

NEWS – Nomura Emerging Wealth Strategy (Emerging Small cap)

Introduction

Most investors in Emerging Markets (“EM”) miss an opportunity – they focus only on the largest EM stocks. Yet there are 14,000+ EM stocks beyond the constituents of the MSCI EM Index, and these stocks tend to have greater exposure to the domestic consumer growth story – the reason many of our clients invest in EM to begin with.

EM Small Caps are an increasingly important asset class for institutional investors to consider. Few investors have to date allocated to this asset class; problems of market access, liquidity and lack of investment vehicles are reasons. Yet EM Small Cap stocks have outperformed larger EM stocks (see table below) despite being largely immune to the recent “hot money” inflows into large caps and ETFs. They are under-researched, and offer diversification to investors who access their potential.

Nomura has developed a strategy which gives access to this broader EM universe – NEWS (Nomura Emerging Wealth Strategy). On 7th April 2011, the Strategy commenced with its first client, a UK local authority, investing in our pooled, Dublin-based UCITS fund (Bloomberg identifier: NOMSCIU).

NEWS Investment Objectives

- Broad, diversified exposure to smaller capitalisation EM companies (non-MSCI EM Standard Index constituents)
- Increased access to the emerging consumer growth story
- Allocation to countries and stocks whose wealth generation is not yet reflected in the stockmarket

Objective:	Measure:
Return objective:	Outperformance of MSCI EM Small Cap Total Return (Net) Index (over rolling 5 years)
Ex-post Tracking Error Range:	5-15%
Universe:	Universe is all listed stocks in Emerging Markets. MSCI EM constituents (large/mid cap) are excluded.
Countries & Currencies:	MSCI-defined Emerging Markets

Past Performance

The table below shows tested performance for the NEWS Small Cap strategy since 1st April 2004 (the longest period for which data is available). Excess return is shown relative to the MSCI EM Small Cap Total Return (Net) Index:

Period	Annualised performance			Volatility		
	NEWS SC	MSCI EM Small Caps	MSCI EM	NEWS SC	MSCI EM Small Caps	MSCI EM
Inception*	22.7	17.0	15.3	29.2	27.5	25.2
5 Ys	20.3	15.2	11.1	32.7	30.7	27.4
3 Ys	13.1	12.2	3.5	37.1	35.3	31.1

Data in USD as of 30/06/2011

* Inception date: 31/03/2004

* From 31/03/2004 to 30/04/2011: data based on model simulated results. No transaction costs considered. Benchmark: MSCI EM Small Cap Total Return (Gross) Index. After 30/04/2011: data based on live portfolio returns. Transaction costs are considered. Benchmark: MSCI EM Small Cap Total Return (Net) Index. Source: Nomura Asset Management.

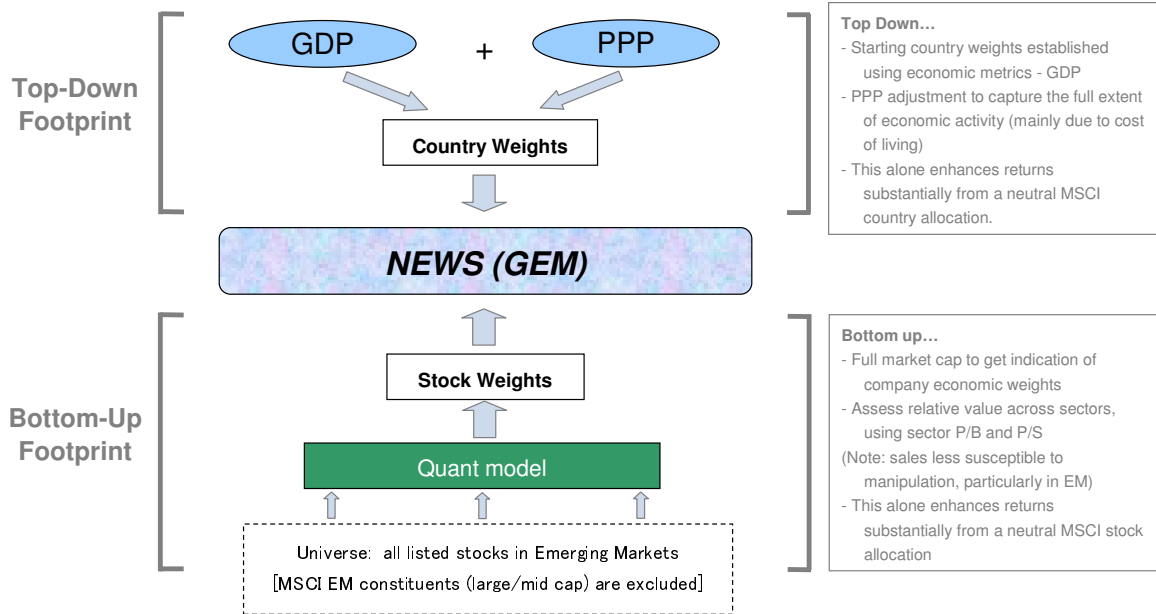
- Contributions from both the top down and bottom up processes have been consistently positive.
- Tracking errors are relatively low, leading to long term information ratios greater than 1.
- Overall volatility of the strategy is similar to that of the MSCI EM Small Cap Index

