

**three emerging markets,
three sharpened skills...**

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...one strategy

**Highlighted winner:
Emerging Markets Investment Manager
of the Year
Nomura**

NOMURA

Seeking out potential in the less developed markets is a challenging role at which only the best can succeed; yet for those that do, the rewards for European pension funds investing in this area can be great. This award recognises those managers that have shown a dedication to the emerging markets space with a view to achieving performance, whatever the market conditions and often in areas where information flow is in short supply.

Nomura Asset Management was presented with the coveted prize of Emerging Markets Manager of the Year award for its unique and innovative approach to the emerging market space; its presence in the market; its expertise; and for creating a regionally focused emerging strategy accessible even to smaller funds.

Nomura is focussed on responding to the needs of European pension funds and uses its specialist asset management capabilities to meet those needs. The firm has provided asset management services to European pension funds since 1984 and through continued success in most market conditions has grown its assets in emerging market equities significantly.

Nomura aims to deliver alpha to the European market through innovative strategies including core, absolute return and high alpha structures coupled with excellent client service. A core objective is to provide European clients with the alpha they are seeking within a risk controlled framework.

Nomura's emerging strategy, now three years old, has delivered outperformance in both rising and falling markets by combining three specialist emerging market managers from each of the three main regions (Asia, Latin America and EMEA) into a single global emerging market product. Clients are able to get the benefit of the three managers, but only have to deal with one. They also get the benefit of manager diversification and uncorrelated alpha.

Nomura has clearly responded to the needs of pension funds by creating this regionally focused emerging strategy. Given governance and budget constraints faced by most pension funds, accessing regional expertise was once something only the largest could enjoy. Nomura's product opens this market up to all funds.

Its unique & innovative offering, coupled with independent third party research puts it ahead of the game in the emerging market space. Congratulations to a deserving winner.



The European Pensions Emerging Markets Manager of the Year award was presented to Nomura Asset Management. Receiving the award is David da Silva, Head of GEM Strategy (centre) at the firm. The award was presented by Comedian Chris Barrie (left) along with one of the judges, Matt Wilmington, International Benefits Actuary, Hewitt (right).

Original Article

The case for emerging markets and regional versus global management considerations

Received (in revised form): 20th October 2008

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is the Head of GEM Strategy at Nomura Asset Management UK Limited. He has been with the firm since 2004. Before this, he held product development roles in Morley Fund Management in London, with specific focus on Japan, Singapore and the United States. He commenced his investment career at Commercial Union Investment Management in South Africa as an analyst and fund manager in 1996. In 1999, following Commercial Union's disinvestment from South Africa, he moved to London to work at Commercial Union's investment management business, Morley Fund Management. He has a B.Com. (Hons) degree from the University of Cape Town, South Africa. In 1999, he attained the Chartered Financial Analyst designation.

ABSTRACT This paper considers whether there is a strategic case to be made for investing in emerging markets and, if so, whether the timing is still right to invest. The question of how best to achieve emerging market exposure is then addressed, in particular whether using a collection of regional specialists is superior to using a single global emerging market manager. Independent research from Oliver Wyman supporting the case for regional specialists is then reviewed.

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Keywords: emerging market equities; case for regional specialists

EMERGING MARKET PERFORMANCE

Emerging market equities have performed relatively well over the 3 years leading up to September 2008, comfortably outperforming developed markets, with a return of 28.4 per cent versus, for example, the 0.6 per cent decline in the S&P 500 in US dollar terms (Figure 1). This relative strength had encouraged many to subscribe to the 'decoupling' argument, which suggests that emerging markets are no longer dependent on growth in the developed world to maintain their own growth rates. Over the past year, however, the decoupling thesis has been

seriously undermined, with emerging markets declining more rapidly than their developed counterparts; the MSCI EM index declined by 33 per cent versus the 26 per cent fall in the MSCI World index (performance up to the end of September 2008 in US dollar terms). In an increasingly globalised and interconnected world, total decoupling always seemed unlikely, but what is true is that emerging countries are less vulnerable to a developed world slowdown than they have been in the past. Better fiscal balance sheets, increasing domestic demand, massive public infrastructure programmes and high savings rates have all helped. Furthermore, growth in trade amongst emerging economies has risen substantially. Therefore, the dependence on the United States, Europe and Japan is less, but still important.

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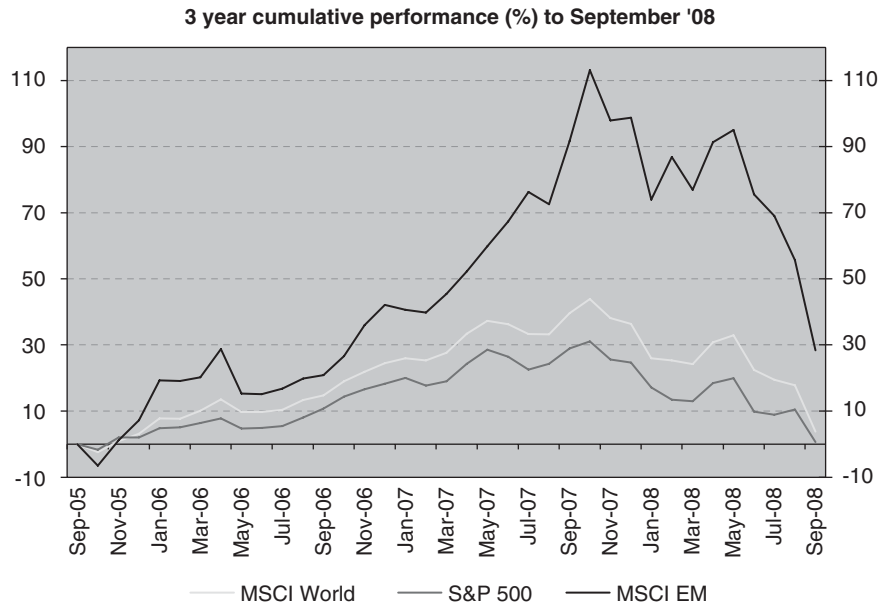


Figure 1: Cumulative performance: 3 years.
Source: Datastream, Nomura. Monthly data as of 30/09/2008.

Over the longer term, the extent of outperformance has been striking. Figure 2 shows MSCI EM performance in US dollar over the 20 years up to the end of July 2008 (the longest period available, as this was the inception of the date of the index).

Another notable feature is how strongly the markets have collectively bounced back following the highly publicised market crises of the late 1990s and early 2000s, including the South East Asian crisis in 1997, followed by the Russian debt default crisis and the dot.com fallout. Despite these knocks, these markets have recovered very sharply.

What has been driving this performance?

Strong economic growth has been key in driving this outperformance. Figure 3, depicting real GDP growth rates, highlights how emerging markets have seen growth accelerate over the past few years. From the narrow growth advantage in the 1980s and 1990s, this differential has increased to unprecedented levels in the past few years. The World Bank is likely to revise down the estimated 2008 and 2009 figures in due course to reflect the impact of the credit crunch, but the overall

trend should be consistent going forward. This chart puts into perspective the fact that despite emerging countries only accounting for a quarter of world GDP, they account for 50 per cent of global GDP growth.

Growing, but is this reflected in the market?

Emerging economies are growing, but is this being reflected in their share of global market capitalisation? There is a relationship in many countries whereby their relative share of global GDP converges to a similar proportion of global market capitalisation. As an illustration of this, Figure 4 shows this relationship for Japan. In the late 1980s, during the Japanese stock market bubble, Japanese equities accounted for 50 per cent of global market capitalisation, despite the economy only accounting for 15 per cent of world GDP. After the bubble burst, the two ratios eventually came into line with Japan's market capitalisation and GDP percentage ratios, levelling off near 10 per cent.

Figure 5 highlights the fact that despite the aforementioned growth advantages, emerging market capitalisations lag far behind their contribution to the global economy. Emerging

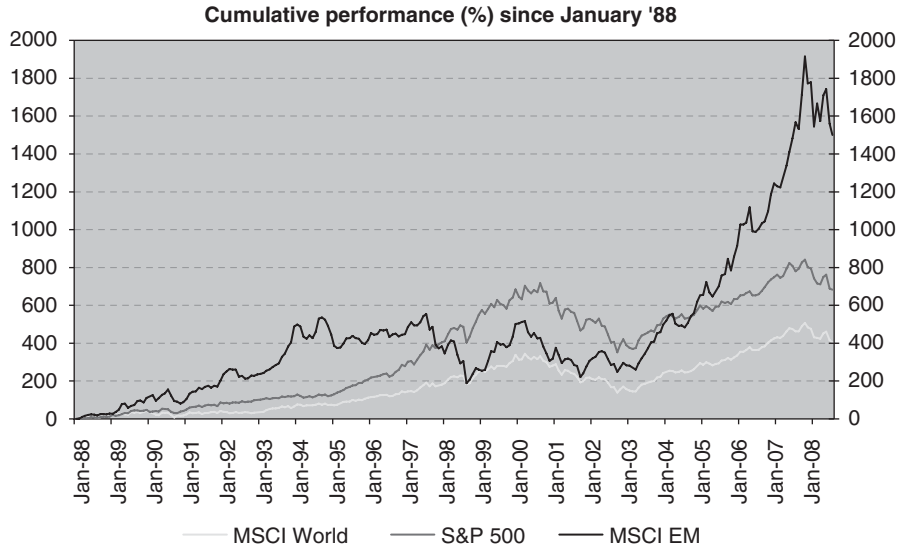


Figure 2: Cumulative performance: 20 years.
 Source: Datastream, Nomura. Monthly data as of 31/07/2008.

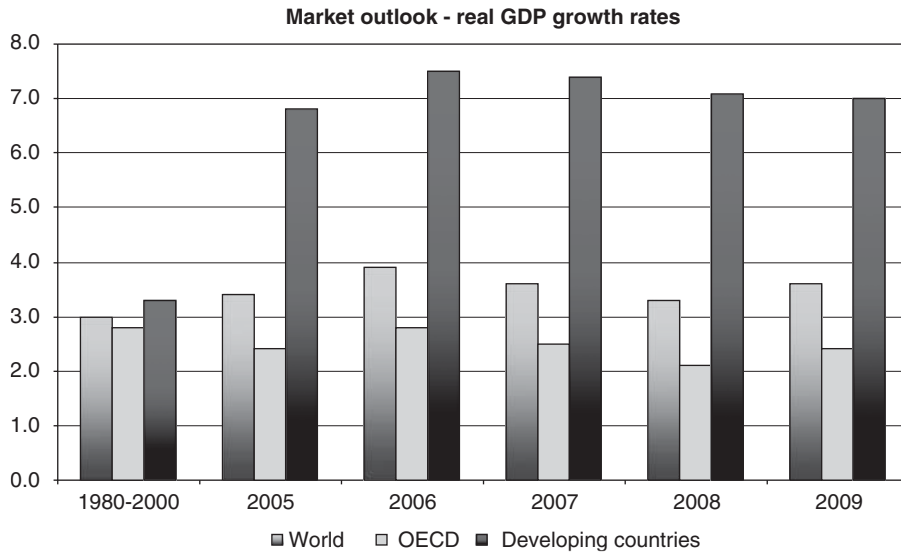


Figure 3: Real GDP growth rates.
 Source: Global Economic Prospects 2008, The World Bank 2008.

markets are nearly 30 per cent of global GDP, but are only 11 per cent of global market capitalisation. Therefore, there is still some way to go. To highlight this point, Figure 6 illustrates how the MSCI World index is currently apportioned: the United States, Canada and Europe account for 75 per cent, whereas emerging markets account for 11 per cent of the

total. The figure also shows the allocations to the main emerging market regions: 50 per cent of emerging market capitalisation lies in Asia and approximately 25 per cent in each of Latin America and Europe, the Middle East and Africa (EMEA).

This reflects the current position, but more important is the trend behind the numbers. In

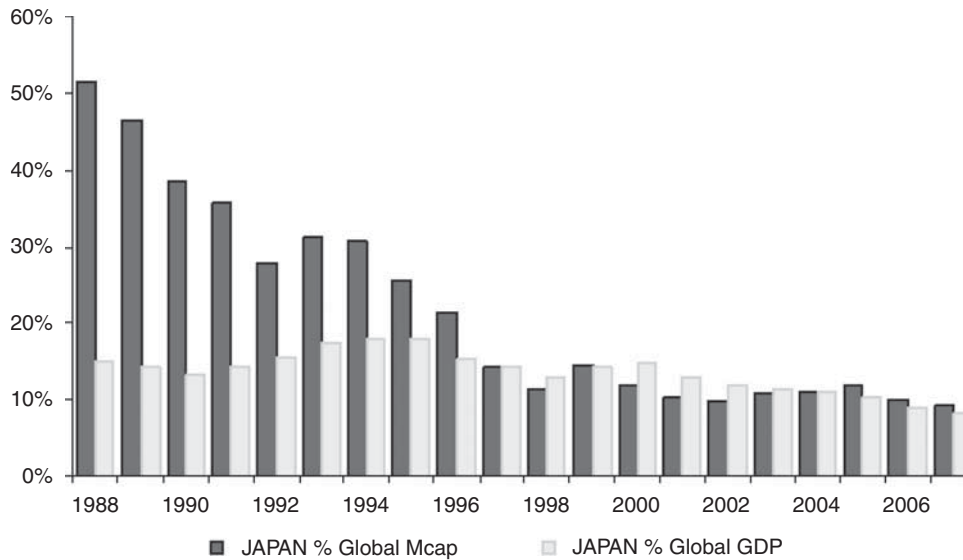


Figure 4: Japan market cap versus GDP percentage.

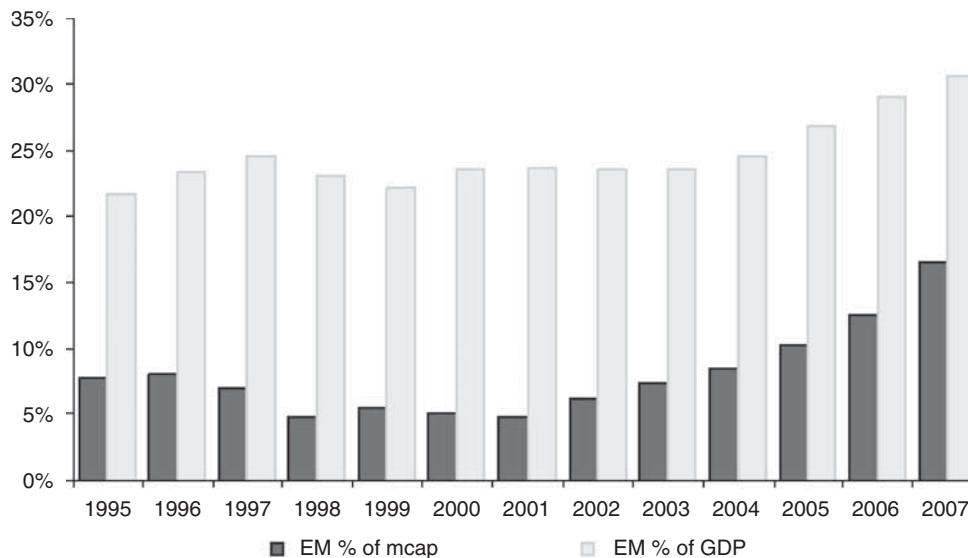


Figure 5: Emerging market cap versus GDP percentage. Source: IMF, datastream.

June last year, emerging markets collectively ranked alongside Japan with approximately 9 per cent of the MSCI World index; in the past year, as a result of relative outperformance and increasing market capitalisation, this has moved to 11.4 per cent, whereas Japan has remained at around 9 per cent.

Despite the increased weight in global indices, there is anecdotal evidence that institutional

investors' weighting to this asset class on average is less than 5 per cent. Consequently, there is ample room for allocations to grow.

LONG-TERM DRIVERS: DEMOGRAPHICS, SKILLS AND PRODUCTIVITY

The medium-term growth prospects look good, but investors should focus on the long-term

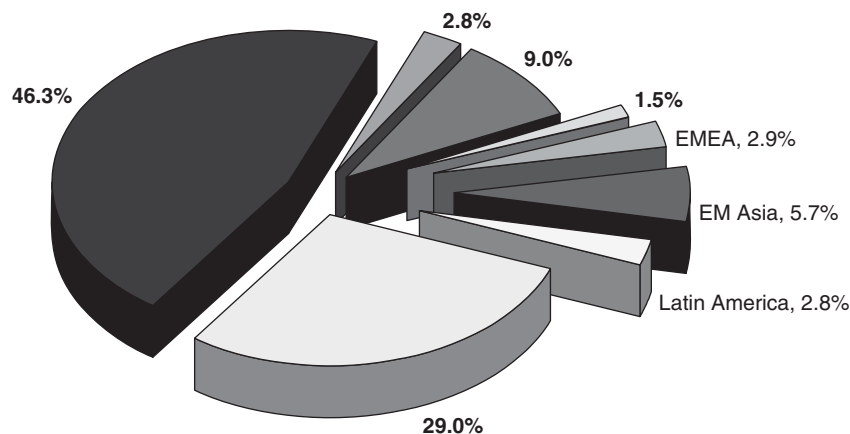


Figure 6: MSCI emerging markets market capitalisation allocation.
 Source: MSCI Red Book as of July 2008.

prospects: where will emerging markets be in 5, 10 or even 20 years' time? In order to obtain a perspective on these outcomes, consideration should be given to key drivers of economic growth, population demographics, skills and productivity.

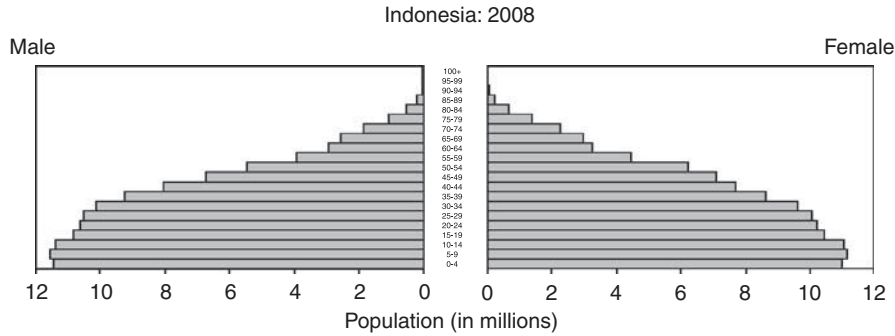
Emerging markets contain 80 per cent of the world's population: this is a young and growing population both in absolute and relative terms. As an indication of the scale and numbers involved, consider the fact that in the first quarter of 2008, a period of significant economic turmoil across the world, China Mobile signed up 21 million new subscribers. This is the equivalent of about a third of the United Kingdom's population purchasing a phone contract in 3 months. If the Chinese population is buying phones, one can extrapolate the exponential growth in demand for all sorts of other consumer goods, the future demand for housing, education and anything else you care to mention.

Apart from sheer numbers, emerging markets exhibit favourable demographic profiles. Basically they have relatively young populations. Figure 7 shows the population pyramids for Indonesia and Japan. Indonesia's profile exhibits a young population, represented by the width of the bottom bars of the figure. Japan is the other extreme. Japan's fertility rate is almost half that of Indonesia. And with a tight immigration policy, the population is expected to peak around 2015.

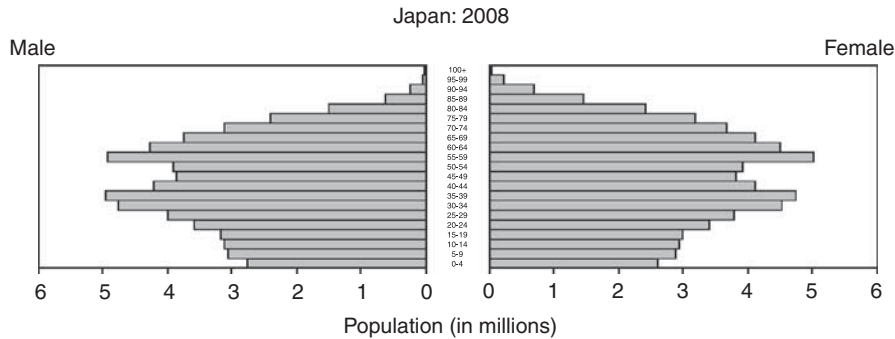
With a declining population and labour force, growth will come under substantial pressure.

Another factor influencing growth is increasing labour productivity, a key determinant of which is skills levels and these are increasing sharply. Figure 8 shows the number of science and engineering students graduating from universities in Japan, the United States, the EU, China and India. Although the data are slightly dated, they give a good indication of trends in this area.

Between them, China and India produced 1.2 million graduates in these disciplines in 2002/2004, more than Japan, the United States and the EU combined. Although these data are open to some criticism (China and India's definition of 'engineer' can be somewhat broader than developed nations' definitions, and emerging market graduates are not necessarily educated to the same standard as those of other countries), it is clear that emerging markets are no longer just the home of low-skilled manufacturing. Increasingly, they can compete in more high-tech, complex manufacturing and in complex services, an example being the Indian IT software industry. Higher skills are also important in that they can free economies from developing in the traditional way and enable them to leapfrog some stages of development. Therefore, in many emerging regions, communities are, for example, completely by-passing fixed-line telephones, and have moved straight to mobile technology.



