InvestmentMetrics

What's Next In Emerging Markets?

by InterSec Research

This piece examines methods of assessing emerging markets exposure, different product offerings and investment team strucutre. We have also included two timely addendums focusing on geopolitcal risk and emerging markets revenue exposure.

Emerging markets have been at the center of allocation discussions, driven in part by market performance. The MSCI Emerging Markets Index annualized return for ten years ending December 2010 was 15.9%(compared to 1.4% for the S&P 500 Index). From the market trough at the end of October 2008, emerging markets have rebounded tremendously, increasing more than 160%. Historically, after similar periods of strong performance, we have seen flows out of the mandate due to rebalancing (Exhibit 1). Compared to the 14% weight within the MSCI ACWI Index as of year end, most available data indicates U.S. plan sponsors are underweight with regards to their dedicated emerging exposures. While a short term tactical pull back could certainly be prudent, expectations are that plans will likely increase their allocations going forward.

Given the continued interest, InterSec Research conducted a brief survey to investment managers, plan sponsors and consultants, at the end of 2010, to shed light on next steps in emerging markets. The survey focused upon three different aspects: first, ways of assessing exposure; second, different product offerings and perceived future interest; and lastly, investment team structure. The results and commentary of these aspects of our survey "What's Next in Emerging Markets" follow below.

Sources of Revenue

In today's global markets, substantial revenues for developed market listed companies are being derived from emerging markets. One of the more challenging issues currently facing plan sponsors is the accurate measurement of their total emerging exposure. It is clear that simply considering their holdings by dedicated emerging markets specialists, or managers who opportunistically make emerging markets calls, will no longer suffice. Exhibit 2 depicts that asset managers overwhelmingly believe a company's primary revenue source is the most important factor in determining emerging market exposure (followed by individual company home office location or country of stock issuance). One problem is, however, no index options which offer an easy method of categorizing companies' geographic revenue currently exist as this information is not consistent in nature or publicly available. A secondary concern is that emerging markets exposure of both developed and emerging markets listed companies may be somewhat understated when measuring a portfolio strictly to a benchmark.

Some investment managers have begun to quantify their true emerging markets exposures based on the revenue sources of the benchmark, as well as their portfolio's individual holdings. Analysis by Causeway Capital Management, for example, found that both the MSCI World and EAFE indices have significant economic exposures to emerging markets. According to Arjun Jayaraman, quantitative portfolio manager, "These faster growing regions of the world account for at least 8-10% of the sales of companies in the global and international equity benchmarks." Utilizing Causeway's analysis (further detail in Addendum B), if we assume their emerging markets revenue estimates for the MSCI World (8.4%) and MSCI Emerging Markets Indices (82.7%) at the MSCI ACWI Index weightings (emerging markets comprise 14% of the MSCI ACWI Index), the conservative exposures total nearly 20%. This estimate

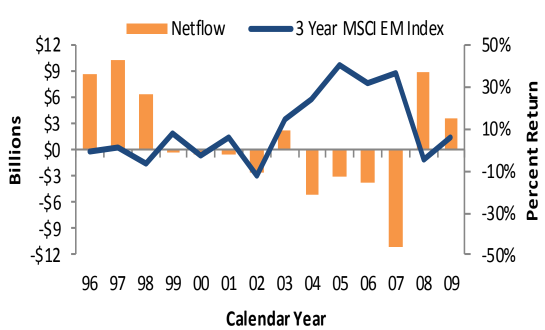


Exhibit 1.

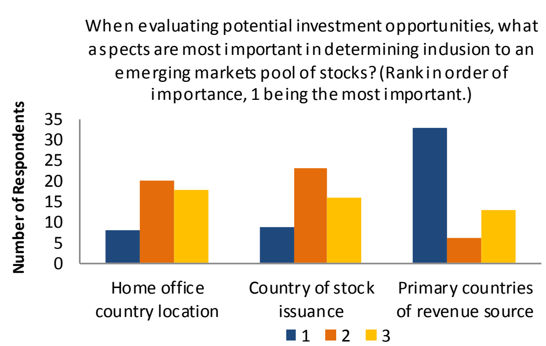


Exhibit 2.

is above the total emerging markets weight of the MSCI ACWI Index, which suggests evaluating companies solely by benchmark characteristics will likely understate actual emerging markets exposure.

