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GLOBAL INVESTING – A PARADIGM SHIFT IN MARKET LEADERSHIP

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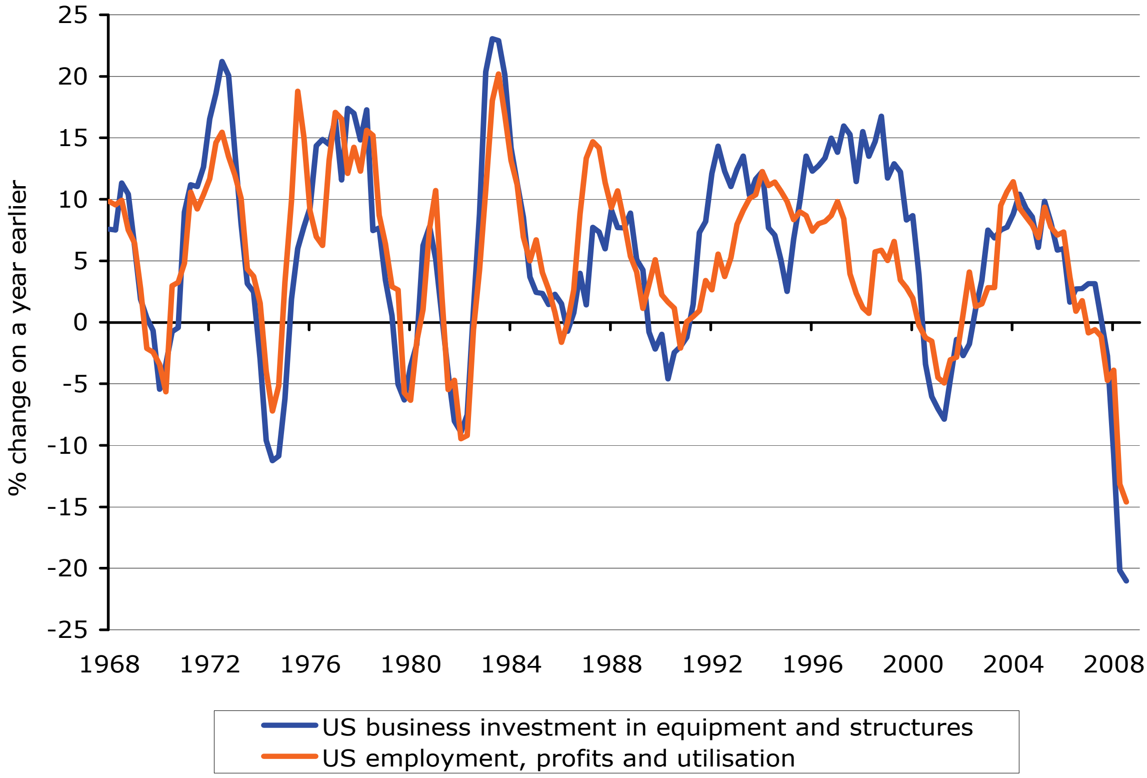
A global revolution is underway - part industrial, part economic and part social. While it has been in place for many years, it is now growing far more noticeable than ever before. This revolution will by no means be smooth; instead, like the past, it will likely be fraught with amazing bull runs and bear declines – particularly in the stock markets of those countries experiencing the revolution. This paper argues that if current predictions hold, a more balanced and even multi-polar world could emerge in which certain developing nations, such as China and India, influence the nature of investment returns far more than they ever had in the past

Uncertain outlook for the developed world

Although the developed world may be emerging from the global financial crisis and recession of 2008 and 2009, any recovery is likely to be fragile in the medium term. In other words, it is foreseeable that investors will experience a period of a few years in which GDP growth and equity returns in developed markets remain modest for two key reasons. Firstly, as households in the developed world begin to rebuild their balance sheets, personal consumption could be constrained for some time. Secondly, given the excess capacity in the system - as shown in Figure 1 by the availability of labour and low factory utilisation in the US - corporate capital spending may be quite modest, at least until companies gain increased visibility and optimism in an improving business outlook.

