CAMBRIDGE ASSOCIATES LLC

INVESTMENT PUBLICATIONS HIGHLIGHTS

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"Emerging Market Uprising: What It Means for Investors" by George Magnus, The Boeckh Investment Letter, October 25, 2010

The current consensus is that emerging markets economies will continue to boom thanks to positive long-term fundamentals. However, the quality of emerging markets institutions, most notably China, must improve for economic success to continue, especially as economies modernize rapidly and become increasingly complex. Historically, emerging markets countries have mixed track records in this area. Thus, market participants should not assume that the next decade will be as robust as the last.

The current consensus is that emerging markets economies will continue to boom in the next ten to 15 years thanks to positive long-term fundamentals. More specifically, emerging markets should benefit from strong fiscal positions, higher total factor productivity, better demographics, and in some cases (e.g., Latin America), improving governance. This view implies that emerging markets assets should encompass a greater share of investor portfolios and is further bolstered by poor prospects (e.g., sustained deleveraging and the consequences of rapid aging) for many advanced economies. However, these same fundamentals do not exist in a vacuum. They have historically been exploited or compromised by governments and local institutions, including those that drive total factor productivity growth, such as the operation of contract law, governance, labor and social institutions, and the infrastructure that serves innovation. Thus, rosy emerging markets projections should be met with some caution.

The quality of institutions is more important than GDP or the ownership of resources in explaining long-term economic success, especially as economies modernize rapidly and become increasingly complex. Improvements in the quality of institutions help offset the natural decay in economic growth that comes with economic maturity. This will play an especially significant role in China. Indeed, weak institutions were one of the main reasons why China long ago ceded its prominent place in the world to Europe. In its current situation, unreformed and weak institutions are likely to prevent the change that China needs to fulfill its potential.

Today's central economic problems concern global imbalances. For instance, China is the world's biggest creditor and will account for about 90% of the net balance of payments surplus accruing to all countries in 2010. While many countries complain about China's exchange rate flexibility, the exchange rate is only one tool in an economy that has a strong structural proclivity to save. Thus, the real issue is why China saves so much, and whether it has the political will to embrace the comprehensive reforms needed to rebalance the economy toward households and services, risking the instability that would accompany this shift.

There are several reasons for China's elevated savings rate. First, its dependency ratio (young and old as a share of the working age population), though bottoming out, is still consistent with high national savings. Second, China's economy is based on exports and capital investment. Such a model requires an undervalued exchange rate to effectively tax consumption and subsidize exports. Third, the Social Security system is still inade-

quate as a substitute for high personal savings. Finally, although households are the biggest savers, with gross savings of over 23% of GDP, the biggest rise in savings in recent years has emanated from companies and the government, accounting for about 19% and 11%, respectively, of GDP.

The rebalancing of China will not happen without the political will of the Communist Party and an improvement in the quality of institutions that facilitate change. While the idea of rebalancing is well understood and a stated Chinese goal, whether the Communist Party structure has the institutional tools to risk radical change remains to be seen. Indeed, such change would likely entail rising domestic stability and unemployment risks. Undeniably, reforms after 1978 paved the way for the current Chinese economic miracle. However, historically, China has often blinked in the face of external and internal threats to stability, becoming defensive, and prone to withdrawal.

Investors cannot be expected to price uncertainty and discount the sort of shocks that might arise in the event of bad political and economic outcomes. However, a core emerging markets position should be maintained, based on three ideas. First, emerging markets demographics and development are driving the growth and expansion of local companies, and the commodity and resource stories. Second, the world is bifurcating between the deflation-prone West and the inflation-prone emerging markets. Further increases in local emerging markets interest rates should be expected and emerging markets currencies should appreciate against the U.S. dollar and the euro. Third, if the economic move toward domestic consumption is sustained, stocks linked to education, health care, and insurance services should fare well.

These ideas should work well for most muddling-through economic scenarios. Regarding economic tail risks, the "spontaneous return of confidence" has a low probability, but the alternative—"de-globalization" arising from policy inflexibility, inertia, or error—looks more plausible. The trouble with tail risks in unpredictable times is that they are more likely to occur.

The uprising of emerging markets during the last ten years of rapid globalization and the primacy of markets over politics (including China) have served investors well. However, in a post-crisis world that has become more unstable, unbalanced, and nationalistic, the ability to reform and change economic direction will be paramount. Thus, the next decade offers no such assurances without strong qualifications.