This has led to some interesting product development. For example, some managers have considered offering products focused upon smaller emerging markets companies that derive revenue solely from their region. Today there is a growing focus on capturing the growing domestic consumer growth. Conversely, other managers have considered lower risk options that specifically focus upon developed market companies that derive a significant percentage of their revenue from emerging markets. This type of product could potentially deliver strong emerging markets-like returns, but with lower volatility and risk. For a similar product, a manager could offer both emerging and developed markets listed names (rather than only developed markets), enabling a manager to essentially tactically allocate between developed and emerging markets listed companies.

Equity Capacity and the Growth of Fixed Income

Several of the 2010 survey questions focused upon products currently managed, product capacity and products most likely to garner interest in the near future as viewed by both managers and consultants. InterSec divided the equity products into capitalization buckets. The most dominant area of total products managed is large cap/all cap (Exhibit 3). This is in parallel with market liquidity expectations (Exhibit 4). Large cap/all cap global emerging products have the most available products for investors, while the more illiquid and capacity constrained products, such as emerging real estate, infrastructure,

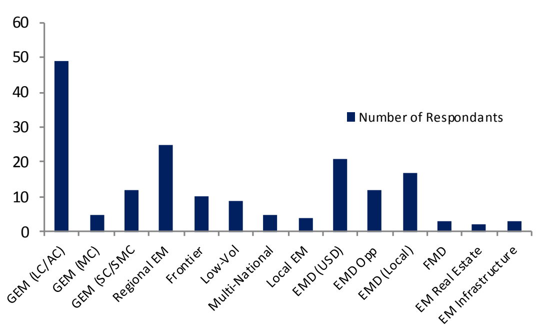


Exhibit 3.

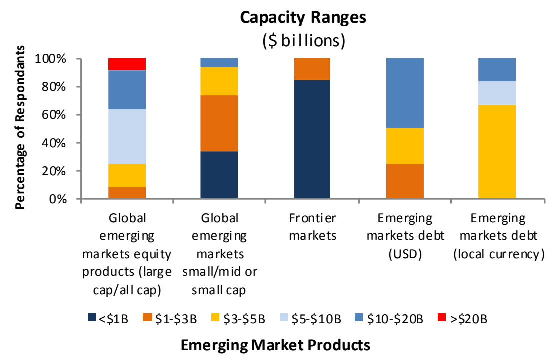


Exhibit 4.

and frontier markets debt, had the fewest number of products to offer.

Nearly half of the respondents believe their most liquid products (large cap/all cap) have approximately $5-$10 billion in total capacity, while a quarter believe their capacity range is $10-$20 billion. More than 75% of the managers surveyed projected small/mid and small emerging markets products capacity to be less than $3 billion (with more than 30% responding less than $1 billion). While frontier markets have garnered interest, capacity constraints limit some managers from investing the time and resources required to launch a product. As seen in Exhibit 4, more than 80% of the respondents label frontier market products with a capacity below $1 billion. Certainly a variety of factors effect capacity decisions. A significant majority (more than 80%) of managers evaluate product liquidity by reviewing average daily trading volume. Typically, products with more holdings tend to have higher capacity targets. Both team and even firm size, in addition to portfolio diversification, can impact capacity ranges.

While managers tend to inquire about regional, frontier, and multi-national products most often, their survey responses suggest the more standard global emerging markets products will continue to lead the pack (see exhibit 5). While managers do believe that regional emerging markets and frontier markets products offer some promise, the consultant responses suggest otherwise. Consultants validate the perceived large cap/all cap interest (Exhibit 6).