Source: U.S. Census Bureau, International Date Base.



Source: U.S. Census Bureau, International Date Base.

Figure 7: Population pyramids for Indonesia and Japan.
Source: US Census Bureau, International Data Base.

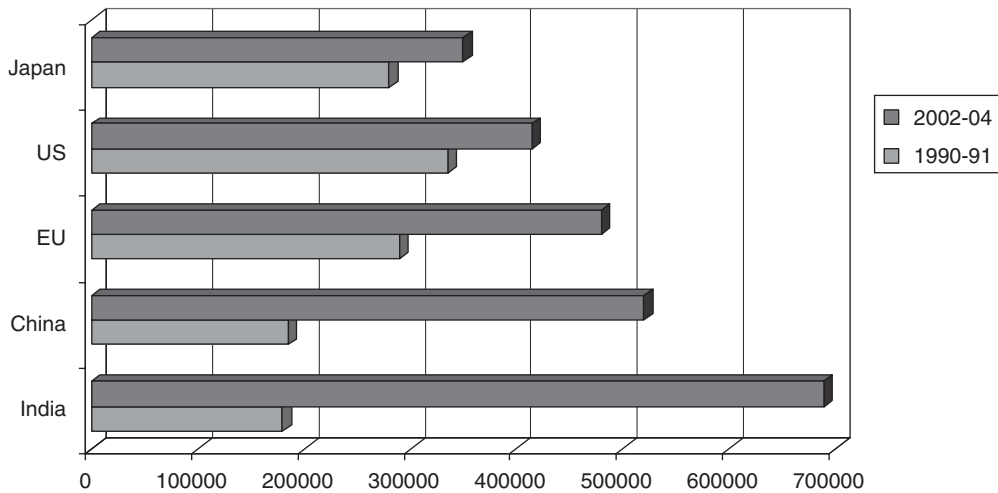


Figure 8: University graduates in engineering and science.
Source: Eurostat 2003 and JP Morgan – June 2005.

PRODUCTIVITY

Improving skills levels is facilitating productivity growth and is ensuring that these rates in

emerging markets remain significantly ahead of those in advanced economies. According to a recent report by the Conference Board,¹

productivity growth rates in 2007 for Europe, Japan and the United States were low, ranging from 1.1 to 1.4 per cent. For BRIC countries (Brazil, Russia, India and China) on the other hand, the average productivity growth accelerated to 8.3 per cent in 2007, from 7.9 per cent in 2006 and an average of 7.5 per cent between 2000 and 2005. What should be borne in mind, however, is that these economies are starting from a lower base and consequently general productivity levels in emerging economies are still very low, at between 10 and 40 per cent of the US level, for example. As wages are much cheaper, the labour cost per unit of output is, however, more competitive in emerging countries than developed ones. As the report highlights, 'Rapid adjustment to competitive pressures and greater innovation in emerging economies signals fundamental and lasting changes in the global competitive landscape'.¹

RISK VERSUS RETURN

When considering the addition of any asset class to a portfolio, it is important to ensure that it not only enhances returns, but does so without a commensurate increase in risk. In isolation, emerging markets have exhibited higher volatility of returns than their developed market peers, but one should consider how this return profile complements the rest of the assets in the fund. This is best understood by looking at the correlation statistics between the various equity

indices. Table 1 highlights the correlations between the MSCI EM index and some of the other developed market indices, over the past 5 and 20 years. It is clear that emerging markets have reasonably low correlations with other equity markets. Consequently, there are diversification benefits from the introduction of this asset class. And this is true both on a medium-term and on a longer-term basis.

As mentioned, emerging markets have a higher volatility of returns than developed markets and therefore, on the face of it, look more risky. But the question that all investors should consider foremost is, do the returns compensate for this higher risk? Table 2 highlights the returns and associated volatility of the S&P 500, MSCI World and MSCI EM.

The table shows that although emerging markets have been more volatile over the past 5 and 10 years, it also is clear that returns have far outstripped those from developed markets. The key figures in the table here are the returns per unit of risk in the furthest right-hand columns. Emerging markets have consistently added more return on a risk-adjusted basis than the developed markets.

HOW BEST TO ACHIEVE EMERGING MARKET EXPOSURE?

If the case for emerging market exposure is compelling, what is the best way to achieve this exposure? One of the major challenges for any

Table 1: World market correlation figures

	<i>MSCI EM</i>	<i>MSCI World</i>	<i>S&P 500</i>	<i>TOPIX</i>	<i>FTSE 100</i>	<i>MSCI Europe</i>
<i>5-year correlation</i>						
MSCI EM	1	—	—	—	—	—
MSCI World	0.87	1	—	—	—	—
S&P 500	0.73	0.95	1	—	—	—
TOPIX	0.62	0.62	0.47	1	—	—
FTSE 100	0.83	0.91	0.78	0.54	1	—
MSCI Europe	0.85	0.96	0.86	0.54	0.96	1
<i>20-year correlation</i>						
MSCI EM	1	—	—	—	—	—
MSCI World	0.67	1	—	—	—	—
S&P 500	0.61	0.86	1	—	—	—
TOPIX	0.40	0.68	0.35	1	—	—
FTSE 100	0.52	0.83	0.69	0.46	1	—
MSCI Europe	0.61	0.89	0.74	0.47	0.90	1

Source: Datastream, Nomura. Monthly data as of 30/09/2008.

Table 2: Risk and return characteristics

<i>Look-back period</i>	<i>Returns (%)</i>	<i>SD (%)</i>	<i>Return per unit of risk</i>
<i>5 years</i>			
MSCI World	7.9	11.6	0.7
S&P 500	5.2	10.3	0.5
MSCI EM	19.0	21.5	0.9
MSCI Europe	11.5	14.5	0.8
TOPIX	3.7	15.1	0.2
<i>10 years</i>			
MSCI World	4.3	14.3	0.3
S&P 500	3.1	14.4	0.2
MSCI EM	14.8	22.5	0.7
MSCI Europe	5.2	16.4	0.3
TOPIX	4.1	18.8	0.2

Source: Datastream, Nomura. Monthly data as of 30/09/2008.

manager is how to deal with such a wide universe as the global emerging markets and how to analyse so many diverse opportunities. It is a very challenging mandate; consider the facts:

- 3 regions (Asia 50 per cent, EMEA 25 per cent and Latin America 25 per cent)
- 26 countries (MSCI)
- 27 currencies
- 79 languages; and
- over 800 stocks in the MSCI benchmark, out of a broader universe of around 14 000 stocks.

This is a lot for one manager to cover well.

REGIONAL MANAGEMENT BEST

On the basis that inefficiencies are greatest at stock level, alpha can best be generated by employing a combination of regional experts, looking for the best stock pickers in each region. The thinking is as follows:

- Regional specialists are likely to have a better understanding of their regions.
- This enhances country allocation decisions and improves stock selection – both in terms of depth of understanding of individual companies and breadth of coverage of the universe.

Key expectations are that better information should produce better investment decisions, and that this in turn should produce more alpha and

improve returns. Oliver Wyman, a management consultancy with particular expertise in the investment industry, were commissioned to carry out research to assess whether these beliefs could be supported by observable data.

INDEPENDENT RESEARCH ON REGIONAL VERSUS GLOBAL MANAGEMENT

Oliver Wyman's project objectives were firstly to examine whether, based on historical performance, there was evidence to support that a product composed of specialist regional managers had the potential to outperform global emerging market funds. Secondly, they considered whether combinations of regional specialists were more risky than single global managers. Their report entitled 'Emerging Market Product Analysis Year end 2007' issued on 22 February 2008 is available on request, and represents the third annual update to their analysis originally conducted for the end of 2005.

Oliver Wyman reviewed fund data sourced from Bloomberg for the 7-year period ending in December 2007. Starting with a comprehensive universe of just over one thousand funds, this was screened to exclude duplicate funds, single country or region funds, and so on, to end with a cleansed universe of 403 funds, representing over \$300 billion of assets under management (AUM), one-third of which came from regional specialist managers.

They then captured all the return data and constructed composites comprising the averages of each quartile for each region and globally. The regional averages were linked together using neutral MSCI weights, and then compared against the global peer averages. For the third year in a row, the analysis revealed that there was a clear alpha advantage for the combination of regional specialists over the generalist global emerging managers. Over the 7-year period, the average top quartile regional managers in combination outperformed the average top quartile global manager by more than 2.3 per cent on an annualised basis up to the end of December 2007, as shown in Figure 9. On an individual calendar-year basis, the analysis also

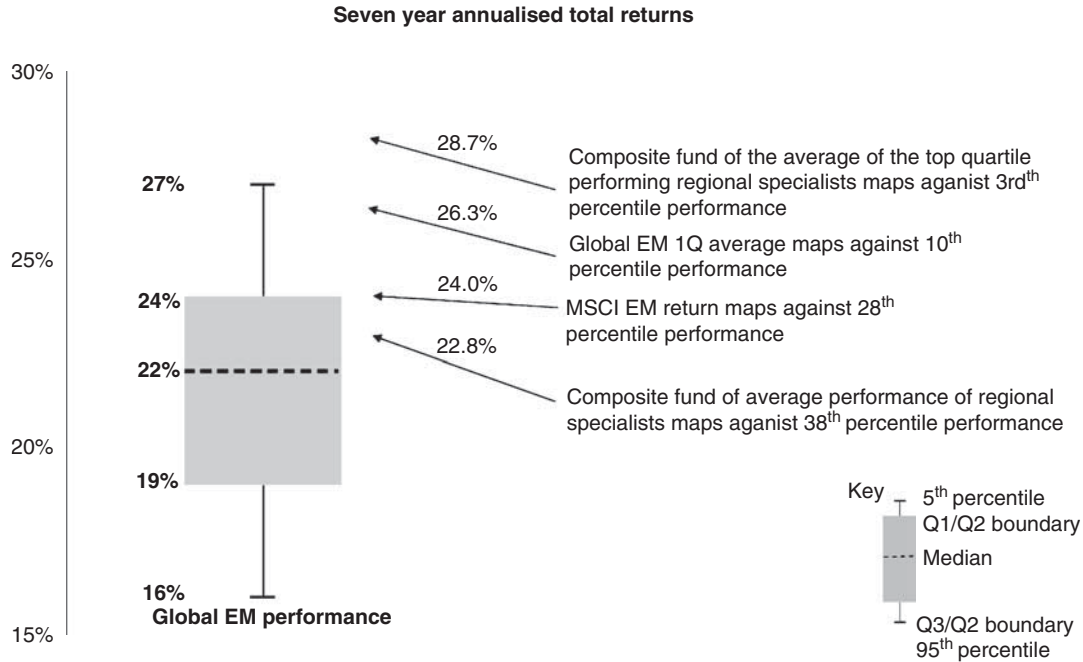


Figure 9: Oliver Wyman: GEM Universe 7-year annualised return spectrum. Source: Bloomberg, MSCI, Nomura, Oliver Wyman analysis.

highlighted the fact that regional specialists outperformed in 6 out of the past 7 years.

The analysis also highlighted a risk advantage when going the regionalist route. Running a Monte Carlo analysis, which entailed generating random combinations of regional specialists, Oliver Wyman concluded that although individual regional managers had higher active risk than global managers (Figure 10, first panel), a combination of them diversifies this risk away, so that on average they presented the same level of risk as the global managers (Figure 10, second panel).

Moreover, when looking at above-average managers, that is those managers who have outperformed over the mean over the period, which is presumably what any selector of managers would probably be focusing on, the combination of regional managers showed a clear risk advantage as compared to global managers, as highlighted on the simplified scatter in Figure 11. Considering returns and tracking errors over 5 years up to the end of 2007, the regional specialist combinations delivered 2 per cent more

return per annum at a lower tracking error, 4.9 per cent versus 5.6 per cent, compared with the global managers, as depicted by the blue shaded area.

OLIVER WYMAN FINDINGS: REGIONAL SPECIALISTS OFFER BETTER RISK-ADJUSTED RETURNS

Drawing all this together, Oliver Wyman’s research supported the rationale for co-ordinating the expertise of regional specialists into a single product. Not only was there a clear alpha advantage, there was also no increase in tracking error associated with these combinations. Furthermore, if better-than-average managers were considered, then there was clear risk reduction, in terms of tracking errors.

CONCLUSION

As highlighted, there is a growing economic case in favour of a strategic allocation to emerging markets in most pension funds. The fundamentals are solid and are supportive of long-term growth

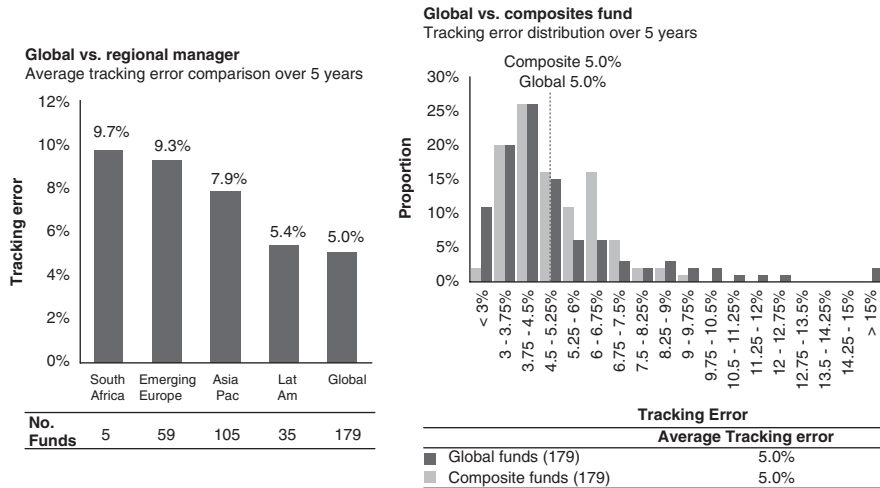


Figure 10: Oliver Wyman: regional and global tracking error data – 5-year horizon.

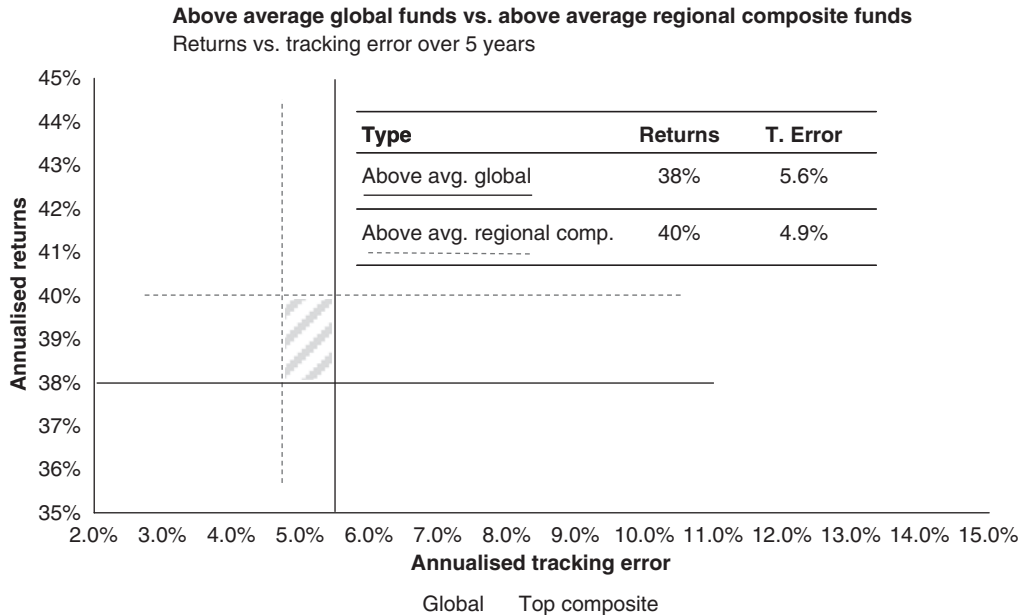


Figure 11: Oliver Wyman: global versus regional risk return chart.

exceeding that of developed nations. The valuations given earnings growth potential are reasonable and, as the asset class provides diversification benefits, the key long-term incentive is that current emerging market capitalisation does not reflect the global share of activity that these economies represent.

The range and diversity of the underlying regions and countries means, however, that

managing a global emerging mandate is a challenge. Especially if you consider that the main alpha-generating opportunities are at the stock level. Evidence suggests the fact that regional managers are best placed to exploit these stock-level inefficiencies. Consequently, a combination of regional specialists should bring added benefits over a global approach. Independent research by Oliver Wyman supports this rationale: their

findings were that, on average, regional specialists in combination offer better risk-adjusted returns than single global managers. Another argument in favour of considering regional specialists is that many of the best global managers are facing capacity constraints, whereas specialists have not seen their capacity tapped to a large degree.

This is an approach that Nomura Asset Management have implemented to good effect. They have developed a structure harnessing the advantages of regional specialists, but with the administrative benefits of a single point of contact for reporting, client servicing and management oversight.

RISK WARNING

This paper has been prepared by David da Silva, who is employed by Nomura Asset Management UK Limited (NAM UK), the investment specialist in the marketing department in October 2008.

This paper is issued by NAM UK, a firm authorised and regulated by the Financial Services Authority. Information and data referenced in the above answers has been taken from sources NAM UK reasonably believes to be accurate. The contents are not intended in any way to indicate or guarantee future investment results, as the value of investments may go down as well as up. Values may also be affected by exchange rate movements and investors may not get back the full amount originally invested. Before purchasing any investment fund or product, you should read the related prospectus and/or documentation in order to form your own assessment and judgment and to make an investment decision. Should you require further information or advice, consult your advisor.

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EXPERT VIEW

Q&A: How to get the best from emerging markets

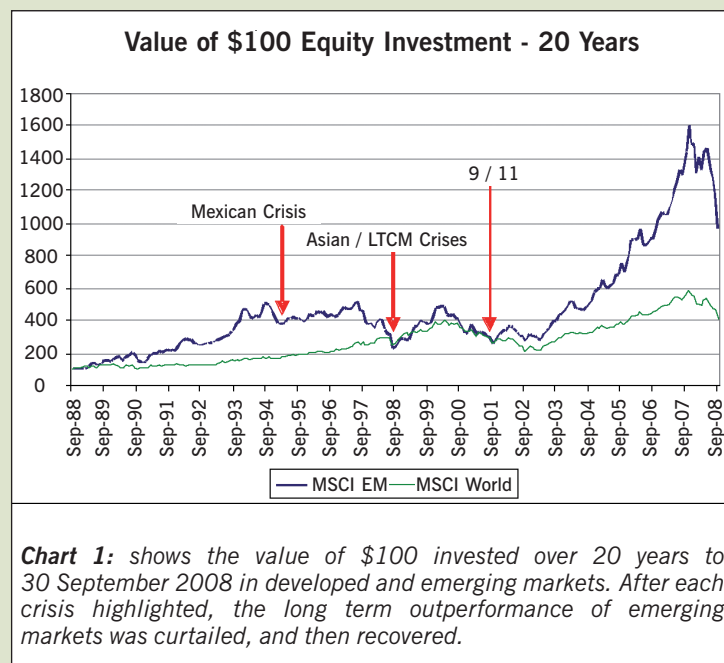
Fraser Hedgley answers some key questions for trustees about investing in this asset class – and compares current emerging market ups and downs with those from history

Recent falls have highlighted the volatility of emerging markets. Is an asset class this volatile appropriate for pension funds?

I am a product specialist for an emerging market fund, so I have to say, "Yes!" Leaving flippancy aside, it is an asset class appropriate only for those with sufficient time horizon to ride out significant volatility and benefit from the economic growth expected to drive emerging market outperformance over the long term. Emerging markets are not new to crises. They have recovered from the Asian crisis, Russian default/LTCM Crisis, the Mexican Peso Crisis, and bounced back strongly. [See Chart 1] Admittedly, this crisis is bigger, but the pattern remains. Favourable demographics, increasing wealth (coupled with growing demand) and increasing fiscal and monetary responsibility (with some notable exceptions) will drive corporate earnings as they have in the past. The return premium that should result from this long-term positive story is available to investors able to tolerate short to medium term volatility.

Should investors seek active or passive investment in this asset class?

Again, I have a vested interest here! But I genuinely believe investors should only take active risk in the asset classes where it is most likely to be rewarded; where there is demonstrable inefficiency and where investor talent exists to capture it. Emerging market equity is one of those asset classes. Anecdotally, much of the day-to-day volatility seen in individual emerging stocks can only be ascribed to over-reaction to newsflow and (to an extent) illiquidity. Investors focused on fundamental value should be able to capture market mispricing and profit from it.



Quantitatively, peer group analysis of emerging market managers suggests the median manager has outperformed over time (in stark contrast to some more developed markets). This suggests that the talent to capture alpha exists, although the spread from upper to lower quartile managers is large, so it is important to choose the "right" manager.