"Emerging Markets Equity in Two Decades: A Changing Landscape" by Timothy Moe, Goldman Sachs, September 8, 2010

Over the next two decades, it is likely that a significant shift will occur in the global equity market landscape as robust economic growth and capital deepening pushes emerging markets above their developed counterparts in absolute size and importance. As institutional investors in both the developed and emerging world react to the changing equity market landscape, it is likely that the capital deepening in emerging markets decreases volatility and provides a valuation floor. Despite the attractive growth story, investors must still be wary of their entry point and how they obtain exposure, as both factors will influence returns.

Over the next two decades, it is likely that the emerging markets growth story will lead to a significant shift in the global equity market landscape. Currently, emerging markets account for 37% of global GDP in US$ terms and 31% of global market capitalization (excluding free-float adjustments); by 2030, these percentages could surge to 59% and 55%, respectively. As these markets grow in depth and size, institutional equity investors in both developed and emerging

markets will benefit from lower volatility and more stable equity valuations.

The author arrives at an estimate of future emerging markets equity market capitalization by first projecting future GDP growth across regions. Emerging markets economic growth should continue to outpace that of developed markets for several reasons, including a workforce that grows due to favorable demographics and rising participation from women. Productivity of this workforce should also increase, as more capital is invested per worker and as education rises. There are downside risks to such growth projections, of course, including potential political, regulatory and security concerns, in addition to potential growth shocks. For example, political decisions will help drive whether economic growth in emerging markets will directly translate to increased corporate profits and the development of the private sector. One potential growth shock would be the impact of rising commodity prices, as increased costs to emerging markets development would depress margins and profitability, limiting growth potential.

Over the long term, faster economic growth should contribute about two-thirds of the expected increase in real GDP in US$ terms for emerging markets, with the remainder driven by currency appreciation. Forecasting future exchange rates has historically been difficult, but rising income levels should ensure that emerging markets currencies rise toward purchasing power parity from current low valuations versus the U.S. dollar.

The final step in translating this GDP growth into a projected equity market capitalization entails using historical ratios of market cap to GDP, and adjusting for different circumstances. Generally speaking, the author assumes that this ratio should rise from current levels for emerging markets as they evolve into developed markets. However, a number of things can cause these ratios to fluctuate, including how open the country is to trade or its status as a financial center. As examples, the openness of the Swiss economy and the status of the United Kingdom as a financial center have meant that the growth in market capitalization in each of their equity markets is less tied to domestic GDP.

The growing size and importance of emerging markets equity capitalization will have important implications for investors in both the developed and emerging worlds. One is that holdings of emerging markets equities in developed markets institutional asset management pools will need to increase to keep pace with increased benchmark weightings. Developed markets equity funds in Europe, Japan, and the United States currently hold just 6% of their $18 trillion in equity holdings in emerging markets. This weighting is less than half of the 13% weight of emerging markets equities in the MSCI All Country World Index, but has been boosted by rising allocations to emerging markets equities in recent years. Looking out ten years, developed markets funds will probably increase their holdings of emerging markets equities to a 10% weight, assuming that 25% of new developed markets equity investments are directed toward emerging markets. During the subsequent decade, given the growth in the equity market, developed markets investors are then likely to channel 55% of new equity investments into emerging markets, eventually reaching an 18% portfolio weighting. These figures imply $4 trillion of new emerging markets equity investments by developed markets funds over the next 20 years, though this will still leave them short of the 31% weight in the MSCI All Country World Index. This analysis makes one big assumption—that the Chinese A share market will be open to foreign investors during the second decade.

Emerging markets equity market growth will not come just from outside investment; economic growth in emerging markets will lead to the

formation of substantial local institutional pools of capital, fueled by high savings rates. Recent trends, such as the explosive growth of institutional equity investing in China, India, and Korea, demonstrate just how quickly domestic pools of savings become institutional capital. In China, for example, the mutual fund asset base has grown from $45 billion in 2004 to $583 billion by the end of 2009. Assuming that currently low allocations to equities rise over time, these trends suggest an emerging markets institutional equity investor base of around $30 trillion by 2030. Developed and emerging markets institutional demand, coupled with the organic growth of existing companies and future stock issuance, will create an $80 trillion emerging equity market capitalization by 2030; 55% of the global equity market capitalization. By 2030, the top three stock markets could be China, India, and the United States.

There are two other important implications of the expected growth in emerging markets equity markets over the next two decades. One is that from a valuation perspective, a deepened institutional bias may be more supportive of equity prices, especially given more support from local domestic investors. The second is that greater institutional ownership of emerging markets equities may lead to reduced volatility. Historical data suggests that equity markets with higher institutional ownership tend to be less volatile, though one caveat is that this data may be distorted by developed markets statistics, which tend to be less volatile overall.

