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Tips for shopping in emerging markets



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With concerns over the debt overhang in many developed countries and the drag on the economy that this will create for years to come, many are looking to the growth engine of emerging markets to turbo-boost portfolio returns.

The arguments in favour of investing in emerging markets are well known and persuasive. Consider the following statistics:

- Emerging market countries make up two thirds of the world's population.
- There are 160 cities in China with populations that exceed 1 million. In the US there are only nine and in the UK just two.
- 700,000 engineers graduate annually from schools in China.
- In 2008, 650 million mobile phones were in circulation in China.
- 80% of the world's toys are made in one of over 10,000 Chinese toy factories.
- Despite making up most of the world's populations and producing a significant proportion of the world's output, emerging market countries only make up 14% of the world's share markets.

These massive populations are being industrialised at a rapid rate, resulting in fast growing economies and the potential for astute investors to make a fortune. However, there are also significant dangers when investing in emerging markets. The recent turmoil in Egypt provides a timely reminder.

MLC pioneered investing in emerging markets in 1994 before it was fashionable, so have experienced some of the pitfalls and benefits. And just as well-travelled tourists can offer valuable advice for shopping in the bazaars and malls of developing countries, we can share some tips based on these 16 years of experience.

1. Know what you're buying

There is no universal policy that determines whether a country is classified as 'emerging' or 'developed'. The more common classifications have been developed by major index providers (such as MSCI, S&P and FTSE) for the purposes of constructing their indices. Factors taken into account include GDP per capita, stock market capitalisation and turnover, sovereign debt rating and restrictions on foreign ownership.

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Exhibits A and B illustrate the 21 countries deemed by MSCI as 'emerging' in their index, together with their approximate weights.

About 80% of the emerging markets index is concentrated in seven countries: China, Brazil, South Korea, Taiwan, India, South Africa and Russia.

In terms of sector exposure, the largest companies are weighted towards IT (e.g. Samsung), Energy (Petrobras and Gazprom) and a number of Financials. Clearly each of these sectors is reliant on the fortunes of developed countries to varying degrees.

Interestingly, few countries have "graduated" and moved from the emerging to developed market index (Israel and Portugal are rare examples). There are more instances of countries being downgraded from emerging to "frontier" status (eg Argentina, which had income per capita above Norway and Sweden in the early 1900s). This highlights the risk of assuming a country will rapidly emerge and underestimates the possibility that economic growth could go backwards. It also highlights the subjective nature of what constitutes an 'emerging', 'frontier' or developed country.

It is also important to look at the portfolio as a whole and understand the different exposures to emerging markets. For example, in addition to global shares, MLC clients potentially would have exposure to emerging markets through Private Equity, Global Listed Property and Diversified Debt strategies.

Exhibit A: Approximate EM Country Weights

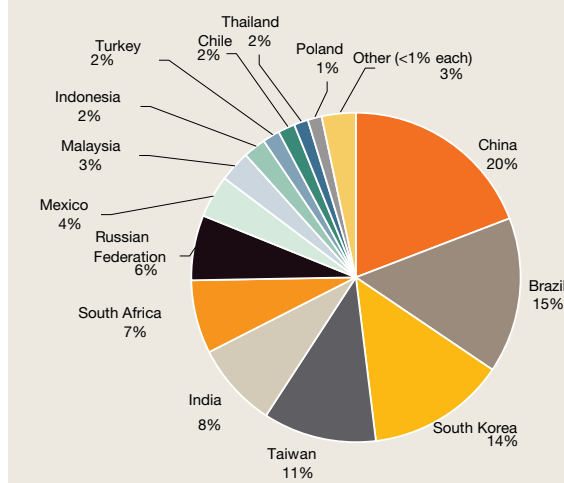


Exhibit B: MSCI Defined EM Countries

- Brazil
- Chile
- China
- Columbia
- Czech Republic
- Egypt
- Hungary
- India
- Indonesia
- Malaysia
- Mexico
- Morocco
- Peru
- Philippines
- Poland
- Russia
- South Africa
- South Korea
- Taiwan
- Thailand
- Turkey

Having a firm understanding of what you are investing in is a good first step when researching emerging markets.

