Smarter, broader allocations to Emerging Market equities

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Question:

- Who are the future consumers of the world?

This developed market family?

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Or this EM family (and 100's millions like them)?

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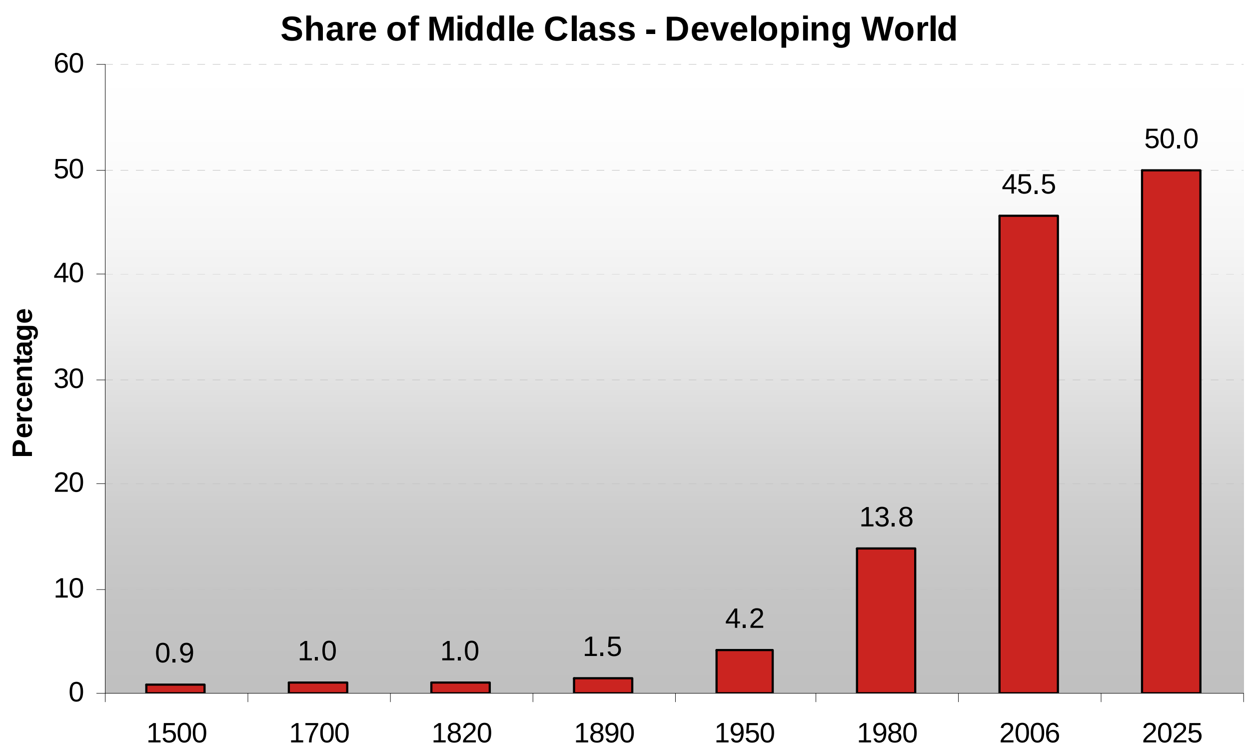
Growing Middle Class



- McKinsey Global Institute

  India predicted to overtake Germany as 5th largest consumer market by 2025.
- Yang Zhiming, Deputy Minister MOHRSS:

  Target of doubling employees' income during the 12th Five Year Plan period

Sources: Second Among Equals: The Middle Class Kingdoms of India and China, Surjit S. Bhalla, 2007, MGI The ‘Bird of Gold’, 2007, China Securities Journal.