Additionally, it is important to note that as governments and monetary authorities recognised and appreciated the severity of the crisis, they injected unprecedented levels of stimulus into the market and introduced mechanisms to buttress the most fragile areas of the banking and housing systems. Specifically, in 2008 and 2009, the governments of the United States, Japan, Germany, China and India alone introduced fiscal stimulus worth in aggregate nearly USD 1.66 trillion.[1] Although the ramifications of this stimulus have yet to fully unfold, they may encourage GDP growth.

Figure 1: US business investment in equipment and structures vs. employment, profits and utilisation[2]



Data as at 30 June 2009.
Source: Macro issues – Spring 2009, Capital Strategy Research.

The blossoming of emerging markets

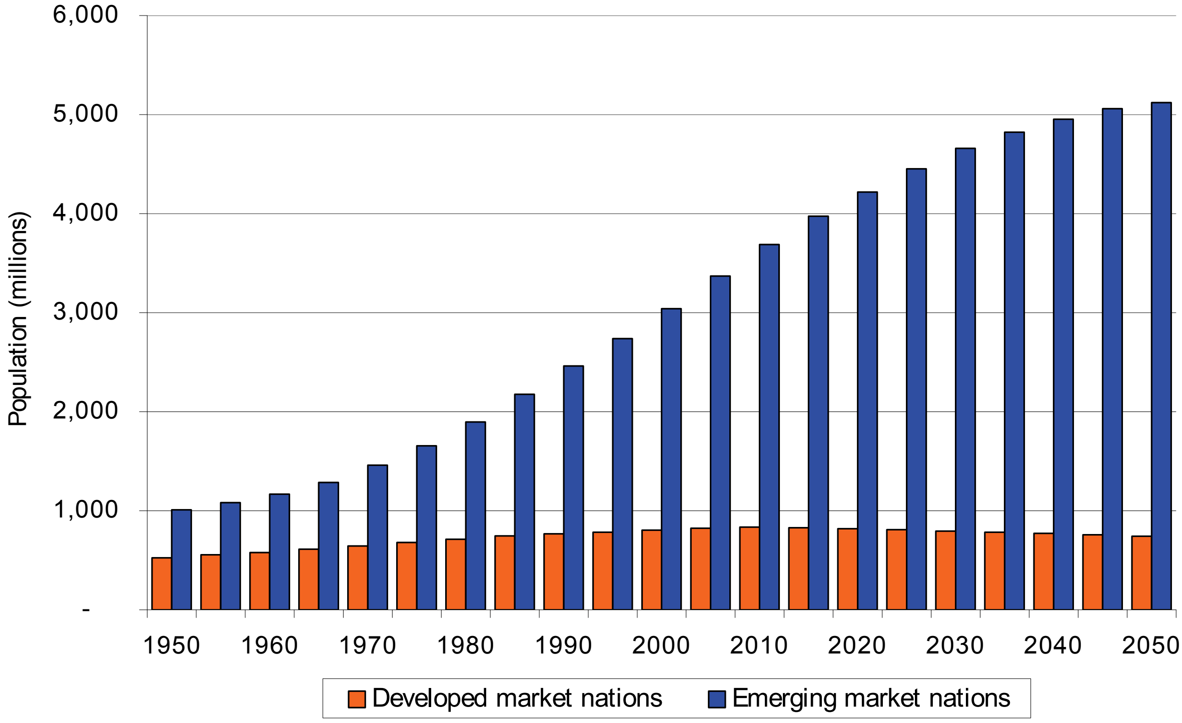
In contrast, the developing world presents a very exciting picture, and there is a distinct possibility that emerging markets have brushed off many of the concerns of being coupled to developed markets.

Currently, a confluence of unprecedented forces is underway. Two nations, China and India, which together represent about 37% of the world's population, have being growing at a rate of between 5% and 10% per annum and are likely to do so for quite a few years.[3] As they industrialise, their GDP per capita rises up an S curve - just as it occurred in the past in the United States, Japan, Taiwan and Korea. This climb up the S curve signifies a lot for private sector consumption and for continued infrastructure investment and also may also lead to rapid changes in society.

Such changes last a long time and can be measured in decades or more. This change has been in place for up to ten years and may well have another ten years to run at a torrid pace. Overlay on this the fact, referred to previously, that the developed world has received tremendous levels of economic stimulus, at the same time as developing countries appear to have unstoppable growth. The implications are tremendous. Put another way, more than 37% of the world's population is growing at a terrific rate and is likely to continue for a while more. The world has never seen this before.

