sustained forever, and often mask budding problems that would otherwise manifest themselves in currency markets. In short, pegs are a *temporary* fix to what are generally long-term problems, and often result in enormous damage when countries are eventually forced to abandon them. Further, other proposed “fixes”—such as restraints on capital inflows and stronger global lines of credit to support currencies under attack—are unlikely to provide a long-term solution to currency problems in the absence of good economic policy. Overall, while currency instability should still be considered a major risk for emerging markets equity investors, it is markedly less so than in the past.

GDP Growth and Capital Flows

As noted above, a high level of GDP growth is not in itself sufficient to ensure a high level of corporate earnings growth or good equity market performance. Moreover, measures of GDP growth typically fail to include large segments of the economy and the available data often lack integrity and are revised infrequently. However, when a country's economy is expanding, opportunities for the productive investment of capital are enhanced. For this reason, we continue to believe that the assumption of above-average growth rates remains an important part of the argument in favor of emerging markets investing, since it creates the conditions under which equities can thrive.

Productive Use of Capacity

Misallocation of capital has been a persistent problem in emerging markets, and helps explain why return on equity (ROE) has been consistently lower in emerging markets than in developed countries. Many emerging markets have a history of providing capital not to businesses that were likely to invest it profitably, but rather to those with political connections, or those deemed "too big to fail." Outside investors, meanwhile—who might have been willing to fund promising businesses—have been prevented from making investments through a variety of roadblocks ostensibly set up to "protect" local economies, but which (predictably) had the opposite effect. Thus, many profitable businesses have been forced to raise money at punitively high rates, while state-owned and related enterprises, many of which swim in red ink, were treated to funds at a far lower price. Recently, however, there have been structural improvements in the way capital is allocated in emerging markets. Indeed it is arguably the case that emerging markets' ROE has been artificially depressed in the past due to antiquated market structures—not to mention meddlesome governments—that substantially hindered the free movement of capital. On balance, then, it seems reasonable to assume emerging markets' future ROE will be higher than its historical average, although probably a little lower than that of developed markets on an ongoing basis.

Improved Transparency and Regulatory Structures

While standards of disclosure and the protection of shareholder rights are much lower in emerging markets than in developed countries (especially the United States[2]), most emerging countries have moved forward in these areas over time. Thus, it is increasingly difficult for controlling groups or insiders to hide information from or make decisions against the interests of minority shareholders (although there will always be those who try!). On the other hand, creditors in particular have been made acutely aware of their relative lack of recourse against defaulting borrowers in many emerging economies. The implementation of bankruptcy laws, for example, has been blocked by interested parties in numerous countries. In addition, there are many documented cases of creditors being helpless to prevent bankrupt companies from transferring assets to other entities owned by the same controlling group, and lacking any means of forcing

[2] Some would argue the United States has gone too far with its requirements, and indeed, since the passage of Sarbanes-Oxley an increasing number of non-U.S. entities have chosen to list in markets such as London or Hong Kong rather than submit themselves to U.S. regulatory agencies. In most cases, it is not that corporations have "something to hide," but rather that they feel the costs of listing in the United States (i.e., the costs of complying with its stringent reporting requirements) are simply too high relative to other markets with comparable liquidity.

borrowers into full financial disclosure. In short, the entrance is wide and inviting, but the exit remains narrow and subject to severe traffic jams. Still, we would note that fraud is universal (see Enron, WorldCom, etc.), and differences between companies in emerging and developed markets are slighter than generally assumed.

Invest in Local Companies or in Global Multinationals?

Even if one is bullish on the economic growth and investment potential of emerging markets, there remains a question of how best to exploit that potential. A policy allocation implies direct investing in local emerging markets companies (either through local listings or American depositary receipts). However, we have also encountered the view that one can achieve exposure to emerging markets by overweighting ownership of developed country companies (primarily large multinational corporations [MNCs]), which are big investors/operators in emerging countries. Examples of such companies include Coca-Cola, Gillette, Nestlé, and ABB (Asea Brown Boveri). There are two problems with this strategy. First, MNCs are *not* generally the dominant companies in emerging markets, and second, their stocks show little correlation with those of emerging markets equities, but rather a high correlation with the equity markets of their country of domicile. In short, when one buys Coca-Cola, one is buying a U.S. equity whose price will rise and fall more in line with U.S. large-cap growth stocks, than with the fortunes of those emerging markets in which it sells some of its products. Further, while high-level managers at MNCs are unlikely to have expertise in the emerging markets in which they operate, investors are still exposed to the risk of crises that could negatively impact earnings. In other words, it could be argued that MNCs expose investors to a certain level of emerging markets risk without offering a corresponding opportunity for reward.