What is the best way to seek alpha in emerging markets?

From the previous argument, you may deduce that I believe in fundamental active management of this asset class. Nomura, recognising the innate difficulty of researching 25 politically, geographically, linguistically and culturally diverse emerging markets (let alone frontier markets), built global emerging coverage using regional specialists. Research

by Oliver Wyman earlier this year demonstrated that regional specialists, combined, outperformed global emerging market managers by 2 per cent p.a. with no increase in risk. This research vindicated our view; that greater focus and depth of research of regional managers yields outperformance over traditional global emerging market mandates.

Our own experience in researching regional specialist managers in Emerging EMEA and Latin America (to complement Nomura's Asian expertise) has revealed the depth of insight regional managers can achieve. Gratifyingly, the performance of the managers Nomura accesses in each region has been strong.

Risk Warning: This article has been prepared with the assistance of Fraser Hedgley, who is employed by Nomura Asset Management UK Limited (NAM UK).

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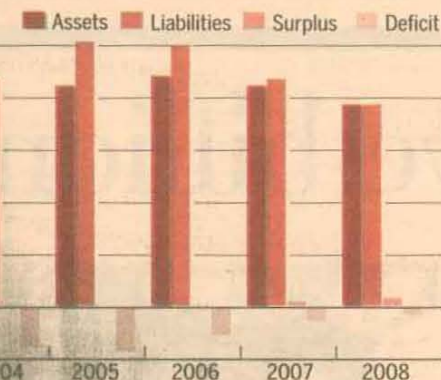
By Fraser Hedgley, CFA
of Nomura Asset
Management UK Limited

NOMURA

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the iBoxx AA index. According to Mercer, as of September 30, 89 per cent of the bonds in this index had been issued by financial institutions and, as bank default risk hit unprecedented levels, yields ballooned to above 9 per cent for five-year paper, from a little over 6 per cent a year earlier. "Recent equity market falls have been offset, on an

accounting basis, by falls in liability values, so company balance sheet liabilities will not have increased by as much as was perhaps expected," said Deborah Cooper, principal in Mercer's retirement business.

The robust IAS 19 picture will allow companies with a September 30 year end to avoid reporting a deterioration in their funding position in their accounts, potentially lessening any pressure to accelerate the closure of schemes.

Although some might see this as an unduly optimistic picture, Ms Cooper argued that if double A bond yields fell in the future this might well be accompanied by rising equity markets.

However the buy-out deficit, the aggregate additional sum FTSE 350 companies would need to provide to persuade insurers to take over their assets and liabilities, jumped to £192bn at the end of September, according to Mercer, from a low of £110bn in November 2007.

Emerging markets still in favour

By Ruth Sullivan

Institutional investors still have a keen appetite for emerging markets in spite of volatility and heavy falls across stock exchanges this year.

Three-quarters of northern European investors are planning to raise exposure to emerging markets equities over the next three years, according to a survey by Nomura Asset Management UK.

"Many institutional investors are looking at emerging markets as a long-term strategic investment," said David da Silva, who runs Nomura's regional emerging market strategy.

"These countries in general continue to grow faster than their developed counterparts, and although they are facing difficulties in the current climate, high savings rates and strong fiscal positions remain a feature of many emerging markets," he added.

Out of the 20 institutions surveyed, a quarter will raise their emerging market exposure between 4-10 per cent, while the rest have more modest plans of increasing exposure by up to 4 per cent.

Investors, whose combined managed assets total €160bn (£124bn, \$215bn), were also moving towards using more regional specialists rather than general emerging market fund managers in search of outperformance.

In times of global crisis, investors' appetite for risk tends to decline and move from more risky and less liquid stocks in emerging markets towards safer, more liquid assets.

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Lewbart acknowledged net outflows from equity funds for both September and the third quarter, but termed them "modest".

Aside from the pressure on asset values, the market collapse may bring about a purge of another sort to the retail investment industry. As brokerage firm share prices weaken, so do the stock-based incentives that tie brokers to companies, driving many to stronger houses, or to start or join small independent firms.

"This is a big deal. It's the breakdown of the wire-

houses," said Brad Hintz, brokerage analyst at Sanford Bernstein, pointing out that any vulnerability at Merrill Lynch and Wachovia creates uncertainty for a vast portion of the US retail sales force. Merrill Lynch declined comment.

Mr Hintz said: "The last big move of this sort was during the scrutiny by [former New York attorney general] Eliot Spitzer, when brokers told their customers: 'I don't trust this company any more. I want to take you people away to a safe place - my own.'"

Expert View: Emerging Markets

There is no one catch-all definition of an emerging market. However, it would typically be associated with a poorer-than-developed world economy, more reliance on basic industries and agriculture than services and technologies, but with an established and reasonably liquid stock exchange, open (at least partially) to foreign investors, and a functional financial, legal and regulatory framework in place.

The most widely used emerging market index provider, MSCI, considers market accessibility, security, suitability for investment and sustainable economic development in determining which markets are “emerging”. They will typically engage in a wide consultation before they change the classification of a country to either “developed”, “emerging”, or “frontier”.

Regardless of the definition used, emerging markets are characterised by relatively rapid economic growth, growing urban populations and industrialisation. They may also have higher volatility than developed markets, some capital controls and stock markets with lower liquidity. They are also associated with a high degree of market inefficiency.

Emerging markets collectively represent more than 10 per cent of the investable world market, as measured by MSCI; a greater proportion than Japan. They contribute approximately 50 per cent of

global economic growth and are home to 80 per cent of the world’s population.

EMERGING MARKETS AND PENSION FUNDS

The high rate of economic growth in emerging markets is expected, over time, to lead to higher earnings growth for companies in those regions, as compared to developed market companies. Greater corporate earnings should lead to greater stock market returns. Thus the prospect of long term returns in excess of bonds and even developed market equities, is attractive to many pension funds.

Emerging markets exposure can also help to diversify risk in conjunction with other asset classes. Although the markets in isolation are volatile, historically they have exhibited low correlations to developed markets and thus aid diversification.

Investment in emerging markets requires a tolerance for equity risk, foreign currency risk and, potentially, some liquidity risk. As noted above, emerging markets can be volatile and over some periods are likely to underperform cash and bond yields. Therefore, an investor should have a long investment time horizon to increase the probability of making good any short term falls.

A defined benefit pension fund with such tolerance could invest in the hope of capturing the expected long term risk



premium of emerging markets. However, we strongly advise pension fund trustees to seek suitable expert opinion before deciding to invest in emerging market equities.

A defined contribution (DC) pension fund may offer an emerging market fund as an option for members or as part of a wider, prescribed investment strategy. The long term return characteristics of the asset class may appeal to members sufficiently far from retirement but, as with all DC investment funds, the risks must be clearly communicated to members to allow them to make knowledgeable investment choices.

OBTAINING EXPOSURE

Some pension funds permit their global equity managers to invest in emerging markets opportunistically. However, this approach is not ideal. Many pension funds therefore appoint a dedicated emerging markets manager.

Some funds go further, and appoint managers to specialist mandates within the emerging markets, such as Latin American equities, Emerging Asia equities or BRIC (Brazil, Russia, India China) equities. Such specialism has appeal given the difficulties of managing a mandate across emerging markets so differentiated by geography, climate, language, currency, politics and regulation. However, due to the complexity of constructing global exposure through regional

mandates, a single, global mandate remains the most popular method of exposure.

Pooled or segregated investment vehicles are also available. Pooled funds are simpler and practical for smaller funds. Segregated accounts offer greater flexibility and may be cheaper for large funds. For emerging market mandates, a pooled fund vehicle is favoured by many pension funds to avoid the considerable administrative burden of obtaining permissions to invest in a range of emerging markets. ■

QUESTIONS FOR YOUR ADVISER

Advisers should assist you with:

- Assessing your risk tolerance and whether or not an exposure is appropriate;
- The timing and size of any investment;
- The pros and cons of specialist regional emerging mandates;
- Which investment manager(s) to appoint.

Ask your investment managers about:

- Their team's experience and track record in emerging markets;
- Market coverage: is the manager a specialist in one area with only basic coverage elsewhere?;
- Fees (typically higher than for developed market mandates);
- Assets under management. Large assets under management can restrict an emerging market manager from implementing investment ideas.



Emerging markets: divide and conquer

Independent research conducted by the consultancy firm Oliver Wyman on behalf of Nomura Asset Management proves that focusing manager skill on separate, regional portfolios leads to a significant alpha premium. There are, however, difficulties in conquering the global emerging world by dividing mandates among specialists within emerging EMEA, Asia and Latin America. This article addresses these two main points.

Regional specialists in emerging markets outperform

In February 2008, Oliver Wyman completed research that investigated the potential of regional specialist manager combinations¹. They found that, net of fees, an average of the regional specialists in the EMEA, Asia and Latin America regions, combined (at regional market weights) to form a synthetic "global" strategy, outperformed the average global emerging market (GEM) manager in six of the seven calendar years to end 2007.

Moreover, as demonstrated in Figure 1, the above-average specialist managers (combined) managed to outperform their global peers by 2% per annum over the five years to end 2007 yet had a lower tracking error.

Should we be surprised? No. Large institutional investors and advisors have long warned us that, by employing generalist managers, we leave alpha on the table.

Yet, while developed world balanced and multi-region mandates are now rarer, in contrast the vast majority of emerging market

Fraser Hedgley explains why focusing on specialist regional portfolios in the emerging market space can bring pension funds their much needed extra alpha

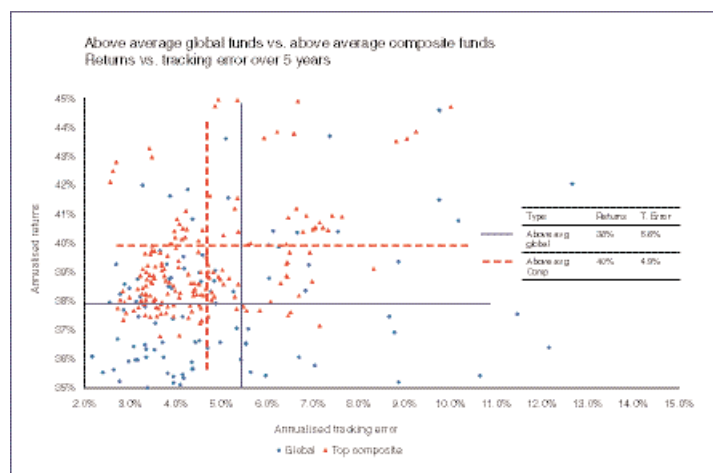


Figure 1: Annualised returns plotted against tracking error for above-average global emerging market funds (blue dots) and for composites of above-average regional managers (red dots). Source: Bloomberg, MSCI, Nomura, Oliver Wyman analysis. Note: Above average funds are defined as funds comprised of managers with above average returns over the defined time period

managers operate on a generalist global basis, attempting to cover countries as diverse as Peru, South Africa, Taiwan and Egypt. A mere glance at the emerging world in total highlights some significant challenges to this approach:

- Benchmark of 785 stocks²
- c14,000 stocks off-benchmark
- 25 countries, 26 currencies, 60+ languages
- Geographical spread of markets
- Varied accounting and reporting practices
- Country-specific factor influence on equity performance

Clearly, a fundamental manager trying to understand each market and select stocks within them faces an immense burden which a regional approach to coverage would help to overcome. This is particularly true if one believes that the greatest inefficiencies in these markets occur at individual stock level.

GEM managers have struggled to outperform

Emerging markets are regarded as among the most inefficient equity markets in the world. However, partly as a result of the



mentioned challenges, over the seven years to end 2007 (the longest period for which there is a meaningful sample size), the average global emerging market manager underperformed the MSCI Emerging Market Index net of fees. Indeed, the upper quartile manager only succeeded in matching the index return. Regional specialist combinations fared better; a composite of the average upper quartile regional managers outperformed the average upper quartile global manager by 2.4% p.a. over the seven year period, as illustrated in Figure 2 (below).

The most vital conclusion of this analysis is as follows: the active investor in emerging markets must be confident that he can choose an upper quartile global emerging markets manager or must employ a regional specialist approach if he expects to outperform.

Appointing regional specialists

The lure of additional alpha through a diversified, regional manager structure is great, but there are barriers to appointing specialist

managers including (1) Potentially higher fees and administration costs; (2) Greater governance and monitoring burden; (3) Difficulty of selecting good regional managers, and; (4) Benchmarking issues.

The first two points are inherent when increasing the number of individual managers employed.

The third point is a difficulty that Nomura will readily attest to. Known for our emerging Asia expertise, we first built a single global emerging market product in 2006, using the regional specialist skills of Charlemagne Capital (in Emerging EMEA) and Gartmore Investment Management (in Latin America). Since then, it has been an ongoing challenge (for the purpose of prudence) to identify skilled reserve managers in each region that remain open to new business. Nomura has had to bring considerable resource to bear on assessing managers in the EMEA and Latin America regions. The ability to devote this resource must be a key consideration for any investor undertaking regional manager selection.

The final point is relevant to all but the largest investors; those who need to appoint managers via pooled fund mandates. Funds pooled at a regional level, governed by UCITS regulations, will suffer from structural underweights to the mega-cap stocks such as Gazprom, China Mobile and Petrobras, since they form more than 10% of the regional indices. Individual stock holdings are limited to no more than 10% of a fund under UCITS.

The largest institutions, with in-house manager research expertise, will no doubt find these difficulties surmountable, and the effort involved can be amply rewarded. Other investors should seek a single product accessing the skills of regional specialists.

To conclude, specialist emerging market managers combined to give global coverage have, on average, outperformed GEM managers. This reinforces the widely accepted idea that specialist managers with more focus and resources to devote to a particular area of investing will outperform generalists. Based on this evidence, for large investors with sufficient resources, or smaller investors with access to cost-effective fund of funds or similar products, seeking regional specialist emerging market managers should be strongly considered.

(1) *Oliver Wyman's Emerging Market Product Analysis, 2007 Update. A summary of the research is available from Nomura*
(2) *MSCI Emerging Markets Index 30 June 2008*

MSCI Emerging Markets Index, 30 June 2008

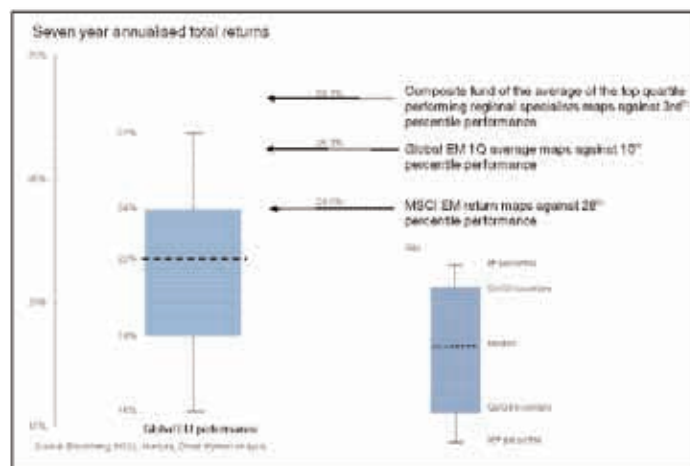


Figure 2: Seven year annualised returns of global emerging market managers, ending 31 December 2007. Source: Bloomberg, MSCI, Nomura, Oliver Wyman analysis. MSCI EM return is the return (including net dividends) of the MSCI Emerging Markets Index

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EXPERT VIEW

China and India – is it time to invest now?

Peter Jenkins explains some of the major factors that are contributing to the development of China and India as powerful, emerging markets

I hear conflicting reports about China and India – some say this is the ideal time to invest in the region, others say that it's already over-valued. Who's right?

All markets are fighting a slowdown at the moment and that affects India and China just like everywhere else. However, we have seen between 15 and 19 per cent earnings growth in India and 25 per cent growth in China this year. Inflation is a concern in both countries, although we are now seeing some pullback on that in China at present. But China's economy has slowed and its interest rates are also rising. Overall, although there are risks to the markets in the short term, we would advocate a long term investment horizon which should put short term fluctuations into perspective.

Much attention has been given to the eye-catching drops in China's A-share market, which lists shares in the Chinese currency, Renminbi, and is only open to Chinese investors. Pension funds from the UK therefore won't have been able to invest in A-shares and won't have been affected by the falls on that market. The B-shares listing, which trades in foreign currencies and is available to overseas investors, has seen more muted performance and hasn't been affected to the same extent.

What are the main risks and rewards associated with investing in China and India?

Over the long term there will be plenty of growth, which will reap big rewards. There is good domestic demand, strong economic growth and good earnings growth. And, although there are some risks to that growth in the current climate, in general that story remains unchanged.

Political risk is present in China as it is still a one-party state. But that one party has a strong handle on the domestic and economic situation. They could mis-handle inflation, but that's unlikely. In India, political turmoil is always present. There will be elections within the year and the ruling coalition has only just survived recently. We are seeing economic initiatives and populist measures that link to an upcoming election. There are no immediate concerns and no significant risks associated with these changes.



What exactly does 'investing in China' mean? Am I buying buildings, stocks and shares, roads – what's included and what types of investment are particularly strong at the moment?

We invest primarily in listed equities in these regions – the bond market is under-developed in China and also to a lesser extent in India.

India has Asia's oldest stock market, dating back to the 19th century and so that is a very different set up from China's A-share and B-share structure discussed see above. Across both markets, we like to see growth in necessities such as infrastructure (investing in essential developments such as roads or airports). India has over \$1trn of infrastructure development planned over the coming years.

China operates with closed capital accounts – meaning that Chinese citizens' money is not allowed to leave the country. As earnings growth has increased and the money can't leak out of the country, that extra capital has fuelled a liquidity boom. That has meant that other areas for investing where we've seen good potential include those involving domestic

demand. The increasing development of the middle class in both countries means that there is more consumer spending. Mobile telecoms are also another good sector and China Telecom is particularly strong.

Shares in companies that rely on exported goods are less desirable. Global growth is falling, which means that demand for exports may fall. Also, we worry about financial institutions and need to be careful when investing in those.

What are the longer-term expectations for this region – is this a good place to put my scheme's money for the next ten years?

We think so. There will be stronger growth in both China and India than in more developed markets. Companies will exploit that – and we will see good business growth. The long term outlook is good, although you might not see growth week in week out, or even on a monthly basis at the moment.

The trade and business links in all BRIC (Brazil, Russia, India and China) show companies beginning to launch products to other, foreign markets. There is significant domestic demand. People will be buying their first ever car in China or India, for example. There are lots of opportunities and it will be hard to stop these economies from accelerating.

Peter Jenkins is employed by Nomura Asset Management U.K. Limited (NAM UK), a firm authorised and regulated by the Financial Services Authority. Information and data referenced in the above answers has been taken from sources NAM U.K reasonably believes to be accurate. The contents are not intended in any way to indicate or guarantee future investment results as the value of investments may go down as well as up. Values may also be affected by exchange rate movements and investors may not get back the full amount originally invested. Before purchasing any investment fund or product, you should read the related prospectus and/or documentation in order to form your own assessment and judgment and, to make an investment decision



By Peter Jenkins,
of Nomura Asset
Management UK Limited

NOMURA

Emerging markets in the grip of inflation: winners and losers



David da Silva considers how rising oil and food prices are impacting upon emerging markets and introduces this four-page special focus on emerging markets

Inflation has provoked alarming headlines across the world. Emerging markets are bearing the brunt of the inflationary pressures. In this feature we consider the causes of inflation, its exaggerated impact on the emerging world and opportunities for investment managers. Inside this special four-page pull-out section three emerging market specialists examine the issues facing Emerging Asia, EMEA and Latin America.

Chart 1, produced by the *Financial Times* (*FT*), highlights the impact of rising food prices on headline inflation across the globe. Their analysis makes it clear the impact of food inflation is more severe in the developing world than it is in developed countries, because consumers in developed countries spend a significantly lower portion of their income on food than their developing counterparts. As an example, households in the US and Europe on average spend about 10% to 15% of income on food, while this number rises to 30% in China and could be as high as 80% in countries in Sub Saharan Africa.

In addition, the *FT* makes the point that as consumers in developed countries consume more processed food than fresh food, the so-called "farm value" of food prices is relatively small. In other words, the costs of processing and transportation constitute the majority of the food article's price, so that price fluctuations in the underlying agricultural commodity are diluted. On the other hand, in emerging markets, the "farm-value" of food is much greater, as the populations rely more on unprocessed staples such as wheat and rice. Consequently the rise of the underlying agricultural commodity prices has a far more profound impact on consumers.

Food paradox

This sets the scene for a paradox. On average, in the developed world, households consume more food than in emerging countries, but this constitutes less of their household expenditure than it does in developing countries. In short, they eat more, but it costs less. So rising food prices mean inhabitants in the emerging world become poorer on a relative basis compared to those in developed nations.

