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CAMBRIDGE ASSOCIATES LLC

GLOBAL MARKET COMMENTARY

WHAT'S BEEN DRIVING THE EMERGING MARKETS EQUITY RALLY?

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What's Been Driving the Emerging Markets Equity Rally?

Since bottoming in March 2003, the MSCI Emerging Markets Index has returned a cumulative 167.4%, or an average annual compound return (AACR) of 41.5%. Partly as a result, we have recently moved the asset class from undervalued to fairly valued, as price appreciation has begun to outrun earnings growth, causing price-earning (P/E) multiples to rise. Still, our outlook remains constructive, as we believe emerging markets offer better value than developed equities. Considering the strength of the recent rally, however, we thought it would be helpful to take a look at its composition; in other words, what has been driving returns, and how should that influence our expectations for future performance? In a nutshell, the emerging markets rally has featured across-the-board strength that likely reflects both rapidly rising earnings and tremendous fund inflows over the past three years (Table A). Our view remains the same: while we consider emerging markets equities among the most attractive investment options at the moment, we would not be surprised to see a quick and painful correction at some point. Absent any change in market fundamentals, however, we would regard such a downturn as a buying opportunity.

Seoul Train

Emerging markets indices remain highly concentrated, with the eight largest countries and five largest economic sectors each accounting for roughly three-quarters of the market capitalization of the MSCI Emerging Markets Index. Of the 167.4% cumulative return over the past 34 months, Korea alone has accounted for more than 31 percentage points (Table B). Indeed, the top eight contributors, which also happen to be the eight most heavily weighted countries, have accounted for roughly 136 points, or more than 80% of the total return. (The MSCI Emerging Markets Index has 26 constituents.) Much of this is due to these large weightings, rather than to differences in absolute returns (Tables C and D). Perhaps the best illustration of this is Taiwan, which posted the second worst return for the period (63.9%), yet still accounted for 8.6 points of the overall return due to its 13.4% weight in the index. On the other hand, while Egypt and Colombia were the top two absolute performers for the period, returning 1,365.9% and 613.4%, respectively, the two together accounted for less than 4 points of the overall return due to their fractional index weights.

Similarly, given Asia as a whole accounts for more than 50% of the index capitalization, the region accounted for 73.4 points, or more than 40% of total return, even though it produced the lowest regional return by more than 100 basis points (132.1%). Among sectors, returns have been more comparable than those for countries over the period in question (excluding energy[1]). Nevertheless, the concentration of returns has been similar: the top three sectors (out of ten) have accounted for roughly 86 points, or slightly more than half the total return, and the top five sectors about 125 points, or nearly three-quarters of the total index return (Table E). Still, relatively small sectors can still have an outsized impact. Energy, for example, contributed nearly 30 percentage points to returns (or 17.5%), despite representing only 9.6% of the index at the beginning of the period.

[1] Excluding energy, sector returns ranged from 115.5% (information technology) to 184.7% (consumer discretionary); energy returned 305.3%.

Improving Fundamentals or Hot Money?

As mentioned above, much of the recent rally has been driven by rapidly rising earnings. Consider: as of March 31, 2003, the overall emerging markets index traded at a P/E of 12.8, while at the end of August 2005, the index P/E was 13.0. In other words, P/E ratios remained basically the same despite the fact that equity prices more than doubled over the period. Indeed, P/Es actually *fell* in Latin America and Europe and the Middle East, while remaining flat in Asia and rising in South Africa. Since August, however, price appreciation has begun to outrun earnings growth. As of the end of February, prices had risen 25.8% since August, while the overall index P/E is now 15.9. While some have expressed concern over the sustainability of the recent rise in emerging markets return on equity (ROE), meanwhile, there is a plausible case to be made that at least a portion of this represents a secular shift driven by fundamental improvements in emerging markets economies that allow capital to be allocated more efficiently.