Global Emerging Markets - some statistics

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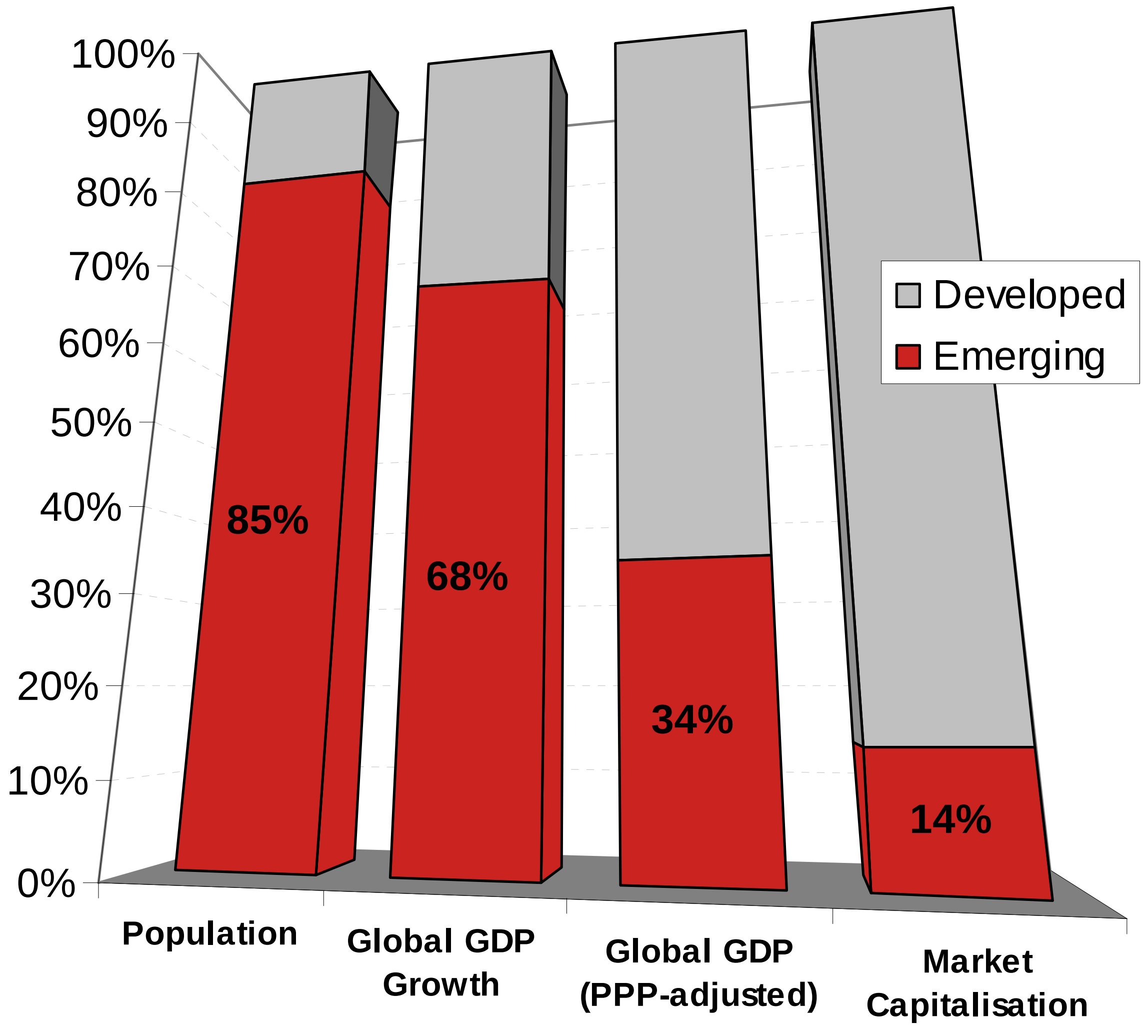

* Source: IMF, OECD, MSCI.

Your asset allocation options?

Market cap weighted

- Overweights the most expensive (and developed) markets and stocks

Liquidity weighted

- Highly correlated to market cap

Equally weighted:

- Naïve approach - practical considerations might impact investability.

GDP weighted:

- Not a new idea – MSCI have published an index for more than 10 years
- Very few managers have adopted as a benchmark

GDP Weighting - why might it work?

- Over the long term, listed shares must be expected to benefit from a proportion of economic activity.
- In emerging markets, that proportion should increase.
- GDP weighting allocates more (than market cap) to countries at earlier stages of stock market development.
- Historical imbalances between GDP weight and stock market weight tend to correct.

