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CAMBRIDGE ASSOCIATES LLC

GLOBAL MARKET COMMENT

EMERGING MARKETS EQUITIES: STILL ATTRACTIVE

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Eric Winig
Marcelo Morales

Emerging Markets Equities: Still Attractive

Emerging markets equity investors have faced stiff headwinds in 2004, with rising global interest rates, slowing money supply growth, and worries about future growth all taking a toll. Yet despite these impediments, emerging markets have actually fallen less than their developed counterparts this year (see Table A). We believe many of the positive elements of the emerging markets story remain intact, and continue to view the asset class as relatively attractive in what is admittedly a mostly overvalued field of contenders.

For the three months ending in July, earnings, cash earnings, dividends, and book value of the MSCI Emerging Markets Index all rose sharply while share prices slid, bringing valuation multiples to levels equal to or slightly cheaper than their historical averages (see Tables B and C). Further, even as emerging markets economies are posting higher growth rates than are developed nations—and emerging markets companies are growing earnings at a faster clip—emerging markets currently trade at a wider-than-normal valuation discount to developed markets. According to Grantham, Mayo, Van Otterloo & Co., the P/E ratio for emerging markets at the end of June was 1.3 standard deviations below its post-1986 mean relative to EAFE ex Japan, and 2.7 standard deviations below its post-1986 mean relative to the S&P 500.

While country specifics clearly differ to various degrees, certain economic and financial improvements seem broadly applicable. For example, one of the consistent rubs on emerging markets is that they are overly reliant on outside capital—so-called "hot money"—and thus vulnerable to severe busts if and when this capital takes flight. Since the turn of the century, however, emerging markets have actually been paying back external debt, and are now less dependent on outside capital than ever before (see Table D). Economic growth in emerging economies, meanwhile, is now above 6%, due in large part to their expanding share of world trade. According to Bridgewater Associates, 23 countries have gained market share in terms of percentage of world exports since 1999; 21 are emerging markets. By comparison, U.S. market share has dropped more than 4 percentage points, or roughly US$234 billion, over the same period.

In addition, emerging nations have on the whole been making reforms that have somewhat improved their investment outlook. In Brazil, for example, the government of President Luiz Inàcio Lula da Silva continues to push for business-friendly initiatives such as across-the-board tax cuts, while Taiwan has improved investor access issues to the point that MSCI recently announced it will phase out the country's "limited investability factor" and give Taiwan a full weighting in the index.[1] Eastern European countries such as Poland and Turkey, meanwhile, continue to attract companies and jobs by offering a low-tax, light-regulation, and low-wage alternative to "old Europe." Fundamentals also continue to improve in Asia, which makes up more than half of the MSCI index, although the region cannot be said to be completely out of the woods yet. Loan-to-deposit ratios, for example, seem to have finally bottomed after a precipitous fall following the 1997 Asian crisis, an indication the region *could* be in the early stages of a new credit expansion. Indeed, despite concerns that the Asian revival is simply due to the impact of China, much of the recovery appears homegrown and thus *potentially* sustainable even if China and/or the United States stumble.

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[1] This will be done in two steps: MSCI will increase the weighting of its Taiwan index from 55% to 75% on November 30, 2004 and to 100% on May 31, 2005.

CLSA Asia-Pacific, for example, forecasts per capita GDP for Thailand, Indonesia, Malaysia, and the Philippines to grow 50% by the end of the decade, and expects the foreign direct investment (FDI) gap with China, which currently attracts twice as much FDI as Southeast Asia as a percentage of GDP, will narrow significantly. Of course, countries such as Argentina, Russia, and Venezuela continue to struggle, but equities in these nations generally reflect these difficulties through low multiples, high dividends, or both.

The recent performance of emerging markets *debt* provides further evidence that conditions are improving in these countries. Year-to-date, the J.P. Morgan Emerging Bond Index Global (which contains sovereign bonds generally denominated in US$) has returned 0.6%, while the J.P. Morgan Emerging Bond Index Plus (which contains external currency-denominated debt instruments such as Brady bonds and eurobonds) has returned 0.1%, not significantly worse than the 1.1% return of the Lehman Brothers U.S. Aggregate Bond Index. While some of the performance is attributable to the abundant global liquidity over the past few years, it is likely that the improved finances of many formerly credit-dependent nations also bolstered performance. In particular, conditions have improved in Latin America, which is generally seen as quite vulnerable to rising global rates. For example, according to the Institute of International Finance, while external debt for Latin American nations rose from US$570 billion in 1994 to US$728 billion at the start of 2004, the ratio of this debt to what the region earns from exports and other external activities has shrunk from 2.7 to 1.8, largely due to strong economic growth. Further, the region's interest payments on external debt have shrunk from 16.3% of external earnings in 1994 to 11.1% today.

