

COMING OF AGE:

A Fresh Look at Emerging Markets

Even after a four-year bull run, emerging market equities still offer investors some of the best long-term return prospects in the world. **Investors seeking a truly diversified portfolio may want to take a closer look.**

By Steven A. Schoenfeld
Chief Investment Officer

Alain Cubeles
Senior Investment Strategist

*Global Quantitative Management Group,
Northern Trust
Global Investments*

IN THE 1970S AND EARLY 1980S, MANY INVESTORS believed that simply owning funds benchmarked to the S&P 500 gave them sufficient exposure to the U.S. market. But after years of experimenting with small- and mid-cap stocks, investors realized they could further diversify their portfolios by adopting a “total market” approach.

Today, some investors still apply traditional thinking to equity investments made outside the United States, believing developed world equities offer all the return and diversification needed for an effective international strategy. But these investors may be missing many opportunities by restricting their foreign equity investments to the developed world.

Lands of Opportunity

While several developed countries currently face formidable economic challenges, such as persistently high unemployment and an aging population, many emerging market countries are enjoying strong economic progress. Consider just a few of the recent developments in emerging markets:

- Brazil’s Companhia Vale Do Rio Doce, already the world’s largest iron ore producer, submitted an

\$18 billion cash offer for Canadian nickel producer Inco as part of Doce’s quest for global nickel market dominance.

- By the first half of 2006, in just more than a decade, China had increased its global exports by nearly five times.
- In India, June 2006 figures showed 20% and 23% year-over-year production gains in consumer products and capital goods, respectively. This led to another major U.S. credit rating agency upgrading India’s sovereign rating, thereby improving that country’s prospects for better domestic liquidity and stronger gross domestic product (GDP) growth.

Many emerging market companies are experiencing consecutive periods of double-digit revenue growth, steadily increasing balance sheet strength and are, in aggregate, more profitable than their developed world counterparts. And while return on equity for all companies around the world has risen during the last four years, companies located in emerging markets have consistently produced a return on equity premium at least 1% higher than companies in developed countries.



Adding some **exposure to emerging markets** can help position your portfolio to benefit from the **exciting growth potential** of emerging market “blue chip” companies.



Structural Reforms Providing Stability

Much of the economic success emerging market countries now enjoy stems from serious structural reforms implemented after the various economic and financial crises of the 1990s. Chief among these reforms, emerging market countries have:

- Reduced dramatically their foreign-currency (mostly U.S. dollar) denominated debt from 90% in 1999 to 10% in 2006 relative to their aggregate GDP;
- Reduced, and in some cases eliminated, their fiscal deficits;
- Experienced current account surpluses, which stand in stark contrast to the trade deficits plaguing many major developed countries;
- Seen inflation recede to single-digit levels; and
- Begun to adopt the standards of generally accepted accounting principles (GAAP) used in the United States, bringing much greater transparency to public and corporate governance practices.

Despite these positive trends, we don't recommend investing in emerging markets at the expense of exposure to developed markets. Canada, Europe, Japan and Australia remain home to hundreds of excellent companies that are global leaders in their respective industries and represent essential investment holdings for most global equity portfolios.

However, emerging market countries are now too significant to ignore — geographically, demographically and economically. These developing economies contribute nearly half of the world's economic activity and are growing at double the rate of developed country economies. They comprise 90% of the world's landmass, including some of its most valuable real estate, and are home to approximately 85% of the world's population.

Adding some exposure to emerging markets may help position your portfolio to benefit from the exciting growth potential of dozens of emerging market companies. Some of the fastest-growing, industry-leading companies — including widely recognized global brands such as Samsung, Cemex, Teva and Embraer — are located in emerging market countries. In many ways, each of these is a “blue chip” company whose home address is far less relevant than its ability to grow and operate profitably beyond its own geographic borders.

Emerging Markets “Growing Up”

The emerging markets asset class is truly growing up. Empirical evidence shows that while emerging markets' investment risks have declined steadily over the past several years, emerging market investors are still earning higher returns relative to similar equity investments in developed markets.

However, the correlation between emerging and U.S. equity markets has also increased during the past decade, prompting some analysts to minimize emerging markets' diversification benefits.

This rising correlation can largely be explained by the following factors:

- The Internet and other advances in communications technology have greatly improved both the dissemination of financial data worldwide and investors' access to all global financial markets;
- The government and corporate reforms enacted in emerging market economies following the 1990s financial crises have proved both sustainable and effective, resulting in lower systemic investment risk; and
- Globalization — the integration of international economic activity — also produces higher correlations between developing and developed markets.

Nonetheless, the correlation between the MSCI Emerging Markets Index and the S&P 500 is still only 63%. In other words — even after their powerful four-year rally — emerging markets still offer robust diversification benefits.

Blend of Strategies Is Best Approach

Today, investors can gain emerging markets exposure through active or passive (i.e., index) strategies. These strategies differ primarily on cost and risk attributes.

Active managers have long played the dominant role in emerging market equity mandates, and many investors still regard active managers as the de facto emerging markets experts. But the argument that active managers can achieve superior returns by capitalizing on emerging market inefficiencies, such as lack of company research coverage and financial reporting delays, is less valid today because of the structural reforms referenced above. In addition, active management fees remain higher (often considerably higher) than fees associated with passive strategies.

On the other hand, an active strategy used either in isolation or in concert with an index approach offers investors the opportunity to overweight certain countries, regions, styles or specialist managers. Perhaps more importantly, active strategies enable investors to benefit from adroit sector, industry and individual security selections.

Using an index strategy can provide broad and efficient emerging markets exposure while also neutralizing one of active managers' greatest challenges: making accurate country-specific allocations. A top-

performing equity market in one year is by no means guaranteed to advance further in subsequent years. For example, Turkey's stock market was among the world's top five best-performing equity markets in 1997. But in 1998, just one year later, the Turkish market ranked among the world's five worst-performing equity markets.

As with any investment, the best strategy is the one that is most appropriate in light of your unique personal situation, investment goals and time horizon.

For Long-Term Returns, Emerging Markets Worth a Look

If you are seeking higher long-term returns, you may want to consider adding emerging market exposure to your portfolio today. Allocating a portion of your international equity investments to emerging markets can give you access to these evolving markets and the higher long-term return potential they offer, as well as provide broader diversification. Regardless of whether you choose to follow an active or passive approach, being there is the key. ■

Steven A. Schoenfeld and Alain Cubeles co-authored "Emerging Markets Investing: Efficiently Adding Emerging Market Equities to a Global Portfolio," an in-depth analysis of investing in emerging markets, from which this article was excerpted. If you would like a copy of this paper, please contact your relationship manager, or call 866.296.1526.

UNDERSTANDING CORRELATION

Correlation describes the strength of the relationship between two asset classes or markets. The asset classes are correlated if the returns they provide are similar to one another in similar market environments. A correlation of 1.0 (or 100%) indicates that the assets are perfectly correlated; they will respond to market conditions in the exact same way. A correlation of 0 indicates that there is no direct relationship between the responses of the asset classes to market conditions.