Conversion of GDP weight and market size

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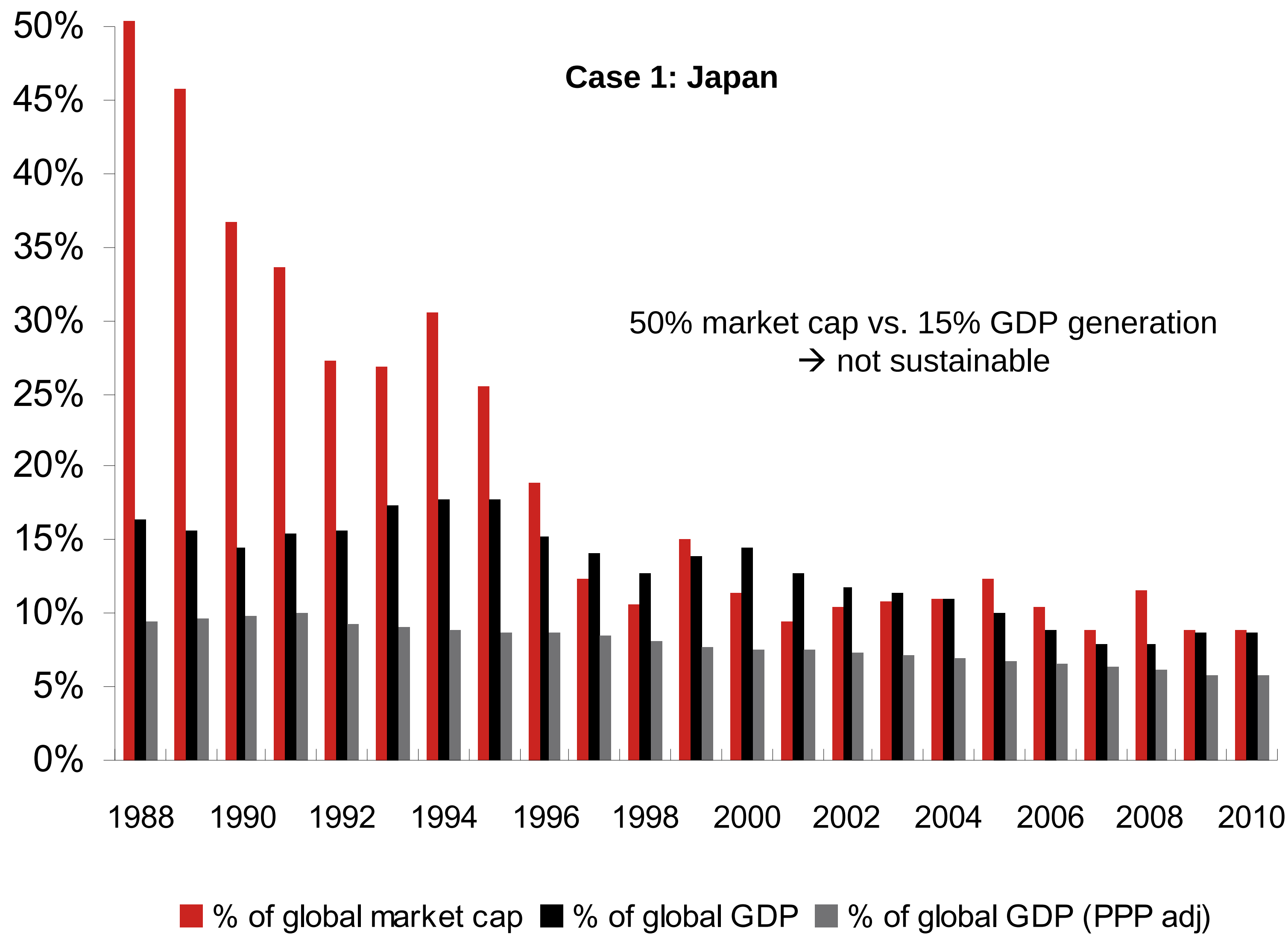

Conversion of GDP weight and market size

GDP weights adjusted for PPP?

