



## Emerging Markets, Post Crisis: New Perspectives on an Old Story

It has been an amazing 12 months for the emerging markets since they touched their recent lows in October 2008. For 2009 through Oct. 15, the MSCI Emerging Markets Index<sup>1</sup> is up 55%. With the panic and volatility of the financial markets upheaval apparently now in the rearview mirror, *Market Insights* turned to BNY Mellon Asset Management professionals for perspective. Contributors include Hugh Hunter of Blackfriars Asset Management, and Warren Skillman and Carolyn Kedersha of The Boston Company Asset Management. The following are questions posed to our contributors, followed by their assessments.

**Q. With the strong run up in emerging market equities, has the market gotten ahead of itself?**

The rally has been driven by the return of risk appetite favoring emerging markets, alongside the global coordinated stimulus response and inventory rebuilding, and the aggressive domestic stimulus by the Chinese government. However, at some point the longer-term performance of emerging markets must be fed by growth in developed economies, which are still deleveraging. We still don't know when growth will resume in developed economies, or how sharp it will be. The equity markets are generally pricing in a strong "V" shaped recovery but it is difficult to believe that the experience of the last 12 months will not leave some lasting effects.

Despite the run up, emerging markets currently trade at valuations of around twice the price-to-book ratios — on a historical basis, these are average valuations. The next stage of the recovery would be for the earnings per share figures to increase. This is already starting in certain sectors but we are early in the recovery cycle, so it makes valuations based on future earnings difficult to estimate with confidence. There was a period during the last recession when emerging market stocks moved higher anticipating a recovery, and it may be that the current rally has been somewhat overdone, requiring some sort of short term consolidation, or a 10% setback.



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<sup>1</sup> See index disclosure on last page.

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India, for example, had a strong rally after the recent positive election result and we believe growth will likely continue at 6% -7% per year for the foreseeable future with enormous long-term requirements for investment in infrastructure.

**Q. How has this crisis been different from prior downturns for emerging markets? How has it been similar?**

Each time there has been an emerging market equity crash, the magnitude of the swings has been reduced. In fact, prior to the start of the decline in June 2008, the volatility of emerging market equities was converging to that seen in developed markets. While emerging markets had a severe downturn in 2007 and 2008, they certainly haven't "blown up" to the extent they could have, and five years ago, you would have expected a much more severe response to the global crash. On the other hand, emerging markets still have a higher beta than developed markets. They underperformed on the way down in 2008 and have outperformed on the way up in 2009.<sup>2</sup> This indicates that while investors are gradually accepting the fact that emerging markets have fundamentally improved, old habits die hard — they still tend to pile in on the way up and on the way down.

The aftermath of the crash has drawn into sharp focus just how far the emerging markets have come compared to the developed world. If you had only the data and no preconceptions, the developed countries today would have the risky image that emerging markets had in the past. In contrast, many emerging markets would seem to be the epitome of prudence and sound economic management. It does not appear to be broadly understood that the stimulus provided by emerging markets has been a major factor in reducing the likelihood of another depression.

Emerging markets stimulus has come from savings, unlike the debt-induced measures that developed countries have been forced to adopt. Emerging markets are arguably at the cusp of a credit-growth induced expansion of their economies, instead of facing a credit cataclysm, as in developed market economies. Emerging country stock markets are also undercapitalized relative to developed markets, with 80% of the world population, 75% of the land mass and 50% of GDP, but only 12% of market capitalization.<sup>3</sup> Yet as recently as 2002, the perception that emerging markets were riskier than developed markets had some truth in reality.

**Q. Can emerging markets still be considered a "commodities play"?**

As the holders of the majority of the world's natural resources, emerging markets should benefit from shortages that lead to higher prices and significant foreign direct investment in such resources (e.g., China), but at the cost of a diminishing national control over them.

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<sup>2</sup> Based on a comparison of The MSCI World Index versus the MSCI Emerging Markets Index.

<sup>3</sup> IMF, Morgan Stanley Research. Estimates from Morgan Stanley Global Economics Team.