While manager responses to our survey favored equity,

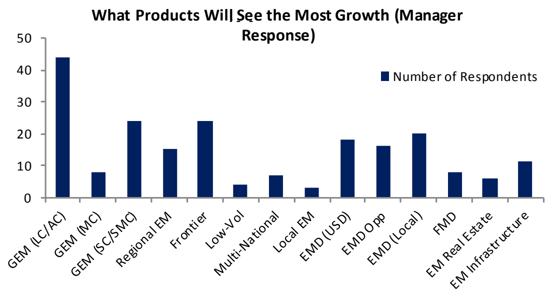


Exhibit 5.

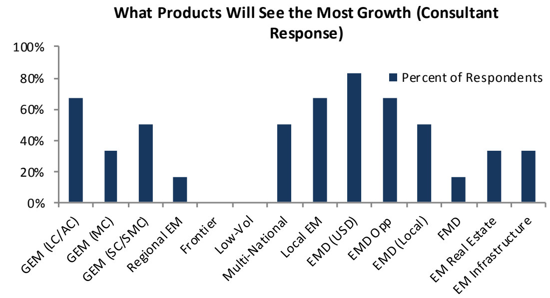


Exhibit 6.

consultants strongly believe in emerging market debt (in both USD and local currency) products which have generated significant U.S. institutional interest recently. InterSec Research currently covers roughly 40 products in our universe, 15 focused on local currency debt. Over the last few years, we have witnessed a rapid increase in emerging debt fundings, which have tripled since 2007. In fact, during the first half of 2010, new fundings to emerging debt products matched their totals for all of 2009. For the first time local currency funds won the lion's share of new business.

Investment Team Structure

In Exhibits 8-15 (as shown in the Appendix) we compare manager and consultant responses on team structure. A common question managers pose to InterSec relates to the significance of emerging markets presence among investment teams. Total assets under management by team location are nearly equally split. However, there has been an increase in the percentage of fundings to products with local analysts. In 2008, nearly eighty percent of the initial fundings went to products with only developed markets offices. In the first half of 2010, more than fifty percent of the initial fundings went to managers with a local market presence. However, in actuality, there appears to be a lack of consultant preference around team location. The one area in which consultants do voice a preference is whether an investment team is responsible for just one emerging markets product. Typically, product proliferation is an underlying concern for both consultants and plan sponsors who tend to be biased towards boutique firms.

Conclusion

Compared to leading market indices, emerging markets allocations for most U.S. plan sponsors are significantly underweight. As covered in our 2010 Mid-Year Industry Review, the World Bank recently estimated that by 2050, four of the top five economies by GDP will be Brazil, China, India and Russia. Based on this and other similar growth assumptions, many industry constituents anticipate a potential paradigm shift toward greater emerging exposure. Based on responses to our survey, it appears the familiar large cap/all cap emerging markets equity strategies will be the most significant recipients of new assets, followed by emerging markets debt. However, some plans will certainly dabble in other emerging markets equity offerings, most likely small/small-mid cap, which provide differentiated holdings, lower correlation and exposure to more local emerging markets focused companies.

Addendum

A. Assessing Geopolitical Risk

Managers' views on evaluating risk within their emerging market allocations hold some clear similarities. Geo-political unrest is seen as one of the greatest risks to investable markets, while credit rating agency risk ranked the lowest amongst investors risk assessment. While not specifically addressed in this survey, inflationary pressures on the largest emerging economies has been a common concern among investors recently.