These trends are projected to continue. While the populations of developed countries are set to reach their peaks or even experience declines, emerging market populations are expected to grow until around 2050.[4] As illustrated in Figure 2, it is estimated that the working-age population (15 to 64 years old) in emerging markets could be nearly seven times that of the developed markets by 2050 according to UN population statistics.[5] In China alone, the McKinsey Global Institute has estimated that the urban population will top 925 million by 2025 and more than 220 cities will have more than one million residents. In comparison, there are currently only 35 such cities in Europe.[6]

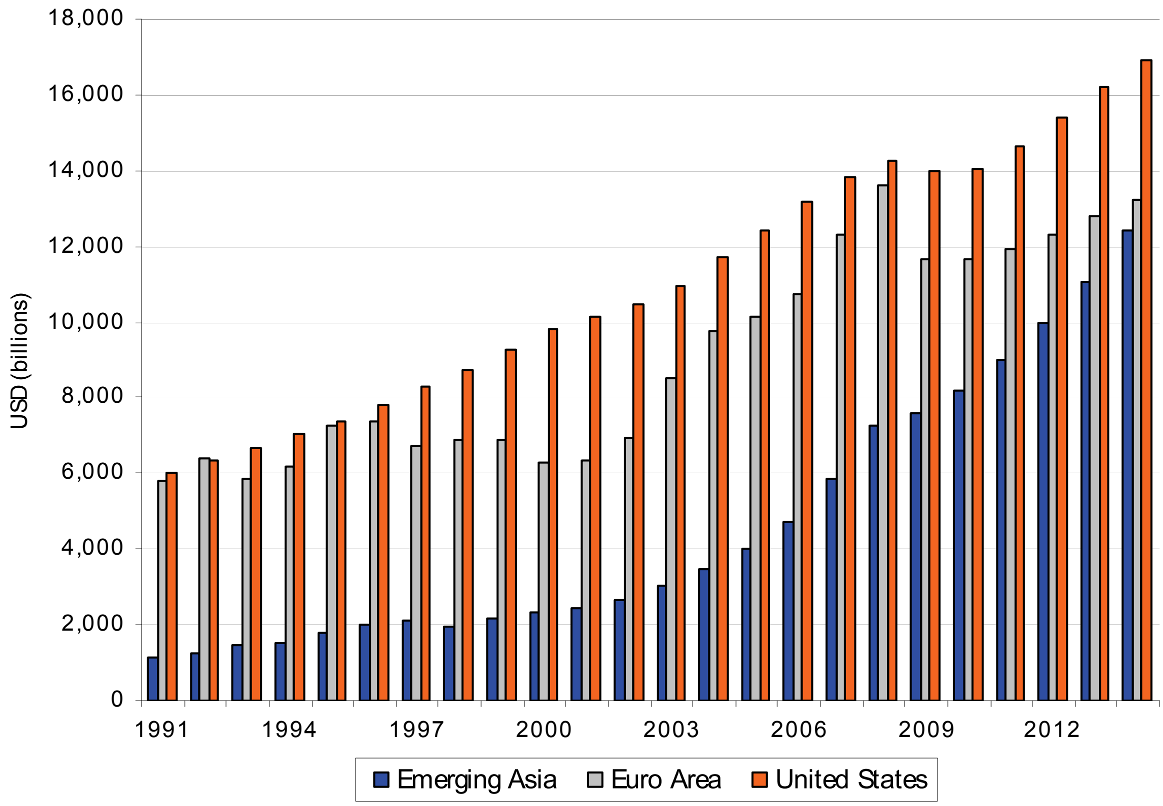
Figure 2: Working-age populations (15 to 64 years old) from 1950 to 2050 (estimated)[7]



Note: Assumes medium variant growth rates.
Source: The 2008 Revision Population Database, United Nations Department of Economic and Social Affairs

There are also notable economic implications for these trends. Figure 3 shows how the contribution of three major economic regions to global GDP has varied over time based on IMF statistics. Ten years ago, emerging Asia represented approximately 15% of global GDP; as at April 2009, it was estimated to represent about 22%. Furthermore, the IMF forecasts continued robust growth in emerging Asian countries during the next five years.[8]

