



# Emerging Markets – Five Thoughts for Ten Years

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## Executive Summary

Following successive years of record-breaking performance — the 53% decline in 2008 and the 79% rally in 2009<sup>1</sup> — the outlook for emerging markets remains at the forefront of many investors' minds. While short-term market predictions are difficult given the volatility of the last 18 months, we have identified positive structural developments in emerging markets that make it easier to map the asset class's long-term potential. The following five thoughts lay out our longer-term views on emerging markets, which we believe will be most important for returns and investment decisions in the new decade. We believe the secular period of outperformance for emerging market equities, which began in 2003, is far from over and that long-term investors should consider the asset class as a core strategic element of their portfolios. At the same time, we argue that the changing dynamics and nature of the asset class will require a new investment approach. We recommend considering more specialised and thematic strategies to capture the structural trends as a complement to broader global and regional approaches.

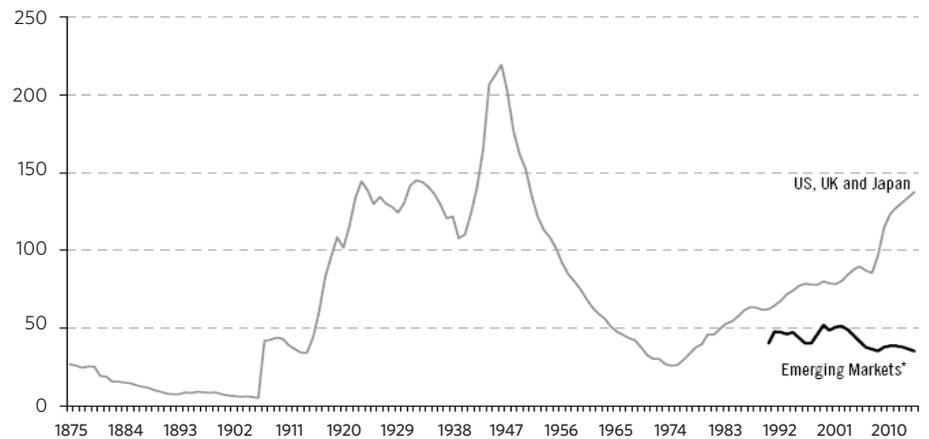
**Thought 1 - Emerging markets have shown resilience to downturns and an ability to drive global growth. We expect both characteristics to endure, adding new support to the decoupling theme.**

Over the last 18 months, emerging markets exhibited an economic resilience that had been absent in previous crises. Although both equities and bonds in the emerging markets universe fell very sharply in the initial global financial turmoil, they were among the first asset classes to rebound and have since recovered significantly. We believe this resulted from investors' belief that these countries' macroeconomic fundamentals remain, for the most part, relatively strong. Having been tested by historic storms during the past two decades, governments enacted the necessary policies that served them well in the crisis. These included liberating fixed-currency regimes, assuming fiscal responsibility, amassing reserves and reducing dependence on external capital. Strong demand for emerging country exports, boosted by buoyant commodity prices and deflationary moves in consumer goods, also helped. We believe that the emerging market financial sector is predominantly well capitalised, fully provisioned, and providing credit appropriately.

<sup>1</sup> As measured by the MSCI Emerging Markets Index.

Secondly, emerging markets have become the engine of world growth. Clearly this was true in 2009 and into 2010, and is likely to continue over the longer term. By contrast, the developed nations face the headwind of deleveraging, which will curtail their ability to reach the rates of GDP growth seen in the last decade. This needs to take place at a government, corporate and personal level and will be a painful, multi-year phenomenon.

**Figure 1: Gross Government Debt to GDP. US, UK and Japan versus Emerging Markets (%)**



\* Countries in the MSCI Emerging Markets Index. See index disclosures at back.  
Source: Citi, February 2010