Predicting and quantifying the true impacts of political strife on local and global equity markets can be extremely difficult. In the beginning of 2008, MSCI began discussions surrounding the inclusion of countries in either emerging or developed markets, and concluded that geo-political risk alone should no longer be used as a "pass-or-fail dimension for the classification of a country as a Developed Market"[1]. As a result of this change in determining factors for inclusion, "Israel was reassessed and reclassified as a developed country based on its economic development, size, liquidity, and market accessibility"[2]. Two recent emerging country examples to consider are Egypt and Thailand. In these two countries, we see vastly different impacts from political unrest on their respective equity markets. After the Egyptian uprising to oust Hosni Mubarak started on January 25, 2011, the MSCI Egypt index has dropped over 20%. Conversely, in Thailand, while clashes between Red Shirt protesters and the military turned deadly in the spring of 2010, there was little impact on equity markets. The MSCI Thai Index actually finished 2010 as the best performing country in the MSCI Emerging Markets Index (up 56.3% in U.S. dollar terms). One difference between the two situations is that the Thai stock exchange never closed, while the Egyptian market has been closed since January 27th (at the time of this printing). To further complicate the issue of measuring political strife on equity markets, many of the affected countries are frontier markets (i.e. Bahrain, Oman, Lebanon, Tunisia and Ukraine), which are often viewed as illiquid and have various barriers to foreign investment.

1 Press Release, MSCI, June 16, 2008

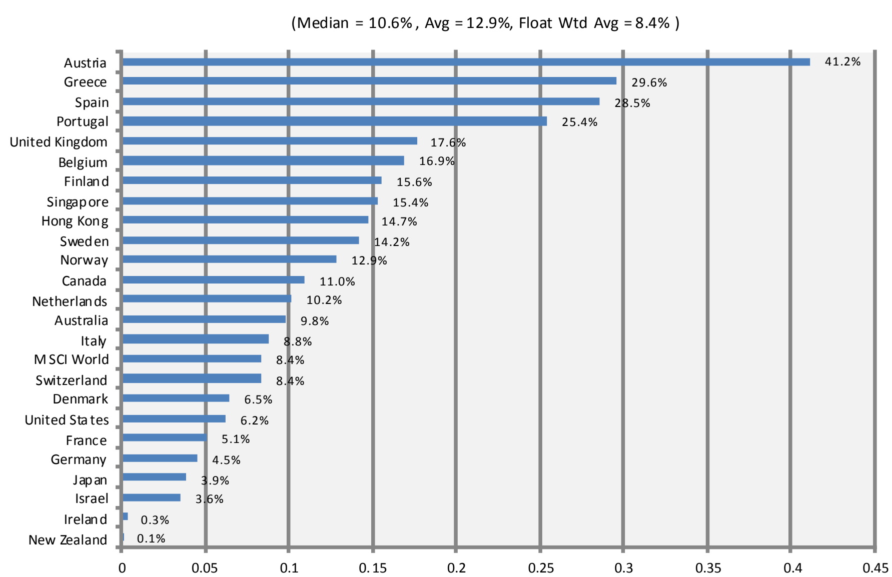
2 Classification of Markets In MSCI Equity Indices, MSCI, January 2008

Addendum

B. Assessing Revenue Exposure

The Exhibit below highlights emerging markets revenue exposure by developed market countries. The range of the revenue estimates among the countries in the MSCI World Index spans from more than 25% (Austria, Greece, Spain and Portugal) to less than 4% (Japan, Israel, Ireland and New Zealand). As noted below, the median country is 10.6%. Arguably, the more surprising country revenue figures are Japan (3.9%) and the U.S. (6.3%), both significantly below the median. Several factors relating to sales reporting may drive the low emerging markets exposure for the Japanese market. These would include 1) classifying part of the revenue for a product manufactured domestically (but then exported to an emerging market) as domestic, 2) the sale of a domestically produced product to a domestic distributor, who in turn exports the product to an emerging market, and 3) the use of equity accounted affiliates for emerging markets business (certainly an issue for the auto business). For the U.S., an important driver for the surprisingly low level of emerging market sales is the fact that many U.S. multi-nationals, in their SEC filings simply report "U.S." vs. "International" sales. More granular sales data is available, but not always in an accessible format. In both of these cases, the emerging markets exposure is probably significantly higher than reported.