Volatility of Emerging Markets and Correlation with Developed Country Markets

As noted in the introduction, the standard deviation of annual returns of emerging markets equities has historically been extremely high. Indeed, while volatility has been lower in recent years, the sudden drop in emerging markets from May 2006 through June 2006 was a reminder that these markets are subject to greater price swings than are developed markets. Indeed, individual country volatility has historically been similar in magnitude to the volatility of *individual* U.S. high-growth stocks. This volatility can be reduced, however, by holding a diversified portfolio of emerging equities, diversified by region, by country, by industry, and by exposure to various forms of risk (e.g., vulnerability to rising U.S. interest rates or falling commodity prices). Since volatility tends to be mean-reverting, it seems reasonable to assume that prospective volatility may be in line with historical averages—perhaps 25% ± 5%.

Correlations Among the Emerging Markets

Although individual emerging country volatility can be extremely high (Argentina's long-term volatility, for example, has been roughly 70%), overall volatility for emerging markets has been much more stable. This is attributable to the fact that although many emerging markets are heavily dependent on commodity prices, emerging markets as a whole evince relatively little *inter*dependence, despite their concentration in a handful of economic sectors. Obviously, their common dependence on global capital

flows makes them simultaneously vulnerable to periods of panic, during which capital flight drives all correlations to one, but historically both regions and countries within regions have remained relatively uncorrelated, which translates into the reasonable levels of volatility cited above.

Correlations versus Other Markets

Emerging markets equity returns are also relatively uncorrelated with those of United States and other developed markets equities (except during brief periods of global panic, such as October 1997 and August 1998). While correlations have ticked higher in recent years, this appears more a result of rampant global liquidity (i.e., correlations among *all* asset classes have risen) than of any inherent change in the relationship between developed and emerging markets. Thus, going forward we would expect correlations to approximate their long-term levels *prior* to the recent liquidity surge. From 1988 through March 2000, for example, the correlation between MSCI EM and MSCI World was 0.55; since then it has been 0.85.