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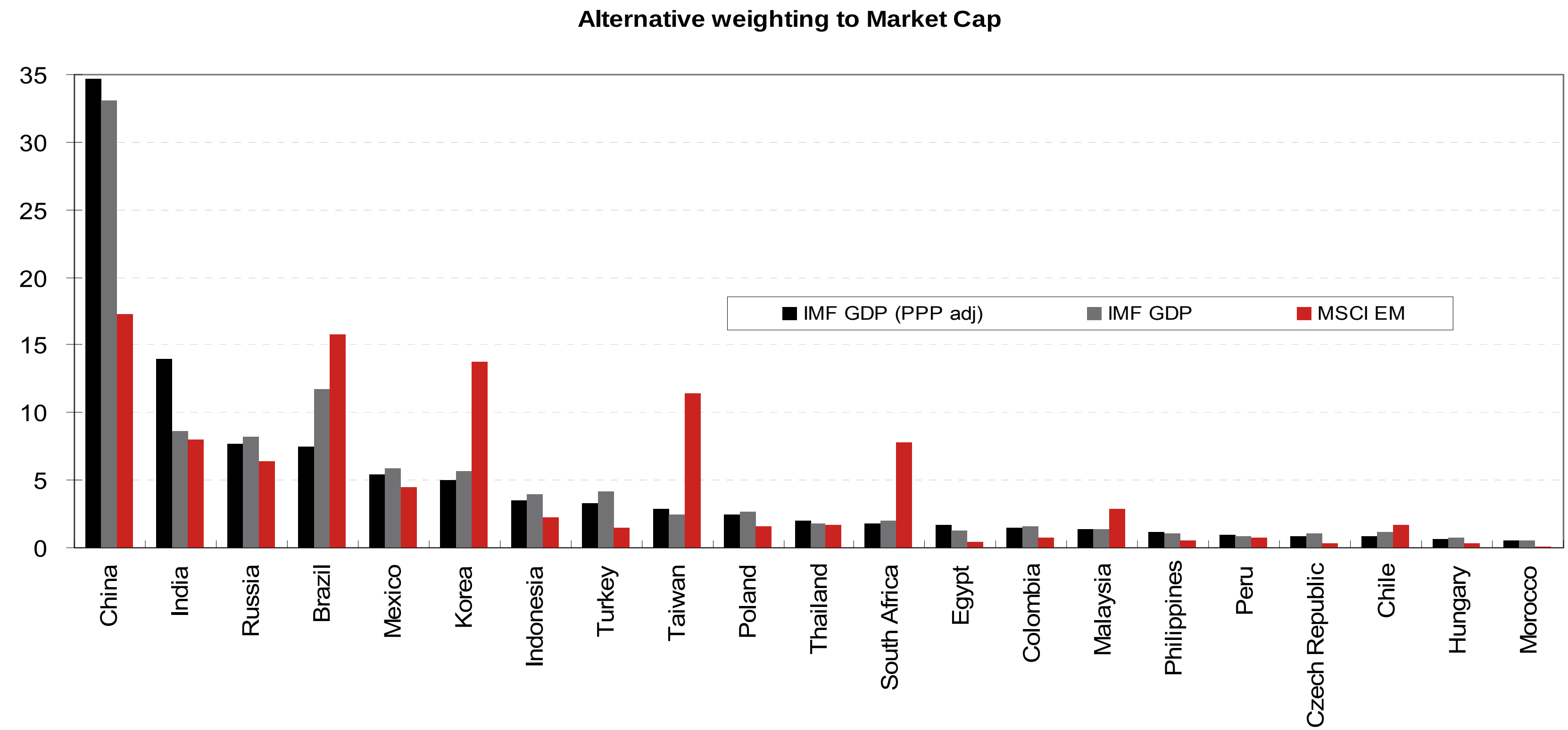
Why adjust for purchasing power?

- Dollar wealth in low cost of living countries goes further
- PPP adjustment gives a fairer comparison of the power of wealth generated across currency borders
- Countries with “undervalued” currencies get greater weight