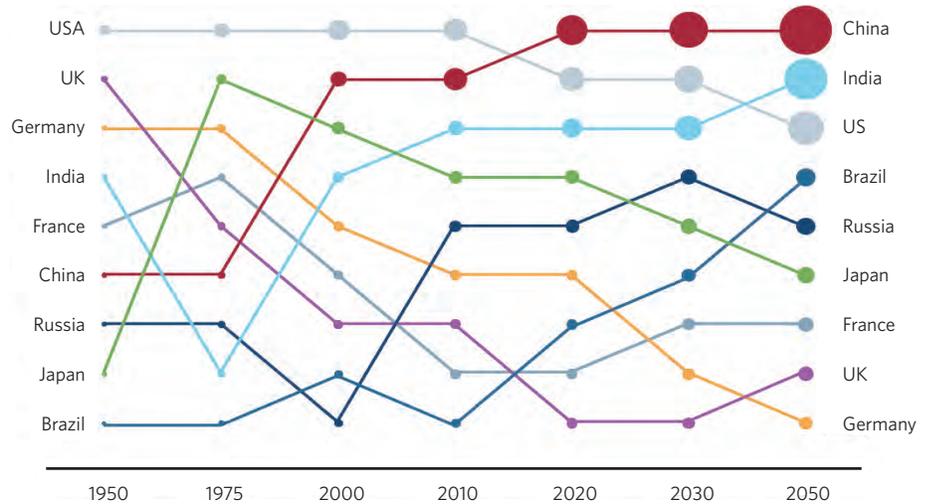
Whilst the global economy is becoming more integrated, we have already started to see renewed evidence of decoupling as emerging countries have established conditions for increasing wealth from domestic activity rather than a dependence on exports to the developed world.

Will the resilience of emerging markets in a crisis and the ability to drive global economic growth be enduring trends in the next business cycle? There are some market fundamentals that indicate the positive trends in emerging markets will hold going forward. Political risk in the emerging world has declined and stability in its major countries has advanced substantially. One significant improvement has been the taming of inflation. This single course of action has allowed businesses and individuals to plan and invest for the long term without fear of runaway inflation and has supported the growth of a sustainable domestic basis for economic growth in many emerging markets. Naturally this victory over inflation needs continued central bank and government vigilance to avoid a return to inflationary uncertainty.

Whilst the global economy is becoming more integrated, we have already started to see renewed evidence of decoupling as emerging countries have established conditions for increasing wealth from domestic activity rather than a dependence on exports to the developed world. As a result, the World Bank and PricewaterhouseCoopers project that China will overtake the US as the world's largest economy by 2020, and India will surpass the US before 2050.

The emerging market universe will change as wealth creation leads some emerging markets to graduate to developed status while some current frontier markets will move up into the emerging category.

### Developed and Emerging Market GDPs, 1950-2050



Source: Data from World Bank and "The World in 2050," PricewaterhouseCoopers 2008; Bank of America ML March 2010

**Thought 2 - The emerging market universe will change as wealth creation leads some emerging markets to graduate to developed status while some current frontier markets will move up into the emerging category. This will increase the opportunity set's breadth and scope and make for greater regional balance within the index among EMEA, Latin American and Asian countries.**

A common criticism of the emerging market asset class is that its constituents never advance beyond emerging status. While this might have been true before, now it is likely to change. There are a number of ways to define what is an emerging market depending on whether it is economies, stock or debt markets under consideration. The World Bank defines countries with gross national income per capita below US\$11,455 as emerging.

For equity investments, Blackfriars uses the MSCI Emerging Markets Index.<sup>2</sup> The most recent change to this benchmark was the graduation of Greece to developed market status in 2001, with Israel following this year. Conversely, Argentina, Jordan, Pakistan and Venezuela have been downgraded to "frontier" status. More significant for equity investors is the change in South Korea's status because it constitutes such a large share of the index. FTSE promoted this third largest market in the MSCI EM Index to developed status in September 2009; MSCI is considering a similar move in 2011. Taiwan, the fourth largest market, is also a serious contender for promotion, though its sovereignty status could remain an issue.

<sup>2</sup> Please see disclosures at back for index definitions.

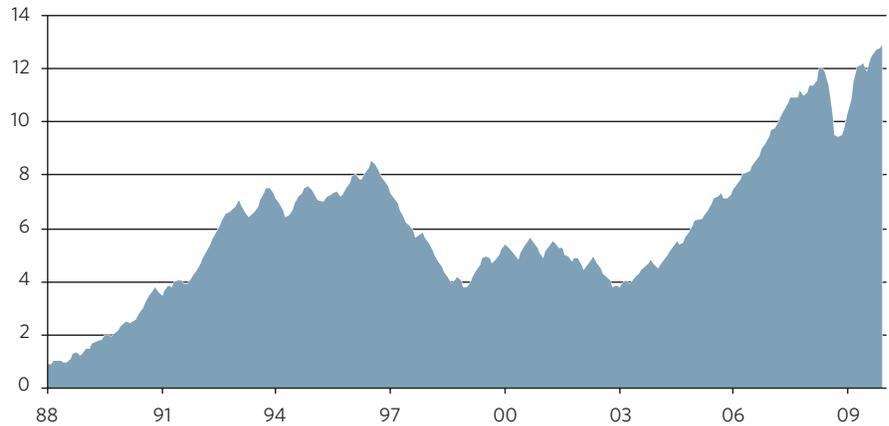
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The asset class as a whole provides a very broad range of exposure to countries at very different stages of their economic, political and development cycles.