At the same time, inflows to emerging markets funds have exploded. As shown in Table A, recent net inflows are off the charts: over the first five weeks of 2005, inflows totaled US$14.7 billion, 72% of the record *full-year* total for 2005, and higher than any previous year on record. While some of this undoubtedly reflects the better prospects offered by emerging markets *vis-à-vis* developed markets, such enormous flows also suggest a bit of frothiness is creeping into the asset class.

Indeed, the history of emerging markets is replete with episodes of phenomenal growth followed by gut-wrenching declines. For the 12 months ended July 31, 1997, for example, emerging markets ran up 32.2%, only to plunge 21% over the next four months. (Developed markets, by contrast, rose 40.6% over the first period, and fell only 4.9% in the subsequent period.) More recently, emerging markets soared 122.3% in the 19 months ended March 31, 2000, then dropped 28.4% over the next eight months. (Developed markets rose 55.3%, and fell 11.6%.)

On the other hand, emerging markets equities showed extended periods of tremendous strength in the early 1990s, particularly when measured in local currency. This distinction is important, as during much of this period sharp rises in emerging markets equities went hand-in-hand with sharp *drops* in emerging markets *currencies*. Beginning with the three years ending December 1990, rolling three-year AACRs (using monthly data) did not drop below 50% until April 1996. Said a slightly different way, the AACR for this entire period (January 1988 through April 1996) was an astonishing 88%, while the cumulative return was more than **19,000%**. (In US$, the period AACR was 24.6%, and cumulative return, 526.4%.)

Clearly emerging markets are significantly different today than in the early 1990s. Most notably, they are larger, have been less volatile, and since the late 1990s/early 2000s have been paying off debt and running current account surpluses. In short, while the recent rapid increase in fund flows indicates frothiness that is likely to reverse at some point, valuations remain reasonable and fundamental improvements continue apace. Historical data on the magnitude and duration of emerging markets rallies, meanwhile, are inconclusive.

Conclusion

We remain positive on emerging markets equities, as they not only offer a better risk-reward trade-off than developed markets equities, but are also attractive on their own merits. As noted above, at least part of the recent improvement in ROE is likely justified due to fundamental improvements. Further, while energy stocks have certainly had an outsized impact on returns due to the sharp rise in commodities (particularly oil), this need not persist for emerging markets to continue to do well. Indeed, *ceteris paribus,* a drop in oil prices would be good for equity markets in general, as it would provide a boost to other economic sectors and to countries that are net importers of oil. Thus, considering emerging markets' still-reasonable valuations and rapid earnings growth, as well as the lack of attractive investment alternatives, it is hardly inconceivable the rally could continue to run for a while. Still, investors should understand that returns will continue to be driven by a small number of countries that dominate the index; thus, the outlook for these countries is, to some degree, indistinguishable from the outlook for the index as a whole. Further, the recent pace of emerging markets fund inflows has been nothing short of astounding. While we are certainly not "calling a top" in emerging markets, such extreme flows are indicative of the optimism typically found at market peaks, and, as stated above, we would not be surprised to see a quick and painful correction in these markets in the not-too-distant future.