Risk Warnings: Hypothetical or simulated performance results have certain limitations. Unlike an actual performance record, simulated results do not represent actual trading. Also, since the trades have not actually been executed, the results may have under or over-compensated for the impact, if any, of certain market factors such as lack of liquidity. Hypothetical trading programs in general have the benefit of hindsight. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. The Emerging Markets are volatile, and small cap stocks can be more volatile than large caps. Investment in small cap stocks are also characterised by low liquidity and potentially restricted market access. Hence the investor should understand that investment in this fund involves substantial risk.

Notes: for the purpose of back-testing the strategy, the MSCI EM Small Cap Total Return (Gross) index has been used to guarantee a like-with-like comparison as the model considers dividends reinvested gross of withholding tax. For the live strategy, the MSCI EM Small Cap Total Return (Net) is more appropriate because withholding taxes paid in some emerging countries cannot be claimed back by foreign investors.

Investment Philosophy / Process: Follow the Wealth, not the Herd

The NEWS concept is based on evidence that economic wealth is not yet adequately represented in the stock markets of many countries, and our theory suggests that it is reasonable to expect this gap to narrow over time. This translates into a strategy that allocates to both countries and stocks ahead of the market, capturing “alpha” from its realisation. NEWS generates outperformance via both a top-down approach (country weighting based on GDP adjusted by PPP – Purchasing Power Parity) and bottom-up approach (stock selection based on full market cap adjusted by sector-wide relative valuation).



Top Down

The economic footprint of a country is best represented by its GDP weight. It therefore makes intrinsic sense to allocate to countries according to the size of their GDP. However, GDP statistics, when compared across currency borders, can be distorted by free market currency exchange rates. If the purchasing power of a currency is understated by free market exchange rate, the economic footprint of that country’s GDP will be underestimated. We therefore adjust the GDP of each country to account for PPP to gain a more accurate estimate of true economic footprint. GDP weights, adjusted for PPP thus form our country allocations for NEWS.

Bottom Up

Within each country, we strip away free float or foreign ownership – these factors may be necessary for the providers of indices, but we find no reason to consider them to quantify economic wealth generation. We use full market capitalisation as our base, but compare valuations of companies across sectors to tilt the NEWS portfolio towards companies whose valuations do not fully reflect their economic footprint. We use Price to Book and Price to Sales to tilt our portfolio. These metrics compare market price to the top lines of companies’ balance sheets and income statements respectively, and are the hardest to manipulate – an important consideration in emerging markets.

Investment Process & People

The NEWS concept has been developed through time by leveraging the experience our quantitative teams at NAM. These teams have built their reputation over the long-term and some members have been recognised as thought leaders in the industry, particularly in Japan.

In the relatively illiquid EM Small Cap space, the experience and resources of our Portfolio Management and Trading teams are an important differentiator for our firm.