Conversely, the cost of extracting these resources, both financially and environmentally, is likely to increase. Addressing climate change will be expensive — prohibitively so in some cases, and may reduce the medium term growth potential of countries with significant manufacturing capacity as cleaner technology is forced upon them.

Brazil is typical of most emerging economies that have been dependent on commodities exports. For example, Brazil is a key supplier of high quality iron ore to China. The country is also typical in having a stock market still dominated by a small number of stocks. Actually, in Brazil's case, the market is dominated by two: Petrobras and Vale, which are both commodity stocks. The country has made efforts to diversify away from the commodity concentration by moving "up the value chain," with companies such as aircraft manufacturer Embraer. The country is also a standard bearer for the structural reforms in public policy and management that have transformed emerging market economies more widely. Further, Brazil is an archetype in having attractive demographics with a young and educated population, an orthodox central bank, and banking systems largely unscathed by the financial crisis.

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**Q. What role are the bigger emerging markets going to play in the world's economic development?**

The relationship between emerging markets and the developed world is also becoming more like one between equals, a theme encapsulated by the BRIC concept (Brazil, Russia, India and China) widely publicized by Jim O'Neill and his colleagues at Goldman Sachs. They argue that the BRIC group has the potential to be among the world's largest economies by 2050, driven by underlying factors such as population size, demographics, and increasing urbanization, with the creation of a sizable and rapidly increasing middle class. Quite apart from the old superpower rivalries that Russia may still hanker for in the political arena, emerging countries such as China are also flexing their economic muscle. While there remains pressure from the U.S. for a devaluation of the Chinese currency, the RMB, it is clear that the Chinese authorities will only let this happen when it suits them, not the U.S. The relationship between the U.S. and China remains centered around mutual trade and capital flows and is currently roughly balanced. The RMB could appreciate to some extent without a material impact on export competitiveness, but other regional exporters would take advantage of the improvement in their competitive positioning.

**Q. Emerging market small-cap stocks fell further during the crisis, but have since rebounded more sharply, compared with emerging market stocks in general.<sup>4</sup> What kind of growth potential do emerging market small caps have?**

Emerging market economies in general have greater GDP growth rates than the developed world, which is one of the main drivers for small caps. However, to this one should add two additional potential catalysts for growth. We believe emerging market small caps are well positioned to capture the growth in domestic demand that is being fueled and nurtured by various government stimulus packages.

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<sup>4</sup> Based on a comparison of The MSCI Emerging Markets Index versus the MSCI Global Small Cap Index - Emerging Markets.

As local governments try to position their economies to be less reliant of exports for growth, they are actively spending on social welfare and retirement programs to encourage their citizens to spend more and save less. Secondly, small cap companies, by their entrepreneurial nature, appear to be well positioned to grow by taking market share. Further, emerging small caps generally didn't have exposure to sub-prime or asset backed derivatives. What the emerging small cap sector does have is a more concentrated exposure to domestic demand. In a world characterized by resuscitation and repair in the developed markets, companies that benefit from local stimulus that is aimed at developing domestic demand should be better positioned to succeed.

**Q. How much riskier are small company emerging market stocks than larger companies? Is liquidity a concern?**

Volatility is higher for small cap stocks. However, the potential for higher risk-adjusted returns is present as well. Liquidity can be a concern at times and it is important that investors be able to monitor the liquidity of their stocks. Also, corporate governance can at times be a concern as occasionally management and prior owners have little experience in appropriate behavior for a public company.

**Q. How do small companies in emerging markets compare in terms of accounting, reporting and transparency issues?**

Emerging market small cap companies generally follow the same level of accounting and reporting that is followed by their larger cap peers in their home markets, but it is more likely that such firms may be owned within a larger holding structure that may or may not be public. As a result, in the small cap environment there is often less transparency at the holding level. One should pay more attention to what is going on at the holding level to better understand the requirements that may be imposed on the listed subsidiary. There are also some differences between larger companies and their smaller counterparts in terms of frequency of communication to the market. Still, most companies are diligent in communicating material events.