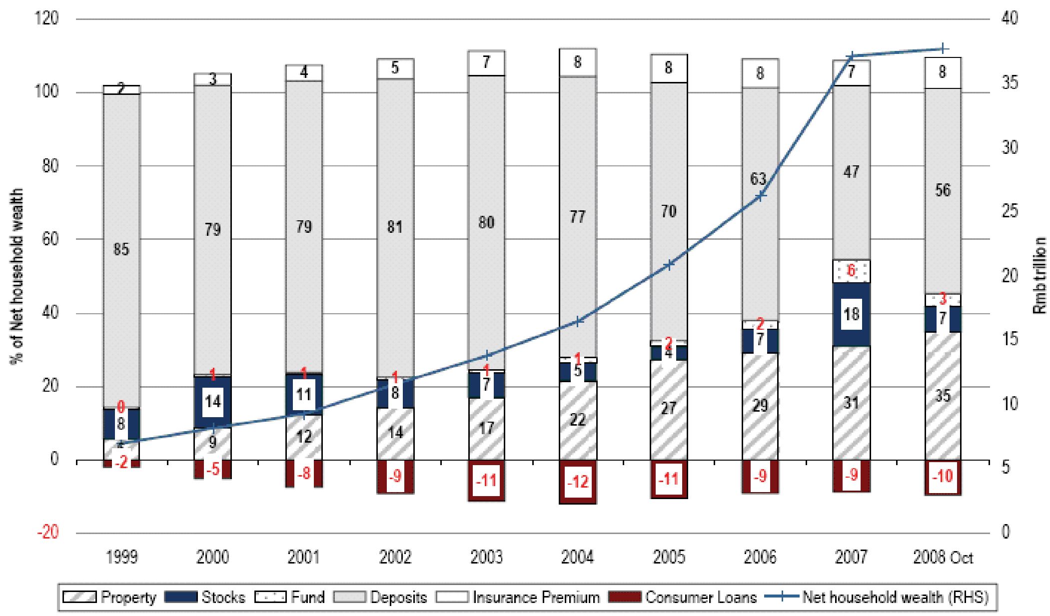
Figure 3: Nominal GDP in Emerging Asia versus Euro Area versus the United States[9]



Source: World Economic Outlook Databases (WEO), International Monetary Fund.

It is also notable that populations in emerging market countries such as China and India have enjoyed increased wealth and savings. The composition and growth of the net Chinese household wealth in the past ten years can be seen in Figure 4. Chinese household wealth has shown remarkable increases in moving from less than RMB 10 trillion in 1999 to more than RMB 37 trillion in October 2008.[10] The result is that private sector consumption is increasing at the same time as enormous investment is being made in public and private sector civil works such as buildings, transport, power and manufacturing – evidenced in part by the USD 588 billion public works stimulus package the Chinese government introduced in November 2008.[11]

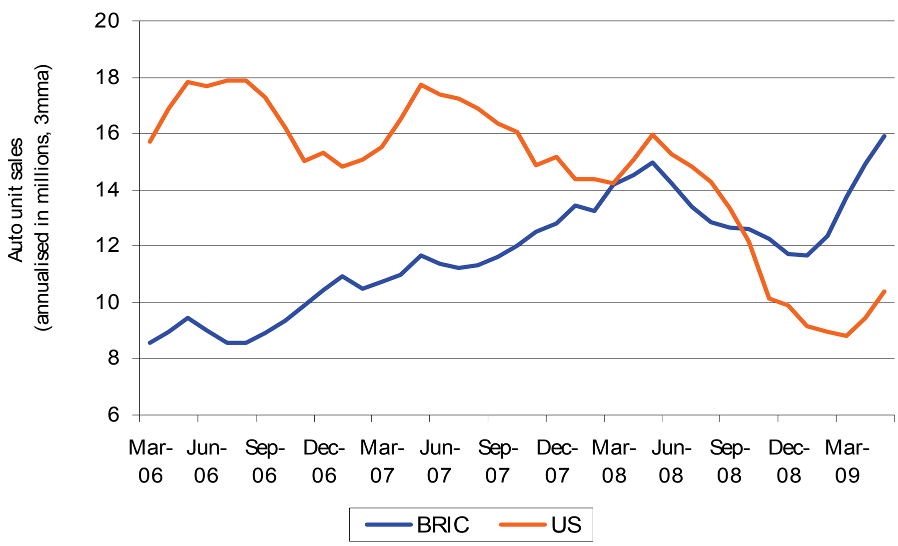
Figure 4: China's household balance sheets[12]



Source: CEIC, WIND Database, Credit Suisse.

