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WHY EMERGING MARKETS ARE CRITICAL TO GLOBAL INVESTING

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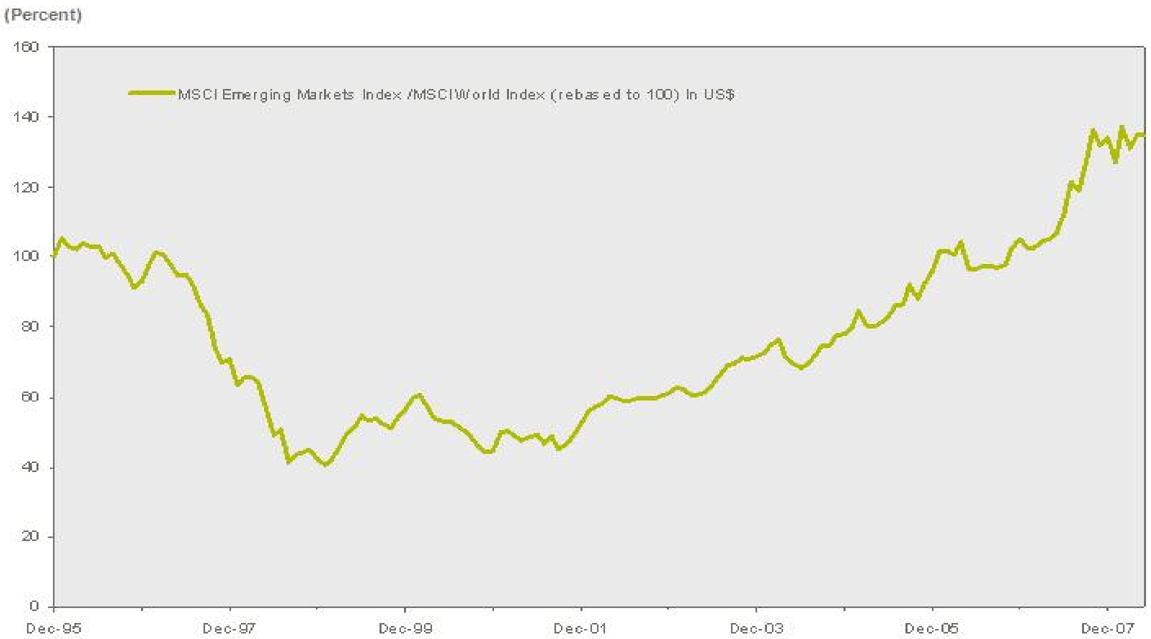
Global equity investing allows investors to expand the opportunity set beyond home borders, to capture the dynamic structural change in many parts of the world economy. A well constructed global equity portfolio possesses the flexibility to invest anywhere around the world, including not just the traditional developed markets but also emerging and frontier markets, where economies are likely to remain significant contributors to global growth. This paper discusses the underlying demographic trends driving growth in emerging market economies. It suggests investors should consider investing in emerging market economies and companies, given the evidence of relatively low valuations and earnings growth.

Emerging Markets have outperformed developed markets since the lows of the Asian crisis

The performance of emerging-market equities in recent years has been difficult to ignore, as their returns since 2002 have comfortably outpaced gains in developed markets.

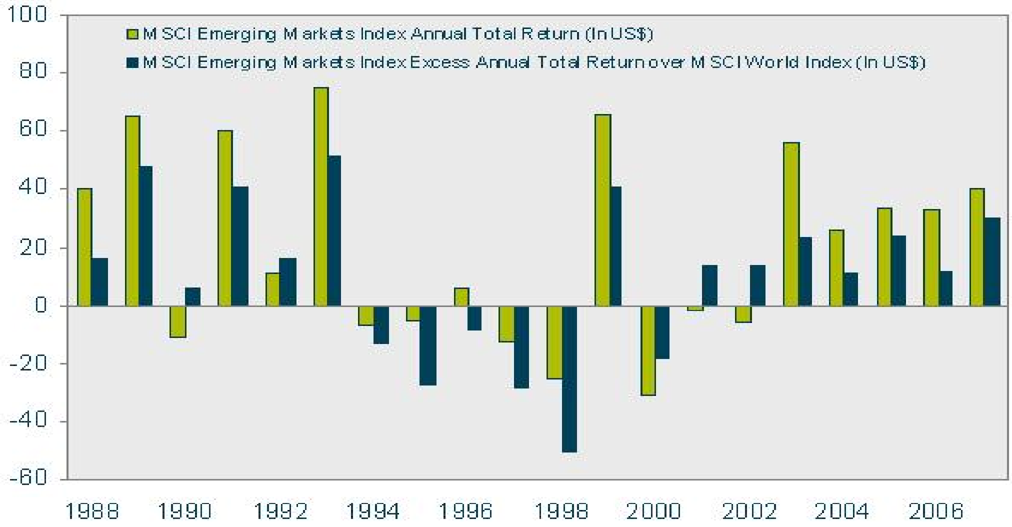
Exhibit 1: Emerging Markets Index vs. Developed Markets Index (Dec 1996 through Mar 2008)