**Q. What kind of special expertise is needed to invest in these emerging markets small caps?**

Coverage by analysts tends to be smaller — as few as four analysts on a given small cap stock. In contrast, a large cap stock might be followed by 12 or more. The reduced coverage may mean some promising stocks may be overlooked. However, with opportunity comes the requirement for more due diligence on the part of the investor. Balance sheet strength and business dynamics must be understood and tracked more closely, as often these companies have fewer external resources to mitigate exogenous events than do larger cap companies.

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Small cap companies tend to target certain niches or specialize in developing new markets. In addition to understanding the dynamics surrounding different industries and countries, the investor in emerging small cap must be able to evaluate whether the niche or new product can be a profitable opportunity. Often this analysis takes place without the benefit of much historical data.

**Q. How have corporate governance and accounting issues changed in emerging markets?**

While these issues merit serious scrutiny even in developed countries, it is in emerging markets where most concerns have been raised. In general, corporate governance in emerging countries has improved immeasurably during the last 15 years. At the beginning of the period, the situation was both deplorable and fantastic: companies did not know what they could say, so they withheld information they should have provided, or else disclosed things they could have kept hidden. Figures produced in emerging markets therefore often still have an element of doubt attached to their veracity.

**Q. From an investing perspective, are the emerging markets appropriate for top-down, country allocation styles, or for bottom-up, company evaluation?**

Conceptually, we believe both approaches are equally valid. As with everything else in the investment world, it all depends on the foundation of management expertise and execution. For the bottom-up “stock pickers,” attractive opportunities can be found in a wide variety of countries — no one region or country has a monopoly on companies with good business prospects, transparent accounting, and sound governance. Post crisis, more companies are being judged on their underlying fundamentals and business model, and on their ability to finance their business opportunities with internally-generated cash flow, with high degree of credit quality. This kind of fundamental, “back to basics” perspective is now more important than leverage and momentum, which often dominated company analysis in the pre-crash environment.

At the same time, emerging market stocks tend to have much higher correlations with their country indices than is now the case in the developed world, and the countries themselves are at different stages of their economic, political and development cycle.

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This opens the door for managers with expertise in a top-down style. The classifications by the Morgan Stanley indices<sup>5</sup> offer some insight into the dynamics in this kind of strategy. For example, in May 2009, Argentina was “downgraded” from the MSCI Emerging Markets Index to the MSCI Frontier Market Index.<sup>6</sup> Countries can be “upgraded” as well. For example, MSCI has indicated that Israel will graduate from the Frontier Markets index next year — its GNP per capita is well above the World Bank threshold. However, its market practices are not consistent with those in other developed countries. Korea and Taiwan are close to the threshold but also have capital control and market conformity issues and graduation may be delayed for several years.

**Q. What is the appropriate asset allocation to emerging markets?**

Having risen from 4% of the MSCI All Country World Index<sup>7</sup> in 2002 to 12% at the end of July 2009, emerging markets have increased their importance in the world's financial universe three-fold. This trend may continue as the sounder economic base can allow for higher growth and financial penetration going forward. The asset class is now too big not to have a substantial core weighting in a global equity portfolio. We believe an overweight relative position can also be justified, given the challenges developed economies face in the deleveraging process, which will take a number of years.

Ultimately, any weighting should be based on the client's tolerance for perceived risks and returns, as well as the overall objectives. Emerging markets do however, appear to offer an attractive risk/return prospect, especially as part of a diversified portfolio. But perhaps investors need to remove their preconceptions and take a hard look at realities before deciding on their allocations. The changing perceptions of emerging market risk have not yet converged with the changed reality, and this theme is one that will influence attitudes and strategies for investment in emerging market equities for some years to come.

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<sup>5</sup> See index disclosure on last page.

<sup>6</sup> The MSCI Frontier Market Index also includes: Bahrain, Bulgaria, Croatia, Estonia, Jordan, Kenya, Kuwait, Lebanon, Lithuania, Kazakhstan, Mauritius, Nigeria, Oman, Pakistan, Qatar, Romania, Serbia, Slovenia, Sri Lanka, Tunisia, Trinidad & Tobago, Ukraine, United Arab Emirates, and Vietnam.

<sup>7</sup> See index disclosure on last page.

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### Index Disclosure

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