Sources: NAM, IMF, MSCI, 31st December 2010

GDP (PPP) weighting - backtest

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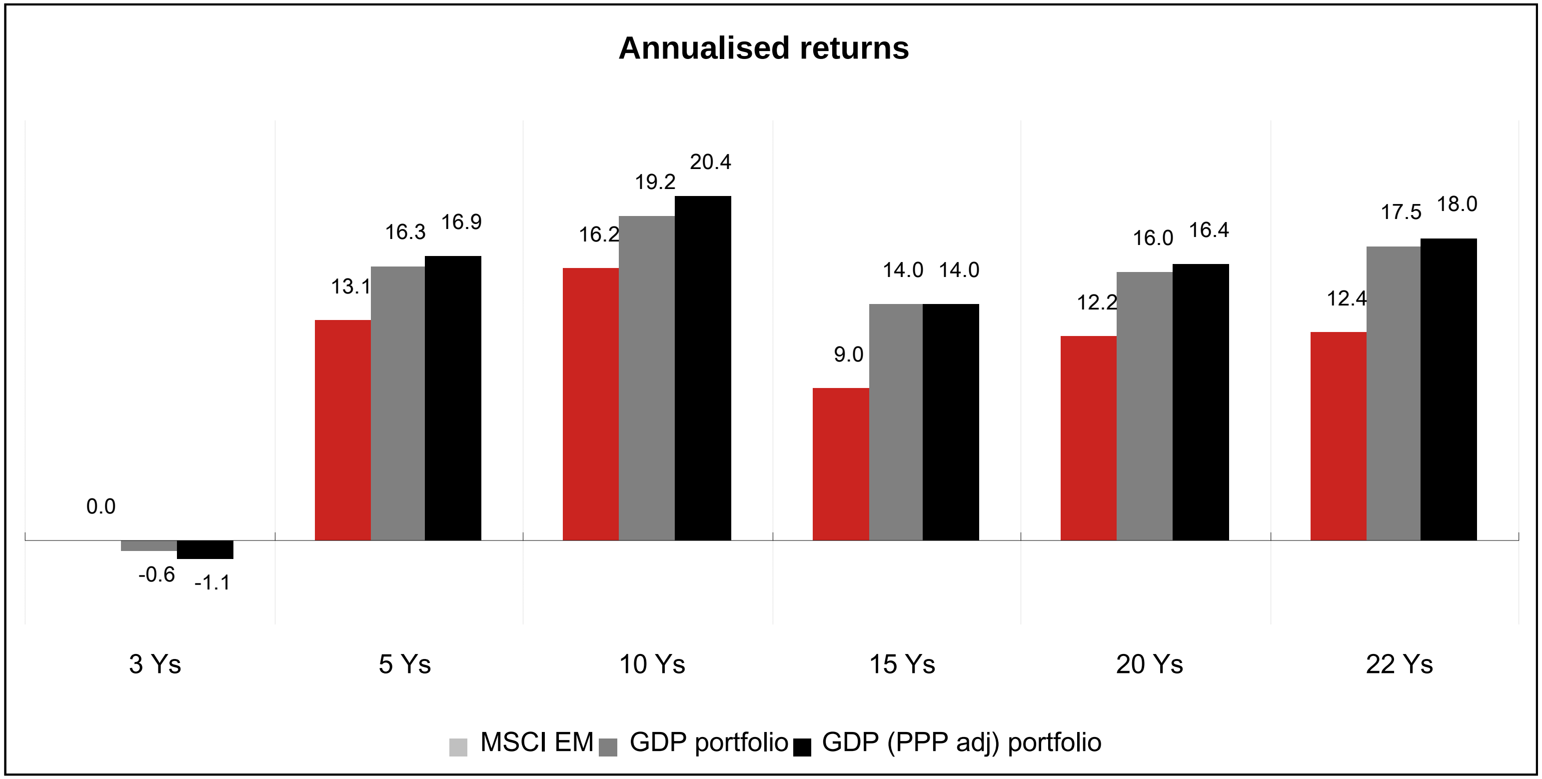
Rebalance annually

Stocks at market cap weights within each currency "bucket"



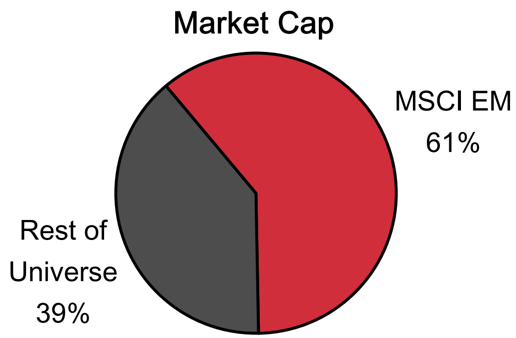
Sources: NAM, IMF, MSCI, 31st December 2010. Returns are annualised, in USD.

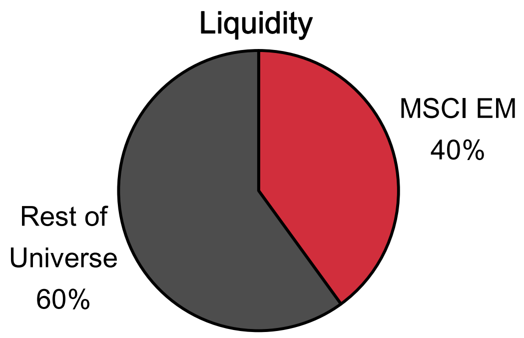
GDP and GDP (PPP adjusted) portfolios rebalanced annually at year end. Country weights based on one year lagged IMF data.

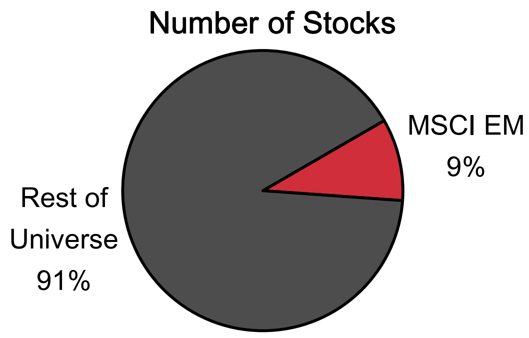
Looking beyond the “index” stocks

MSCI’s standard index consists of approximately 800 stocks

Smarter allocations to these stocks are important, but what of the 8,000+ stocks beyond the MSCI standard index?