Source: MSCI

Nevertheless, some investors remain unconvinced. They argue that in the past, cyclical outperformance has invariably been followed by corresponding weakness, particularly for those emerging market economies which are sources of raw materials and which tend to be buoyed by rising commodity prices. With many commodity prices at record levels, these investors doubt whether the pace of absolute gains and magnitude of relative outperformance is sustainable versus the developed markets (see Exhibit 2).

Exhibit 2: Emerging Markets Return vs. Developed Markets Returns (1988 through 2007)



Source: MSCI, CSFB Research, through Dec 2007. Past performance cannot guarantee future results

These skeptics believe that the higher perceived risks associated with emerging markets – whether political, economic or corporate – still outweigh the potential rewards. Many emerging markets still lack structural legal reforms to enforce property rights and government red-tape can inhibit an entrepreneurial culture, all factors which can dampen economic growth.

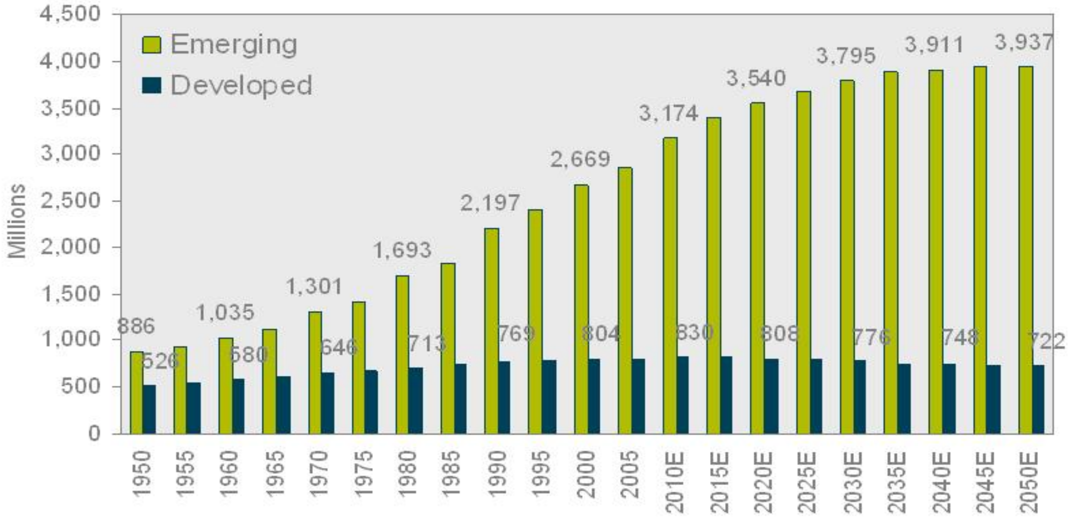
But we believe that a fundamental, bottom up investment approach that is able to analyze these risks can identify mispriced investment opportunities. As such, an allocation to emerging markets is crucial for a successful global portfolio. Adding emerging markets to a global portfolio opens an investor up to a much broader opportunity set and provides exposure to the rapid social, economic and financial development underway in these countries. We believe the importance of emerging markets is increasing and will continue to do so.