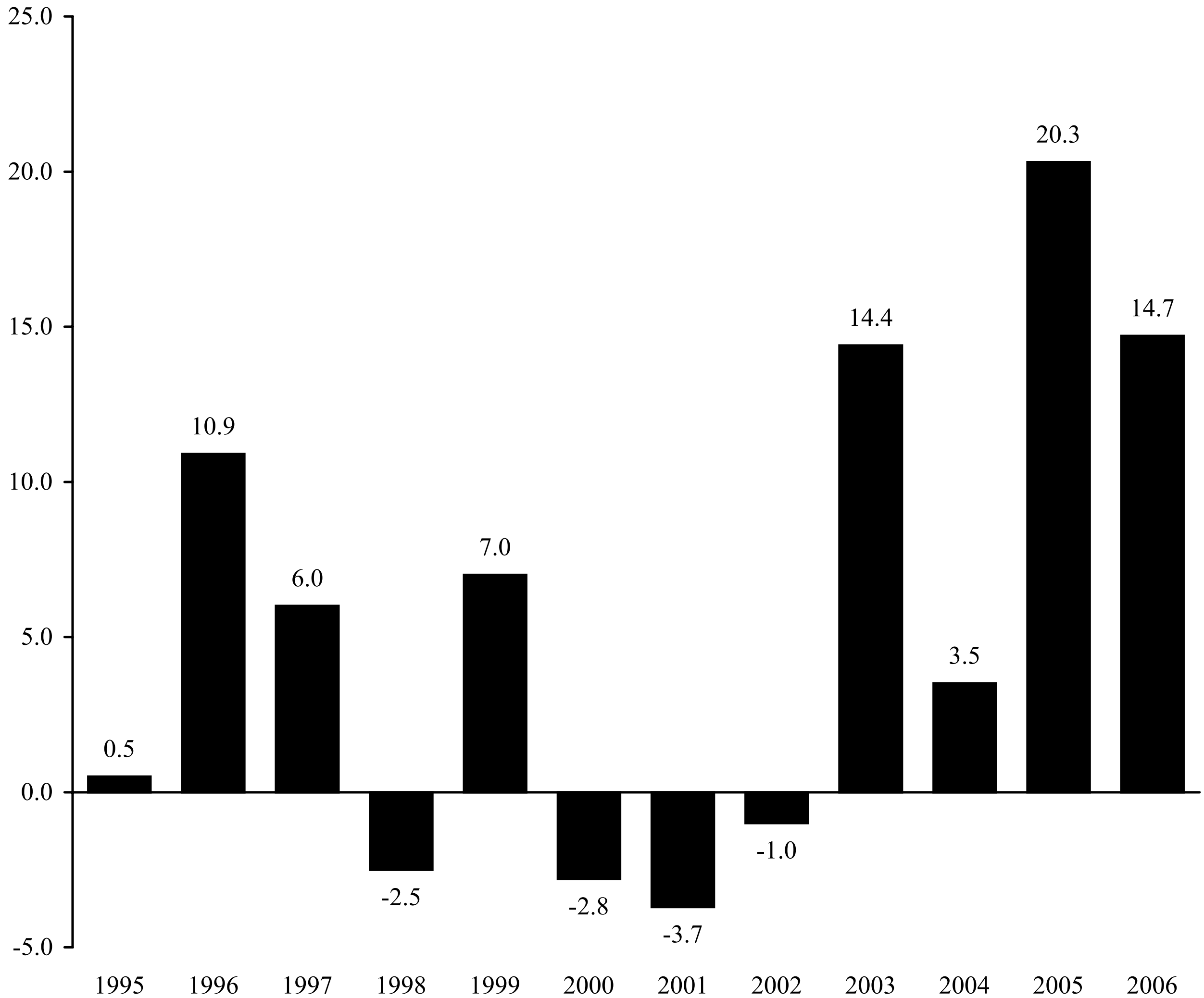
Table A

NET INFLOWS INTO EMERGING MARKETS FUNDS

1995-2006

(US$ billions)

All Dedicated Emerging Markets Equity Funds



Sources: Morgan Stanley Research and Thomson Datastream.

