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## GLOBAL MARKET COMMENT

### EMERGING EQUITY INDICES: CHANGES AFOOT

March 2004

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## Emerging Equity Indices: Changes Afoot

Global equity investors may soon be required to grant Korea and Taiwan the international prestige and respectability they have long sought. Two leading index providers, FTSE and MSCI, are considering increasing the market capitalization of either country, or both, in their global equity indices, which would force benchmark-sensitive investors to increase their allocations to the two Asian countries. FTSE and MSCI, apparently prompted by the World Bank's recent reclassification of Korea to a "high income" country, are also exploring whether the countries should migrate to developed market status. The World Bank based its decision on Korea's gross national income (GNI) per capita measure, which MSCI also uses as one of its criterion for a country to graduate to "developed" status. Encouraged by Taiwan's recent liberalization of market regulations, the index providers are considering whether to change its status as well. These potential changes would not only affect the country and sector exposure for emerging equity investors, but would have far-reaching implications for global developed markets investors as well.

### How Will Altering the Status of Korea and Taiwan Change Emerging Markets?

Korea is already the largest country in the MSCI Emerging Markets (EM) Index, accounting for 18.9% of its total market capitalization and roughly one-third of the Asian subregion, which in turn makes up 54.4% of the index. In the MSCI EM Index, Korea has a US\$170 billion market capitalization, which is less than half of the total US\$319 billion market cap of the Korean Stock Exchange (KSE). Similarly, the total market cap of the Taiwan Stock Exchange (TSE) is nearly four times larger than the country's current weight in the MSCI EM Index (US\$441 billion, compared with US\$114 billion). Therefore, reweighting Korea and/or Taiwan upward would almost certainly intensify the Asian bias of the emerging equity index.

The extent of the change depends of course on how the final adjustment plays out. The composition of the MSCI EM Index could change along the lines of those outlined in Table A.<sup>1</sup> At a maximum,<sup>2</sup>

- Korea could account for 30.4%, and Asia, 60.9%; or
- Taiwan could account for 35.9%, and Asia, fully two-thirds (66.6%); or
- Their combined weight could total 55%, and Asia, 70%.

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<sup>1</sup> For simplicity, we show the extreme case of MSCI adopting the *entire* market cap of the KSE and TSE, though this is unlikely to occur in reality because MSCI employs a free-float adjustment factor to each security in the index. Due to the high degree of restrictions on foreign investment in Taiwan, MSCI uses a Limited Investability Factor (LIF) of 0.55; this means that at a *maximum*, a company's free-float adjusted market cap will be reported at 55% of its total unadjusted market value. Recent market reforms in Taiwan have prompted MSCI to consider increasing or eliminating the LIF altogether. Even if it is eliminated, however, each security in the Taiwan index will be adjusted for free float on an individual basis. According to Goldman Sachs, eliminating the LIF will increase Taiwan's market cap to 20.8% in the MSCI EM Index, which would make it the index's largest country.

<sup>2</sup> Assuming each country's full market cap were included.

The possible changes would also affect sectoral composition of the indices.<sup>3</sup> Increasing the representation of Korea and Taiwan, separately or together, would expand the weights of technology (currently 17.1%) and other cyclically sensitive sectors in the MSCI EM Index (Table B); information technology currently accounts for about 26% of the KSE and 41% of the TSE. If either Korea or Taiwan were to leave the index, the market cap of information technology would fall 5 to 6 percentage points, while if both countries were to graduate to developed indices, the sector would shrink from 17.1% to about 3%. The only other notable change of their joint migration would be the increase of the market cap of the energy sector in the MSCI EM Index, from 11.3% to roughly 16%. (The other sectors would not change or change by only 1 to 3 percentage points.)

### **Ripples Among Global Equities**

The possible changes with Korea and Taiwan would affect global developed equity benchmarks as well (see Table C). If Korea were to graduate from MSCI EM to MSCI Pacific ex Japan with its entire market capitalization, it would become the developed subregion's second largest country (34.6%), while Taiwan's potential entry would make it the subregion's largest market (42.2%). If both countries entered MSCI EAFE with their entire market cap, they would account for 55.8% of the Pacific ex Japan subindex, which in turn would account for 35.3% of the index's total market cap, up from 28.8% currently.

### **How Will Markets Adjust?**

Many observers believe that the protracted review process of the index providers will ensure that the status of Korea and/or Taiwan will not change until 2005 or beyond. Greece, for example, met the World Bank's "high income" country threshold in 1991, but was not admitted to the MSCI Developed Markets Equity Index Series until March 2000. For MSCI, in order for a country's status to change from "emerging" to "developed," it must meet a host of criteria in addition to the GNI factor, including the degree of government regulation, the regulatory environment, restrictions on the repatriation of capital, and the country's risk perception.

Goldman Sachs has dismissed speculation that either country will be imminently rerated, noting that similar rumors have been circulating for several years and that neither country currently satisfies MSCI's criteria to migrate to developed status.