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### Emerging Markets as a Percentage of MSCI ACWI



Source: ING, February 2010

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The corollary to markets exiting the emerging equity universe will be frontier markets moving up. The probable first candidates (Kuwait, Qatar and the United Arab Emirates), are located in the Gulf region, which has little representation in the current index. Although the net effect of these changes would be to reduce the universe's market capitalisation, the opportunity set for investors would increase in breadth and scope. Additionally the benchmark would become more balanced across the three regions: EMEA, Latin America and Asia, by reducing the dominance of the latter, currently at 55%.

The frontier markets today have characteristics that resemble emerging markets 15 to 20 years ago. An investor who held the asset class for the 22 years since the inception of the MSCI EM Index in December 1987 would have made an annualised capital return of 11% in US\$ terms, compared with a return on the MSCI World index of only 4.9% per annum.<sup>3</sup>

These trends will make for an evolving set of opportunities within the asset class. As an investment manager, we are developing our coverage of upcoming countries to encompass the available range of opportunities aimed as we seek to maximise performance.

**Thought 3 - While emerging market countries provide diversity to an investor, they are linked by a common set of attractive secular conditions that are likely to drive growth over the next decade.**

The asset class as a whole provides a very broad range of exposure to countries at very different stages of their economic, political and development cycles. This lack of homogeneity provides investors with the ability to gain exposure to a diversified asset class. Amid this diversity, there are attractive secular conditions in many of the countries:

#### Supportive demographics:

- A young, economically productive workforce
- High savings rates and modest personal debt
- Rapidly rising GNP per capita
- Urbanisation and consumption

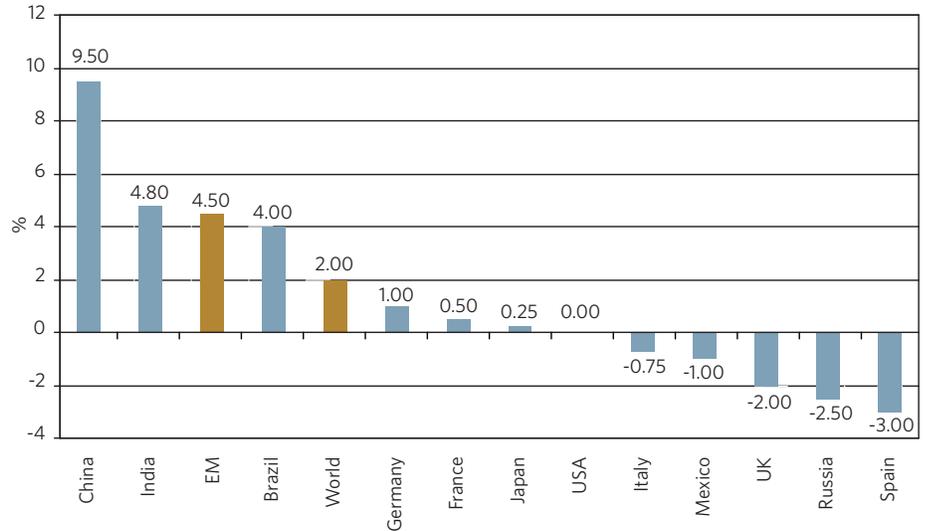
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<sup>3</sup> Source: MSCI, Bloomberg. Past performance should not be taken as an indication or guarantee of future performance. See index disclosures at back.