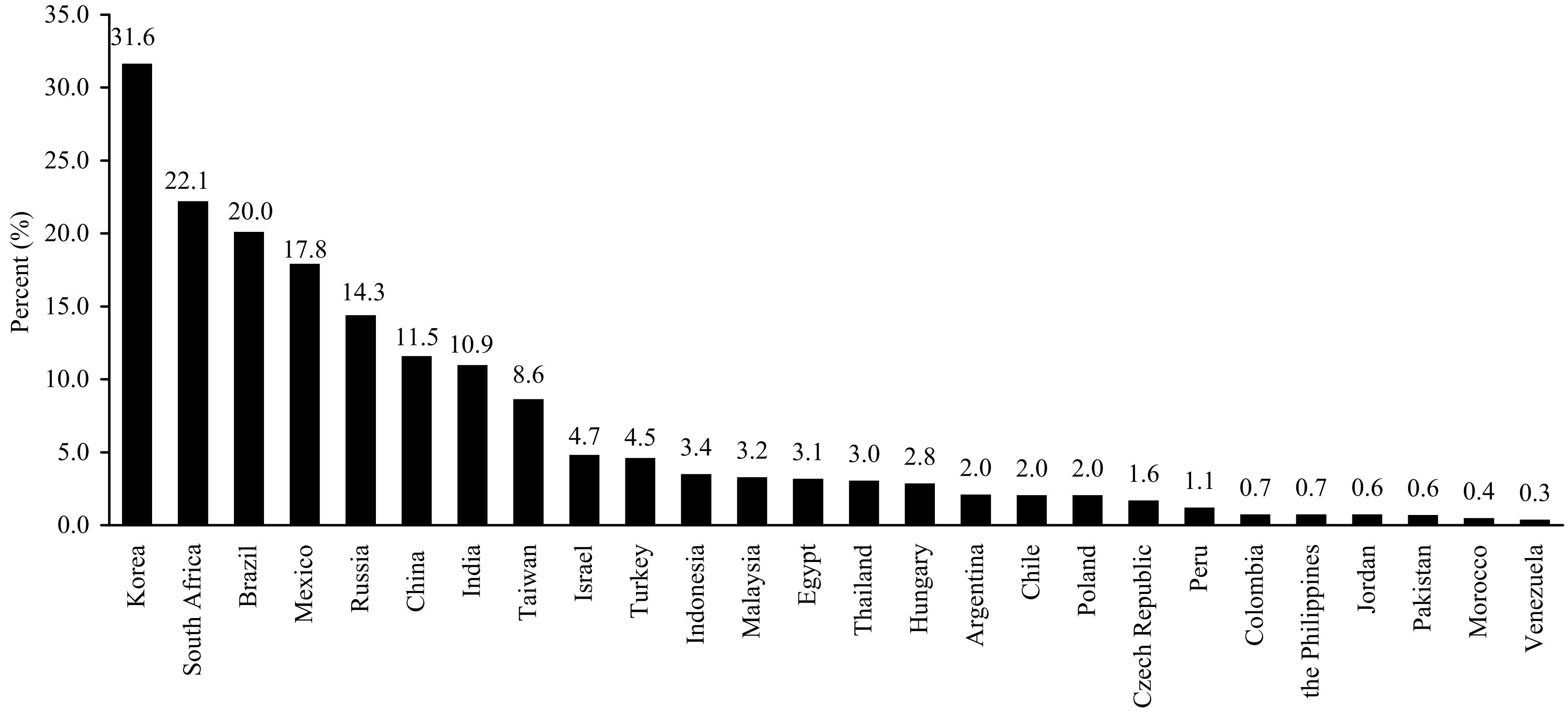
Notes: Data for 2006 are through February 8. More than 72% of the 2005 flows have already been made for 2006 by February 8.