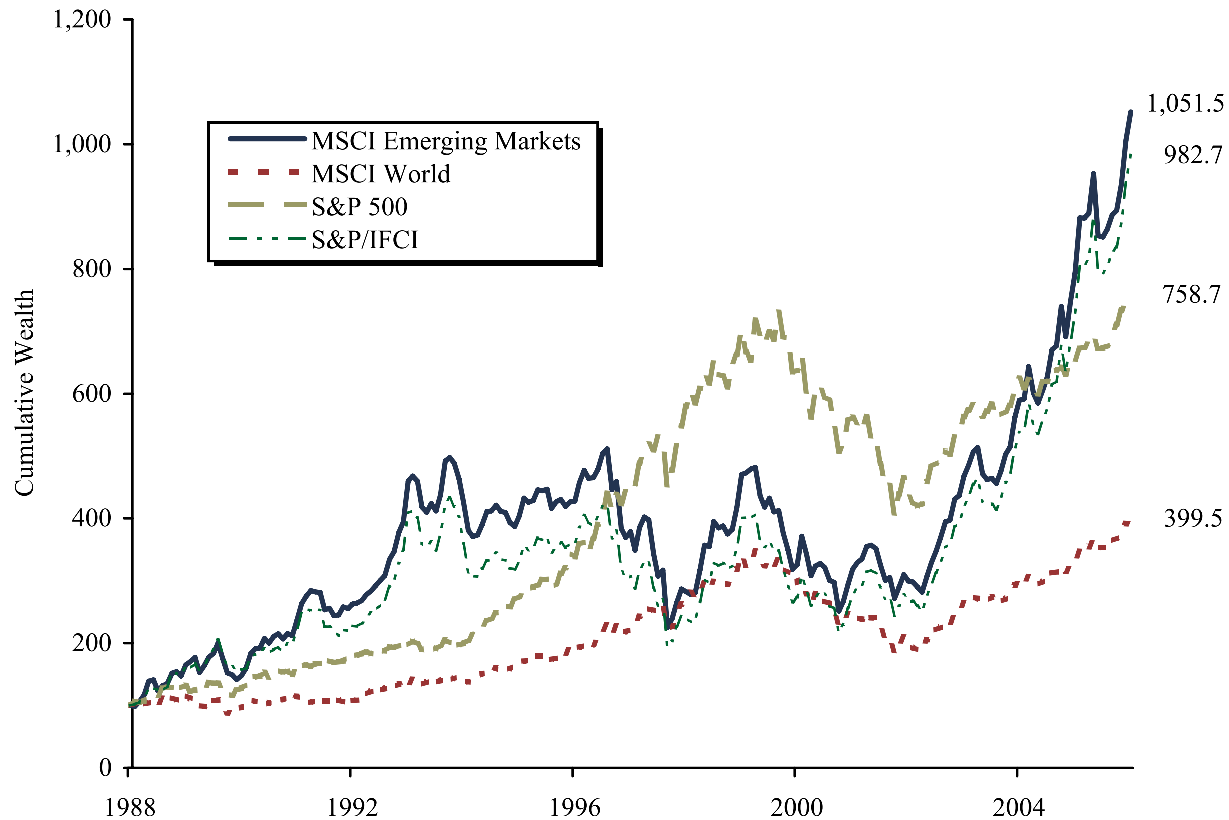
Conclusion

Equity returns are abnormally distributed, particularly in less developed markets. All the important action is crammed into the "fat tails" at each end of the distribution—e.g., the MSCI EMF's 74.8% return of 1993, its -18.8% annual return of 1997-98, and the 37.4% average annual compound return (286% cumulative) from October 2002 through December 2006. During such boom or bust periods, investors typically misprice risk because they make the common mistake of extrapolating recent experience into the future, despite the fact that history tells us such extremes create the very conditions that cause their reversal. Over-investment results in the construction of buildings for which there are no tenants and of factories producing goods that can only be sold below cost, while crashes result in the destruction of excess capacity and demands for financial sector reform. Put simply, emerging markets are a highly volatile asset class, and should be treated as such. At the same time, many emerging markets economies have undergone significant economic improvements that should enable more sustainable growth and improved profitability going forward. Furthermore, we continue to believe that Asia represents the best growth story for equity investors; given that emerging markets equity indices are heavily weighted to Asia, they should benefit from this secular theme.

For these reasons our general advice is to maintain an overweight to emerging markets relative to their market weight of roughly 7% of global equities, but limit this allocation to no more than 15% or 20% of the equity portfolio. Further, it is *critical* that investors take a long-term perspective and recognize these markets are subject to booms and busts. In short, while emerging markets equities will likely continue to travel a bumpier road than those of developed markets, we believe they represent better value over the long term, *but only for investors willing and able to stomach the occasional gut-wrenching downturn.* Investors should also review existing policy allocations to re-affirm or revise them, but commit to rebalancing. Finally, investors should implement new allocations in gradual stages, accelerating commitments during periods of weakness.

CUMULATIVE WEALTH OF MSCI EMERGING MARKETS, MSCI WORLD, S&P 500 AND S&P/IFC

January 1, 1989 - December 31, 2006
(December 31, 1988 = 100)



	MSCI Emerging Markets	MSCI World	S&P 500	S&P/IFCI
Cumulative Return (%)	951.5	299.5	658.7	882.7
AACR (%)	14.0	8.0	11.9	13.5
Standard Deviation	23.1	14.0	13.9	22.3

