

EMERGING OPPORTUNITIES

“the next ‘bull-market’ rally in developing-nation equities has begun...”

Mark Mobius, Executive Chairman, Templeton Asset Management, March 2009

Until the summer of 2008, global emerging markets (GEM) had enjoyed a six-year period of relative outperformance, as investors recognised their superior growth prospects and improving risk profile. However, this came to an end when the global financial crisis worsened and there was a general flight out of riskier assets. GEM equities were one of the worst performing asset classes in 2008: the MSCI Emerging Markets index was down by 53%.

Emerging markets became a casualty of the US banking and housing crisis even though their direct exposure to the financial turmoil was limited. So why did emerging markets suffer?

- Investors became hugely risk averse so sold their GEM positions on a huge scale.
- Concern grew that the economic recession in the West would spread worldwide.
- The Asia region in particular was already suffering from higher inflation due to spikes in energy and food prices.
- A subsequent collapse in commodity prices hurt Brazil and Russia.

Some investors argued that the spread of economic weakness has proved the ‘economic

decoupling’ theory to be wrong. Interestingly, a recent survey of fund managers carried out by S&P Fund Services found support for the decoupling theory: they argue that while the essence of decoupling theory lies in diverging fundamentals between developed and emerging economies, the correlation between stock market moves and macroeconomic trends is low in the short term.

So with all this in mind, what are the prospects for the asset class? Is the prognosis really weak and are investors about to give up on GEMs? Or does the current environment represent an excellent buying opportunity for a long-term investor?

What are emerging markets?

GEMs encompass the economies defined to

be in the developing world. They are a diverse group of fast-growing and sometimes volatile economies and markets. Below is a summary of the 22 markets that are in the MSCI Emerging Markets index.

What is driving emerging markets?

Two important trends will drive forward emerging market economies for years to come.

The first is infrastructure. The investment we have seen in building roads, railways, power plants, schools and hospitals in recent years is only the tip of the iceberg. China is, of course, leading the way in this regard, but the infrastructure spending boom has further to go (China only spends 9% of GDP on infrastructure). In India, which only invests 4% of GDP on infrastructure, the requirement is arguably more demanding. In Mumbai for example, one million people a day commute to the city, where more than 10,000 kilometres of track is set to be laid down in the next few years.

The second trend, clearly linked to infrastructure, is demographics. It is a fact that around 90% of the world’s population lives in emerging markets. What is more, studies show that populations in emerging economies will grow by around one billion people between 2009 and 2050, while



“China’s stock market may surpass the US as the world’s largest by value in three years.”

Mark Mobius, July 2009

developed economies will suffer a net loss of 100 million people. The rapid growth in these economies means companies around the world will have to shift their focus, at least to some degree, away from US consumption and towards consumer demand in markets where the growth potential is greater.

That growth is coming from urbanisation; we are seeing strong evidence of this in China and India, where new cities are springing up and existing cities are becoming overcrowded. The UN estimates that 17 of the largest 20 cities in the world will be in emerging markets by 2017; that means one million people per week moving from rural to urban locations. This trend towards urbanisation will take decades and

means structural growth in demand for housing, mobile telephones, power utilities and consumer goods, and indirectly commodities.

Transparency, political stability and commitment to free markets

Political and economic turmoil has been a feature of life in GEM investment. In the 1990s we had Mexico’s Tequila crisis in 1995, Russian default in 1997, and the Asian economic crisis in 1998. However, emerging markets have gone through a substantial evolution since the crises of the 80s and 90s, and have learned their lessons, both politically and financially. Political stability has brought with it improved economic policies, creating much more stable markets and

financial systems, with lower debt levels. Many emerging countries have benefited from high commodity prices, and used the proceeds to strengthen domestic finances. Whereas only 5% of emerging market countries were rated investment grade in the early 1990s, today just over 50% of the market value of the main benchmark (MSCI Emerging Markets Index) is investment grade.

There are a number of examples of GEM countries where the political and business environment has improved. China is a good example; although still run by the communist regime and restrictive relative to western markets, the stock market has gradually opened up to investors and the business environment is more

Emerging Asia	Latin America	Eastern Europe, Middle East & Africa (known as EMEA)
China	Brazil	Czech Republic
India	Chile	Egypt
Indonesia	Colombia	Hungary
Korea	Mexico	Israel
Malaysia	Peru	Morocco
Philippines		Poland
Taiwan		Russia
Thailand		South Africa
		Turkey

Source: MSCI Barra, June 2009



accommodating to foreign corporate investors. Meanwhile, across the Taiwan Strait, a new government there has heralded a thaw in relations with its neighbour. We have seen a resumption of direct flights between Taipei and Chinese cities, and a series of steps towards normal business relations.

The results of Indian elections in 2009 also offer a huge opportunity. A strong mandate for reform was given to the incumbent prime minister Manmohan Singh and there are high expectations that the government will make the changes needed to transform this bureaucratic giant. And in Indonesia, forthcoming elections have, so far, resulted in very little press coverage in the West. This is a good sign; elections here are traditionally tumultuous and often violent affairs; perhaps this country is maturing politically.