This outcome relating to food inflation has similar parallels in fuel prices, as fuel is also a substantial component of emerging countries' Consumer Price Indices. Together, food and fuel inflation have had a massive impact on the eco-

nomie and political landscapes of the developing world. This has recently flared up in many well publicised protests across the emerging world. Fortunately, there are signs that soft commodities and energy costs may have peaked in the short term, and so the worst may be over. Notwithstanding, there remain wide ranging consequences of these price changes. Whilst, for most, the effects of inflation are negative, some countries are well placed on an energy and agricultural footing to weather and even profit from this new environment.

Illustrating this, Chart 2 highlights the first round impact of commodity price rises on trade accounts. What is apparent is the diversity of results across these emerging countries. Some, like Bangladesh and India, will struggle, while others, like Saudi Arabia and Argentina, are well placed. Understanding these broader economic impacts is crucial in making investment decisions on a company level.

Challenging environment

The articles which follow in this sponsored feature highlight that, despite the profound impact of inflation in the developing world, for informed investment managers there are indeed areas where opportunities exist to make money and deliver returns. What is clear is that the emerging markets investment landscape has changed, making what is already a very challenging mandate even more complex. As an example of this, commodity prices have proven very difficult to call and factor-in accurately in valuation models. The extent of price rises was well in excess of the wildest estimates at the start of the year. This, in turn, has affected country fortunes, industries and sub-sectors in different ways and ultimately impacted company valuations considerably. Chart 3 was published in the IMF World Economic Outlook earlier this year, and highlights the expected oil price range over the twelve months, with the various confidence intervals associated with the forecasts. On 25 March this year, participants in oil futures markets put the future value of oil around US\$100 per barrel, a pricing that suggested that there was less than a 5% probability of spot oil exceeding \$135 per barrel over the short term. Yet on 4 July, the price touched \$147. Significant, experienced players in the oil futures market in March were willing to supply oil at less than \$100. Small wonder that

many outside observers of the oil market, such as equity investment managers, were surprised by the immoderate price rises.

An uncertain future

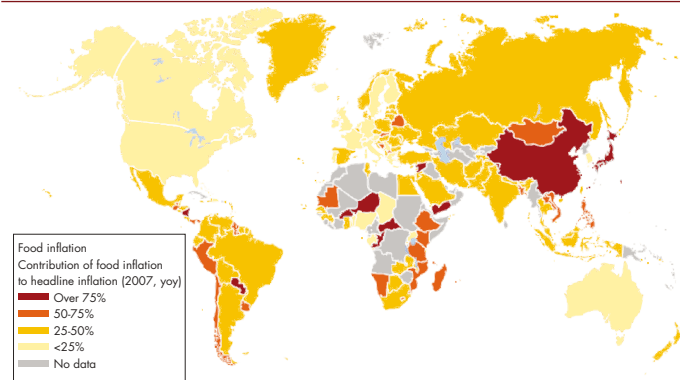
As oil prices and other commodity prices fed through and impacted earnings expectations across all industries, investment managers faced the prospect of positioning portfolios in a more volatile and uncertain climate.

The following articles by Gartmore Investment Management, Charlemagne Capital and Nomura Asset Management Singapore highlight issues which are pertinent to each of the specific regions in which they invest for the Nomura Asset Management GEM strategy: Latin America, EMEA and emerging Asia respectively. They have all had to contend with inflation and commodity price rises in their regions and it is apparent that, although in many ways the forces driving inflation are global in nature, regional knowledge and expertise are key in understanding where the investment opportunities are best located. It is crucial that within this environment managers are able to target companies that can increase or maintain their margins and so have valuations solidly underpinned by earnings.



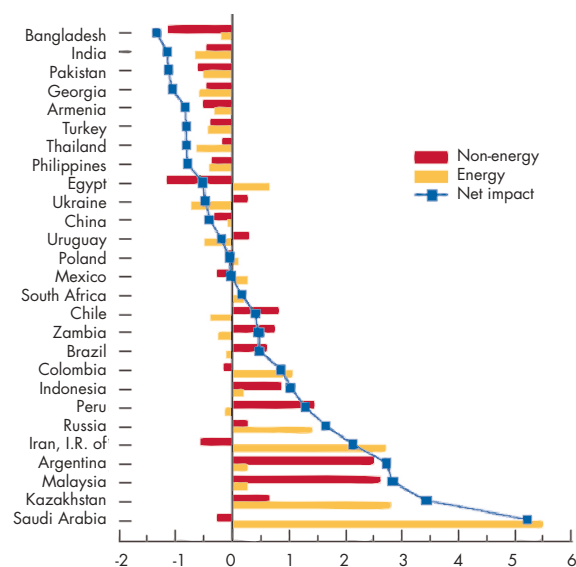
David da Silva, CFA is head of GEM strategy at Nomura Asset Management U.K. Limited

Chart 1: The impact of rising food prices on headline inflation worldwide



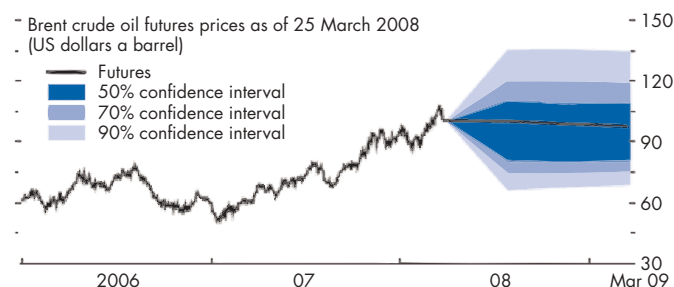
Source: *Financial Times*, Published April 13 2008. Last updated: May 6 2008

Chart 2: First round impact of commodity price changes on trade balance of selected countries, 2007 (contribution to change in trade balance in percent of GDP)



Source: IMF World Economic Outlook, April 2008: Housing and the Business Cycle

Chart 3: Energy and metal prices and metal consumption growth



Source: IMF World Economic Outlook, April 2008: Housing and the Business Cycle

EMEA stock selection in an inflationary environment: Uralkali case study

At the start of 2006 came the first signs of significantly rising food prices across the globe. This was particularly evident in emerging economies where the impact on personal consumption was most conspicuous.

The causes were increased demand for food across the world, a result of numerous factors including increasing levels of affluence, continued urbanisation of emerging populations, which has drawn production away from rural areas and farms, and supply disruptions (drought, storms etc). In addition, and something which was to become more and more of a factor, was the increasing amount of land dedicated to bio fuel production.

So with demand growing and food in short supply, it was clear to us that the rising price trend was set to continue for the next few years, though it is fair to say that we did



not envision the steep price rises we have seen on soft commodities such as rice, wheat and other staples, as

highlighted more generally in the CRB Spot Index chart (Chart 1).

So how did we at Charlemagne Capital, as stock pickers, interpret these developments and respond to generate alpha? An obvious point of call given this backdrop would have been to invest in food producing companies; however, these have not always been in a position to pass on rising input costs and so in an inflationary environment would see their margins shrink and their valuations under medium term pressure. With farmers demanding more from their land and trying to increase yields, it was clear that there would be increased global demand for fertiliser.

Following preliminary investigations with our local and international contacts, we realised agrichemical producers had indeed already started seeing price rises and that it was a challenge to find any that were still offering good value. Looking more closely at the fundamentals of the business we realised potassium carbonate, also known as potash, which is a key component in most fertiliser mixes, was in short supply and evidencing a strong price rise.

Our analysis revealed there were few reliable potash producers, and that the industry dynamics looked strong. We initially targeted our investment via Israel Chemicals, a broadly diversified industrial chemicals producer, which among many different production lines was also a key global potash producer. We liked this company on a fundamental basis, and, having visited it, were happy with management and its business strategy, and, most importantly, the valuation according to our calculations was still favourable.

Nonetheless, as a diversified chemical company this was not a pure potash play, which was not

ideal, so investigating the market further we found that there was a significant Russian producer of potash called Uralkali. Crucially, potash fertiliser production was the sole business of this company. Its reserves are located in the Verkhnekamskoe Deposit, which is the second-largest known potash deposit in the world, reported to contain in excess of 3.8 billion tonnes of potash ore.

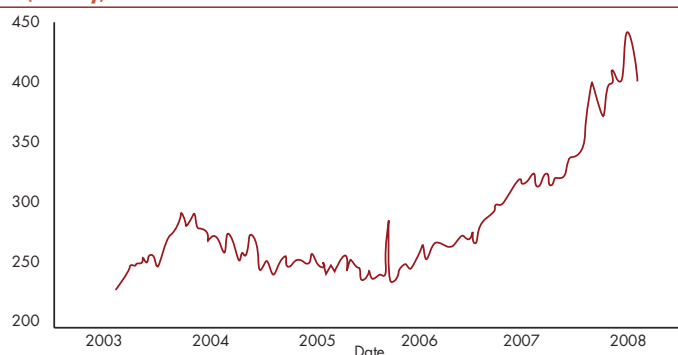
So, we analysed the company fundamentals, held several discussions with management and had on-site meetings at the company. Demand for potash remains strong. The market for potash is relatively tight, with high barriers to entry, and this has sent the price of fertiliser sharply higher. Uralkali's sales are tied to long term contracts, providing low cashflow volatility, but as these contracts fall away, it gains exposure to the higher spot price, thus enhancing earnings growth.

At the same time, it plans to increase capacity by 30% by 2010. We were satisfied that the company fundamentals stacked up well, growth prospects were good, management was experienced and effective and the industry background was favourable. We then considered how the share price rated against this background. Running our numbers and cash flow analysis, it was clear the stock was attractively priced and if indeed the market for potash continued to grow, then Uralkali was ideally positioned in the industry to add significant shareholder value.



Julian Mayo is an investment director at Charlemagne Capital

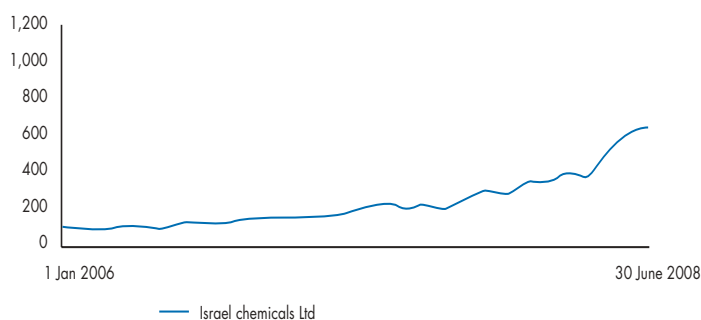
Chart 1: CRB spot index foodstuffs – price index from 5 August 2003 to 5 August 2008 (weekly)



High 444.19 (1 July 2008) Low 231.26 (5 August 2003) Last 403.01

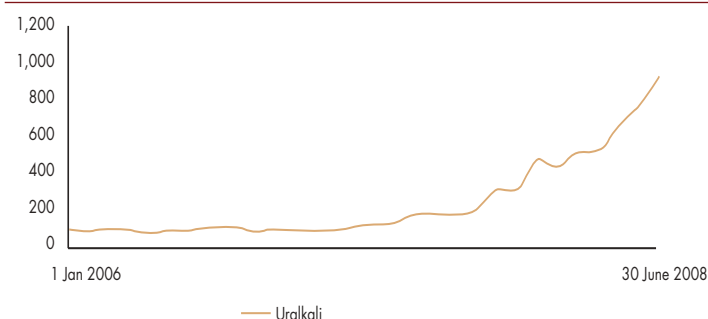
Source: Thomson Datastream

Chart 2: Israel Chemicals USD stock performance



Source: Thomson Datastream
Data based to 100 as at 1 Jan 2006

Chart 3: Uralkali USD stock performance



Source: Thomson Datastream
Data based to 100 as at 1 Jan 2006

How did this strategy play out?

Firstly, as we are all no doubt aware, food prices have continued to rise – this has been a key trend.

Secondly, food producers in a bid to improve yields have demanded more fertiliser, and in turn the price of potash has risen sharply. Recently, we have seen potash spot prices for Asia delivery topping the \$1,000 per tonne mark; this is more than five times the level achieved three years ago.

Finally, mining companies producing potash, like Israel Chemicals and Uralkali, have seen sharp price escalation over the past few years, as shown in Charts 2 and 3.

Although we pride ourselves on our stock picking ability, the case study above highlights that we target our stock picking opportunities harnessing broader industry and market information: considering trends, seeing suppliers, customers and competitors. Our extensive regional experience and depth of research enable us to capitalise on opportunities to deliver added value to our investors.

Inflation in Asia: not just a monetary phenomenon



Hiroyuki Nakai is a senior economist at Nomura Asset Management Singapore

"Inflation is always and everywhere a monetary phenomenon." On the surface, this famous assertion by Professor Milton Friedman in the 1970s still seems valid in Asia today. Consumer Price Indexes (CPIs) are now increasing rapidly and monetary authorities are raising rates to counter the inflationary pressure. However, just how true is Professor Friedman's statement?

In the case of the 1970s, the oil price shock – a supply side factor – was the trigger for an inflationary spiral, and price increases extended across almost all goods and services amid strong demand-side pressure. Inflation accompanied a general price level increase, and monetary policy tightening was effective in calming inflation expectations and easing the demand-side inflationary pressure by cooling down economic demand. That is why Professor Friedman described inflation as a "monetary phenomenon".

This current outbreak of inflation in Asia is not the same as in the 1970s. For now, much of the inflationary pressure is still concentrated in the form of food and fuel price increases, and is more pronounced in emerging countries than developed countries, as highlighted in Charts 1 and 2. Although the second-round effect of higher food and energy prices is a concern, namely higher wage claims, prices of other goods and services have not yet seen any significant increases. In this context, the current inflation outbreak in Asia (and elsewhere) is so far still limited to just a change in relative-price levels. Of course, tighter monetary policy is useful for containing inflationary expectations. But a cooling down of the economy cannot fix the rising food and energy prices since demand for these commodities is less price sensitive. Even worse, monetary tightening could impede structural adjustments in the economy to fit with the relative price increases of food and energy.

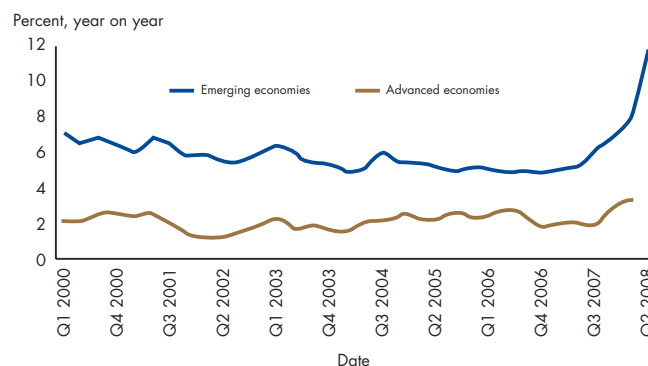
Another crucial issue in parts of Asia is concern over social stability. Compared with advanced economies, per capita GDP levels are generally lower in Asia while these countries often have wider income disparities as well. This means that recent food and energy price rallies threaten the daily purchasing power and well-being of huge numbers of low income people. Due to the prevalence of such social structures in Asia, the weightings of food and energy in the Consumer Price Indexes are relatively high compared with developed Western economies, as highlighted in Chart 3.

Hence governments have recognised inflation to be a social issue too, and are therefore utilising fiscal measures. For example, China, India, Malaysia, and Indonesia have adopted (de-facto)

fixed price systems for fuel, while other governments are paying subsidies or reducing indirect taxes. Retail prices of wheat flour and some other cereals are regulated in India, and most Asian governments have a subsidised rice distribution system.

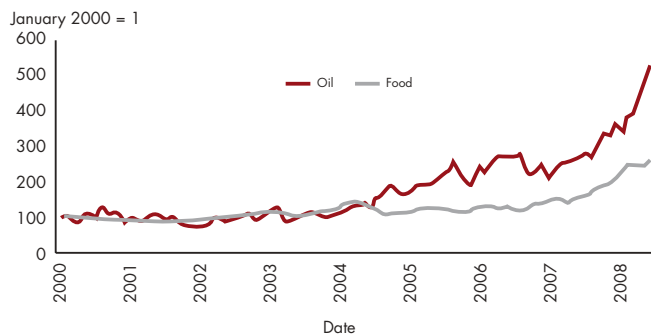
Regulatory pricing systems for food and energy worked well under a low-inflation environment and even at the initial stages of this current inflationary cycle. In another words, fiscal measures in Asia have been used as a major anti-

Chart 1: Consumer price inflation 2000-2008



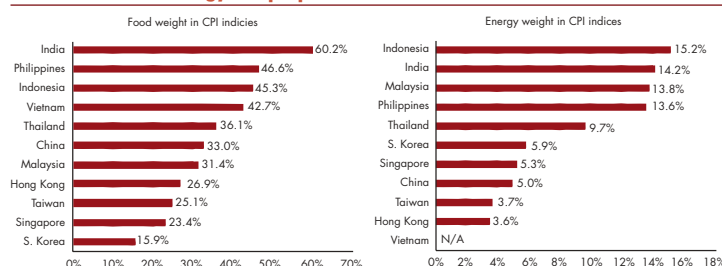
Source: Datastream, Nomura

Chart 2: Commodity prices (2000-2008)



Source: Datastream, Nomura

Chart 3: Food and energy as a proportion of CPI indices



Source: CEIC, Nomura Asset Management U.K Ltd

inflation policy tool. However, as crude oil and food prices rallied – the former doubled from July 2007 to June 2008 – ballooning subsidy burdens have started to threaten fiscal stability. Consequently, Asian governments have been forced to change their policy stances and allow fuel (and to some extent, food) prices to rise as the market moves. China, India, Malaysia, and Indonesia have raised retail fuel prices significantly in the second quarter of 2008, while accepting the risk of aggravating social tensions. Other governments have taken a more conservative approach and have increased subsidies.

Such fiscal policy reverses have prompted some monetary authorities in Asia to change their policy stance. In an environment dominated by the financial market turmoil and the risk of a possible global economic slowdown, Asian central banks, with the exception of the People's Bank of China, had maintained a bias towards monetary easing until the first quarter of 2008, or, throughout the period when fiscal policy changes were taking effect. From the second quarter, they have started to tighten their monetary policies in an effort to contain the inflationary expectations and to halt currency depreciation by maintaining confidence in their monetary policy. But, since the downside economic risk is still a real threat, some Asian authorities are wary of over-tightening their monetary policies. In short, they are willing to bear higher rates of inflation as long as they look relatively short-lived.

Investment strategy in an inflationary environment

Although we are principally stock pickers, we incorporate macro factors in our stock selection process. In effect, how will inflation impact on the earnings of any one stock? This integration of bottom up and top down factors results in more robust investment decisions at the stock level.

Our view that inflationary pressures will rise over the long term certainly makes things more challenging. However, it also provides us with opportunities to make money for our clients.

For example, we are overweight selected resource and basic material stocks such as the diversified miner BHP in Australia and the Korean steel company, POSCO. In the long term, these stocks will benefit from continued strength in prices for commodities. We see that the commodity bull run will continue for the medium term, following years of under investment in the sector.

However, we must also be cognisant of what, in our view, could be excessive euphoria on inflation beneficiaries or analysis on the winners and losers that may be faulty. As such, we are actually overweight energy stocks. We feel valuations are excessive and optimism on continued sharp rises in oil prices is misplaced. Notwithstanding, it pays to be discerning and look within the broader sectors and view the dynamics of the constituent sub sectors. As an example, we are optimistic about the prospects for oil explorers, while we think oil refiners are not well placed to be able to pass on input price increases.

We are also overweight the Philippines. This may seem paradoxical given it is a major importer of commodities and therefore a loser from higher inflation. However, it is also a major exporter of people – 10 million at last count. Many of these are highly skilled and are increasingly employed in Middle Eastern countries buoyed by oil revenues. Remittances back to the Philippines are running at over US\$1.4bn per month and providing a substantial fillip to the economy.

As highlighted above, a fundamental aspect of our stock analysis is to isolate companies that are best placed to maintain or improve margins by passing on input cost increases to their customers. To execute this effectively in a universe as diverse as emerging Asia requires regional experience, extensive resources and deep company research.

Oil price rises: impact on Latin America



In 1996, the economist Roger Bootle published a book titled *The Death of Inflation*. At the time, the global economy was expanding, and the process of globalisation was helping to keep costs down while productivity increased. Now inflation is back. Oil reached a new record over US\$147 a barrel in July, and higher energy costs are feeding through global production chains. While the rising trend reversed sharply in late July, oil is still trading close to ten-times 1998 levels.

There are a number of complex features in place that account for the dramatic rising trend over the last decade. The thirteen members of Organisation of Petroleum Exporting Countries (OPEC), which control more than 40% of the world's oil, highlight the currency effect of the US dollar. Saudi Arabia, Nigeria and Iran have all increased production in 2008, but these nations also have a vested interest in maintaining the value of their core asset for future generations. Now the world economy is slowing. According to the International Energy Agency, non-OPEC output is forecast to increase by a small margin in 2009, amid some scepticism that this will be achieved. The recent explosion on the Baku-Tbilisi-Ceyhan (BTC) pipeline carrying Azeri crude from the Caspian Sea to Turkey highlights the possible vulnerability of supplies. This makes the market sensitive to shifts in sentiment.