Despite accounting for more than 60% of the liquidity of the EM universe, few investors allocate to smaller EM stocks, and few investment products are offered. Why?

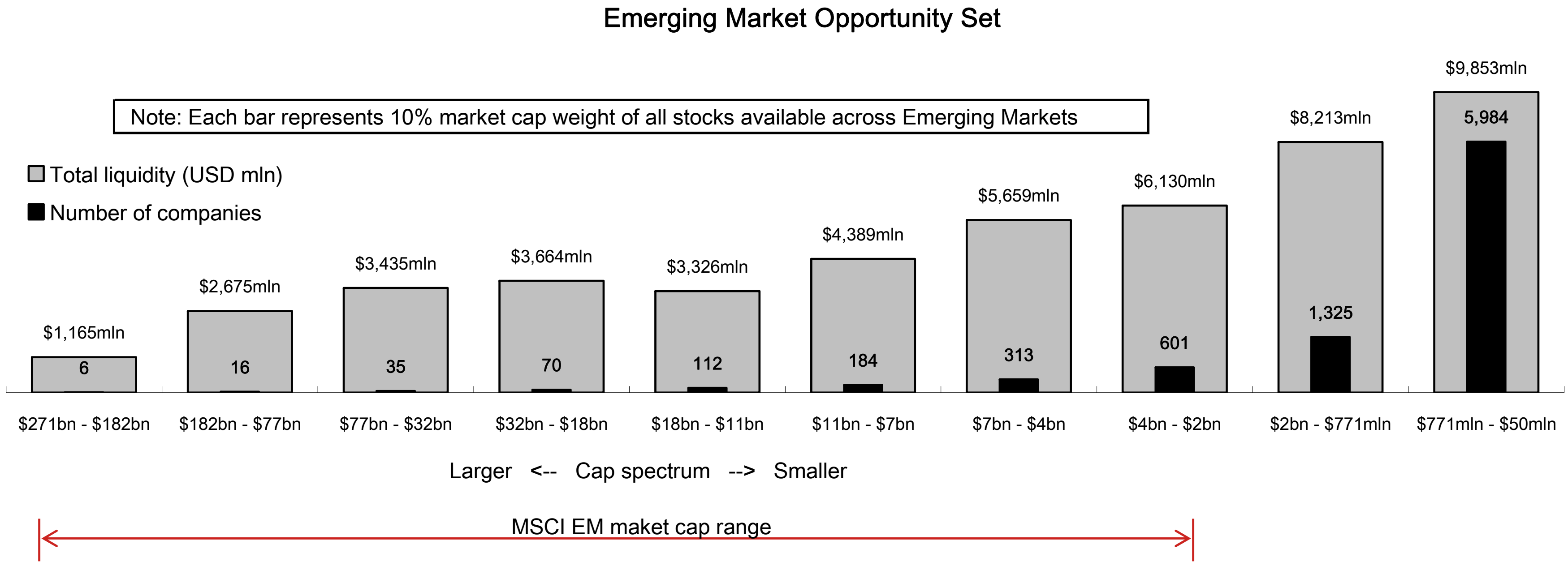
Notes: MSCI EM constituent countries only. Companies which do not trade or whose market cap is below $50mln are excluded from the universe.
Source: Factset; Nomura Asset Management. Data as of end June 2011.

Challenges of fundamental analysis:

Geographical, cultural, linguistic diversity.

Breadth of universe: 8,000+ names of investable size and liquidity[1]

Liquidity and capacity:



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Sector allocation: MSCI EM vs. rest of Universe