Table B

PERFORMANCE ATTRIBUTION FOR MSCI EMERGING MARKETS COUNTRY INDICES

As of January 31, 2006

Local Currency



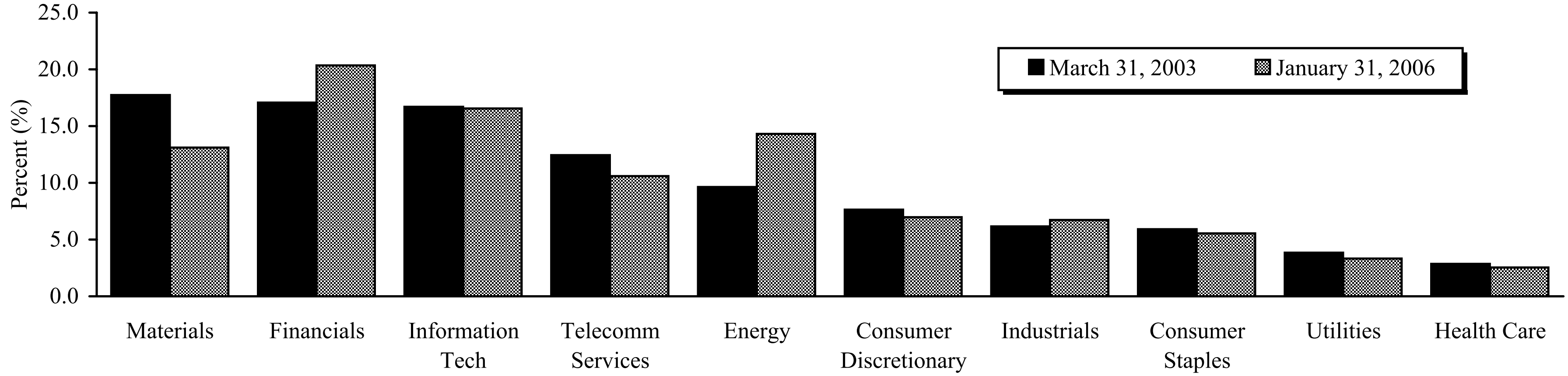
Sources: FactSet Research Systems, Morgan Stanley Capital International, and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Country returns are from April 1, 2003 through January 31, 2006. Country weights are as of March 31, 2003. The total cumulative return for the MSCI Emerging Markets Index in local currency for the period of April 1, 2003 to January 31, 2005 is 167.4%. 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. Total returns for MSCI Emerging Markets indices are gross of dividend taxes.

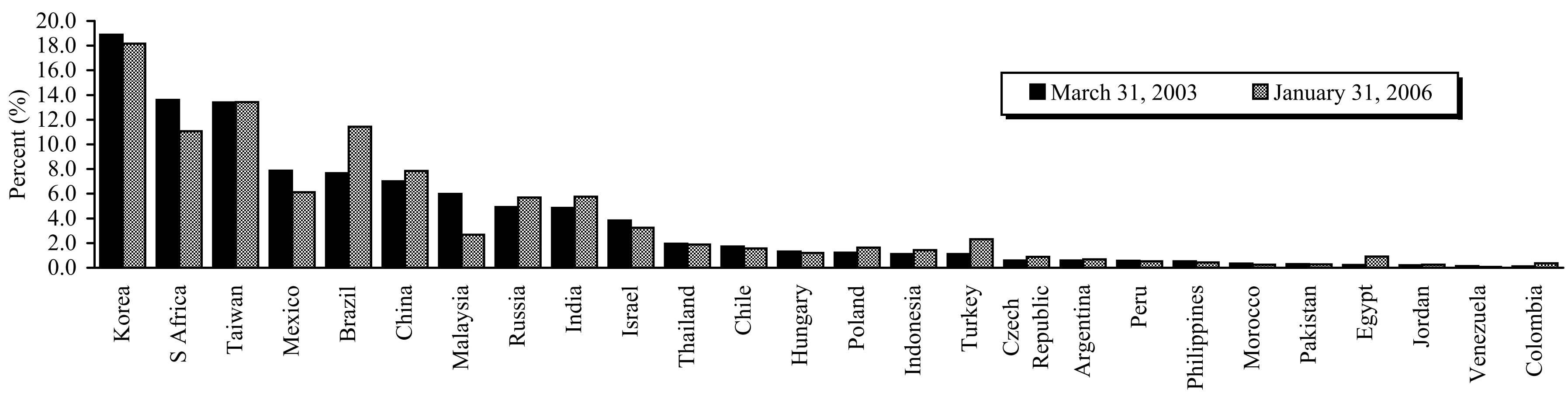
Table C

MSCI EMERGING MARKETS ALLOCATIONS

Sector Allocations (%)



Country Allocations (%)