There are, of course, a number of risks to emerging markets equities, including the threat of a global financial crisis that would send investors fleeing to the safety of high-grade debt and other "safe havens" such as gold. Even barring such an apocalyptic scenario, emerging markets could be undone by a simple stalling of the global economic recovery, or a general rise in risk aversion among cross-border investors. Further, while fundamentals have improved, much work remains to be done. There is also always the risk that government officials will use improved conditions as a pretext for putting off or forgoing important reforms to appease politically powerful groups, thus setting the stage for economic problems in the future.

On the whole, however, emerging markets equities look attractive, particularly in an investment world virtually devoid of inexpensive financial assets. While risks remain, and high volatility is to be expected, low valuations, high dividends, and robust growth make the risk-reward trade off in emerging markets today more favorable than in many developed markets subject to higher price risk.

Table A

MSCI EMERGING AND DEVELOPED MARKETS TOTAL RETURNS

In Local Currency

	One-Month 7/1/04-7/31/04	Three-Month 5/1/04-7/31/04	Calendar YTD 1/1/04-7/31/04	Trailing One-Year 8/1/03-7/31/04	Cumulative Trailing Three-Year 8/1/01-7/31/04
World	-2.9	-0.7	1.5	13.5	-9.5
Emerging Markets	-1.6	-4.1	-2.8	20.8	46.4
EM Asia	-2.9	-8.1	-7.4	13.8	43.3
China	0.4	6.6	-10.0	29.5	23.4
India	8.1	-5.5	-10.7	38.7	67.2
Indonesia	5.3	0.2	18.9	62.3	109.1
Korea	-7.0	-16.6	-8.4	4.7	67.8
Malaysia	1.5	-1.7	5.0	16.2	39.5
Pakistan	0.3	-4.5	6.2	15.8	270.0
Philippines	-0.7	2.0	9.7	28.5	1.3
Taiwan	-6.5	-10.4	-9.9	0.4	17.9
Thailand	-1.3	0.4	-11.9	43.2	151.8
EM Europe & Middle East	-5.2	-5.1	5.1	30.6	65.9
Czech Republic	2.8	-1.2	22.4	37.3	132.6
Egypt	10.5	2.6	36.7	118.4	219.4
Hungary	1.4	7.0	30.8	49.0	89.9
Israel	-11.0	-6.7	8.2	18.5	10.2
Jordan	5.1	11.6	13.2	38.0	115.2
Morocco	3.4	2.5	16.4	23.1	20.5
Poland	-2.9	-4.8	7.1	18.3	41.0
Russia	-8.2	-12.8	-5.1	23.4	140.9
Turkey	8.6	11.1	5.6	91.8	93.5
EM Latin America	2.2	7.9	5.6	40.7	69.2
Argentina	4.6	3.0	-2.8	35.9	190.6
Brazil	5.7	14.7	-0.5	50.4	78.2
Chile	3.8	8.1	8.0	20.9	38.3
Colombia	0.2	-11.6	32.4	64.9	263.8
Mexico	-2.6	1.5	14.7	35.6	59.1
Peru	-1.3	2.7	-10.1	42.7	136.7
Venezuela	-0.6	-7.0	21.7	77.6	362.3
MSCI South Africa	1.9	-1.1	-2.4	14.1	31.7

Table A (continued)