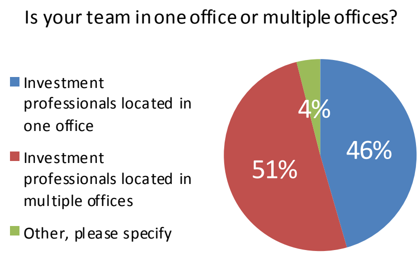
Exhibit 7: EM Revenue Exposure by Country



Sources: FactSet, Bloomberg, MSCI, Causeway Capital Management LLC.

Appendix

Exhibit 9: Managers Market Presence



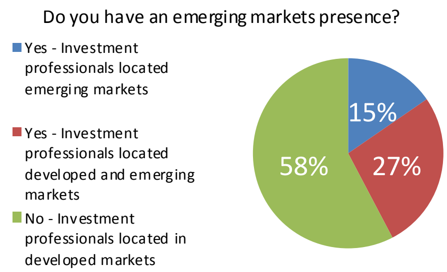
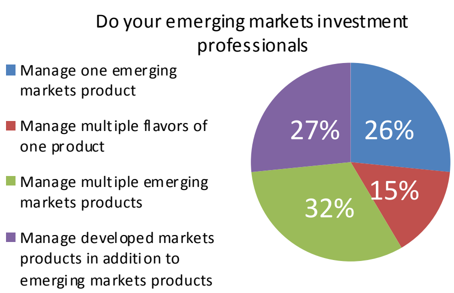


Exhibit 10: Managers Team Responsibilities



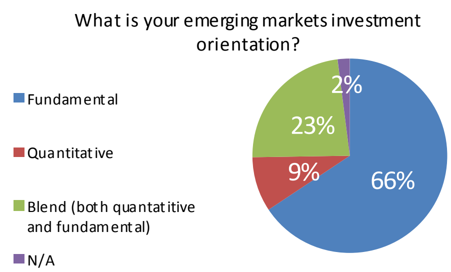
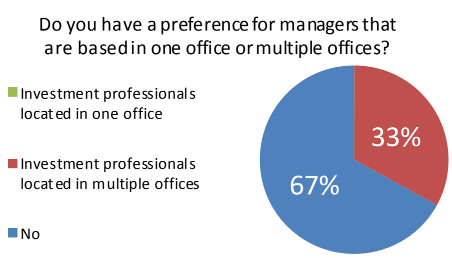


Exhibit 12: Consultant Preference: Team Location

Exhibit 13: Consultant Preference: Market Presence



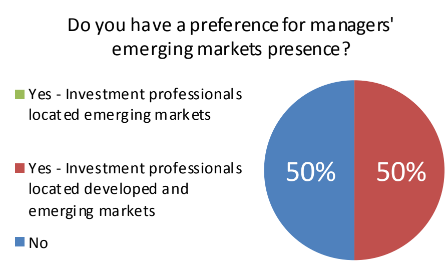
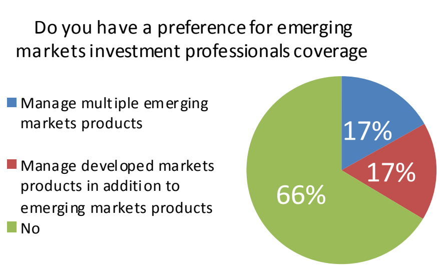
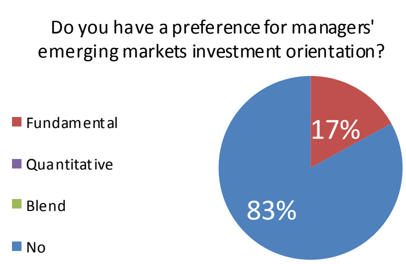


Exhibit 14: Consultant Preference: Team Responsibilities

Exhibit 15: Consultant Preference: Orientation





InvestmentMetrics

Based in Darien, Connecticut, Investment Metrics is an independent provider of investment performance analytics, manager research, reporting and data solutions for investment consultants, wealth advisors, asset managers and investors.

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