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

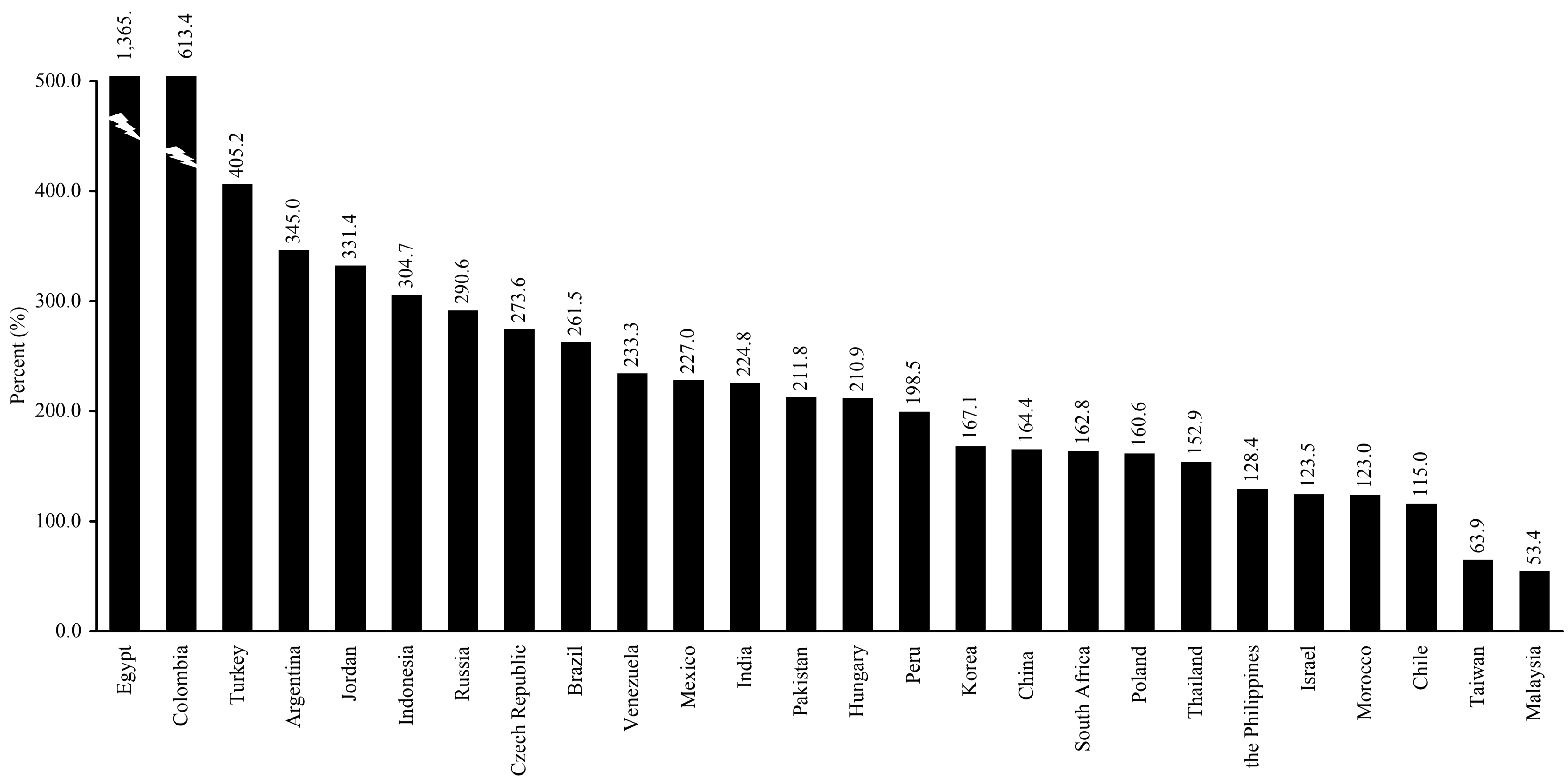
Note: As of January 29, 2004, MSCI renamed all regional Emerging Markets and All Country Indices so that the suffix "free" no longer appears in the index name.