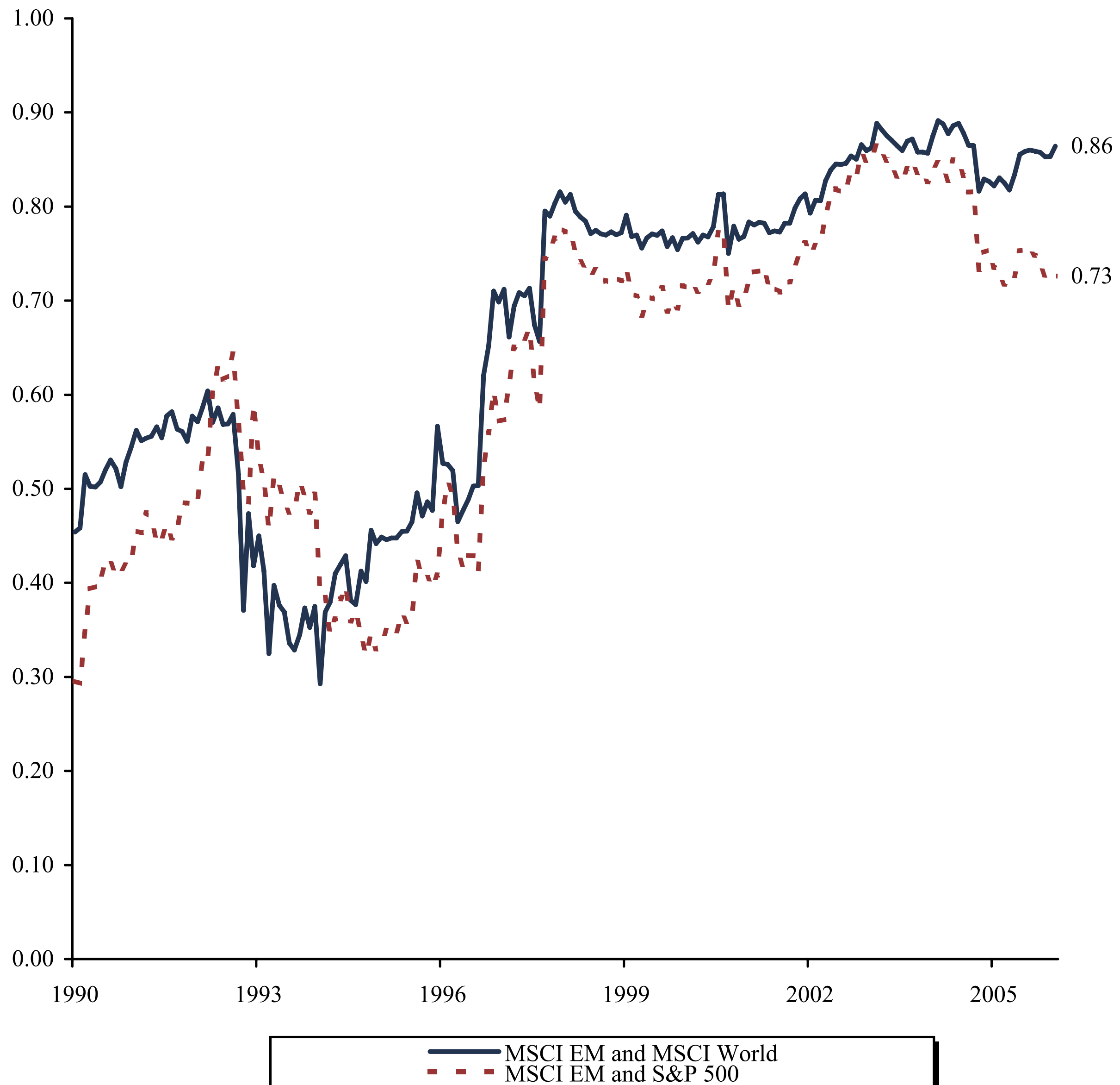
Sources: Morgan Stanley Capital International, Standard & Poor's, International Finance Corporation, and Thomson Datastream. MSCI data provided "as is" without any expressed or implied warranties.

Notes: Data are in U.S. dollars. Total returns for MSCI Emerging Markets indices are gross of dividend taxes. Total returns for MSCI developed markets indices are net of dividend taxes.

MSCI EMERGING MARKETS ROLLING 36-MONTH CORRELATIONS WITH MSCI WORLD AND S&P 500

January 1, 1989 - December 31, 2006

U.S. Dollars



Sources: Morgan Stanley Capital International, Standard and Poor's, and Thomson Datastream. MSCI data provided "as is" without any expressed or implied warranties.

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