2. Location, location, location

Another important aspect to appreciate is that the emerging markets index is based on where companies are located (ie domiciled or listed) rather than where a company derives its earnings.

For example, a retailer who is domiciled in the US and derives all of the company's revenue in South America is classified as a developed company. On the other hand, a company based in an emerging economy that is more dependent on the fortunes of the developed world (Samsung is an example), is still counted as an emerging stock.

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Exhibit C shows the relative performance of a basket of emerging market focused stocks (yet US-listed) versus the US share market. This return profile is not dissimilar to the outperformance of emerging markets stocks compared to developed.

The point is that the distinction between emerging and developed markets is set arbitrarily and not on where revenues are derived. We believe this arbitrary classification policy has ramifications for how to invest in emerging markets, something we touch on later.

3. It's the price you pay that counts

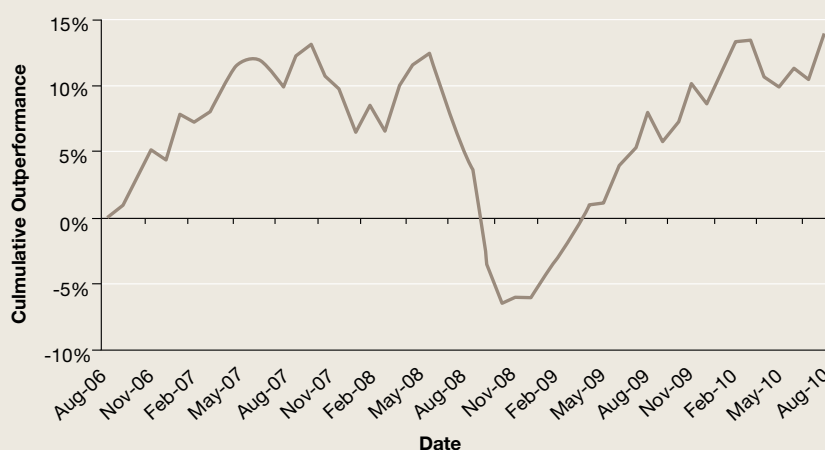
One commonly held misconception is the link between economic growth and share market returns.

When people talk about the 'emerging market story' they often are referring to the high economic growth of emerging countries such as China or India rather than the share market.

There are three main reasons why a strongly performing economy does not necessarily flow through to share market returns.

Firstly, and most importantly, share markets are forward looking. This means that if everyone believes the growth prospects for emerging markets are strong, share valuations already price this in. If future economic growth does not meet these lofty expectations, equity markets will probably disappoint. In essence, share market returns depend on the price you pay.

Exhibit C
Relative Performance of EM-focused US stocks vs US stocks



Source: Bloomberg

Secondly, even if economies and company revenues are expanding, some industries have had, at least historically, difficulty translating this into profits. Two examples are IT (which has gone sideways as an industry over the last decade) and airlines, which have significant capital expenditure requirements. (A widely circulated joke is that the only way to become a millionaire from the airline industry is to be a former billionaire.) If a country has a significant weighting to these industries, it creates a headwind for investors.

Finally, the share market may not be a good reflection of the underlying economy. As described, the indices are created based on domicile rather than earnings, and listed companies could derive their revenues from developed nations. Another common feature of emerging markets is that many entities are controlled by the state or privately held. If these entities benefit more than publicly available companies, the share market may perform very differently to the wider economy.

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There have been numerous studies looking into the link between economic growth and share market performance. Some recent analysis compiled by Arrowstreet Capital is shown in Exhibit D. It highlights the correlation of real stock returns with GDP growth in three MSCI universes and over three time horizons. The three MSCI universes are global all-countries, emerging markets, and developed.