Table D

CUMULATIVE PERFORMANCE FOR MSCI EMERGING MARKETS COUNTRY INDICES

April 1, 2003 - January 31, 2006

Local Currency



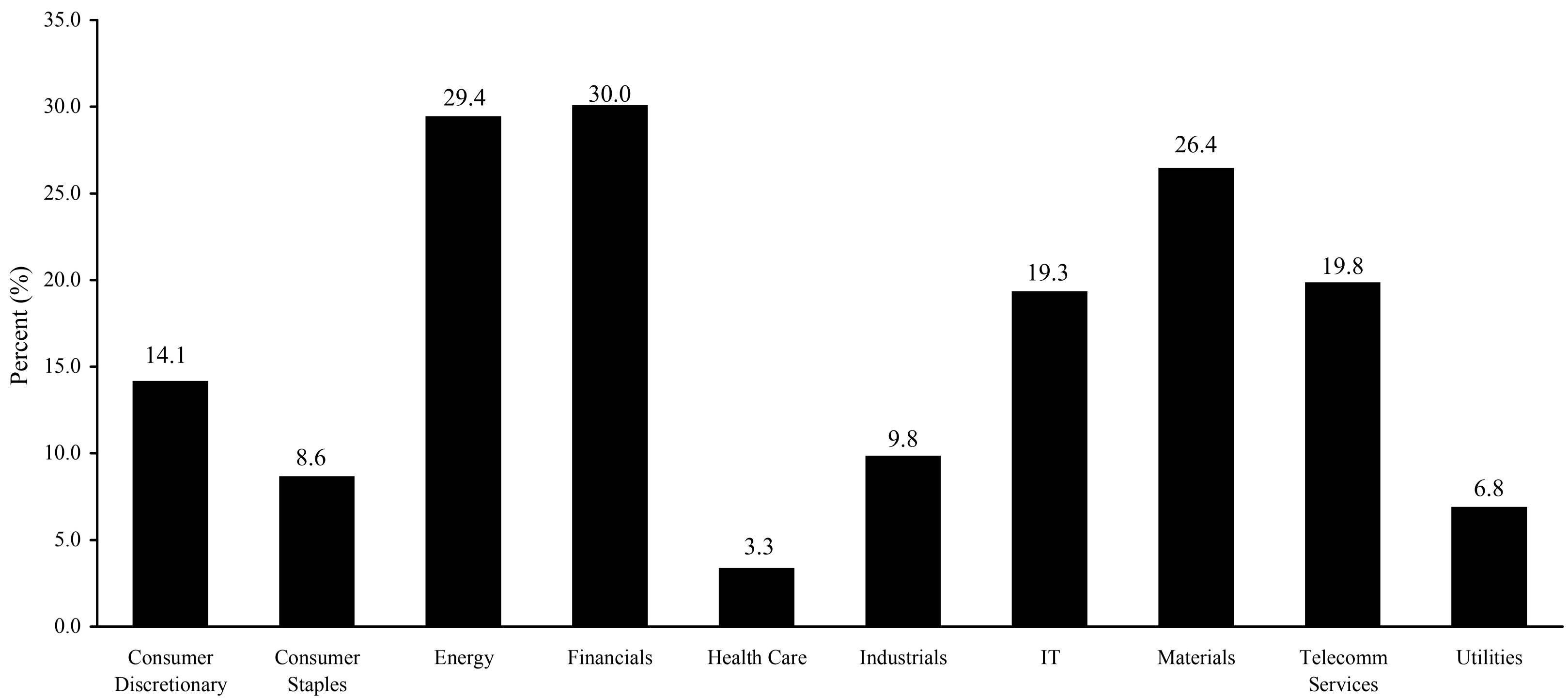
Sources: Factset Research Systems, Morgan Stanley Capital International, and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Returns for Egypt and Columbia are not to scale. 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. Total returns for MSCI Emerging Market indices are gross of dividend taxes.

Table E

PERFORMANCE ATTRIBUTION FOR MSCI EMERGING MARKETS SECTORS INDEX IN LOCAL CURRENCY

As of January 31, 2006



Sources: Factset Research Systems, Morgan Stanley Capital Management, and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Sector returns are from April 1, 2003 through January 31, 2006. Sector weights are as of March 31, 2003. The total cumulative return for the MSCI Emerging Markets Index in local currency for the period of April 1, 2003 to January 31, 2006 is 167.4%. 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. Total returns for MSCI Emerging Market indices are gross of dividend taxes.