On the demand side, the momentum appears to be par-

tially demographically-driven. The world's population has more than doubled since 1950 to 6.6 billion people, yet some key energy-utilising technologies, like the combustion engine, have not been challenged in the mass market. The aspirations of millions of consumers, particularly in newly emerging economies, have prompted a surge in demand for energy. While the US has 450 cars per 1,000 people, in India the figure is 8 per 1,000. In China, car ownership is reported to have increased by one third in a single year in 2007, reaching 20 per 1,000. The arrival of low-cost cars, priced around US\$2500, is also expected to boost the trend – albeit at lower levels of energy consumption per vehicle.

While demand increases, there are also a number of potentially market-distorting features in place. Asian economies, such as China and India, have both had established systems of subsidies which have kept prices approximately 30% below market levels. In 2008, both countries appear to have recognised that these systems are not viable. Both reduced subsidies in 2008. A number of Latin economies, including Mexico, also have subsidies in place.

Within the market, the complexity lies in trying to forecast the interplay of economic, technological and environmental limiting factors. The extraction of oil from oil sands, shale, and in deep-water offshore locations, is possible, for example, but constrained

by the cost of extraction. In Latin America, preliminary findings on the continental shelf located off the east coast of Brazil suggest there is significant potential for the commercial extraction of oil from the Campos and Santos basins. Brazil barely features in international rankings of major energy exporters. If recent finds are proven to be viable, the country could be listed as the holder of the eighth largest oil reserves in the world. However, the full potential of these fields will depend on the ability of companies such as Petrobras of Brazil, Repsol YPF of Spain and BG of the UK to overcome the practical issues that surround the extraction of oil and gas from beneath 2,000 metres of sea and 2,000 metres of salt rock. These include operating in conditions of extreme cold in deep water, heat in rocks within the earth's crust and at high pressure.

Interest in Petrobras' discoveries has contributed to the dominant role that the company plays within the benchmark MSCI Latin America Index. Petrobras alone accounted for 18% of the index at the end of July; part of a scenario where energy stocks constitute almost one quarter of the value of the entire index. This has obvious implications in the upswing of the oil pricing cycle, or when the trend reverses. Analysts have also been attempting to price in the spin-off benefits for providers of energy equipment and services, a sector which has outperformed in the year to date.

However, the longer prices remain at elevated levels, the

greater the incentive for technological innovation and substitution. According to energy analyst Daniel Yergin, the price outlook will vary according to the degree of technological optimism or geological pessimism.

Investment strategy

Gartmore's Emerging Markets Latin American funds are positioned by virtue of their holdings to take advantage of the new era in developing energy sources, particularly deep-water oil exploration. In comparison to integrated oil companies, deep-water oil exploration and production companies offer more sustained benefits over the oil cycle. Drilling for oil in depths greater than 400 metres demands complex and costly technological solutions, including the use of floating drilling platforms.

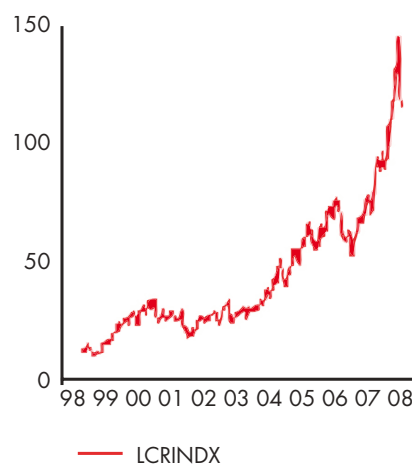
Our holdings span various facets of energy development and include Petrobras, widely regarded as a leader in deep-water exploration, and other related companies, such as Usiminas, the producer of steel plate, and Tenaris, the manufacturer of seamless steel tubes that carry oil and gas, plus Confab, the maker of natural gas pipelines.

Perhaps, more critically, we have identified the 'supply crunch'. Many mature economies have failed to solve their own energy supply requirements at a time when demand from emerging economies is growing. New frontier discoveries, such as offshore Brazil, could potentially change the geopolitics of energy. Already, we have seen that emerging markets dominate global oil exports expect this to continue.



Chris Palmer is head of global emerging markets at Gartmore Investment Management

Chart 1: London Brent crude oil index US\$/BBL – price index



Source: Thomson datastream

High over 12 months	145.65	04/07/08
Low over 12 months	68.91	23/08/07
Avg of 12 months	101.60	

Performance

	-1M	-3M	-12M
Actual value	138.45	121.99	70.41
% change	-17.02	-5.82	63.17

Background information

Start date	21/11/1988
Currency	US\$
Datatype	PI

three emerging markets,
three sharpened skills ...one strategy

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Key personnel:

David da Silva, CFA, head of GEM strategy
David da Silva is head of GEM strategy at Nomura Asset Management U.K. Limited. He has been with the firm since 2004. Prior to this he held product development and product specialist roles in Morley Fund Management in London. David has an Honours B. Com Hons degree from the University of Cape Town and in 1999 he attained the Chartered Financial Analyst designation.

Nomura's Global Emerging Market Strategy team:

Jolly Ng Kok Song, CFA, Nomura Asset Management Singapore
Gabor Sitanyi, CFA, head of research, Charlemagne Capital Limited
Chris Palmer, CFA, Gartmore Investment Limited

Background:

Wholly owned by the Nomura Group, Nomura Asset Management (NAM) is one of the largest investment managers in the world.

Our regional presence, extensive experience and research capability in Asian equities gives us global recognition as a specialist manager.

Investment style and philosophy:

NAM's philosophy is founded on the belief that capital markets are not fully efficient. Whilst there is scope for active fund managers to add value, to do so consistently requires considerable resources, skill, and discipline.

Our investment style is seen as a "core" or "flexible". We focus on identifying stocks which are trading at less than their fair value. Our relative value

approach means that our investment process is designed to add value in all market conditions.

Products and services:

NAM's goal is to provide "world class" products and client services to investors, i.e., to provide products that meet the diverse and existing needs of clients, achieve superior investment results, and give an exceptional level of client service.

We offer regional and country strategies covering Asia Pacific, Japan, India and China. Additionally, we have established a unique global emerging markets equity strategy involving three regional specialist managers: NAM in Singapore manages the Emerging Asia region while two external specialist managers manage EMEA and Latin America regions.

Key features of investment process:

The philosophy underlying our GEM strategy has two basic tenets. The first is that stock selection is the best place to add value. The second is that regional expertise is the best approach to stock selection in emerging market investments. We believe that three regional specialists are better placed to add alpha than one generalist manager.

Based on this belief, we complemented our emerging Asia expertise with the skills of two regional specialists. Following competitive search exercises we selected Charlemagne Capital as our EMEA (Europe, Middle East and Africa) specialist and Gartmore Investment Management as our Latin America specialist. Regional allocations are kept within a neutral range around the MSCI Emerging Market benchmark weights. Each of the specialists operates entirely independently, we do not blend styles or strategies; resulting in a diversified, regionally neutral strategy with global coverage.

All three managers are predominantly stock pickers, focusing on company fundamentals with comprehensive company visit policies. They place heavy emphasis on primary research to complement third party research when available. Under-



NOMURA

standing and correctly forecasting cash flows is crucial to their valuation processes. Top down factors are considered to ensure that the macro-economic and political fundamentals are supportive. Although the overall portfolio has a growth bias, the managers follow what could be described loosely as a relative value approach, and the combined style characteristics of the strategy are purely a residual outcome.

Research and development:

Our GEM strategy is the result of nearly five years of development on the part of Nomura. Both its development, and on-going credibility, relies on our belief that greater alpha will be generated by a regionally focussed specialist manager approach compared to that available from one manager trying to cover all three regions.

This belief has been validated by annual studies (available on request) conducted on our behalf by Oliver Wyman across the universe of over 200 competitor firms. The most recent one (for 2007) concluded the alpha uplift was 2% per annum.

Key facts:

Total assets under management world-wide as at 30 June 2008 were \$250bn. GEM strategy has \$479m as at 30 June 2008.

Distribution:

The geographic distribution of institutional assets worldwide is as follows:

- Equities: 53%
- Fixed Income: 34%
- Balanced: 6%
- Other: 7%

Source: NAM Tokyo as at 30 June 2008

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The poacher's guide to game-keeping in emerging markets



The performance of emerging market investment managers over recent years has been (on average) so dismal* that an observer might conclude these markets are amongst the most efficient in the world. This is patent nonsense. Liquidity-driven bubbles in China, far-beyond-consensus commodity price appreciation, unexpected political instability, fundamentals ignored – we have heard the excuses. What should the investor in emerging markets be looking for from his manager – how to pick the winners in emerging markets? Somewhat unusually, Nomura Asset Management (“Nomura”), one of the “poachers” in these woods, can offer an interesting perspective.

How should we know?

This article sets out some key points you should be looking for when appointing an emerging markets manager. However, before we begin, we ought to establish a little credibility. Nomura is an asset manager after all, so why should anyone trust an asset manager on the subject of how to pick asset managers?

Nomura's regional emerging market strategy is somewhat unique. We have built a global emerging product by

choosing external investment managers in Emerging EMEA and Latin America to complement our own expertise in Emerging Asia. We also select back-up managers and monitor the universe of suitable candidates. That puts us in the business of manager selection as well as asset management. So we are both “poacher” and “game-keeper”. We hope that by reading this article, you will appreciate how we choose investment managers, and this knowledge will be useful in making your own selections. We also hope it will stimulate you to be interested in our fund.

We suspect that many of the ideas raised in this article would be shared by the true “game-keepers” – the investment consultants, many of whom have enviable manager research resources. For those investors with insufficient in-house resource to undertake the research described in this article, we recommend that the advice of an investment consultant is sought in the manager selection process.

Take pity on the managers

It can be difficult to feel sorry for any investment manager, but consider the challenge faced by an emerging markets specialist:

- 785 benchmark companies;
- 14,000 off-benchmark companies;
- 25 countries, 26 currencies, 60+ languages.

The geographical spread of the countries alone implies considerable time spent on aircraft, not to mention regular exposure to jetlag – provided that you need to actually go and see the companies, of course. Quantitative managers, or those based in a major centre such as London or New York, expecting their investee companies to come to them, do not suffer from this issue. However, we believe that a fundamental manager will derive benefit from meeting companies on the ground, and so we look for firms that make regular trips to the regions they invest in (and have the language skills and relevant cultural awareness), or base their analysts close to the companies they research. Research must be focused and organised to suit the resources of the firm and its philosophy.

Quantitative managers have their own challenges to face; high on the list will be the difficulty of sourcing accurate data as inputs and ensuring that models, often imported from developed markets and “adapted”, add genuine value. There are undoubtedly some excellent quantitative emerging markets managers, but they do not suit our requirements, and hence we do not consider them. As a result, we make no comment on their selection in this article.

Local presence, language ability

We believe that local knowledge of the markets in which managers invest is preferable. Therefore we seek (ideally) managers whose analysts or portfolio managers have lived, or do live, in the countries of their speciality and speak their languages.

That local knowledge will aid decision-making is intuitive, particularly given the strong influence of local politics on the emerging world, and given the largest sector in the MSCI Emerging Markets Index is Financials, where profits are heavily influenced by local economic conditions. However, there is little statistical evidence to back up the theory. In 2007, a study by Melvyn Teo (*The Geography of Hedge Funds*, Melvyn Teo, University of Singapore) showed that hedge funds with a physical presence in their investment region outperform others. Hedge funds and long-only active equity funds are very different animals of course, but they share the goal of adding value through informational advantage, so we believe this research supports our preference.

Similarly, Oliver Wyman's 2008

*An analysis of a universe of 182 global emerging market funds constructed by Oliver Wyman found more than 75% of funds underperformed the MSCI Emerging Market Index (net of fees) over two years to 31 March 2008.



study (Emerging Markets Product Analysis, Year end 2007 update) of regional emerging market equity managers demonstrated that regional funds, when combined to give global coverage, outperform global emerging market managers. Regional managers can be closer to the markets in which they invest, and their alpha advantage is proven. Chart 2 illustrates the results of the study.

Digging deep

Large cap stocks in the emerging markets are well covered by sell-side analysts. Whilst this coverage can have an unobvious (sale focussed) agenda and can be short termist in nature, the sheer number of investors delving into company finances, absorbing newsflow and forecasting “fair value” implies a degree of efficiency. At the mid to small cap end, the number of analysts covering companies drops away sharply. To give an indication of this, Gazprom (the Russian oil giant, and one of the largest index stocks) was examined in 46 separate reports posted to Bloomberg in July alone. By contrast, there have been just 15 reports relevant to Arabtec (one of the more recent and smaller cap stocks added to the Nomura portfolio) added so far in 2008.

Nomura, by researching regional managers, typically comes into contact with teams who have the resource and the willing to research the small cap and off-benchmark areas of the market for pricing anomalies. Those investors seeking managers who operate on a global basis should seek similar reassurance.

Capacity – how much is too much?

One factor that prevents many managers from investigating small cap companies is capacity. Large funds will fail to research small companies simply because it is impossible for them to gain a meaningful position. Growing asset sizes lead to other symptoms which erode alpha: stocks ignored due to the inability to trade without moving markets and stocks held on to for too long once they pass price targets.

The question then becomes, ‘How much is too much?’, a question that provokes much mumbling and downward glances throughout the asset management world. The phrase, “We are reluctant to give a hard figure for capacity,” grows increasingly hackneyed with each manager interviewed. Here’s our hard figure: US\$5bn. That figure was derived from looking at the portfolios of each of our underlying managers

and ensuring they could continue to liquidate 75% of the portfolio over a ten-day period using only a fraction of average daily trading volume. However, that figure is (intentionally) conservative and, for some managers, a higher capacity figure may be appropriate. Moreover, it should be remembered that liquidity is not static. At end June, the free-float of the MSCI Emerging Market Index was US\$3.3trn, a figure that has doubled in three years. Larger, more liquid markets should yield higher capacity numbers.

Portfolio construction and risk control

Beyond looking for a clear link between conviction and risk allocation, it is important to identify any systematic biases in portfolio construction (particularly tilts that are not in keeping with the manager’s philosophy or research process). Many managers in this space rely on the output of BARRATM and “experience” to keep their risk under control, but we seek managers who are aware of the risks relevant to their forecasts (e.g. interest rates, oil price, etc) both at stock and portfolio level and stress test to confirm their thinking. We are content with managers using consensus forecasts for such variables where they feel they cannot add value, but they should understand the portfolio consequences of “consensus” being wrong.

Organisation

We look for product focus – firms not trying to be all things to all people, and focusing on their competitive advantages. Alignment of interests with clients is important, and the firm must have adequate retention policies in place, particularly in the case of smaller teams, where a number of individuals may be key. The support of parent organisations/owners is also an element to look for, as is a degree of autonomy.

The details

Through trading costs, errors and inefficiencies, alpha can be given away. It is an expensive luxury to have compliance, risk management experts and portfolio administration teams review the operations of the managers one selects – it is a review that few investors will undertake. From Nomura’s point of view, it is an unacceptable reputational risk not to undertake such a review (and we periodically re-check our findings). However, in place of such a detailed check, careful questioning about dealing functions (preferably

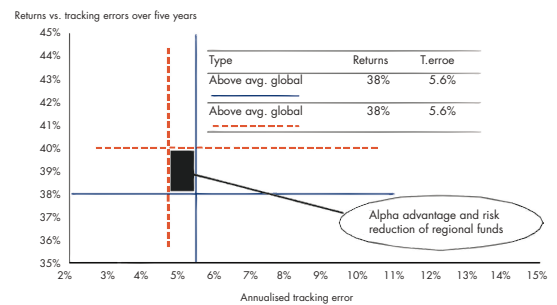
separate from portfolio management), broker use and assessment, order processing systems and trade cost monitoring can reveal potential sources of problems. This important area should not be ignored in the selection of managers.

Conclusion

This article cannot present an exhaustive list of what we look for in a manager (and no manager is “perfect”), but it gives a guide to what we believe to be vital. In choosing a fundamental emerging markets manager, we recommend seeking one close to its market, with product focus and the means to retain its key staff. Look for purposeful, organised research feeding into a clear portfolio construction process, with a dealing team and back office that will not “give back” the hard-earned alpha of the investment team. Keep an eye on capacity – walk away if you believe a manager to be hampered.

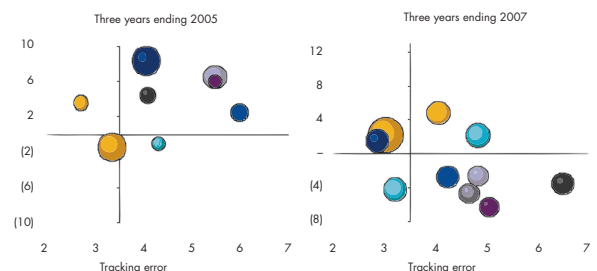
Fraser Hedgley, CFA, is a product specialist for Nomura’s Global Emerging Market Strategy.

Chart 1: Above average regional (Asia, EMEA, Latin America) managers in combination have outperformed global emerging market managers over the five years to end 2007 by 2%p.a.



Source: Bloomberg, MSCI, Oliver Wyman analysis. Note: above average funds are defined as comprised of managers with above average returns over defined time period

Chart 2: The charts indicate (by size of bubble) the size of assets under management of the greatest asset-gathering emerging market managers at end 2005, and the contrast in their performance over the three years ending 2005 and 2007



Source: Provided by Intersec Research



Who's got the alpha in emerging markets?

This article makes the case for appointing dedicated managers of emerging market equities. Further, it explores the merits and difficulties of obtaining this exposure through regional specialists within the EMEA, Asia and Latin American emerging markets. The results of independent research and research conducted by Oliver Wyman on behalf of Nomura Asset Management U.K. Ltd. ("NAM") suggest that a considerable increase in alpha is available to investors prepared to appoint regional specialists.

First steps into specialist management

Roughly 20 years ago, the idea of "balanced" mandates was set aside in favour of specialist managers of equities, bonds, property, etc, working within a strategic allocation governed by fixed weights and/or market capitalisations. The rationale was simple: few investment managers could (in good conscience) claim to be skilled in managing all asset classes and fewer still could claim to be skilled tactical asset allocators.

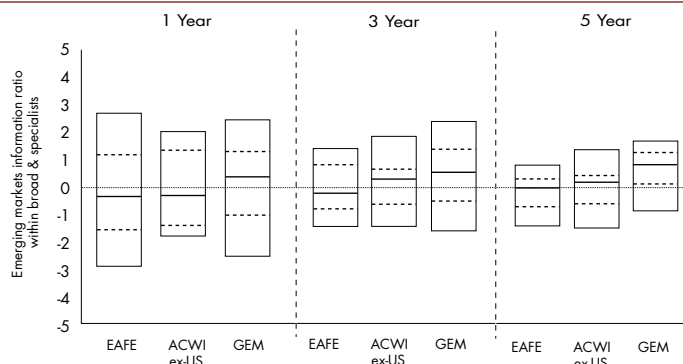
That rationale applies equally today and

balanced mandates have become vastly outnumbered by specialist structures. The number of investment houses with genuine expertise in managing just bonds and equities (let alone the increasingly overwhelming array of alternative investments) remains low, and tactical asset allocation is a specialist world dominated by a few highly-resourced quant houses.

Equity mandates lack specialisation

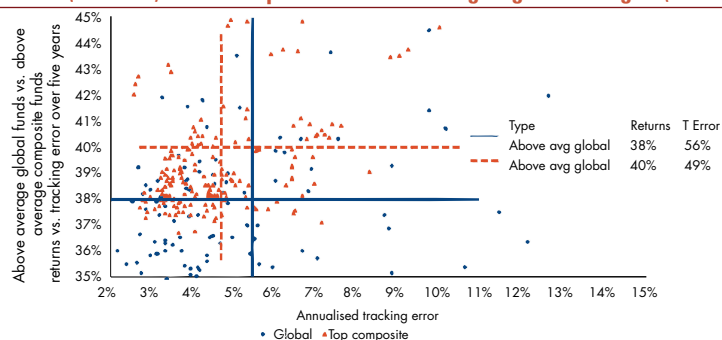
If we drill down one strategic level into equities and particularly the emerging markets, the idea of abandoning generalist managers in favour of specialists has not taken hold. Worldwide, institutions award Global or "International" equity mandates far more frequently than any other appointment. These mandates often allow managers a small allocation to the emerging markets, as either an off-benchmark allocation from a developed market mandate (which has provided a useful boost to performance in recent years), or as part of an "All Countries" benchmark. This seems contrary to the idea of specialisation that is so established at the equity/bond level.