As the wealth effect has gathered pace, an increase in discretionary income has translated into greater purchases of household goods and consumer durables. One leading indicator is annualised sales of automobiles and light trucks. In 2008, the number of automobiles sold in BRIC countries exceeded for the first time the number sold in the US,[13] much of it driven by China and India.

Figure 5: Automobile unit sales in BRIC nations (Brazil, Russia, India and China) versus the US[14]



Source: Garner, Wang and Silva. Asia/GEMs Equity Strategy, Morgan Stanley Asia/Global Emerging Markets Research

Solutions for investors

If an investor subscribes to the view that emerging markets such as China and India will represent an important area of economic growth in the future, there are several ways to target the opportunity, including investments in:

- A regional fund
- An Asian-focused emerging markets fund
- A broader emerging markets fund
- An all-country world equity (ACWE) fund
- A global developed fund

Of these approaches, a reasonably broad equity strategy - namely either an ACWE or global developed strategy with an integrated and flexible allocation to emerging markets - is preferable to a narrower one for two key reasons:

- Firstly, although the long-term compound annual growth rate in emerging market equities may well outstrip that in developed markets, at the same time, bull and bear market cycles in emerging markets are likely to be more pronounced than in the developed world. This volatility is caused by several correlated factors, including business and regulatory risk, limited depth in markets and also varying levels of shareholder protection in companies where there is limited float.

- Secondly, using a global portfolio captures a very important constituency - namely global firms that stand to benefit from the ascent of certain emerging markets. These companies, which are generally domiciled in the developed world, give great exposure, both direct and indirect, to the opportunities that emerging markets represent.

In other words, a global or ACWE portfolio strategy provides both access and diversification. On the one hand, it affords the investor the ability to participate in emerging market opportunities, yet it also can shelter the investor from the market fluctuations that may be more pronounced in developing areas.

So how can investors achieve emerging markets exposure without direct investment? The second benefit above provides an answer - by investing in global firms with a presence or potential in the developing world.

The following is a closer look at some of these companies and how they may benefit from their exposure to emerging markets:

- **HSBC Holdings plc.** The banking and financial services giant has continued to expand aggressively in emerging Asia both commercially and operationally. According to its 2008 annual report, the company launched its own mainland Chinese subsidiary in 2007 after holding minority stakes in three Chinese associate firms. Furthermore, the company opened offices in 2008 in Guangzhou, Shanghai and Beijing as part of its launch of private banking operations in mainland China. As at the end of 2008, the company had approximately 37,000 employees in India and another 15,000 in mainland China.[15]

- **Potash Corporation of Saskatchewan Inc.** According to company reports, approximately 42% of the world's fertilizer consumption in 2008 occurred in China and India alone. The company estimates that, as living standards rise, fertilizer consumption will increase from approximately 50 million tonnes to nearly 80 million tonnes in China, and from about 25 million tonnes to nearly 50 million tonnes in India.[16]

- **BorgWarner Inc.** The auto parts supplier has had a long exposure to emerging markets and has been active in India for more than 20 years. Reported sales in its joint venture firms in China and India alone in 2008 reached USD 220 million, and the company is positioned for further growth in the region. In November 2008, it signed a joint-venture agreement with several leading Chinese automakers to produce various dual clutch transmissions modules.[17]

- **Wal-Mart Stores, Inc.** Per company publications, the mega-retailer operated 243 stores in China, including 132 "Supercenters", and it employed more than 70,000 associates in the country as at January 2009. In India, the company has engaged in a wholesale cash-and-carry arrangement as well as a back-end supply chain management operation with a local retail distributor.[18,19]

- **The Walt Disney Company.** The company is continuing its expansion in the emerging markets. According to company annual reports, the company released its first animated films last year that were specifically targeted for local audiences in China and India. Furthermore, the company has expanded its merchandising capabilities by launching a line of baby personal care products in cooperation with an Indian pharmaceutical company that will be sold in more than 400,000 retail outlets. In China, the points of distribution for Disney merchandise now exceed 5,000, and its publishing division launched its first English-language learning centre in Shanghai.[20]

In addition to their in-depth exposure to emerging markets, these companies' global nature means they possess several advantages. Firstly, they tend to be broadly diversified – while they stand to benefit from the advance of developing markets, they are not entirely beholden to it. Secondly, in contrast to the principally growth-oriented stocks in emerging markets, these companies tend to be more mature - they have healthy capital structures and pay dividends. Thirdly, these firms are generally transparent with professional management teams and shareholder accountability, reflecting diminished company-specific risk.