Demographic shifts are fueling faster growth in emerging economies

One of the most significant global demographic changes to have taken place over the last 50 years is the growth of the labor force in emerging markets, which has far outstripped that of developed nations (see Exhibit 4). In 1950, almost 900 million people were of working age in emerging economies, compared to 500 million in the developed world. By 2000, the working population in emerging markets had risen to 2.7 billion, against a developed-economy workforce of 800 million.

Furthermore, estimates foresee a widening of this gap, with a projected emerging-market workforce of nearly 4 billion by 2050, in tandem with an estimated fall in developed workers to 700 million.[1]

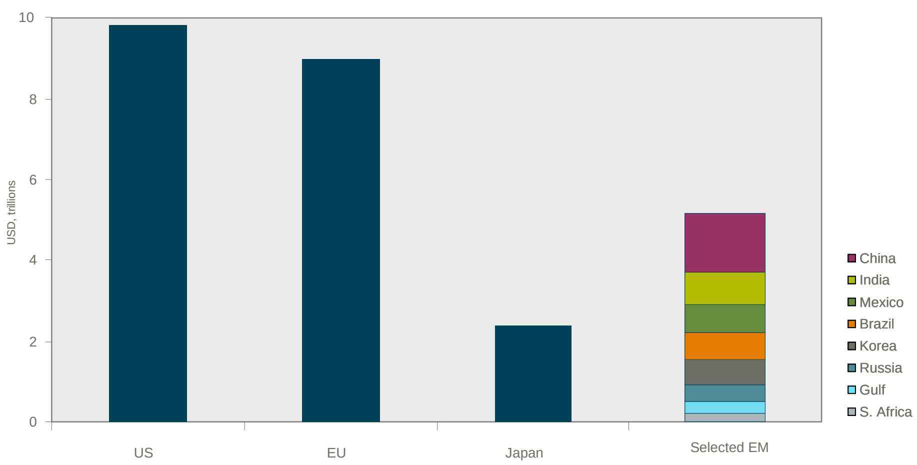
Exhibit 4: Global Population Demographics



Source: Bloomberg, As of 30 May 2008

As well as providing a relatively low-cost, rapidly expanding pool of labor, the change underway is producing increasing numbers of consumers. Currently, the combined consumption of households in emerging markets is valued at half the level in the US and is already more than double that of Japan (see Exhibit 5). This consumption is expanding at an impressive 7% per annum, with demand from China leading the way.[2] The boom is feeding end-use demand and, in a virtuous circle, leading to expanding trade between emerging markets.

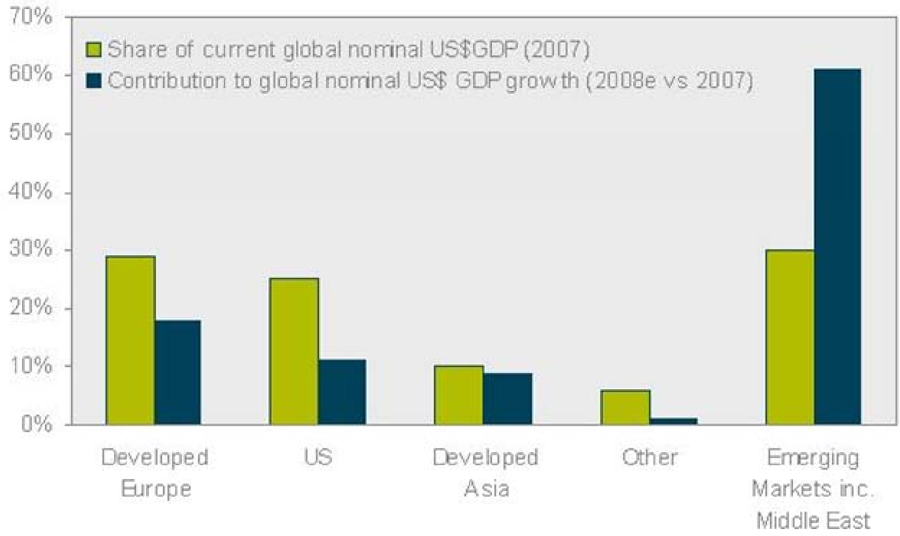
Exhibit 5: Household Consumption Spending, 2007e



Source: World Bank, EIU, Datastream, Morgan Stanley Research.