Chart 1: Information Ratios of Europe, Africa and Far East ("EAFE"), International ("ACWI ex US") and Global Emerging Market ("GEM") managers over periods ending 31 December 2007



Source: Intersec Research

Chart 2: Annualised returns plotted against tracking error for above-average global emerging market funds (blue dots) and for composites of above-average regional managers (red dots)



Source: Bloomberg, MSCI, Nomura, Oliver Wyman analysis. Note: Above average funds are defined as funds comprised of managers with above average returns over the defined time period.

Dedicated emerging market managers outperform

Studies conducted by US-based Intersec Research™ reveal that the focus of dedicated emerging markets managers has led them to outperform the emerging market allocations of Europe, Africa and Far East ("EAFE") and International managers. Chart 1 illustrates this result, comparing the information ratios of broad mandate – EAFE and International (labelled "ACWI") managers – with those of global emerging market ("GEM") specialists. Over all periods shown, the median GEM specialist manager has generated positive information ratios, higher than those of the median EAFE and International managers.

The evidence suggests that the appointment of a dedicated emerging markets specialist would have been beneficial for investors over recent years. Not only would such an appointment have allowed investors to fully participate in the emerging market growth story that has driven returns so strongly over recent years, it would also have ensured that investors achieved a superior alpha contribution from their active managers.

Whilst a dedicated emerging markets manager is therefore a worthy addition to a broader equity manager line-up, is there merit in taking the idea of specialist management further?

Can regional specialisation improve returns in emerging markets?

If specialism at the global emerging market level can increase returns, it seems natural to pursue the concept and investigate specialism one level further down; to check whether regional specialisation within the emerging markets improves performance. The case for doing so appears still stronger when we consider the obstacles to successful, fundamental emerging market equity research:

- Benchmark of 900+ stocks (MSCI EM)
- Circa 14,000 stocks off-benchmark
- 27 countries, 27 currencies, 70+ languages
- Geographical spread of markets
- Varied accounting and reporting practices
- Country-specific factor influence on equity performance

NAM commissioned Oliver Wyman in 2006 to investigate the potential of regional specialist manager combinations. They found that an average of the regional specialists in the EMEA, Asia and Latin America regions, combined (at regional market weights) to form a synthetic "global" strategy, outperformed the average global emerging market manager over one, three and five years ending 31 December 2005. This study was conducted on a net of fees basis. Oliver Wyman has since repeated the study on two occasions, using data ending December 2006 and December 2007; the results are consistent with the original findings. On each occasion, combinations of regional specialists were found to have outperformed global managers.

Increased return is beneficial for investors, but it is reasonable to expect combinations of regional managers to yield some diversification of manager style also, so we might expect to see a decrease in risk. From the latest Oliver Wyman study, Chart 2 compares a universe of "composites", formed by combining (at random) above

average performing regional managers, with the universe of above average global managers. The composites of regional managers not only outperform the global managers by 2%p.a. on average, they do so with lower tracking errors to the MSCI Emerging Market Index.

In our view, the results of this analysis also cast doubt on the extent to which global managers add value through active regional asset allocation. The composites of regional managers were neutrally weighted to the regions (and thus had no access to this potential alpha source). Nevertheless, (on average) they outperformed global emerging market managers.

Difficulties of appointing regional specialists

There are downsides to appointing specialist managers. The investor may well have to allow for higher overall fees in a specialist structure and greater governance and administration costs. If the allocation to emerging markets is small, the use of pooled funds may be unavoidable if specialists are used, since the assets available are split between a greater number of managers. Also, the difficulty of finding skilled managers and monitoring their progress can be considerable. NAM can certainly testify to this point; since NAM first built a combination of regional specialists into a single product in 2006, it has been a continuous challenge to identify a sufficiently broad set of skilled candidate managers in each region that remain open to new business.

For the very largest institutions, with extensive in-house resources, these difficulties may be surmountable, and NAM's experience suggests the effort involved can be amply rewarded. However, smaller institutions may have their options limited to a small number of providers or fund-of-funds (many with an additional level of fees) if they are to benefit.

Conclusion

As demonstrated by the research, specialist emerging market managers have, on average, outperformed the emerging market allocations of more broadly-mandated investment managers. Similarly, research shows that combining specialists within the EMEA, Asia and Latin American regions has, on average, improved risk/return outcomes over those of more traditional global emerging market managers. This reinforces the widely accepted idea that specialist managers with more focus and resources to devote to a particular area of investing will outperform generalists. For large investors with sufficient resources, or smaller investors with access to cost-effective fund-of-funds or similar products, seeking regional specialist emerging market managers should be strongly considered based on our evidence.

Fraser Hedgley, CFA,
GEM Product Specialist

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Investing in 'emerging' Europe

Many economies in Central and Eastern Europe offer attractive investment opportunities to trustees, says **David da Silva**, CFA of Nomura Asset Management UK Limited

What are the market opportunities in emerging Europe?

The investment opportunities in the region stem from the favourable political and economic climate which has been ushered in post the communist era. The market friendly conditions have created opportunities for individuals and firms alike: low labour costs, coupled with high education standards, and strong productivity have prompted many multinational companies to set up bases in the region. Our GEM strategy philosophy at Nomura Asset Management is to work with regional specialists who are best placed to extract the alpha from these markets. For emerging Europe we work with Charlemagne Capital, an emerging market specialist company with extensive experience in the region. They add that an important factor supporting the macro environment has been accession, or even potential accession, to the EU which has prompted a responsible fiscal, regulatory and legal framework to the clear benefit of the corporate sector. Russia is a special case, although not subject to the influence of the EU in the same way as the countries of central Europe, it is nevertheless pursuing an equally ambitious programme of reform which is seeing its economy move away from a dependency on the energy and materials sectors to more broadly based activity with consumer demand at its core. Furthermore it is worth noting that as economies close to the EU mature and develop, others appear on the radar screen, offering perhaps the same opportunities to investors as central European economies offered ten years ago and more. These markets include those labelled as "Frontier", such as Kazakhstan, and prospects for these countries have been recognized by the likes of the index provider MSCI as well as by the number of funds now beginning to invest in this area.

Consequently, from a fundamental perspective emerging Europe seems attractive, but what is important from an investor's perspective is whether the valuations reflect this yet. We believe that valuations are attractive though specialist regional skills are needed to uncover the best opportunities. On a relative basis, forward price to earnings ratios for MSCI EM Europe are currently approximately 30% below the average ratios in MSCI EM Asia and EM Latin America. Furthermore, the current level is in line with the five year average whereas for the other regions they are above their respective averages. These favourable valuations however should be weighed against the fact that earnings growth rates are at roughly a 30% discount to the other regions, and over

the 12 months to 25th April 2008, EM Europe has lagged the performances of Asia and Latin America by 11% and 28% respectively, delivering a modest 10% return in US dollars. All data references taken from MSCI and IBES Aggregates, 25th April 2008.

What are the key macro dynamics in the region?

As stated in the previous answer, the favourable macroeconomic backdrop is underpinning its competitiveness, and this in turn is attracting foreign direct investment. As confidence grows, we are seeing rising consumer demand. However, the region cannot be separated from current global themes: financial distress, rising commodity and food prices, inflationary concerns and the monetary policy response. Charlemagne make the point that the impact of the sub-prime crisis and credit crunch is nowhere near as pronounced as what we have seen in developed economies. This is a consequence of the fact that these emerging economies are not as closely linked into the international credit markets, and are funded in essence by their own domestic depositor bases. Regardless, we believe that it is perhaps better to view these markets in the context of their relationship with Developed Europe. The latter has shown encouraging resilience to the current global slow down and this has provided some support to the satellite emerging economies which are dependent on these export markets.

It is also worthwhile considering the region from a longer term perspective, as Charlemagne highlight, emerging Europe is still throwing off its communist yoke and putting its own economies in order. To a large extent this process is helped by the lure of the EU and the Euro, as touched upon earlier. The results however are already apparent in improving fiscal balances and current account surpluses (though not in every country), which some would say were necessary prerequisites for successful investment. The increasing importance of the consumer sector is also providing some insurance against external woes.

Does the region offer less risk by virtue of its proximity to EU?

EU accession and integration have resulted in what many perceive as a less risky environment in which to invest, a view supported by our regional specialist Charlemagne. They add that the proximity of the EU has been central to the economic renaissance of the region and will most likely continue to provide a positive input for many years to come. Though physical

proximity is important, especially in terms of trade, the influence of the EU is deeper than this and is having an impact further afield. In comparison to such regions as Asia and Latin America, it would perhaps be fair to say that this European tie does equate to less risk as policy actions are constrained by such ambitions. However, it is worth pointing out that as with any market, risks remain and that unexpected political and or economic developments might jeopardise future returns.

How well established are these stock markets?

The region's stock markets, in their present form, are relatively new arrivals, having been set up in the early 1990s following the collapse of Communism. However, despite this short history the Russian stock market has become a dominant player in the region, thanks to the size of its economy and the strong performance of its energy and materials sector, with a market capitalization in excess of USD 1,000 billion. This places it in the same league as the largest stock markets anywhere in the world. National stockmarkets in some other countries continue to struggle however and this may, in time, lead to some consolidation in the industry. As Charlemagne make clear, from an investors point of view, it matters little whether emerging European companies are traded locally or abroad. Indeed, in some respects it may be more secure and less risky to use western exchanges, particularly when investing in some of the new Frontier markets. ■

Thanks to John Dawe at Charlemagne Capital for his contributions

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By David da Silva, CFA
of Nomura Asset
Management UK Limited

NOMURA

Panellists exchange views on emerging markets, discussing alternative methods of selection, where the current alpha generators lie and predictions for how the asset class will develop over the next five years

NO QUICK FIXES

The second *Professional Pensions* Conjecture debate looked at the case for scheme investment in emerging markets.

Joining *Professional Pensions* editor Len Roberts were Nomura head of marketing and client service Mark Roxburgh, Aerion Fund Management investment director John Arthur and Mercer principal Debbie Clarke.

LR: What are your views about emerging markets generally, the effect of the credit crunch and why trustees should be considering an allocation to the asset class?

MR: Over the last five years, pensions schemes that have had exposure have done exceptionally well relative to perhaps more developed markets. Although there will be volatility going forward, we still think there is a very fundamental economic case built on either increased exposure to emerging markets.

As far as the credit crunch is concerned, I think we need to try to keep it in proportion. This is primarily an issue for developed markets rather than emerging markets and, to that extent, emerging markets have come

through fairly unscathed, albeit affected by, but not directly impacted by, the credit crisis.

As far as the broad economic case is concerned, it really comes down to one key thing: that the current share of world market cap emerging markets enjoy – perhaps 12pc of the total – doesn't really reflect the very fundamental gross domestic product contribution that they make.

JA: Longer term, I am totally in tune with Mark here. I think one has to accept that the growth rates will be faster in emerging markets, and therefore one should see faster growing profits, share prices and a better return.

DC: Fundamentally, I think emerging markets are less efficient than the developed markets and ultimately that should be a good long-term opportunity for pension funds on a long-term basis.

LR: Should emerging markets be seen as an asset class in its own right, or part of a global equity portfolio?

MR: One of the factors will be whether the fund has enough of a governance budget or

people skill set to actually implement a standalone mandate and there isn't any particular solution that applies across the board.

I think the large funds tend to go for a dedicated asset exposure and the more medium-sized ones perhaps might see it as part of a global equity portfolio, and then there is a whole raft of people in between. It is really down to the particular circumstances of the fund concerned.

DC: The issue for trustees is very much as Mark said – it is the governance of how they get that exposure. Clearly, pension funds have quite a lot to think about at the moment and the question of whether or not it should be global or emerging market is perhaps some way down their thinking.

JA: We see it as part of our equity allocation within the fund, mainly because of the material correlation between emerging markets returns and developed market returns.

However, our benchmark includes a weighting in emerging markets – making it that bit harder to beat.

LR: What are the questions trustees should be asking when they are considering an allocation to emerging markets?

DC: Trustees should be asking what volatility the management are expecting in terms of the asset class and how they are actually managing the funds in terms of the risks they are taking.

But the important thing is for trustees to ask themselves if they are comfortable with the long-term perspective they have to take.

JA: I agree with that entirely. It is fundamentally about the risk appetite of the fund and the trustees and, in my mind, it has to be done on a long term basis. Without that, then I think you are running a risk of getting disappointing returns in the short term and finding you have not got the risk budget or the capital backing to accept that.



Len Roberts



Mark Roxburgh



Debbie Clarke



John Arthur

MR: I think one of the issues trustees have to identify is where they are going to take the assets from in order to put this into emerging markets.

LR: Is there a temptation for trustees to see emerging markets as a quick fix?

JA: I think there might be a thought that it can be a quick fix and if people feel that they have the ability to make that decision and make that call, then by all means.

We do not feel we have the expertise to make that sort of call, particularly where the trustees set us a strategic benchmark.

So we will move slightly overweight, slightly underweight emerging markets but in terms of long term, it has been a decision set up by the trustees in consultation with their advisers.

DC: I don't think many trustees are looking at it as a quick fix.

In reality, they might look at the performance and think they would like to capture that. Most of them are looking at it from that longer-term perspective and that is what they have to do.

MR: I agree, I think a core allocation, as John and Debbie have mentioned, is the way forward and that is certainly what we see funds actually doing.

JA: One point I would like to add to that: the other issue with emerging markets is the cost – the cost of dealing, the cost of access and management fees. This suggests that you should take a slightly longer-term view because you are paying more

MR: And maybe just one other point. There are differing standards of corporate governance in emerging markets and this is something trustees would need to be comfortable with and to understand before making an allocation.

PROFESSIONAL PENSIONS EVENTS CALENDAR

JUNE 19

PIMCO
Leeds/London/Birmingham

JULY 9

BULK BUYOUT FORUM
London

SEPTEMBER 11

PENSION SCHEME OF THE YEAR AWARDS
Park Lane Hilton, London

SEPTEMBER 11

MFI FORUM
Park Lane Hilton, London

NOVEMBER 19

PROFESSIONAL PENSIONS SHOW
ExCeL, London

NOVEMBER 28

SAIM AWARDS
The Renaissance, Chancery Court, London

DC: I would agree with Mark about the whole corporate governance perspective on this. A key part of what we look for in emerging market managers is how they deal with corporate governance in emerging markets because it is very different from what you have in western markets.

LR: I understand there are concerns about capacity though, and some managers have now actually closed to new business. Is this actually inhibiting the growth of the asset class?

JA: I think there is an issue here and of course it is quite often the better managers that run up against that problem.

This is particularly an issue for smaller funds where having the clout and the leverage to get access to those managers is quite difficult.

MR: I saw some statistics the other day that suggested something like nine out of the top 15 business winners in the US market in this asset class were closed to new business.

So it is very much a capacity-constrained market and it is crucial to make sure that you know how your selected manager is going to manage that capacity issue.

DC: Yes, I think capacity is an issue in this asset class and what we look for in terms of that is managers who have some sort of framework for thinking about capacity, monitor that framework well and then close when they recognise that they are reaching capacity and they actually can't continue to add the alpha.

LR: Are emerging markets suitable for defined contribution plans?

MR: It obviously depends on the investment horizon of the individual in the plan. Given what we said about emerging markets being perhaps a medium to longer-term asset allocation call, then I guess it is probably more appropriate for people at the earlier part of their pension planning, rather than perhaps in the latter stages where the volatility that we have discussed may be a bit inappropriate.

DC: My view would be that it is exactly the sort of asset class that a DC investor who is looking to invest over the next 30 to 40 years should be investing in.

JA: I think again it comes down to longevity and what your timeframe is. It is all about taking risk in the belief of higher returns where you have

the time to take that sort of risk and reap the higher returns.

LR: Where are most of the alpha generators in the emerging markets mandates?

MR: Our general principle would be that we believe that the greatest inefficiencies are probably at the stock level and that creates opportunities for managers who have a research or resource base that enables them to exploit that.

JA: Yes, our experience has been that it is the inefficiencies at the company level. You have got less perfect information, you have got less people doing the research so right down at the company level, that is where we see the major inefficiencies.

DC: I would agree with both Mark and John in terms of if one looks back again over the years, then increasingly it has been stock selection that has driven performance. And that has been the area where you get the greatest inefficiency.

LR: Mark, I think you have a slightly different way of selection, don't you? Could you give us your views on that?

MR: We combine with some external managers to provide a global emerging markets product.

We asked an independent consultant to look at where the alpha was being generated and whether a regional structure would actually offer investors more alpha on the basis that managers would be close to the region and they would have better information; better information would mean better decisions and better decisions should produce more alpha.

They suggested this sort of structure could increase returns by between 60 and 200 basis points per annum if you could get some good quality regional managers in place.

JA: If it can be provided in an efficient manner from a fee perspective, then I believe that having an Asian manager, a Europe, Africa, Middle East manager and a Latin America manager grouped together in a fund should be an interesting way to look at the asset class.

DC: If you can find people and can put the managers together without additional fees then that would be interesting.

I think the other thing that perhaps global emerging markets managers bring to the piece is those who are good at perhaps identifying some of the frontier countries as those

come through and incorporating those into the global emerging markets mandates.

MR: I certainly think that a manager who is focused on the region should be able to exploit those frontier markets. I think they are interesting markets and, as long as the manager has got a skill set in that area, they should be given the remit because it will be a source of additional return but not add a significant amount of risk to the overall portfolio.

JA: It is a balance, it is a useful way of looking at things; it should add more value but on the other side, anything more complex takes more time and effort to monitor.

LR: Are fees a constraint on the growth of the sector? Is it a key issue?

MR: We are not in hedge fund territory here but I think you are probably looking at emerging markets as being certainly one of the higher

traditional equity classes in terms of fees.

However, I think the real issue is to ask about the alpha a manager can produce. If you can find a successful manager or managers who are going to produce you north of 3pc per annum, then higher fees are not that significant in the context.

LR: How will the asset class develop over the next five years?

MR: We think pension funds in the UK will allocate more money to the asset class.

We will clearly see some volatility as a result of ongoing effects of the credit crisis. But we still think the fundamentals look quite attractive. So perhaps lower returns but we still think there will be good returns over the medium term versus the more developed markets of the world.

JA: I would assume the higher beta of emerging markets and the ability to add alpha better in less perfect markets should lead to higher returns but we have had five-year periods when

emerging markets have been slightly disappointing.

I think emerging markets will provide better returns but would be more comfortable saying that if I was commenting over a 10 or 20-year time period.

DC: If you look at the last three to five-year numbers, investors have had 40pc plus returns from emerging markets and on a five-year view, while we still expect returns to be high, I think we have perhaps had the best of emerging markets in that period. Despite this, on a 10 to 20-year view, we still see emerging markets as offering excess returns relative to other markets.

NEXT CONJECTURE DEBATE

For more information on the next Conjecture debate please visit www.professionalpensions.com



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LEGISLATION AND DRAFT LEGISLATION

Pensions Bill (HL Bill 50) and Explanatory Notes	The Stationery Office
The Occupational Pension Schemes (Transfer Values) (Amendment) Regulations 2008, SI 2008/1050	The Stationery Office
The Occupational Pension Schemes (Employer Debt - Apportionment Arrangements) (Amendment) Regulations 2008, SI 2008/1068	The Stationery Office The Stationery Office
The Local Government Pension Scheme (Amendment) Regulations 2008, SI 2008/1083	The Stationery Office
The Firefighters' Pension Scheme (Scotland) Order 2007 Amendment Order 2008, SSI 2008/160	The Stationery Office
The Firefighters' Pension Scheme Amendment (Scotland) Order 2008, SSI 2008/161	The Stationery Office
The draft Financial Assistance Scheme (Miscellaneous Provisions) Regulations 2008	The Stationery Office

REGULATORY AND INDUSTRY MATERIALS

Draft Finance Bill Guidance:	HM Revenue and Customs
• Overseas pension schemes - amendment of pension input amount	
• Benefit Crystallisation Event 3 test	
• Inheriting tax-relieved pension savings	
The powers of the Pensions Regulator: Amendments to the anti-avoidance measures in the Pensions Act 2004	Department for Work and Pensions
Government responses to various consultations including: Non-European Schemes Exemption; Internal Dispute Resolution Procedures; Transfer Values; Cross-border Activities; Financial Assistance Scheme	Department for Work and Pensions
Pensions Regulator Corporate plan 2008-2011	The Pensions Regulator
Multi-employer withdrawal arrangements	The Pensions Regulator
Section 89 report - G.E.C. 1972 Plan (telnet)	The Pensions Regulator
Trustee Good Practice Guide: Guidelines for trustees managing pension schemes through the Pension Protection Fund assessment period (consultation)	Pension Protection Fund
Consultation on the requirement under Section 171 of the Pensions Act 2004 to equalise compensation to allow for differences in the GMP formula	Pension Protection Fund
Management Plan 2008/09 - 2010/11 Incorporating Business Plan 2008/09	Pension Protection Fund
Briefing Note 45 - Choosing a charging structure for personal accounts	Pensions Policy Institute
Conceptual Framework for Technical Actuarial Standards and Scope & Authority of Technical Standards Exposure Drafts	Board for Actuarial Standards
Structure of new BAS standards (and implications for adopted GNs): Consultation Paper	Board for Actuarial Standards
Exposure Draft: Reporting Actuarial Information	Board for Actuarial Standards
Committee of Public Accounts Fifteenth Report of Session 2007-08: The Pensions Regulator: Progress in establishing its new regulatory arrangements (HC 122)	The Stationery Office
Briefing Note 46 - How much will pensions and long-term care cost in the future?	The Pensions Policy Institute

MISCELLANEOUS

Survey on fully funded, technical provisions and security mechanisms in the European occupational pension sector	CEIOPS
Recommendation On Good Practices For Financial Education Relating To Private Pensions: Recommendation Of The Council	OECD

Emerging markets provide the opportunity to add value

IF INVESTORS STRUCTURE A PORTFOLIO TO TAKE ADVANTAGE OF THE PROSPECTS OFFERED BY EMERGING MARKETS, THEY COULD ACHIEVE OUTPERFORMANCE, SAYS **PETER JENKINS**



Peter Jenkins

Emerging market equities rewarded investors with great performance over the last year and have produced excellent returns over a longer period. The MSCI Emerging Markets Index has produced long-term outperformance since its inception in 1988. Those of you wary of the volatility of emerging markets and aware that recent falls have been worse than those suffered in developed markets, might view these losses in the context of long-term gains achieved so far. For over 20 years the MSCI emerging markets returns have been more than double those achieved in, for example, the S&P 500, and four times those achieved by the MSCI World Index.