MSCI EMERGING AND DEVELOPED MARKETS TOTAL RETURNS

In U.S. Dollars

	One-Month 7/1/04-7/31/04	Three-Month 5/1/04-7/31/04	Calendar YTD 1/1/04-7/31/04	Trailing One-Year 8/1/03-7/31/04	Cumulative Trailing Three-Year 8/1/01-7/31/04
World	-3.3	-0.4	0.1	17.6	0.6
Emerging Markets	-1.8	-3.3	-2.5	23.4	51.7
EM Asia	-3.5	-9.1	-7.4	14.2	50.5
China	0.4	6.6	-10.4	29.5	23.4
India	7.1	-9.4	-12.1	38.0	69.9
Indonesia	8.3	-3.7	9.6	51.2	117.4
Korea	-8.1	-16.3	-6.6	5.7	86.2
Malaysia	1.5	-1.7	5.0	16.2	39.5
Pakistan	-0.1	-6.1	4.4	14.5	305.1
Philippines	-0.4	2.1	8.8	25.6	-3.1
Taiwan	-7.5	-12.4	-10.0	1.7	20.6
Thailand	-2.4	-2.8	-15.5	45.4	178.5
EM Europe & Middle East	-5.1	-3.8	4.5	32.9	73.5
Czech Republic	1.9	1.6	19.0	49.2	242.3
Egypt	10.1	2.4	35.7	116.4	103.0
Hungary	1.2	8.5	31.4	69.4	160.9
Israel	-11.3	-5.5	5.8	17.1	6.2
Jordan	5.1	11.6	13.2	38.0	115.7
Morocco	2.4	2.8	12.2	29.8	54.4
Poland	-1.4	5.1	10.1	25.8	64.5
Russia	-8.2	-12.8	-5.1	23.4	140.9
Turkey	9.9	7.5	1.2	86.6	75.4
EM Latin America	3.7	6.5	2.2	36.1	36.8
Argentina	3.9	-1.4	-4.3	34.4	-2.5
Brazil	8.4	11.9	-4.9	47.4	43.2
Chile	2.8	5.4	-0.3	32.9	44.0
Colombia	3.2	-10.3	40.8	81.6	219.1
Mexico	-1.5	1.4	12.9	24.5	27.4
Peru	-0.2	4.1	-9.2	44.3	140.0
Venezuela	-2.4	2.5	31.0	7.1	26.8
MSCI South Africa	1.0	9.7	3.9	35.0	73.7

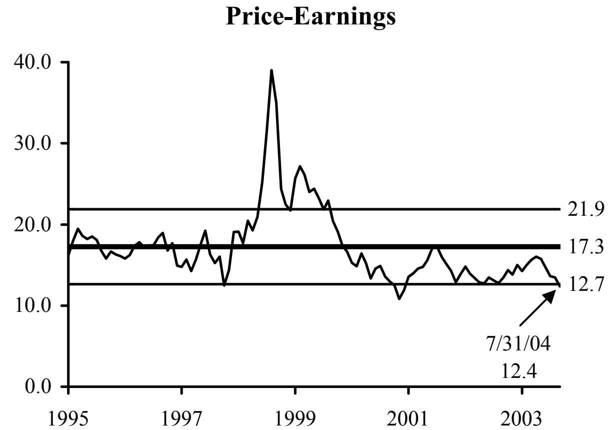
Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

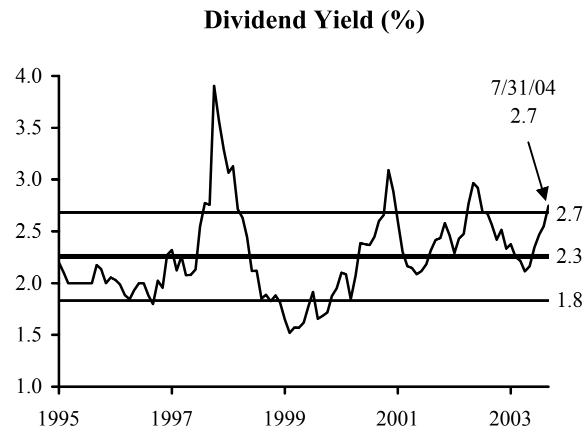
Note: As of January 29, 2004, MSCI renamed all regional Emerging Markets and All Country indices so that the suffix "free" no longer appears in the index name.