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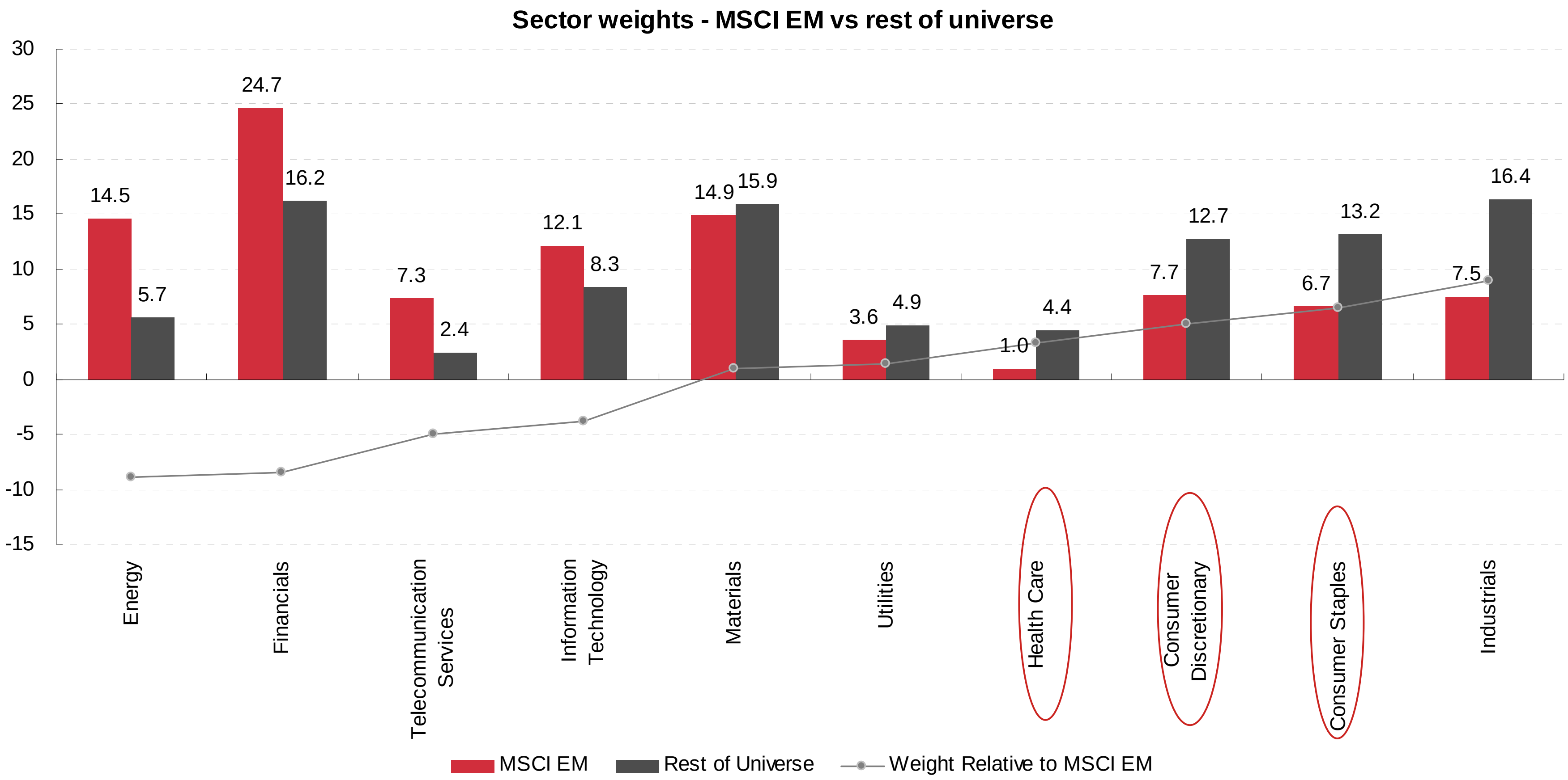
Greater weights to consumer-oriented sectors

Energy and financials reduced



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EM Small cap – diversifier or return enhancer?

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Volatilities and Correlations over 10 years:

Asset Class	Return	Volatility	Reward to Risk
MSCI EM SC	15.57	26.19	0.59
MSCI EM	14.34	24.63	0.58
MSCI World	3.93	17.42	0.23
S&P 500	1.94	15.90	0.12
TOPIX	2.14	17.07	0.13
FTSE All Share	4.44	18.36	0.24