Conclusion

As the remarkable and unprecedented demographic and economic changes in the world continue, countries such as China and India could represent an even larger share of global GDP in the years to come, potentially offering incredible investment opportunities. Investors who wish to capture these investment opportunities have a wide range of choices. Although they can invest in regional funds with direct exposure to companies in emerging markets, many investors may also benefit from a global seamless approach.

While investors should seek out emerging market exposure, they should do this in the context of understanding the risks. The problem is that the risks are not easy to understand or anticipate. Therefore, the optimal way to gain both the required flexibility and exposure is to delegate the decision to an experienced investor with the capacity to allocate to and from emerging markets within a larger global investment strategy. The significant advantage of this approach is that the same investor should also be able to consider and take advantage of developed market opportunities that yield significant exposure to emerging markets when it is appropriate to do so. By using a global approach, portfolio managers can invest in the best stocks around the world in a way that cannot be achieved using a patchwork of regional or market-specific mandates.

In conclusion, an ACWE or global seamless strategy can offer the investor the best of all worlds. It provides a dynamic and active allocation to appropriate sectors and regions, as well as an appropriate participation in strongly growing regions around the world. Finally, it provides prudent diversification so investors can avoid some of the volatility they might experience with more direct emerging markets exposure.

[1] Ibid.
[2] Macro issues – Spring 2009, Capital Strategy Research. Published 1 April 2009.
[3] World Economic Outlook Databases (WEO). International Monetary Fund. Obtained at www.imf.org/external/data.htm#data
[4] World Population Prospects: The 2008 Revision Population Database. United Nations Department of Economic and Social Affairs. Obtained at http://esa.un.org/unpp/index.asp
[5] Ibid.
[6] Woetzel, Jonathan and Farrell, Diana. "Preparing for China's Urban Billion". McKinsey Global Institute, March 2008 (updated February 2009)
[7] World Population Prospects: The 2008 Revision Population Database. United Nations Department of Economic and Social Affairs. Obtained at http://esa.un.org/unpp/index.asp
[8] World Economic Outlook Databases (WEO). International Monetary Fund. Obtained at www.imf.org/external/data.htm#data
[9] Ibid.
[10] Credit Suisse Research Paper. Data obtained from CEIC Macroeconomic Databases for Emerging and Developed Markets, WIND database, and Credit Suisse.
[11] "China's 4 trillion yuan stimulus to boost economy, domestic demand". Posted on Chinese Government's Official Portal. Obtained at http://english.gov.cn/2008-11/09/content_1143763.htm
[12] Credit Suisse Research Paper. Data obtained from CEIC Macroeconomic Databases for Emerging and Developed Markets, WIND database, and Credit Suisse.
[13] Garner, Wang and Silva. Asia/GEMs Equity Strategy, Morgan Stanley Asia/Global Emerging Markets Research. 3 June 2009
[14] Ibid.
[15] HSBC Holdings plc Annual Report and Accounts. Issued by HSBC Holdings plc. Obtained at www.hsbc.com/1/PA_1_1_S5/content/assets/investor_relations/hsbc2008ara0.pdf
[16] 2008 PotashCorp Online Annual Report. Issued by Potash Corporation of Saskatchewan Inc. Obtained at www.potashcorp.com/microsite/annual_report/2008/downloads
[17] BorgWarner Letter to Stockholders 2008 Annual Report on Form 10K. Issued by BorgWarner Corporation. Obtained at www.bwauto.com/invest/2008-annual-report.shtml
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[20] The Walt Disney Company 2008 Annual Report. Issued by The Walt Disney Company and Subsidiaries. Obtained at http://corporate.disney.go.com/investors/annual_reports/2008/index.html