The graph suggests there is no clear correlation between stock market returns and economic growth (irrespective of region, or time periods over 1, 5 or 10 years).

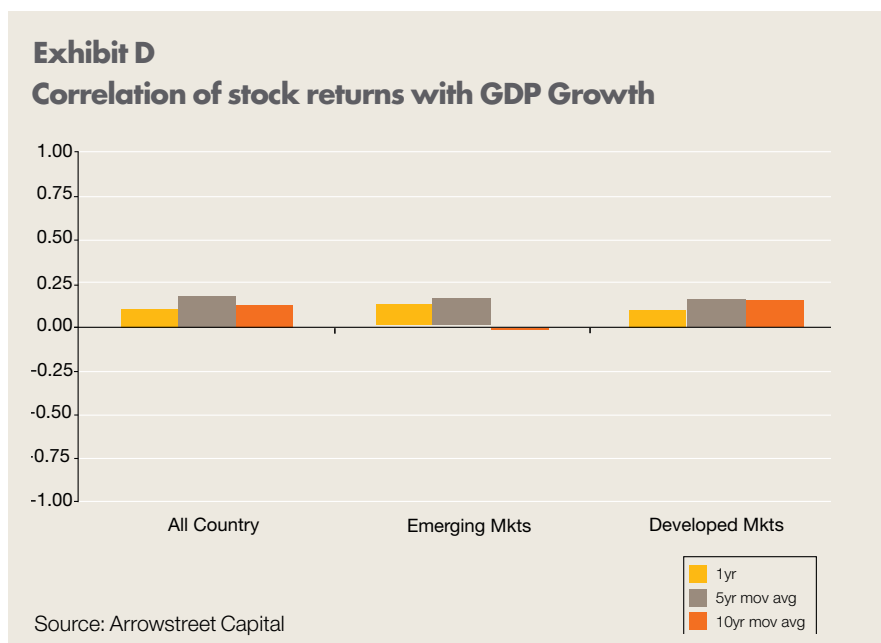
Many other studies arrive at a similar conclusion. It is therefore a very dangerous strategy to simply invest in the country or region that has the highest economic growth and expect to generate the highest stock market return.

4. Do not restrict managers through artificial borders

As described above, the distinction between emerging and developed markets is subjectively determined by index providers that create "artificial" borders essentially based on where each company is listed.

A common industry approach in putting together a global equities portfolio is to split global mandates along similar lines. That is, the portfolio comprises managers who are restricted to:

- companies in developed markets only
- emerging market stocks only



Our view is that constraining and restricting managers in this fashion will end up costing investors. It doesn't make any sense to restrict a manager from purchasing a stock that they like simply because it is excluded by an index provider.

In an increasingly global investment world, fund managers need to take into account competition from other firms, irrespective of where they are located. It is difficult for a research analyst to form a view on a US car-manufacturer without factoring in the impact of Asian car makers. Therefore, we have found that the more capable global managers want the flexibility to invest across the widest opportunity set, which includes emerging markets.

Another benefit of not restricting managers is that the overall allocation to emerging markets is determined by the underlying managers. And if the managers are focussed on finding the best companies globally the allocation is determined bottom-up instead of top-down.