Looking forward, the short-term outlook is somewhat cloudier, reflecting a more uncertain global economic picture. As has happened in 2008 to date, developments in developed economies and markets will likely be the major factor determining market direction for the moment, particularly if the global market downturn continues as emerging

markets look ripe for profit-taking. International investors will take profits wherever they have them and for those investors that have had a decent exposure to this asset class for any length of time, there are temptingly large gains to be realised. It is for this reason that in times of crisis markets tend to move together; ie markets become more correlated. However, looking beyond the immediate concerns, the prospects for emerging markets remain very bright.

Over the longer term, equity markets will follow the growth of economies and corporate earnings, and both are likely to be significantly greater in the case of emerging markets than in developed markets. From our studies over the next few years we expect emerging market GDP growth to average 6%-7% annually, a figure two to four times greater than the equivalent for G7 economies, and we expect annual corporate earnings growth to exceed those numbers. Against this backdrop of robust earnings growth, emerging market valuations remain attrac-

● Emerging markets will define general market direction in the short term

● Underexposure to the asset class bodes well for future performance

● The DWP is taking a closer look at scheme governance

tive; the forecast price earnings ratio (PER) on 2008 earnings is less than 12 times, only slightly above the five-year average, and a substantial discount to developed markets.

Despite the fact the growth profile and valuations are attractive, and emerging markets have been receiving strong fund inflows in

“OVER AND ABOVE THE ATTRACTIONS OF TOP LINE GROWTH, AN ADDITIONAL ATTRACTION OF EMERGING MARKETS TO INVESTORS ARE THE OPPORTUNITIES THEY AFFORD TO SIGNIFICANTLY OUTPERFORM THE INDICES”

recent years, we believe that these will continue as emerging markets are still significantly under-represented in investors’ portfolios; in short G7 investors and savers remain structurally underweight this asset class. This state of affairs is all the more surprising given that global equity indices generally carry neutral emerging market weights at well below 10%. This current level of under-exposure augurs well for market performance in the future.

Over and above the attractions of top line growth, an additional attraction of emerging markets to investors are the opportunities they afford to significantly outperform the indices; in short, to out-

perform what we already expect to be an outperforming asset class. The whole structure of emerging markets and the way they operate gives fundamental and disciplined investors a chance to outperform the indices without taking undue risks; namely adding alpha. Alpha is a measure of the difference between a fund’s actual returns and its expected performance, given its level of risk against market indices as measured by beta. In this sense it is a good measure of the value added by a manager over and above movements of the index.

There are three main reasons why this is achievable in the context of emerging market equities. Firstly, the global emerging market universe allows for a much wider degree of diversification over and above that which can be achieved through a spread of investments across developed markets. Emerging markets embrace a wide range of countries in different geographical locations with different economic structures and at very different levels of development. They range from giant resource rich economies such as Russia and Brazil, through to manufacturing based economies such as Korea; from countries at a very basic level of development to countries as developed and wealthy as Taiwan; from relatively unrestricted economies such as Chile, to those with much state intervention and restricted capital accounts, such as China; and from

states which have freely floating exchange rates to those that actively manage or even peg their currencies.

The case for diversifying portfolios through emerging market exposure is captured in the relatively low correlations between emerging markets and developed markets compared to those between developed markets themselves. For example, the 15-year correlation between the S&P 500 Index and the FTSE 100 Index is 0.73 compared to 0.61 between the MSCI Emerging Markets Index and the FTSE 100. Further, correlations within the emerging markets universe are significantly lower than those within that of the developed markets. Consequently, skillful asset allocation between emerging markets enables investors to focus on those markets where the growth and corporate profiles are best for any stage in the economic cycle. For example, strong global growth and trade may well lead to greater outsourcing by first world companies, and prime beneficiaries of this trend such as India and China could be overweighted. On the other hand, when commodity prices are rising Russia and Brazil might look more attractive. To illustrate, a recent example of an opportunity to add value through asset allocation: over the first quarter of 2008, the MSCI World fell by 9.0% in US dollar terms; the MSCI Global Emerging Market Index also fell 10.9%, but within the index there was startling

outperformance from the Middle East region where, benefiting from high oil prices, markets such as Jordan, Bahrain, Oman, Qatar and Kuwait rose strongly, the latter up by over 10%.

Secondly, within emerging markets there are excellent opportunities for adding value through stock selection. One of the main drivers of most emerging markets is foreign fund flows. Overseas investors tend to focus their attention on the representative and larger capitalisation stocks within each market. These represent better-researched, more liquid investments, but by the same token they are usually well known stories and their stock is often fully valued. Consequently, the most attractive investment opportunities can often be found outside the larger names for those investors who are prepared to expand their investment horizons and research efforts accordingly.

Thirdly, emerging markets often present greater opportunities than developed markets by virtue of

“IN GLOBAL PORTFOLIOS INDIVIDUAL EMERGING MARKETS OFTEN REPRESENT RELATIVELY MARGINAL POSITIONS. CONSEQUENTLY, FOREIGN INVESTORS CAN BE VERY HEAVILY OVERWEIGHT”

“COMPARED TO DEVELOPED MARKETS, LOCAL INSTITUTIONS ARE USUALLY MORE MARGINAL PLAYERS IN THE MARKET; DOMESTIC INSURANCE FUNDS, PENSION FUNDS AND ALIKE ARE OFTEN IN THEIR INFANCY”

their greater volatility. On a five-year view the standard deviation of returns of the MSCI Emerging Index is 5.4, compared with a figure of 2.8 for the MSCI World Index, or 2.6 for the S&P 500. Some of this volatility can be accounted for by greater fluctuations in underlying economies, currency movements, or is just a function of market size, but an additional factor is the way the market works. In global portfolios individual emerging markets often represent relatively marginal positions. Consequently, foreign investors can be very heavily overweight or cut exposure to nothing depending on market attractiveness at any specific time, and this can result in some extreme money flows.

Local investors too can be somewhat fickle in their investment activity. Compared to developed markets, local institutions are usually more marginal players in the market; domestic insurance funds and pension funds are often in their infancy and hence do not have the same overall clout and are correspondingly less of a stabilising influence on the market. This leaves retail investors as more significant players than is the case in developed markets, and this

contributes to volatility.

Retail investors tend to invest on newsflow, often trying to pre-empt foreigners. They often lack a deep understanding of the underlying fundamentals, global forces and company prospects. They often trade using borrowed funds, possibly on margin, and thus have a limited capacity to endure losses. As a result, stock prices tend to get pushed to the limits of valuations, both on the upside and the downside. Such volatility presents opportunities for the cool-headed, well-researched and longer-term investor to pick just the right moments to buy and sell.

The prospects for the emerging market asset class look good, and there are significant opportunities to outperform. The key for the foreign investor is to structure an investment approach to take full advantage of the considerable opportunities that currently exist.

Peter Jenkins is an investment specialist at Nomura Asset Management UK

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FIVE

Investors debate decoupling theory

Ever since shadows from the US subprime crisis began to lengthen over markets, investors have begun to wonder how much truth there is to the theory that less developed markets are no longer closely correlated to developed markets. *Caspar Hoare* tests the theories

The debate is critical for investors because if emerging markets are still not correlated, they may be able to provide relative and absolute outperformance even given the other risks usually associated with the asset class.

Problem number one: there is no single definition of what an emerging market is any more. Somewhere between under-developed and developed, it may have a basic financial infrastructure in place, but lack liquidity and trusted regulation. Politics invariably features. One commentator defines an emerging market as one where "politics matters as least as much as economics".

The upside is the faster economic growth derived from younger populations spending, saving and paying taxes. Emerging markets have delivered strong gains to savvy investors who engaged at the beginning of the decade. "Emerging market returns have been phenomenal in both absolute and relative terms," says Todd Henry, portfolio specialist on emerging market equities at T. Rowe Price. "Investors have been reaping around 38% returns annualized for the past five years."

Jerome Booth, head of research at emerging market specialists Ashmore, asserted in December that emerging equity markets were de-linking from developed markets, and that they would perform not only differently from developed markets, but better. "Now is the time for the active top-down macro manager of emerging equity," he says. "The more the global market disruption and volatility, the greater the ability of the macro-manager to add alpha."

T. Rowe Price's Henry agrees that there has been a decoupling. The allocation of the firm's flagship emerging equity product, weighted in financials, real estate and consumer, bears that out. But he cautions that returns from emerging markets will not be as hefty as they have been since 2000.

However Joseph McDonnell, head of Morgan Stanley's Global Portfolio Solutions division, thinks



Jerome Booth: time to add alpha

the de-coupling theory is overdone. McDonnell, who has advised both Shell and IBM pensions teams, believes pension funds will benefit from a dedicated and significant long term allocation. "I can see an argument for having as much as one third of an equity allocation in emerging markets," he says. "That's a big jump from where allocations are today at 3% or 4%."

So what makes the institutional investment industry so sure that emerging markets will deliver? National economies have become more integrated through trade, foreign investment, capital flows and migration, suggesting that a recession in larger economies will pull down smaller ones with them.

In January of this year, the MSCI Emerging Market index dived as the subprime contagion swept through Europe and central banks moved to cut interest rates. Then, in early April, Ben Bernanke, Federal Reserve Chairman warned the US Congress of a possible US recession.

John Pollen, head of emerging market equities at Pioneer Investments, argues that despite a poor January performance, emerging markets proved extremely resilient to the subprime crisis compared to the wider market. The index was pulled down with the rest of

EMERGING MARKETS



David da Silva:
strong emerging
market trade
growth

the market in mid-August and then simply rebounded as sharply as it had fallen to resume its climb through the rest of the year. Since then the index has continued to outperform the MSCI World Index.

Ashmore's Booth notes that decoupling should not be confused with short term detachment. "Short term moves are still correlated to global markets in most cases," he says. Emerging markets continue to be a high volatility asset class and emerging equities will not be immune to sudden movements in world markets.

But it's the mid to long-term potential in emerging markets that asset managers are bullish about. They believe that the long term economic engines that drove returns higher since 2000 are still powered up.

Pioneer's Pollen points to the series of economic reforms that many emerging countries implemented from which they are benefitting today. After the downturns in the 1990s, emerging nations sought to manage their debt better and build up significant reserves through active currency market intervention. Most now enjoy a trade surplus and large currency reserves, which help cushion their economies from external shocks.

The surpluses enable central banks to give the economies a fiscal stimulus if foreign investment slows, or dries up. Improved monetary policies have also helped create low inflationary environments conducive to private market long-term real investments.

Booth believes emerging market currencies will appreciate as the dollar weakens. With stronger domestic demand and greater fiscal and monetary control, stronger economies are inevitable, and in his view will drive equities higher.

Trade growth

Trade among emerging nations is another major driver for economic growth. Significantly, it is at the expense of trade with developed countries. The top eight emerging markets now contribute the same to global growth as the entire G7, and Booth reckons that a US recession could slow emerging market growth to 8%.

Compare this to the European Commission's 2008 forecast for GDP growth in the Euro area of 2.2% and 2.4% in the EU. Both emerging markets and the EU have around 30% of global GDP share.

Exports from China, acknowledged as the global economic powerhouse, to Brazil, India and Russia, the next three largest emerging economies, were up by more than 60% in 2007 and those to the Middle East by 45%. However, China's exports to the US slow significantly in the year to January. Emerging markets as a group now export more to China than to the US.

"While developed markets still exert a huge influence on emerging markets, we believe that intra-emerging market trade growth strongly supports the decoupling

argument," says David da Silva, global emerging market product specialist at Nomura Asset Management.

Mark Roxburgh, head of Nomura's marketing and client services, says the voracious appetites of new 'middle-class' demographics, will offset the effects of any slowdown. According to Euromonitor International, the Chinese middle class grew from 65.5 million to 80 million in the two years to January 2007, and is expected to reach 700 million by 2020.

That demographic trend has the power to support real economic growth. Domestic consumption rose almost three times as fast as in the developed world, and according to HSBC, real capital spending rose by 17% last year compared to 2.1% in rich economies. Nearly all (95%) of China's growth came from domestic demand. "This substantially larger middle class with higher disposable incomes will ultimately transform the Chinese consumer market for the benefit of retailers and banks, among others," says Pioneer's Pollen.

With urbanisation, developing nations have to invest in massive infrastructure building programmes. This in turn supports further inter-emerging market trade. Most emerging market revenue derives from raw materials and energy exports. China and India's insatiable demand for oil is a boom for commodity driven economies like Brazil, whose exports soared by 26% in the year to February. Infrastructure also promotes further productivity, and in turn, further economic growth, and that benefits investors in the long run, says Pollen.

Hazards

The risks associated with decoupling are difficult to identify and to time. Commodity prices are seen as one hazard. China's growth is currently propping up prices – it accounts for a third of the increase in oil demand since 2003, and 66% of additional copper and aluminium demand. A downturn in the Chinese economy could hurt commodity exporters more than a US recession.

Others warn that much of China's consumption is used for processing into exports, leaving it exposed to the global consumption cycle. One commentator said that a 3% drop in China's growth rate to 8% could remove the supply deficit from energy markets and send most industrial metals into surplus, hitting emerging exporters hard.

There has already been something of a correction, according to Henry at T. Rowe Price. The price spreads between emerging markets and developed ones have narrowed and in some measures, there is a slight premium. But Ashmore's Booth maintains that growth in China, at least, still justifies the price: "Insofar as the market is pricing in, and companies are delivering stronger earnings growth in emerging markets than in the developed world, then there is no bubble."

He also advises that volatility in emerging markets is approaching developed market levels. Nomura warns that investors who rode the bull market since 2000 have started to bank profits, creating a new source of volatility. "Those who have reaped strong returns over the last five to 10 years will be tempted to take their chips off the table to fund different commitments. They may also be resetting their allocation targets," says da Silva. "However, a lot of new allocations are being made, which is dampening the effect of a sell-off."

Taking a regional approach to emerging markets

Emerging market equities are now seen as a mainstream asset class that many would see as having an importance far beyond their current capitalisation weightings in the MSCI index. Not only has the performance of the equity markets over the last five years been spectacular, but in addition, the globalisation of international trade has led to drivers of sustained growth becoming structurally imbedded across a vast swathe of emerging countries across the globe. The long term high GDP growth rates this implies will ensure the global emerging markets will only increase in importance in equity portfolios. However, with over 15,000 listed stocks in the universe and over 900 in the MSCI Emerging Markets index across 25 countries, managing a global emerging markets portfolio is an ambitious task. Not surprisingly, a recent research report by Oliver Wyman commissioned by Nomura Asset Management (*Emerging Markets Product Analysis*, February 2008, Oliver Wyman) found 72% of the nearly 200 global emerging market funds examined underperformed the MSCI EM index over a seven-year period. For institutional investors seeking to raise their weightings to emerging markets substantially, the situation is even more dire, as the historically best performing managers are often closed to new business, or in some cases, should be even if they are not already. Anecdotal evidence suggests the experience of falling from top quartile to fourth quartile within a year of closing a fund to new business is not an uncommon occurrence. It is clear many previously successful managers have gone down the route of asset gathering at the expense of performance in markets that can be heavily capacity constrained with the inevitable degradation in returns.

But what are the alternatives for gaining exposure to the global emerging markets? Choosing a second or third tier global manager that happens to be open for business is an unattractive option. But there is another route. That is to choose a collection of regional managers that combined can give a global exposure. There are many top tier regional and country managers with capacity to spare, as the demand for regional managers historically has been far less than for global. This is clearly a strategy many of the largest institutional investors are already adopting, but it is also a strategy that even smaller schemes should consider seriously and the rise of multi-manager solutions can open up cost effective ways to do this. But for institutional investors, what does

a collection of regional strategies imply in terms of likely returns, volatility and costs? Whilst it may seem intuitively obvious that regional managers should have more specific expertise than their global counterparts covering the same region, does the evidence really support this? Oliver Wyman's study examined these issues using a statistically robust and defensible approach to produce results that carry a high degree of credibility.

The emerging market universe can be broadly split into the Asia Pacific region, which covers around half of the capitalisation, Latin America and Emerging Europe together with South Africa. Oliver Wyman's study examined a universe of just over 1,000 funds. After eliminating single country funds, duplicate funds, non-equity funds, misclassified funds and funds with less than a three-year track record or assets of less than US\$5m, they were left with just over 400 funds. Of these, 47% were global, 28% Asia Pacific, 16% emerging Europe, 9% Latin America and 1% South African. Using net returns for all the funds produced a level playing field for analysis, whilst great care was also taken to deal with other complications. Finally, they rebalanced the regions on a yearly basis according to the MSCI weighting for each year, which raises the issue of whether global fund managers are able to add value through tactical asset allocation across regions, with little evidence to support this.

Balancing risk and return

The return comparisons stand out quite clearly in the Oliver Wyman analysis. The composite fund comprised of the top quartile regional managers outperformed the global top quartile average in six out of the last seven years. Moreover, the excess return of the composites over the global was over 2% p.a. The question that any institutional investor would pose, however, is whether the excess return seen in a portfolio of top quartile specialist regional funds has been produced through having greater risk against the benchmark than top quartile global portfolios? To answer this question requires great care to ensure statistical robustness. Whilst the composite global fund returns analysis used the average of the regional manager returns, this inherently strips out some of the volatility, so it does not provide



a valid approach for comparisons of risk. A statistically robust comparison required creating a set of global composite funds based on random selections of managers. First of all, one fund was randomly selected from each region and the returns weighted as per the MSCI weightings to build an example of a hypothetical "global composites fund". The monthly deviation of the composite fund from the MSCI global EM index was calculated and the standard deviation taken to give the monthly tracking error (annualised to give the more familiar tracking error figure). This process was then carried out multiple times to produce a set of composite funds, enabling analysis of the average tracking error of this data set to be carried out.

The analysis looked in detail at the risk profile of composite portfolios of regional funds compared to global funds. On a stand alone basis, the regional managers examined had a larger tracking error than the global funds, with an average tracking error of around 7.9%, whilst single manager global funds had an average tracking error of 5.0% over a five-year time period. The global fund tracking errors were also consistently lower than regional funds over the one, three, five and seven-year timeframes. Oliver Wyman suggested one rationale for this could be the differing investment strategies, as regional funds are more likely to invest in more volatile small and mid cap stocks which would often be outside the MSCI universe. However, on a composite basis, the difference in tracking errors disappeared and the average tracking error for composite funds was smaller

or equal to that of single manager global funds. Oliver Wyman attributes this to two diversifying effects: firstly, the larger number of holdings relative to a global fund, and secondly, beneficial diversification due to the more "local" nature of regional EM holdings. One attribute of emerging markets is that their correlation with developed markets is increasing and this is primarily a function of the larger stocks in the indices, which may be becoming more closely tied to their global sector peer groups. Regional managers with more expertise to invest outside the MSCI universe are therefore more likely to benefit from the diversification benefits of investing in numerous companies overlooked by international global investors because they do not pass through market capitalisation and liquidity screens.

Composites emerge the winners

Combining the return analysis with the risk analysis provides an even more stark comparison of the trade-offs between above average quartile composite portfolios of regional funds versus above average global managers. The above average global managers had higher tracking errors than average global managers, which can be attributed to taking on higher risks to achieve higher than average returns. However, the composites of above average regional managers had no increase in measured tracking errors compared to the composites of the average managers. Whilst the reasons may be debateable, the conclusions are clear, as Oliver Wyman pointed out: "A composite fund consisting of top regional managers outperforms top global managers by 2%, whilst achieving a significant decrease in tracking error." Given that new investors may often not be able to access new capacity for their investments at top global managers, the choice of a collection of top regional managers does not appear to be a second rate alternative and is arguably a superior choice.