**Supportive economics:**

- Higher rates of economic growth
- Government investment in infrastructure and development
- Control of a substantial proportion of the world's natural resources
- Foreign reserves providing stability

**World Consumption, average growth 2009-2010**

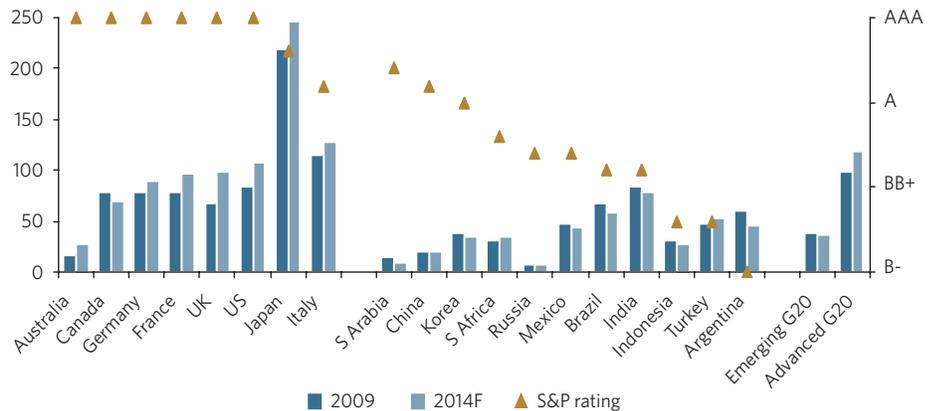


Source: Goldman Sachs

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**Government debt/GDP (% left-hand side) and S&P rating (right-hand side)**



Source: IMF Staff position note November 2009, Bloomberg

**Supportive business conditions:**

- Stable banking system, willing and able to extend credit
- Intermediation of individuals and small businesses into the financial system
- Increasing importance of globally competitive EM companies
- Ongoing corporate governance improvements
- Rising local consumerism to offset more cautious developed market consumers
- Underdeveloped and rapidly growing domestic consumption markets

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The expected stronger economic growth in emerging markets should allow companies operating in these countries to generate stronger sustainable normalised earnings growth over time which in turn would support higher investment returns and relative outperformance.

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**Supportive governments:**

- Democracy in ascendancy in many of the countries
- Communism removed in EMEA and adapting in China.

All of these factors support our belief that the secular period of outperformance for emerging market equities, which began in 2003, is far from over.

**Thought 4 - There is a wide range of attractive trends that will drive investment returns.**

Although the themes above are likely to support long-term economic development at a pace far exceeding that in the developed world, it is important to remember that there is not a direct short-term relationship between economic growth and stock market returns. For example, between 1996 and 2002 whilst China's GDP grew by over 7.5 percent annually, the Chinese stock market fell in all but one of those years. The relationship comes in the long term through higher economic growth translating into greater domestic wealth and a stronger financial system. This is the phenomenon that has underpinned investments in emerging markets for the last 10 years and is expected to continue for the next decade.

We believe capital markets in the emerging world will continue to develop through domestic wealth creation. At the end of 2002 emerging markets accounted for less than 4% of global equity market capitalisation.<sup>4</sup> This had risen more than three-fold to 13% by the end of 2009 through both stock market outperformance versus the developed countries and stock issuance, privatisations and IPOs. This capital raising is likely to continue as companies look to invest both domestically and internationally.

At the moment there is little to differentiate emerging from developed countries when looking at valuations and corporate profits growth forecasts for the next two years, as the recovery in developed world's earnings are bolstered by the recovery in the financial sector. Beyond this horizon, however, the expected stronger economic growth in emerging markets should allow companies operating in these countries to generate stronger sustainable normalised earnings growth over time which in turn would support higher investment returns and relative outperformance.

Over the next few years, we expect a number of attractive areas to be recognized by investors. These have the potential to create investment opportunities to capture the sustainable demographic and economic developments within the emerging markets universe that are likely to both drive and support their longer-term growth.

**Attractive categories span a range of sectors including:**

- Infrastructure
- Consumption
- Agriculture & water
- Resources
- Energy, both carbon and sustainable
- Technology
- Global leaders

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<sup>4</sup> As measured by the MSCI All-Country World Index (ACWI).

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There are various ways to tailor emerging market exposures to suit an investor's needs but sound fundamental analysis is key to capturing the evolving opportunities in this highly diverse asset class.