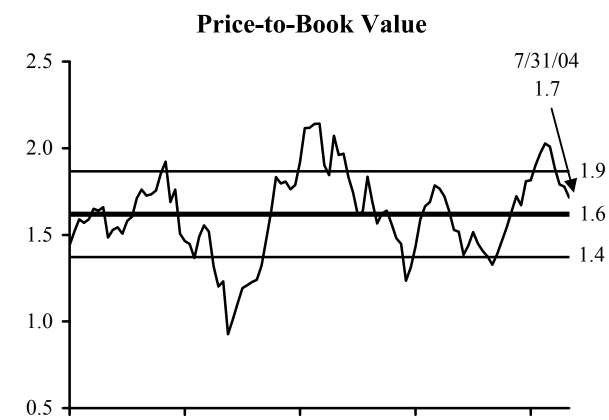
Table B

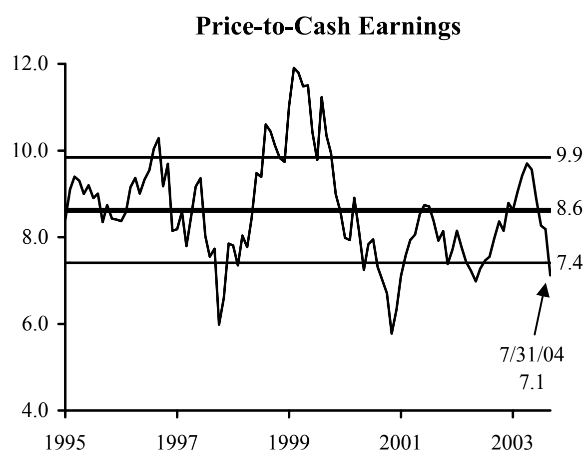
MSCI Emerging Markets

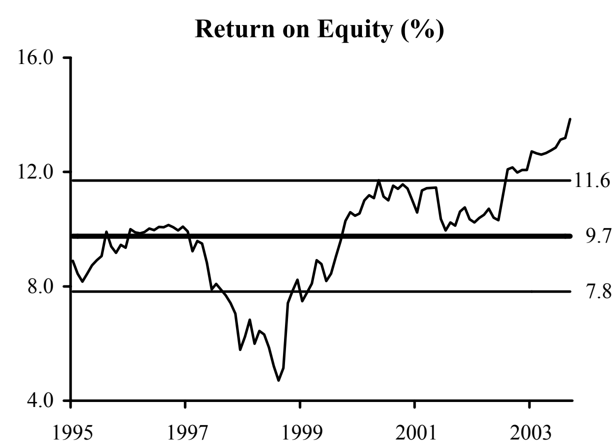
November 30, 1995 - July 31, 2004











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

Notes: ROE is calculated by dividing the earnings per share by the book value per share. Book value per share is calculated by dividing the index price by its price/book ratio. Earnings per share is calculated by dividing the price index by its price/earnings ratio. As of January 29, 2004, MSCI renamed all regional Emerging Markets and All Country indices so that the suffix "free" no longer appears in the index name.

Table B (continued)

MSCI EMERGING MARKETS VALUATIONS

As of July 31, 2004

	Price-to-Book Value	Price-to-Cash Earnings	Price-Earnings	Dividend Yield
Emerging Markets	1.7	7.1	12.4	2.7
EM Asia	1.7	6.9	12.1	2.7
China	1.9	7.3	14.4	2.4
India	3.0	11.1	14.8	1.9
Indonesia	2.3	6.9	10.2	4.0
Korea	1.3	5.2	9.5	2.8
Malaysia	1.8	9.9	15.3	2.2
Pakistan	2.3	6.3	9.3	7.0
Philippines	1.5	7.5	16.2	1.6
Taiwan	1.7	8.0	14.4	2.9
Thailand	2.3	8.0	11.6	2.9
EM Europe & Middle East	1.6	7.7	12.8	2.3
Czech Republic	1.1	5.1	22.1	5.7
Egypt	2.5	6.5	10.5	3.4
Hungary	2.2	4.8	11.2	2.5
Israel	2.5	22.0	32.3	1.0
Jordan	2.6	11.4	27.8	2.0
Morocco	1.9	9.6	9.6	9.6
Poland	1.8	5.3	15.2	1.9
Russia	1.2	5.8	7.8	2.9
Turkey	1.5	7.6	10.8	2.6
EM Latin America	1.9	6.7	12.1	2.9
Argentina	1.7	5.9	29.0	1.3
Brazil	1.7	5.7	9.6	3.6
Chile	1.6	10.0	24.2	1.9
Colombia	1.3	10.2	11.3	3.3
Mexico	2.2	7.4	13.9	2.3
Peru	2.3	17.1	20.3	2.5
Venezuela	1.6	5.1	19.2	8.7
MSCI South Africa	1.8	8.6	13.4	3.2

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

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Table C

IMPROVING FUNDAMENTALS OF EMERGING MARKETS EQUITIES

As of July 31, 2004

MSCI Emerging Markets

	Growth (%)			
	Earnings	Dividends	Book Value	Cash Earnings
One Month	6.6	5.5	1.5	12.5
Three Months	13.6	12.3	5.4	19.6
Calendar Year-to-Date	16.0	16.5	5.9	21.5
2003	40.7	40.5	15.5	29.9
2002	-7.7	-2.9	0.9	-10.0

MSCI Emerging Markets Asia

	Growth (%)			
	Earnings	Dividends	Book Value	Cash Earnings
One Month	11.7	11.6	1.4	23.9
Three Months	23.5	14.3	6.3	34.7
Calendar Year-to-Date	25.3	23.2	6.6	38.0
2003	30.5	59.8	5.9	17.5
2002	5.7	-2.2	11.8	-3.2