Understanding the risks

By the very nature of emerging markets, risks will remain. It is important to understand these, so that investors can

balance the potential return with the likelihood of market volatility.

A good example is, still, political risk. Although it has improved, as we've just seen, there will still be problems: take Argentina for example. Once an economic force comparable with Australia and New Zealand, financial difficulties led the government to intervene in the economy, with disastrous consequences. After defaulting on its government debt and devaluing its currency, Argentina became a financial pariah. More recently, Thailand has been in the news this year with another coup d'état.

Protectionism is another potential hazard facing investors in the future. As emerging economies become wealthier and grow faster, they come onto the radar screens of predatory Western companies looking to acquire faster-growing companies to please their shareholders. A recent example of this is China, where the authorities understand the potential value in their corporate sector and are extremely reluctant to allow assets to be acquired by overseas investors

before they are able to realise their full value. China was unwilling to allow juice maker Huiyuan Juice to be bought out by Coca-Cola.

The potential impact of wide-scale protectionism would be shrinking world trade and a severe slowdown in the path to globalisation. In the long run, this would also stunt the growth of the very economies in which protectionism is most prevalent.

Lastly, investors in emerging market stocks are exposed to 'inefficiencies', a politically correct term. Richard Titherington, chief investment officer and head of emerging markets at JPMorgan Asset Management, describes it more eloquently as "lying, cheating and stealing". Corporate governance in emerging markets is still an issue; while some are embracing open and honest business practices to encourage overseas investors, others remain stuck in their ways.

Representing an opportunity

The emergence of GEMs makes it all the more apparent that the area is significantly

Emerging market facts

- Emerging markets account for around 36% of the global economy in terms of gross domestic product (GDP) and they are forecast to continue as drivers of global growth in the aftermath of the current developed market crisis.
- China contributes the most to global economic growth, with Russia, Brazil and India among the top eight.
- Populations in emerging markets are expected to grow five times faster than in developed countries.
- By 2030, more than one billion people in emerging markets are forecast to join the consumer middle class of spenders.
- Emerging markets hold 75% of the world's total foreign exchange reserves.
- Emerging markets are home to more than 90% of oil and gas reserves, 70% of coal reserves and 60% of copper, nickel, iron ore and bauxite reserves.
- Over the past ten years, the MSCI Emerging Markets Index has massively outperformed its developed market equivalent.
- Emerging markets are more risky, are they not? Over the past ten years, a blended portfolio of emerging markets and developed markets exposure would have demonstrated a similar level of volatility, but providing far better returns than a pure developed markets portfolio.
- Despite all this, emerging markets have just 11% of world equity market capitalisation. But this is growing.

under-represented in global benchmarks; not just in terms of natural resources, population and financial wealth, but in its current and potential contribution to world economic growth, particularly given the slowdown in the developed world. During the early-to-mid 1990s, emerging economies contributed only 3-4% of world growth, but fast forward 12-15 years and the emerging market contribution is over 50%, and is predicted to rise. Despite this, emerging market equities make up only 11% of the quoted equity universe.

As a consequence, there is an argument that emerging market assets should form an integral component of any diversified investment portfolio. Allocations to

emerging markets could rise greatly, due to the increasing influence of these nations on global economic momentum.

But how much should you allocate and to where?

The structure of the emerging markets universe and the portfolio of related investment vehicles have also evolved rapidly. The last decade has seen a spate of fund launches associated with the BRIC (Brazil, Russia, India and China) countries, and, more recently, with the New Frontiers countries that represent the next wave of developing markets.

How much of your own money you should allocate to GEMs very much depends on

your investment aims (how long you want to invest for, looking for an income or capital growth etc) and your appetite for investment risk. Your consultant can help you with this.

The fund featured below is unique, and we would be happy to recommend it to our clients (subject to its suitability for your individual requirements).

Email us on invest@devereandpartners.com for further information or contact your local consultant directly

Fund in focus

Nomura Global Emerging Markets III – 80% Protected Fund*

deVere & Partners believe this GEM fund of funds is an excellent way to invest in this exciting asset class. It is a highly liquid fund that invests in six underlying funds managed by some of the world's leading emerging markets fund managers. If you are interested in adding some spice to your portfolio, this is an ideal option. Here are a few reasons why:

- Capital protection of at least 80% of the amount you invest (after fees)
- Potential growth from access to the world's fastest growing economies
- Access to leading GEM fund managers
 - Goldman Sachs, Legg Mason, Pictet Funds, Pioneer Funds, Franklin Templeton and WestLB Mellon
- An open-ended fund, meaning there is no expected maturity date
- Highly liquid fund with daily pricing so you can get your money in and out when you need it
- Offered by Nomura, a leading global investment bank, based in Japan, with 26,000 employees in 34 countries