These positive drivers have translated into an increasing share of global GDP for emerging markets, and they now account for approximately 30% of the total. In the last 12 months, as many developed economies have slowed, emerging markets have contributed by far the largest portion of growth, so that in effect they are now leading the global economy.[3] World nominal GDP grew approximately $5.1 trillion in 2007. Emerging markets comprised about 47% of this growth versus 12% for the US.[4] The differential in the growth rates of emerging and developed markets, evidenced since 2000, is forecast to continue (See Exhibit 6)[5] partly due to these demographic trends.

Exhibit 6: Share of 2007 and Expected Contribution to 2008 Global USD$ GDP Growth



Source: Morgan Stanley Research, As of 17 April 2008

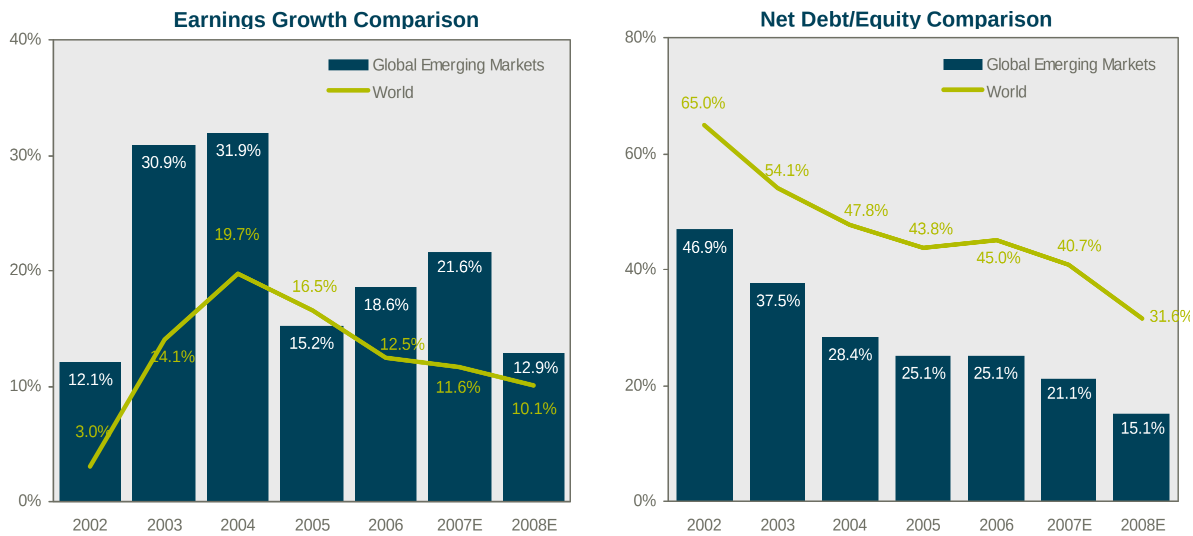
Faster growth has led to improving fiscal positions

Emerging markets are now in a much stronger fiscal position than during past economic cycles. Many now combine significant foreign-exchange reserves, growing revenues from the expanding global demand for a wide variety of natural resources, stronger currencies and the rapid growth of their domestic markets. A good example is Brazil, which recently had its sovereign ratings upgraded to investment grade by two of the three major credit rating agencies because it has benefited from these factors.[6]

As a result, many emerging market nations are less reliant on the US economy. Compared with just a few years ago, we believe most emerging market economies are in much stronger positions to withstand all but a deep and prolonged US economic downturn. This enables them to sustain their relatively high growth and supports a favourable view of their prospects for long-term investors.

The improving macroeconomic background for emerging markets has been matched by advances at the corporate level (see Exhibit 7). Earnings growth among emerging-market companies has outpaced the rate in developed economies, allowing companies to tackle their balance sheets and reduce debt levels.[7] Lower debt levels and consistent earnings have piqued the interest of the broader capital markets.