FTSE just announced that it will not alter the status of any country in 2004, though Korea and Taiwan could be promoted in 2005. The index provider also promises to give at least six months notice before changing the status of any country. Lastly, in March 2005 it will introduce shadow indices, primarily covering Chinese equities, to help prepare investors for the transition to including them in the FTSE Global Equity Index Series.

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<sup>3</sup> It is not possible to calculate precise sectoral weightings because companies in the KSE and TSE are not classified according to the Global Industry Classification Standard, which the MSCI indices employ.

When these potential changes will occur and how widespread their effects will be remains to be seen. The major index providers will certainly go to lengths to minimize the disruption, probably by moving gradually and phasing in the changes. An expansion of the coverage in the emerging markets indices could, by improving the breadth and liquidity of the emerging equity index, prove to be a stabilizing force for the asset class. However, when they finally occur the changes could heighten the risk of this inherently volatile asset class. By magnifying the index's biases toward Asia and cyclically sensitive sectors, they could produce a more concentrated and volatile index. Over the coming months, investors should monitor the prospective index changes to determine whether the changes will in fact alter some of the fundamental features of the asset class.

Table A

## REWEIGHTING KOREA AND TAIWAN IN THE MSCI EMERGING MARKETS INDEX

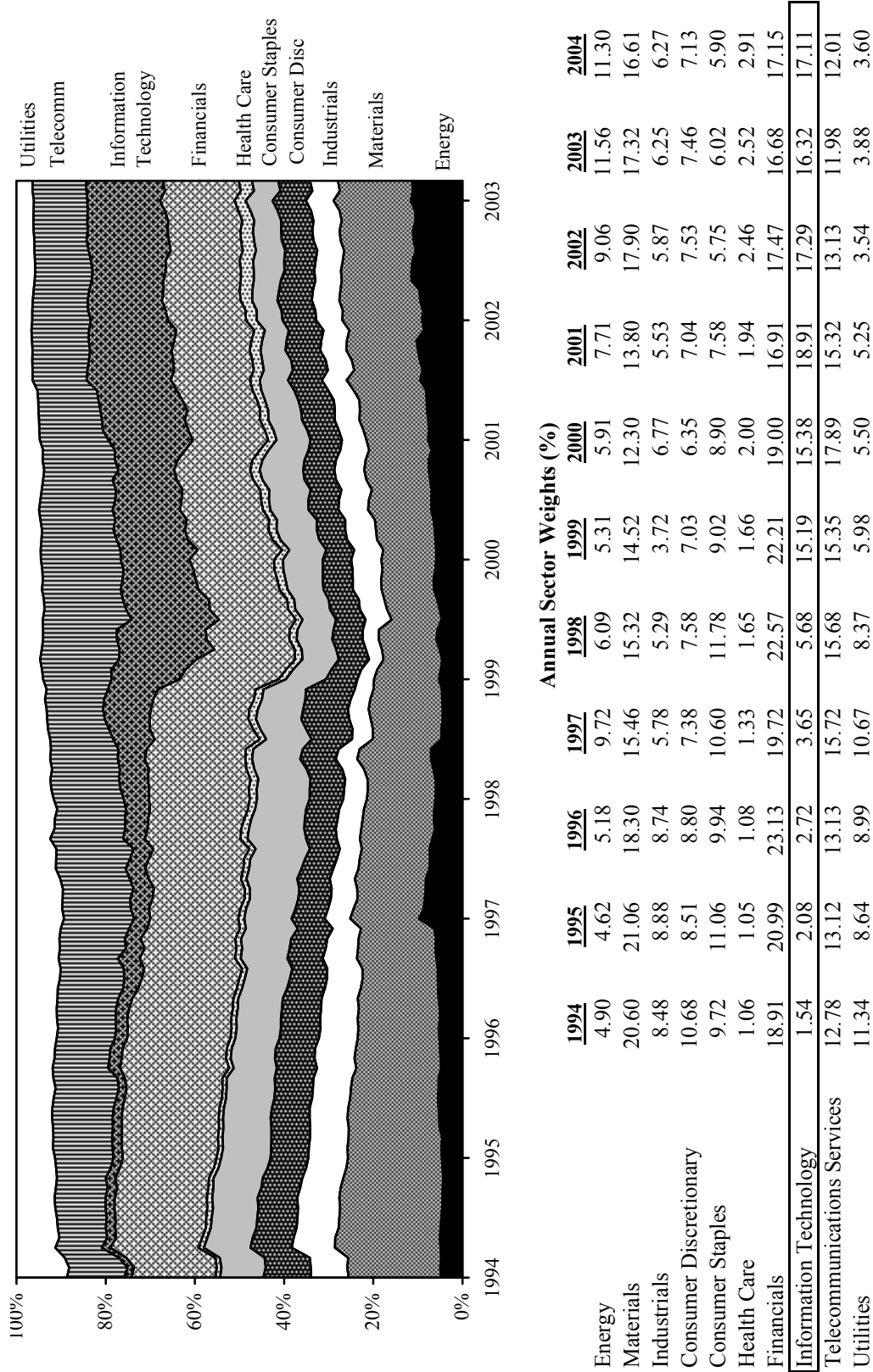
As of February 29, 2004

	Percent of Index (%)			
	MSCI Emerging Markets <u>Index</u>	Three Scenarios		
		Korea with Full <u>Market Cap</u>	Taiwan with Full <u>Market Cap</u>	Korea & Taiwan with Full <u>Market Cap</u>
Korea	18.9	30.4	13.8	23.1
Taiwan	12.6	10.8	35.9	32.0
China	8.3	7.1	6.1	5.4
India	5.0	4.3	3.6	3.2
Indonesia	1.6	1.4	1.2	1.0
Malaysia	4.7	4.1	3.5	3.1
Pakistan	0.2	0.1	0.1	0.1
Philippines	0.5	0.4	0.3	0.3
Thailand	2.8	2.4	2.0	1.8
MSCI EM Asia	54.4	60.9	66.6	70.2
Argentina	0.6	0.5	0.4	0.4
Brazil	8.4	7.2	6.1	5.5
Chile	2.0	1.7	1.5	1.3
Colombia	0.1	0.1	0.1	0.1
Mexico	6.8	5.8	5.0	4.4
Peru	0.5	0.4	0.3	0.3
Venezuela	0.1	0.1	0.1	0.1
MSCI EM Latin America	18.4	15.8	13.5	12.1
Egypt	0.3	0.2	0.2	0.2
Morocco	0.2	0.2	0.2	0.2
South Africa	13.1	11.3	9.6	8.6
MSCI Africa	13.6	11.7	10.0	8.9
Czech Republic	0.6	0.5	0.4	0.4