In conclusion, the rapid economic growth in emerging markets will fuel larger, institutionalized equity markets, with important implications for investors. But investors seeking to capitalize on the emerging markets growth story should be aware of two major caveats: their entry point and the means by which they obtain exposure. Evidence shows a positive correlation between earnings and returns, but investors must avoid overpaying for growth and not forget that starting valuations and returns are negatively correlated. Furthermore, it matters how investors achieve their exposure to emerging markets. Equity markets are not necessarily a reflection on underlying economies; over 30% of S&P 500 revenues come from outside of the United States, while 60% of Taiwan's listed corporate earnings come from technology companies that sell their products outside Taiwan.

"It Takes a Consensus to Create a Mania" by Chen Zhao, Bank Credit Analyst, November 5, 2010

There is a growing consensus among investors that developed markets equities are yesterday's news and emerging markets equities are the place to be. Any time there is consensus among investors, it is usually a good time to re-evaluate the investment. While there is some talk of emerging markets being the next bubble, valuations are not challenging and investment trends that resemble bubbles often last longer than many professionals forecast. Recognizing this, it is better to continue to participate than to be left behind.

There is a growing consensus among investors that developed markets equities are yesterday's news and emerging markets equities are the place to be. Any time there is consensus among investors, it is usually a good time to re-evaluate the investment. Emerging markets equities as an asset class have been favored by some over developed markets equities for years, but the consensus trade of emerging versus developed markets is now starting to look similar to that of technology stocks in the 1990s. However, investment trends that resemble bubbles often last longer than many professionals forecast, and investors may be in for a "melt up" before an eventual meltdown. Recognizing this, it is better to continue to participate than to be left behind.

There are three reasons why the current bull market in emerging markets may not end anytime soon. The first is cyclicality, as the recent improvement in data might be a sign that the global economy is beginning to rebound. Developed world industrials have improved relative to their Asian peers, which historically has been a sign that conditions in the G7 are firming up and that a major pullback in emerging markets is unlikely. The second is more structural. Weaker economic growth in developed economies has pushed interest rates lower, spurring large inflows of capital into emerging markets as investors seek higher returns. This type of capital tends to rotate from one asset class to another, allowing prices to rise and deviate from their underlying value and bubbles to form. The third reason is that most emerging markets countries are reluctant to see their currencies appreciate, cutting off their comparative export advantages. Yet most emerging markets currencies, particularly those in Asia, are undervalued. As countries resist the loose U.S. monetary policies and artificially depress their currencies, bubbles develop and the risk of inflation increases.

Looking at the historical relationship between emerging and developed markets since the 1970s, it is clear that over long periods of time, emerging markets have outperformed. The compound annual return in emerging markets stocks since 1970 is 10.7%, compared to 6.6% for the S&P 500. Since 1980 a pattern of regular ebb and flow between emerging and developed markets' performance emerges. From 1982 to 1993, emerging markets stocks posted solid performance, which came to an end when developed markets government bonds sold off, bursting the emerging markets bubble. This led to a subsequent "lost decade" for emerging markets stocks relative to developed markets. Following a great run for the S&P 500 in the 1990s that ended with the bursting of the tech bubble in 2000, emerging markets stocks have outperformed over the last eight years since 2002, led by China and its growing importance to the global economy. If history is any indicator, emerging markets could have a few more years of outperformance before a re-rating or correction would be due. Valuations for emerging markets equities currently appear fair, and the equities are more attractive than in prior decades. In the 1990s, the forward price-earnings ratio (P/E) for emerging markets stocks reached 20 and hit 39 in 1994, using normalized earnings. Today, the forward P/E is 11.5 and multiples of normalized earnings are at a P/E of 17.3.

In evaluating the consensus of emerging versus developed markets, it is worth considering what will bring to an end the secular bull market in emerging markets stocks. The biggest risk is inflation. At the present time, core inflation in most emerging markets is low. A stronger global economy, boosted by overstimulation and a prolonged period of currency undervaluation, could be the force that drives core inflation higher in emerging markets, causing asset prices to overheat. Taking this into consideration, the bottom line is that investors should remain exposed to emerging markets stocks with exposure to underlying currencies, because stimulus will produce either asset or currency inflation, or some combination of the two. Considering the historical relationship between emerging and developed markets' equity performance, as well as the potential for renewed global economic strength, the case for emerging markets is intact. However, investors should keep their eyes open for any acceleration in inflation in emerging markets as the first signs of trouble. Until that time, the risk of not being fully exposed to emerging markets is greater than the risk of being underinvested. ■

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