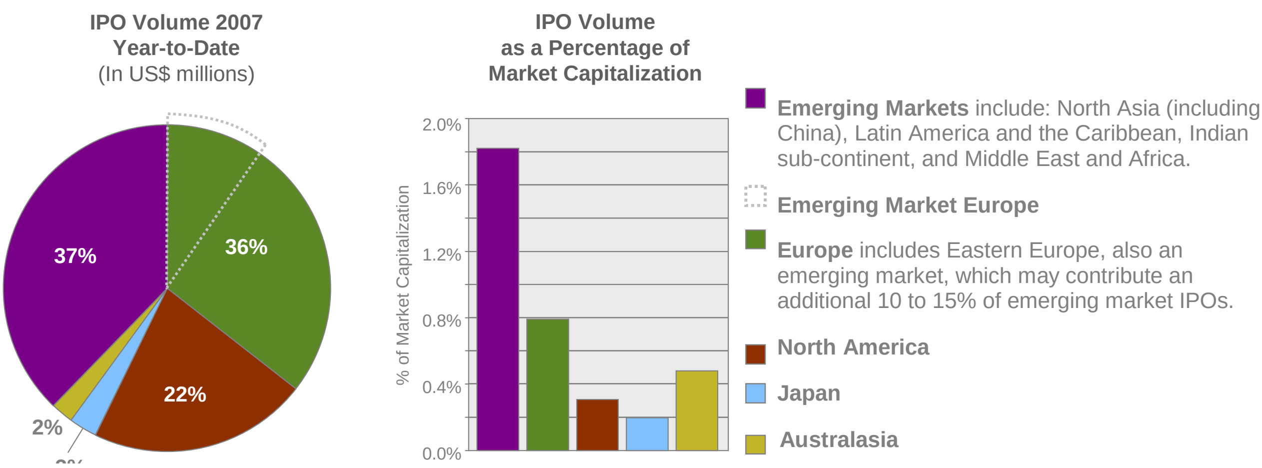
Exhibit 7: Corporate Earnings Comparison



Source: UBS, As of 31 December 2007

Finally able to access better financing terms, emerging market companies have consequently increased their corporate transparency. Consequently, 2007 emerging market IPOs outpaced developed market IPOs[8] (See Exhibit 8).

Exhibit 8: IPO Volumes



Source: Dealogic

Government-led reforms supporting a positive business climate have also contributed to the improving macroeconomic environment. After previously lagging, the return on equity in emerging markets has matched that of developed markets for several years (See Exhibit 9). As such, it is not surprising that valuations for emerging-market stocks have narrowed their traditional discount to those in developed markets (See Exhibit 10).

Exhibit 9: Return on Equity and Relative Performance (USD$)

Source: MSCI, CSFB Research

Stronger fiscal position complimented by relatively low valuations

Many investors now perceive that emerging-market companies harbor less company-specific risk, while political risk in a number of emerging countries has also diminished. In short, emerging-market stocks no longer encompass the same risk expectations they once did. However, even though valuations here have become richer, they remain comparable to developed markets and still offer the opportunity to find attractive investment opportunities (See Exhibit 10).

Exhibit 10: Emerging Markets vs. Developed Markets Valuations

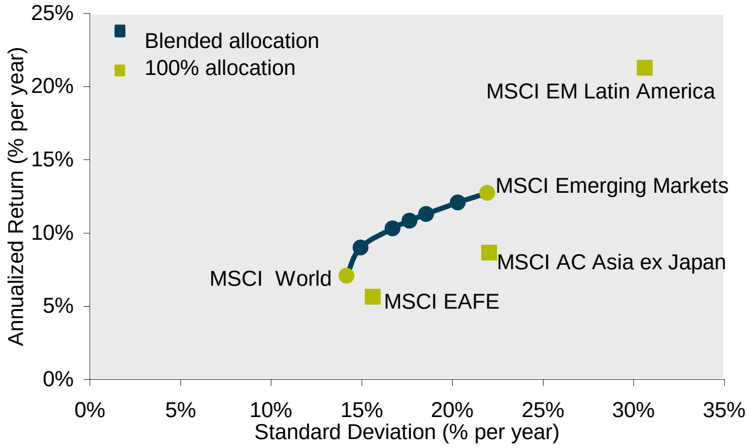
Source: UBS, UBS Warburg: MSCI * 12 to 24 months forward consensus