Hungary	1.0	0.9	0.8	0.7
Israel	3.9	3.3	2.8	2.5
Jordan	0.2	0.1	0.1	0.1
Poland	1.2	1.1	0.9	0.8
Russia	5.0	4.3	3.7	3.3
Turkey	1.6	1.4	1.2	1.1
MSCI EM Europe/Mid East	13.5	11.6	9.9	8.8
MSCI Emerging Markets	100	100	100	100

Sources: The Bloomberg, Morgan Stanley Capital International, and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Figures may not total due to rounding. Korea and Taiwan's market cap represent the total market cap of the Korea Stock Exchange and the Taiwan Stock Exchange, respectively. As of November 2001, MSCI renamed the China Free, Indonesia Free, Malaysia Free, Philippines Free, and Thailand Free Indices so that the suffix "free" no longer appears in the index name. Subsequently, MSCI renamed all regional emerging markets by deleting the word "free" in January 2004.

**Table B**  
**MSCI EMERGING MARKETS ECONOMIC SECTOR WEIGHTS**



Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Data for 2004 are through February 29. As of January 2004, MSCI renamed its emerging markets index by deleting the word "free".

Table C

## IF KOREA AND TAIWAN GRADUATE TO DEVELOPED MARKETS INDICES

As of February 29, 2004

	Percent of Index (%)				Percent of Index (%)			
	MSCI Pacific ex Japan Index		Three Scenarios		MSCI AC Asia Pacific ex Japan Index		Three Scenarios	
	If Korea Full Market Cap is Included	If Taiwan Full Market Cap is Included	If Korea Full Market Cap is Included	If Taiwan Full Market Cap is Included	If Korea Full Market Cap is Included	If Taiwan Full Market Cap is Included	If Korea & Taiwan Full Market Cap is Included	
Korea	---	---	---	---	15.5	---	---	---
Taiwan	---	---	---	---	10.4	---	---	---
Australia	64.4	64.4	64.4	64.4	35.5	64.4	64.4	64.4
China	---	---	---	---	6.8	---	---	---
Hong Kong	22.2	22.2	22.2	22.2	12.3	22.2	22.2	22.2
India	---	---	---	---	4.1	---	---	---
Indonesia	---	---	---	---	1.3	---	---	---
Malaysia	---	---	---	---	3.9	---	---	---
New Zealand	2.7	2.7	2.7	2.7	1.5	2.7	2.7	2.7
Pakistan	---	---	---	---	0.1	---	---	---
Philippines	---	---	---	---	0.4	---	---	---
Singapore	10.6	10.6	10.6	10.6	5.9	10.6	10.6	10.6
Thailand	---	---	---	---	2.3	---	---	---
Total	100	100	100	100	100	100	100	100

Sources: The Bloomberg, Factset, and Morgan Stanley Capital International. MSCI data provided "as is" without any express or implied warranties.

Notes: Figures may not total due to rounding. Korea and Taiwan's market cap represent the total market cap of the Korea Stock Exchange and Taiwan Stock Exchange, respectively.