MSCI Emerging Markets Europe & Middle East

	Growth (%)			
	Earnings	Dividends	Book Value	Cash Earnings
One Month	2.3	-4.0	3.9	2.7
Three Months	2.2	12.2	5.0	8.2
Calendar Year-to-Date	18.0	28.0	6.0	13.3
2003	80.7	72.5	37.7	49.8
2002	-26.8	-8.0	9.4	-11.2

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

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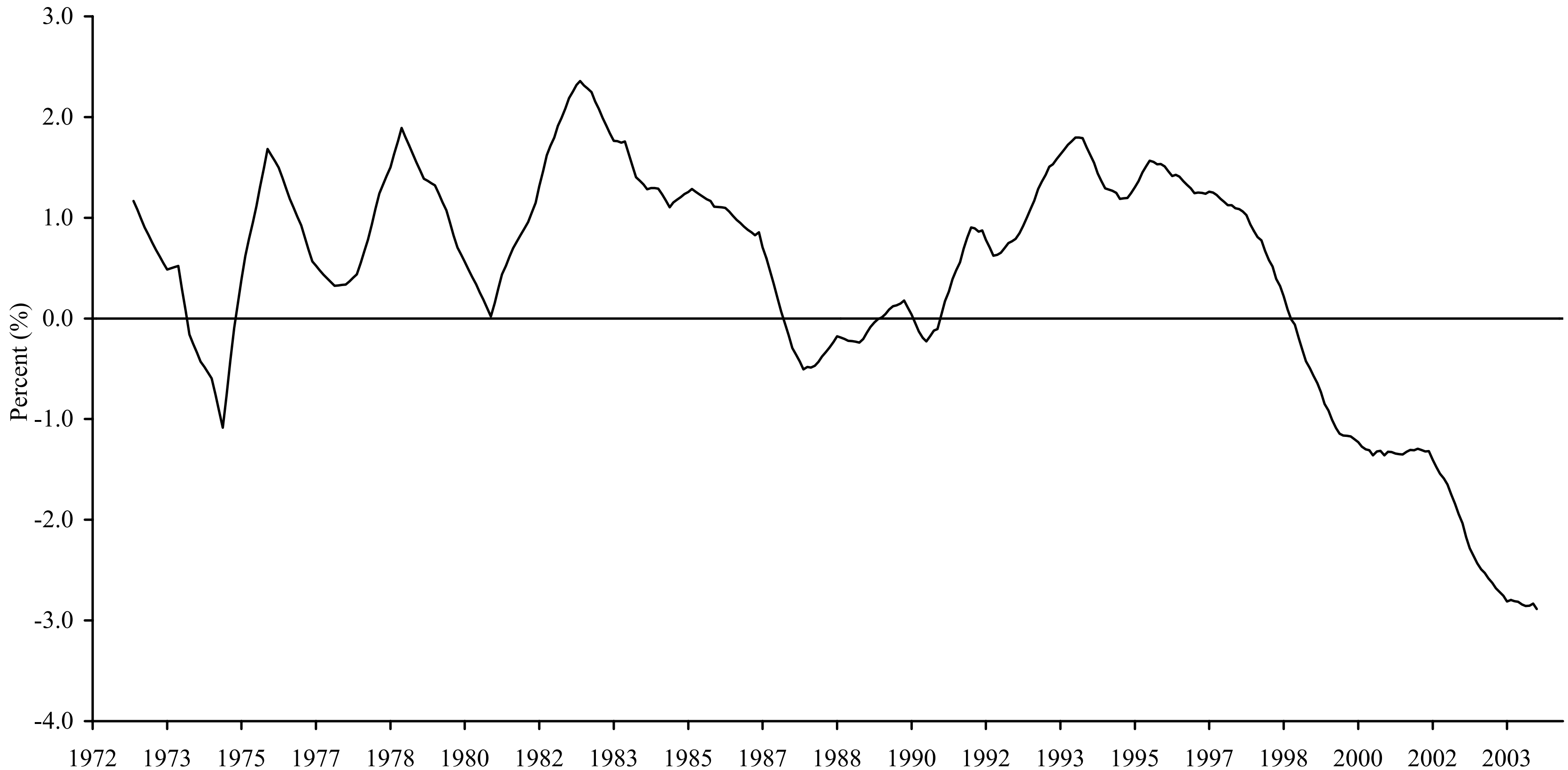
Table D

EMERGING MARKETS DEPENDENCE ON FOREIGN CAPITAL

1972-2004



Source: Bridgewater Associates, Inc.

Notes: Data for 1972 starts in December. Data for 2004 are through May 31, 2004.