Constructing a portfolio to take advantage of these trends

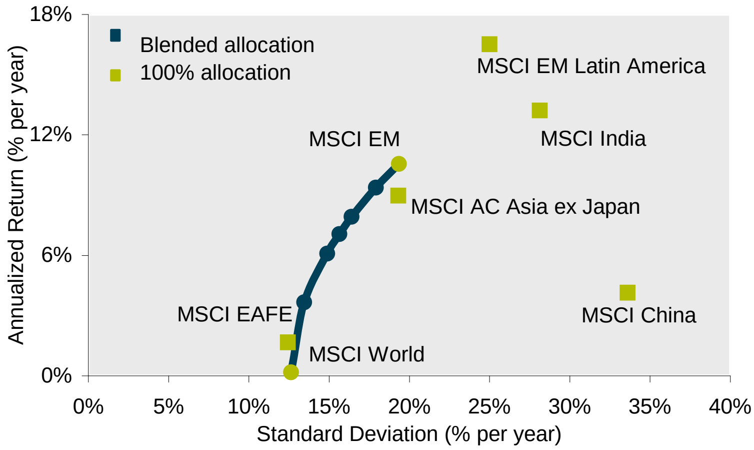
From a portfolio construction perspective, these drivers of future global growth are not yet reflected in the MSCI All Country World Index (MSCI ACWI). This benchmark, which relies on a historical view of growth to determine its weightings, currently comprises 10-12% emerging markets. If an investor considers that emerging markets will contribute to approximately 30% of future global growth, then placing a larger emerging market allocation in a global portfolio could deliver a higher tracking error and excess return. Exhibit 11 plots the annualized returns of different indices over time. These graphs blend the MSCI World and MSCI Emerging Market indices to show how a global portfolio with a growing emerging markets allocation increases return and risk (blue line). It plots individual index returns to show volatility in single country indices (green points).

Exhibit 11: Annualised Returns (AUD$)

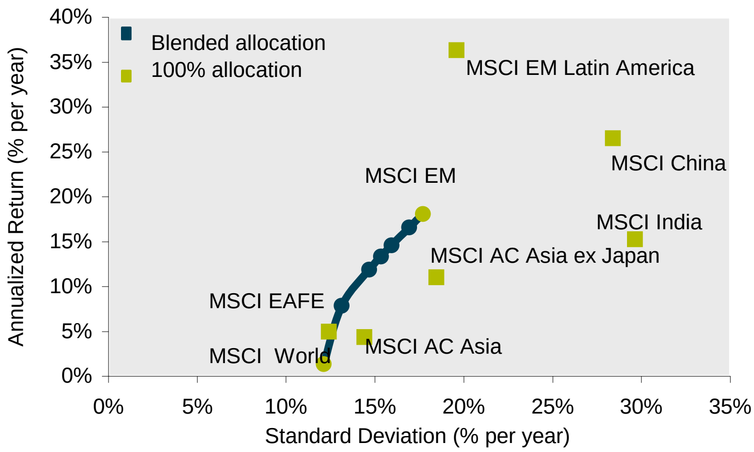
Over a Twenty Year Period ending 30 Jun 2008



Over a Ten Year Period ending 30 Jun 2008



Over a Three Year Period ending 30 Jun 2008



Source: Zephyr StyleADVISOR. It is not possible to invest in an index

It is true that there is a degree of polarization in the emerging-market universe, with some very strong economies as well as weak ones. In addition, the outlook for certain nations—such as Mexico, Singapore, and Taiwan—is affected by their relative reliance on exports to America. As such, we urge caution when considering adding a single sector fund such as an India, China or Brazil to capture the opportunity that currently exists in emerging markets (See Exhibit 11). Investors would do well to consider the level of volatility risk they desire in their portfolios.

For global investors, the structural changes underway in the world economy have boosted the importance of emerging markets irrevocably. Investors seeking to take advantage of this future growth should consider a diversified global portfolio that provides the flexibility to invest in international markets and the ability to capture some of the potential growth of emerging markets.

[1] Source: Bloomberg

[2] Source: World Bank, EIU, DataStream, Morgan Stanley Research

[3] Source: IMF, Morgan Stanley Research

[4] Source: Ibid.

[5] Source: Ibid.

[6] Source: Reuters, 29 May 2008. Fitch: BBB-, S&P: BBB-, Moody's is reviewing for possible upgrade.

[7] Source: UBS

[8] Source: Dealogic