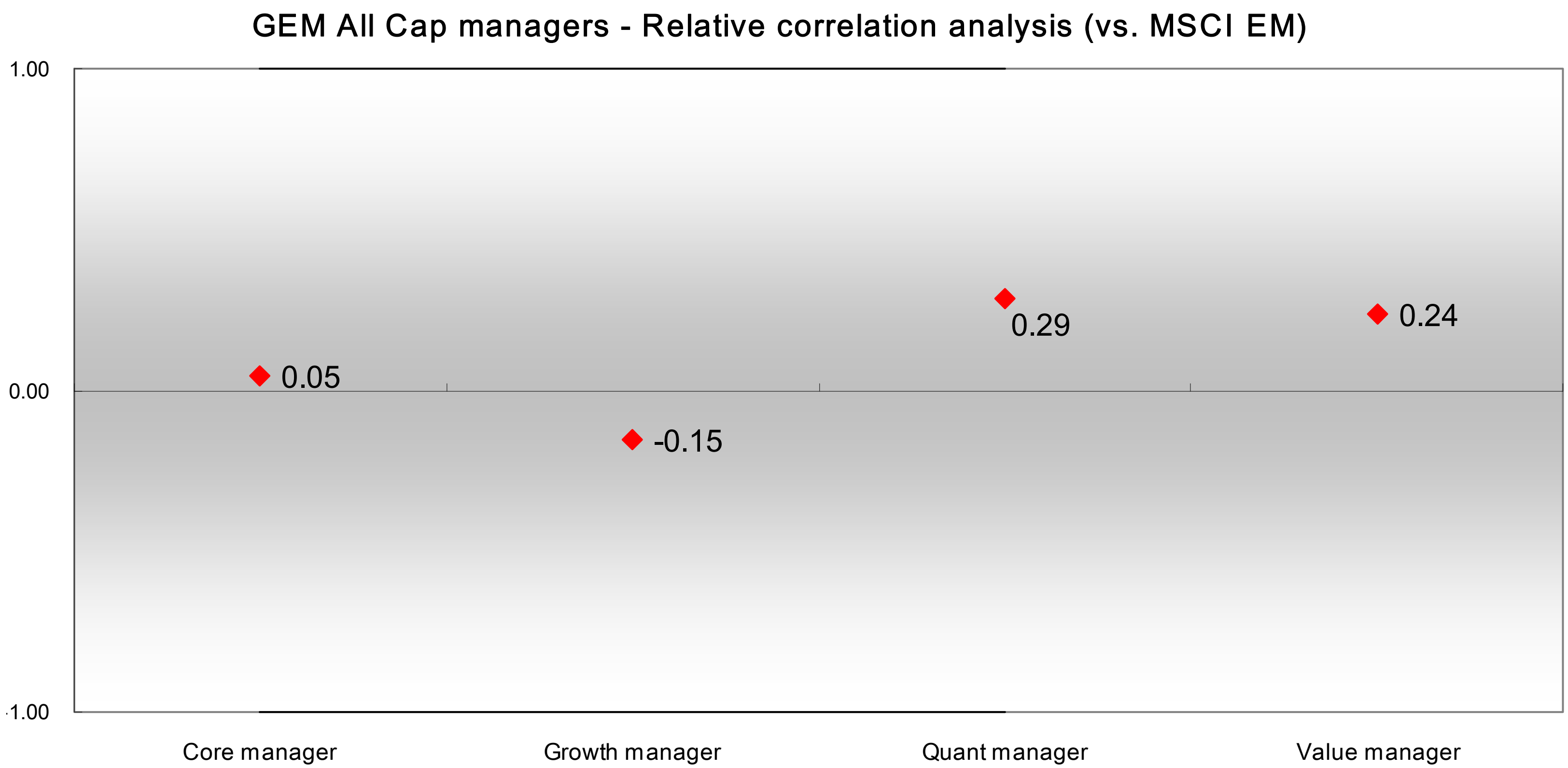
Source: NAM, Datastream. USD Terms 30/09/01 to 30/09/11

Correlation table	MSCI EM SC	MSCI EM	MSCI World	S&P 500	TOPIX	FTSE All Share
MSCI EM SC	1.00					
MSCI EM	0.97	1.00				
MSCI World	0.88	0.91	1.00			
S&P 500	0.78	0.82	0.97	1.00		
TOPIX	0.60	0.61	0.65	0.55	1.00	
FTSE All Share	0.83	0.86	0.94	0.87	0.61	1.00

Source: NAM, Datastream. USD Terms 30/09/01 to 30/09/11

“Active” Correlations?

Assuming you have emerging exposure already, would a small cap exposure help diversify existing “active” risk?



This chart shows how the excess returns of each manager above the MSCI EM index is correlated to the excess returns of a representative small cap strategy backtest.

Source is MPA with the following managers being used to represent the different styles – Core = Aberdeen, Growth = Alliance Bernstein Growth, Value = Alliance Bernstein Value and Quant = Batterymarch. The Small Cap strategy is Nomura’s NEWS Emerging Small Cap Strategy. Data over the period from 1/4/2004 to 30/06/2011 (period of NEWS backtest).

Conclusions

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Allocating to EM:

- Funds with less than 30% of equity allocated to EM, underestimate its importance

Allocating to the MSCI EM stocks:

- Market cap might provide a good benchmark in EM, but it is not a sensible way to allocate capital
- Alternatives, including GDP (PPP) weighting have outperformed and seem more reasonable than market cap alone

EM Small cap:

- Offers a broader exposure to the future of wealth generation – emerging market consumers
- More effective return enhancer than diversifier
- Think quant!

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