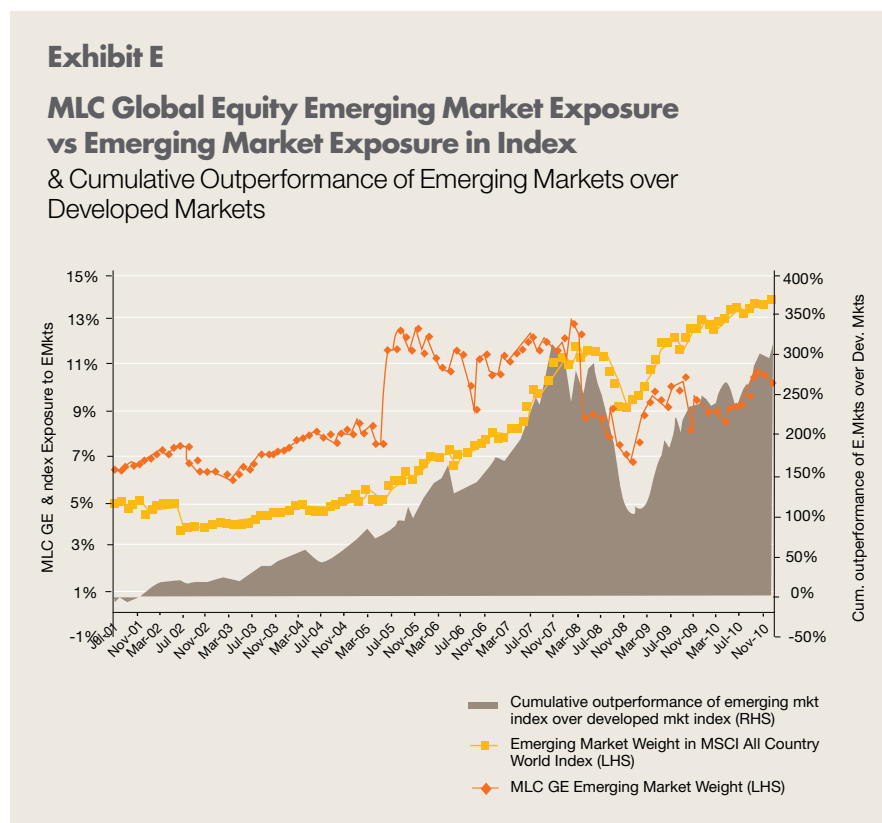
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This approach has really benefited our clients for a number of years. Exhibit E shows MLC's exposure to emerging markets stocks (orange line) compared to the exposure to emerging markets within the broader MSCI global index—ie where the orange line is above the yellow, MLC's portfolio had an overweight position to emerging markets. The shaded area in blue represents the cumulative outperformance of emerging markets to developed markets over this same period.

You can see that, in aggregate, our managers invested more in emerging markets up until October 2007. This covered a period of significant outperformance. From that point, our managers had an underweight position which coincided with a period of underperformance. Clearly, the timing of this contributed significantly to returns.

While we wouldn't expect our managers to get this timing as perfect in the future, we are of the firm belief that they are in a much better position to assess the risks and opportunities and determine the allocation based on their analysis of individual companies.

Furthermore, while a truly global approach makes sense from a bottom up perspective, there are a couple of other angles worth considering. Firstly, it may be possible to identify specialist EM managers whose greater focus creates strong alpha potential. Secondly, from a top down perspective, it is a sector with clearly distinctive investment characteristics—it is often seen by investors as a proxy for risk (it sold off more than developed markets in 2008 despite the different fundamentals), is subject to investor sentiment capital flows, has potential speculative



bubble risk etc. This means there is an argument that can be made for considering a separate exposure that can be adjusted actively using a Strategic Overlay approach.

5. You can't set and forget

Perhaps more than any other asset class, we believe it is paramount to be active in terms of how much you allocate to emerging markets and in which stocks you select. Especially compared to other equity markets, emerging markets are relatively inefficient. There are fewer investors and research coverage, companies can be tightly held and markets are subject to more wild swings based on sentiment.

There are also more risks. Currencies are more volatile, political risk is greater and corporate governance is typically not up to the same standard as developed countries. Further, it is often more difficult and expensive to trade. Managers with a strong research capability are therefore in a much better position to assess these risks.

Emerging markets may well prove to be the key driver of global growth in the next few decades, creating significant opportunities for investors. However, it is not without risks for novice 'shoppers'. While there is much you need to consider when investing in emerging markets, we believe the tips outlined above, based on experience, are a good guide to start harnessing these opportunities.



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