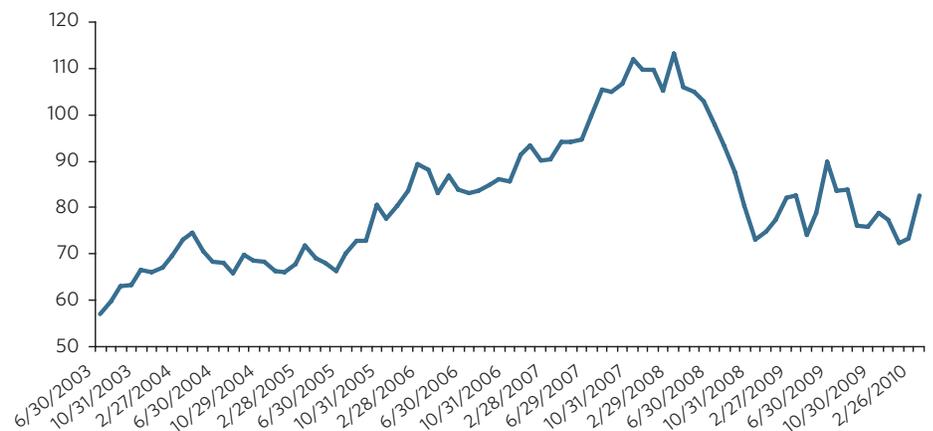
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Companies in a wide range of sectors across the emerging market universe may benefit from positive trends in these categories. We believe attractive sectors will include: resources and capital goods stocks supported by the demands of infrastructure investments and recovery in global demand; consumer stocks, including retailers, mobile phone and technology companies capitalising on the consumption trend; and strategic demand for raw material companies arising from the finite supply and growing demand for natural resources from base metals through energy to food and water. Finally, banks will be able to capitalise on the growth in financial intermediation as credit is extended to individuals and companies and demand for financial services opens up to a broader population.

Indeed, as emerging market economies, stock markets and financial systems have generally exhibited greater robustness than in the developed world, there is an argument that these markets should trade at a valuation premium to the developed world. The higher rates of return on equity would also be an argument for a premium valuation.

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**Return Adjusted price to book MSCI Emerging Markets versus MSCI World**



Source: Factset, February 2010

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**Thought 5 - There are various ways to tailor emerging market exposures to suit an investor's needs but sound fundamental analysis is key to capturing the evolving opportunities in this highly diverse asset class.**

Given the different stages of development for each of these countries and the varying domestic and external forces, we think it is important for investment managers to use both a top-down and bottom-up process. This provides the opportunity for investors to capture alpha in their portfolios by making the correct country allocation decisions, whilst also seeking to generate value from selecting the companies best positioned to profit from these varying themes and trends.

Our belief is that fundamental analysis must form the core of the decision-making process for both country allocation and stock selection. Although historically value has been the primary structural driver of investment returns in emerging markets, there will be times when growth will dominate, and it is important to have the flexibility to respond to these changing drivers as conditions dictate.

There are many ways to capture the significant opportunities available through the asset class. For investors looking for diversified exposure, an active global emerging markets approach can make sense, while those looking for a similar investment approach but with higher potential return/risk profile can adopt a more concentrated strategy.

Investors looking for a more focused approach may wish to invest selectively in specific regions or countries to capture a particular investment trend or gain exposure to the dynamics of a geographically-linked group of markets. This will include the current new group of frontier markets that are opening up for outside investors.

Finally, there is the option to invest in the various broad-based sectors to capture the general trends we have identified as central to the potential success of emerging markets over the coming decade.

In conclusion, we believe that the long-term prospects for those countries outside the developed world are very positive, and that there will be an increasingly broad range of ways for investors to gain exposure to the attractive trends that are developing and will continue to build over the coming years.

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#### **Hugh Hunter, CFA**

Hugh Hunter, CFA, is Chief Executive of Blackfriars Asset Management, based in London. Until December 2009 he was also Head of Emerging Markets responsible for a team of 14 investment professionals providing investment expertise in global and regional emerging market equity and bond assets. Hugh joined Blackfriars (formerly WestLB Mellon Asset Management) in 1998 as a Global Emerging Markets Asset Manager and was appointed CIO and Head of Global Emerging Markets in 2004. He has been directly involved in Emerging Markets investments since 1991.

Hugh has been a CFA Charterholder since 1993 and graduated from Plymouth Polytechnic in 1981 with a degree in business studies.

## Index Disclosure

The **MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of June 2009 the **MSCI Emerging Markets Index** consisted of the following 22 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey. The **MSCI World Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. As of June 2007 the **MSCI World Index** consisted of the following 23 developed market country indices: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States. The **MSCI ACWI (All Country World Index) Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. As of June 2009 the **MSCI ACWI** consisted of 45 country indices comprising 23 developed and 22 emerging market country indices.

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