Selecting and managing a portfolio of regional managers is therefore conceptually attractive. However, for institutional investors with relatively small weightings to emerging markets, it is an expensive and onerous task. Multi-manager solutions are becoming available, although the typical model implies a double layer of fees. One alternative that may become increasingly attractive is for groups of top tier regional managers to package their products into a global solution on a co-operative basis with just a single layer of fees. Such products open up new capacity in emerging markets through utilising top tier regional fund managers. If, as Oliver Wyman's study has shown, they also have better return and risk profiles than existing top tier, let alone second tier, global managers and in addition have similar fee levels, they would seem to be an attractive choice for new investors into emerging market equities.

Joseph Mariathasan reports on the results of a recent study, which would seem to show composite funds grouping regional managers can prove a better emerging markets investment option for pension funds than investment through one global manager



For more on emerging markets go to: globalpensions.com

Emerging markets focus

KOREA: Steady outlook ahead

Eric Poh is employed by Nomura Asset Management Singapore Limited (NAM Singapore), the appointed fund manager to the Emerging Asia portion of the Nomura Funds Ireland Plc – Global Emerging Markets Fund

Since midway through last year, the ongoing crisis originating from US sub-prime mortgage lending and its dramatic impact on the global credit markets has effectively undermined the performance of major equity markets around the world. The economic impact of this crisis, on top of the slide in US real estate prices, has shattered consumer confidence. Hence domestic consumer demand, which accounts for the bulk of the US economy, is expected to slow down if it has not already done so.

In the four months ending February 2008, the US equity market

as represented by the Dow Jones Industrial Average has lost 12% of its value. In comparison, the South Korean equity market, represented by the KOSPI, has lost an even greater 17% of its value in the same period.

However, unlike the situation in the US, the South Korean economy remains quite resilient. As shown by Chart 1, economists have rushed to downgrade US economic growth forecasts over the next two years. On the other hand, the downgrades to forecasts of South Korea's economic growth are still relatively mild.

Unfortunately, it seems that investors have been indiscriminately reducing their exposure to the equity markets with little regard for the fundamentals. If we look at the fund flows, foreign investors have been the main sellers of the Korean equity market. Over the past four months, foreign investors have reduced their exposure to the Korean equity market by about US\$20bn, bringing foreign ownership levels from 32.5% as at the end of October 2007 to 30.9% as at the end of February 2008. Historically, the correlation between the US and Korean equity markets has been strong. Moreover, global investors still continue to view Korea as an emerging market (associated with greater risks). As a result, the Korean equity market has suffered heavier losses than the US equity market.

Looking ahead, we still expect the Korean economy to stay resilient, despite what many analysts believe could turn into a global slowdown.

First, export growth has so far

remained relatively strong. The adverse impact of the expected slowdown in US economic growth on exports could also be offset somewhat by the strong economic growth and continuing demand from China. As seen below, China and Europe have overtaken the US as the main destinations for South Korean exports.

Second, the domestic economy is expected to improve, mainly due to the recent change of government. For several years, domestic sentiment has been weak due to the previous administration's harsh anti-speculative measures targeted at the property market. With property prices being depressed, domestic spending has been cautious. With the election of the new president, MB Lee, these restrictive policies are likely to be reversed. As a former CEO of Hyundai Engineering & Construction, president Lee has a pro-business mindset and is well known for his market-oriented policies. Indeed his election campaign focused mainly on economic issues. As a result, he is very likely to implement measures to boost domestic demand. However, it is important that his Grand National Party wins a majority in the upcoming parliamentary election in April this year so that he can implement his policies effectively.

In addition, due to his background, the new president has a strong relationship with major business leaders. He is likely to use his influence to push Korean companies to increase their fixed investment, which has seen lacklustre growth over the past few years. Already, the Korea Chamber of Commerce is

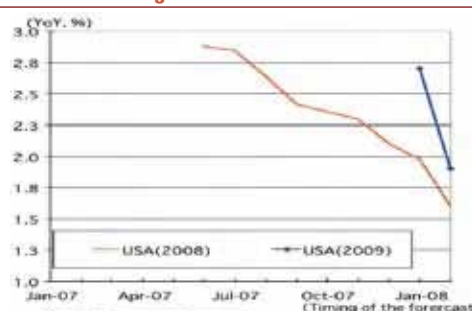
forecasting that investment plans for manufacturers would increase by about 15% in 2008. Overall, although Korean economic growth could decelerate in line with the slower global economic growth, we believe it is likely to remain relatively steady.

Although South Korea's economic fundamentals seem resilient, the historical correlation between the South Korean and US stock markets remains relatively strong. Given the cautious outlook for the US stock market in the near term, this might affect the performance of the South Korean equity market.

Nevertheless, other factors are still relatively supportive. First, equity valuations are attractive, with South Korean stocks trading at a price to 2008 earnings ratio of about 11.9. This compares favourably with the US equity market, which is trading at a PER of about 13.2 based on 2008 earnings. Second, domestic investor sentiment remains positive. As the chart below demonstrates, domestic retail investors are pouring significant assets into the Korean equity markets.

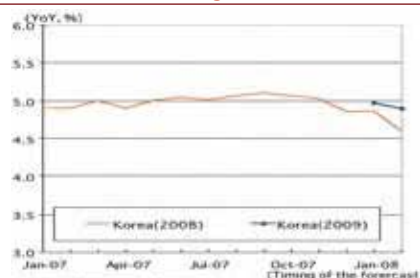
This trend is expected to continue in the near future as many of these retail investors have chosen to invest through regular saving/instalment plans. At the same time, the low birth rate in South Korea, which will result in an ageing population, has highlighted the need for people to invest for their own retirement. In other words, the profile of retail investors seems to be changing. Whereas they tended to invest in the equity market for short term gains in the past, they are now looking for more sustainable returns over the long term.

Chart 1: USA economic growth



Source: Consensus forecasts

Chart 2: South Korea economic growth



Source: Consensus forecasts

RUSSIA: Life in the old bear yet

John Dawe is employed by Charlemagne Capital (UK) Limited, the appointed fund manager to the EMEA portion of the Nomura Funds Ireland Plc – Global Emerging Markets Fund

Investors who backed president Putin when he assumed power in 2000 through an investment in Russian equities have been handsomely rewarded over the past eight years, both in absolute terms and relative to investments in other emerging markets. As the accompanying chart shows, the MSCI Russia Index has grown seven-fold over this period, outpacing Brazil, China and India.

This performance has come against a backdrop that has seen the Russian economy bounce back from the debt crisis of 1998 to record GDP growth rates averaging almost 7%, with inflation falling from 85% in 1999 to a low of less than 8% in 2007 (though in common with other economies, inflation has since risen). This has also been coupled with strong current account and budget surpluses. Naturally, Putin has been heaped with praise for this achievement, which has seen a significant improvement in the living standards

of the average Russian, even though the extent to which his actions have been responsible for this renaissance is debatable. The quadrupling of the oil price, which has poured money into the state coffers, may be a rather more important factor.

But now, as Putin hands over the reins of power to his protégé, Dmitry Medvedev, investors in emerging markets, who always need to keep half an eye on political developments, are rightly concerned that nothing should get in the way of further gains for Russian share prices.

Medvedev, for his part, has been making all the right noises to reassure investors. At the Krasnoyarsk economic forum on 15 February, he unveiled his economic programme and was at pains to project an image of economic liberalism, supporting the continued development of a market-based economy. Medvedev specifically mentioned promoting the rule of law, cutting

bureaucracy, lowering taxes and investing in infrastructure; all music to investors' ears.

Such statements also provide some comfort in respect of the transition from Putin to Medvedev. There remains some uncertainty as to how power will be shared, given that Putin is favoured to take on the position of prime minister. The consensus is that Putin will continue to wield considerable power and influence, at least initially, and that Medvedev will not step out of line. But as Medvedev finds his feet and grows into the position of president, this situation could certainly change over time, much as Putin himself cut loose from his predecessor, Boris Yeltsin, who also handed him the presidency on a plate. Of course there will always be doubts as to the extent to which positive pre-election rhetoric will be carried over to the post-election period, but should Medvedev break free from Putin and become his

own man, there seems to be a good chance that his actions and policies will be designed to extend rather than reverse the developments that have supported Russia's stock market over the past eight years.

However, it is wrong to suppose that a change from like to like will result in little change in economic policy over the short term, for other forces are at work which may require significant changes. Unfortunately, just as Putin inherited an economic situation that could only get better, so Medvedev is faced with an economic situation that, over the short term at least, looks set to deteriorate. Inflation is rising as global demand for energy and commodities pushes prices for such goods ever higher, whilst at the same time global economic activity has faltered in the wake of the sub-prime crisis.

With no further national elections scheduled for almost four years, economic policy can now be refocused away from simply pleasing the electorate and towards more meaningful structural reform. Given the extent

Rising food prices mark return of agflation

In 1798, the Reverend Thomas Malthus suggested that a growing population, increasing at an exponential rate, would eventually be checked by the limitations of its resource base. In fact, the catastrophic situation he envisaged has not come to pass on a global scale. The application of technology in population control and agricultural intensification has made it possible for us to feed a population now estimated to number 6.6 billion. We have become adept at increasing yields, and the International Grains Council estimates that total output reached record levels in 2006, surpassed again in 2007. If total agricultural output is increasing, why are agricultural commodities rising so sharply in price?

Global food prices have jumped 75% since 2000. Both demand and supply-side factors are contributing to 'agflation'. On the demand side, many emerging economies have moved from subsistence-dominated agriculture, where farmers grow produce for their own consumption, to more sophisticated, specialised supply arrangements. At the same time, food consumption patterns have changed.

Demand has shifted away from basic calories, such as those obtained from largely vegetarian diets, towards those obtained through more protein-rich consumption. Meat production is highly grain-intensive, which means one obtains fewer calories from consuming a kilo of meat compared to the energy obtained from the grain used in its production. It takes around four kilos of grain to produce a single kilo of pork. Beef is even more demanding, with a cow having to consume an average of eight kilos of grain to deliver a kilo

of meat. In emerging markets, consumption of cereals has stabilised, but demand for meat has doubled. The net effect is that farmers now feed about 200-250 million tonnes more grain to their animals than they did 20 years ago.

At the same time, the rising oil price and concern about the warming effect of carbon dioxide emissions has prompted a policy focus on biofuels. In theory, biofuels produce lower net emissions of carbon dioxide than energy generated from burning fossil fuels. In fact, the situation is far from clear as the UK-based science body, the Royal Society, has published a report suggesting that some biofuels could have a higher carbon cost, due to the fertiliser and energy used in production and processing.

In 2007, US president George Bush signed legislation requiring a five-fold increase in biofuel production by 2022, backed by a complex subsidy scheme. Some land previously used for food production, for the production of wheat and soybeans, is being utilised to cultivate maize for ethanol. South American neighbour Brazil has also made significant progress with its bio-fuel strategy, using sugar cane in ethanol production. It produces more ethanol per hectare than the US maize-based schemes. It has, however, been criticised for forcing deforestation, pushing ranching and soybean production further into the interior of the country.

In addition to demand and supply-side factors, the market mechanism itself may be contributing to food price inflation. At a time of volatility on the world's financial markets, hard and soft commodities have had more investor attention. There has been an increase in the

number of specialised commodity products launched in 2008, highlighting that commodities offer returns not correlated with stocks or bonds.

With the price of wheat and soybeans at record levels in February 2008, and global food inventories at multi-year lows, it is fair to assume that farmers will respond by increasing planting. According to the International Food Policy Research Institute, a 10% increase in price should yield a 1-2% increase in supply.

The need to increase agricultural output does raise some major policy issues. One, which the European Union has failed to address, is the potential of Genetically Modified Organisms (GMOs) to enhance output. For some time, biotechnology companies such as Monsanto have insisted GM products can help increase yields substantially. It believes the yield grown from maize produced in the US could double by 2030, with genetic modification enhancing features such as crop resistance to disease or drought. While the EU stalls, the area of GM crops under cultivation is growing fast in the emerging markets, including Latin America. According to International Service for the Acquisition of Agri-biotech applications, Brazil, Argentina, Uruguay and Paraguay all have millions of hectares in production. In Brazil, planting increased from a low base by 30% in 2006-07. Industry consultant Croponosis suggests the market for agri-biotechnology more than doubled in value between 2001 and 2006, and could reach US\$8.4bn by 2011.

For global consumers, it will take time to bring additional agricultural land into production. There is poten-

tial to do this, for example, in Brazil, Russia, Kazakhstan and parts of Africa, although water supply continues to be a limiting factor in many areas. In the meantime, higher food prices will distribute costs and benefits unevenly. Rising prices affect those with the lowest incomes disproportionately, as individuals have to spend a higher percentage of their income meeting basic needs. In the US, food makes up around 10% of an average family's consumption basket. In sub-Saharan Africa, the figure is 60%. Concern about this has prompted many countries, including Argentina, Mexico, Russia, Morocco, China and Egypt, to introduce some form of price controls.

At the same time, the world's food producers should benefit. At country level, exporters such as Brazil, India and South Africa should gain, with benefits weighted towards rural rather than urban areas. Major food importers such as the Gulf states and Japan will pay more. At micro-level, rising farm incomes give farmers the opportunity to invest and increase yields. The potential for companies offering agricultural technology is evident, from those offering basic mechanisation to more sophisticated applications.

These trends offer opportunities for investors, but also suggest some major policy challenges. Access to water will be a critical issue, one that may have to be balanced with strategic decisions on food security. There is an urgent need to enhance yields, but concerns over the safety of genetic modification still linger. These complex issues are becoming the most critical in global agriculture since the 'green revolution' of the 1960s.

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of his victory in the presidential election, Medvedev now has a window of opportunity to introduce changes that in other circumstances, and at other times, could prove politically impossible. He also has a free hand to take action in response to the current situation, action that could entail a reversal of the previous tight fiscal and loose monetary policy, as interest rates rise to meet the challenges of inflation and government spending is directed more towards the infrastructure investment that the economy so badly needs. The recent transformation of the Stabilisation Fund into the Reserve and National Welfare Funds, to receive some of the tax revenues arising from the oil, gas and other similar industries, will go some way towards supporting a sustainable level of government spending in the future.

Although Russia's economic performance has certainly been impressive over the last eight years, it could have been even better. Both India and China have seen their economies grow at significantly

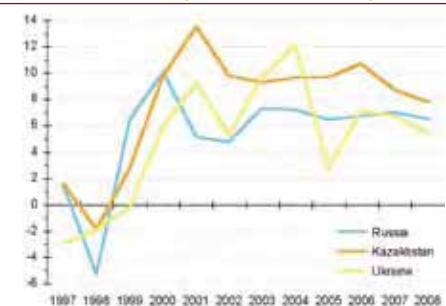
faster rates than Russia's, particularly over more recent years; GDP growth rates have also been stronger in some of the other countries that comprised the former Soviet Union, such as Kazakhstan and the Ukraine (see accompanying chart), many of which do not share Russia's wealth of natural resources. Indeed, outside the energy and materials sector, the Russian economy has little to show for itself on the world stage; it still, for example, produces no manufactured exports of any significance. One only has to travel outside the main centres to seemingly travel back in time, to appreciate the potential for economic development that still exists. After all, it is only in the last couple of years that the level of GDP has returned to where it was in 1991, the year the Soviet Union finally fell apart.

It therefore seems likely the Russian economy could see GDP growth of more than 10% a year, in the same league as China and India, given better infrastructure in terms

of both physical transport links and a stronger legal system, and a more dynamic business sector that relies less upon the state-like control of the behemoths of Moscow and St Petersburg and rather more on a growing number of more efficient small and medium-sized enterprises, fuelled by competition. In this way, Russia could emulate other emerging markets that have less historical baggage and are more fleet of foot. We can again draw some comfort in this respect from Medvedev's Krasnoyarsk speech, in which he proposed reforms targeted both at developing domestic capital markets and improving conditions for the development of small businesses.

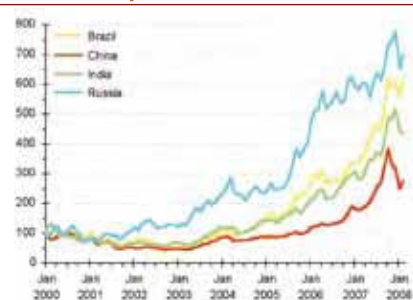
Ironically, it is the fact that so much more remains to be done that makes Russia such an attractive investment proposition at the moment. Russia still has enormous potential to reward investors, significant parts of the economy remain underdeveloped, and those who stick with it might well reap the return.

Chart 3: GDP growth rates (percentage forecast post 2006)



Source: IMF world economic outlook

Chart 4: Stock market performance (MSCI indices, USD net total return)



Source: MSCI

Global Emerging Markets

David da Silva of Nomura Asset Management UK Limited explains the essentials of investing in GEMs

What is a GEM fund?

GEM funds invest in stocks listed on stock exchanges in emerging markets, frequently referred to as developing countries. Although there is no exact definition of emerging markets, it is safe to see these as being all the markets outside the established developed markets of North America, Europe, Asia and Australia. Although this includes a broad cross section of countries around the world, it is worth noting that market capitalisation of emerging markets of the global index is approximately only 11%, as calculated by the MSCI Index*. GEM funds attempt to capture the growth potential across these markets by detailed stock selection and country allocation.

The term 'emerging market' refers to the stock market itself rather than to the underlying economy. For example Korea, Taiwan and Israel are included in the emerging markets universe whereas on a number of criteria these economies could be categorised as developed. This means that within the investment universe a broad range of underlying economies are represented. This gives the fund manager the opportunity to invest in a very wide range of industries and themes.

How does it differ from other emerging markets funds?

GEM funds differ from other emerging market funds in that they can invest anywhere across the developing world. Many other emerging market funds narrow the universe of available investment to specific regions or countries. A popular option at present is BRIC investing, focusing on the powerhouses of the emerging world, Brazil, Russia, India and China. But there are other options such as BRICS including South Africa, Chindia (China and India), Latin America and the Middle East. In our view this narrowing of the universe excludes some of the exciting growth opportunities typical of less well covered countries and regions of the world. This is why Nomura Asset Management have concentrated on the global option with coverage by three regional specialist teams, to capture as many investment opportunities as possible.

What types of GEM fund are available?

GEM funds can be distinguished by the management structure in place. Many are single-manager funds, where one firm covers all the emerging regions with a single fund management team, each team member sharing either regional, country or sector responsibilities. This requires resources to ensure optimal coverage. It is a significant challenge to do well, given the diversity, on a regional, country, language and economic level.

Another option is to choose fund of funds or manager of manager products. These can group together several global fund management firms into a single product taking into account each manager's style preferences. There can be several layers of fees to accommodate the managers and the product providers. There is also an option to create a global product by grouping together regional specialists who focus on emerging countries in Asia, Latin America and EMEA (Europe, Middle East and Africa). The intuitive appeal of grouping together three regional specialists, needs to be weighed up against the governance costs required to monitor the managers. We have followed this regional specialist approach in constructing our Nomura GEM product, and have found that regional specialists with their local knowledge and experience are well placed to uncover stocks likely to outperform that might not be obvious to more generalist investors.

Is a GEM fund right for my pension scheme?

Although emerging markets have outperformed developed markets over the long term, they are characterised by greater medium term volatility. It is important to consider whether your pension scheme can bear this higher risk. A key consideration therefore has to be the scheme's investment time horizon. Generally we would consider that the investment horizon would have to be at least 5 to 10 years, allowing the fund to deliver enough of a return to compensate for the extra volatility. This risk should also be considered in light of how correlated emerging markets are to your scheme's existing investments. Generally speaking emerging markets have had a lower correlation with developed markets. There can be valuable diversification benefits to

schemes overall, by including emerging markets in the scheme's investment line-up, although remember that in times of crisis correlations can rise significantly. As with all investments we would recommend that you explore all possible risks before investing.

How have GEM markets been affected by the recent stock market problems?

Emerging markets fallen more sharply than their developed counterparts. Despite this we retain a positive long term view on the asset class based on strong fundamentals. Emerging economies are now in a far healthier economic position than they have ever been. Many economies now have current account surpluses, governments have tightened fiscal controls and corporate debt remains at modest levels. Although for the moment they are dependent on trade with the developed world, we are already witnessing emerging markets benefiting from rising domestic demand and growing trade between emerging economies. This development will increasingly insulate them from any broader slowdown.

That said, in times of severe market turmoil globally, such as in January 2008 investors will take profits where they are available and the strong performance of emerging markets in recent years has created a lot of gains. In this sense the selling of emerging markets might be characterised as 'technical' in that it is a pure market reaction and not an indication of more fundamental problems. Distinction should be made between economic and market decoupling. Markets tend to move together in any sell off but over time they should reflect the underlying earnings (and economic growth picture) and we retain strong bullish view on GEM fundamentals.

**Morgan Stanley Capital International Emerging Market Index as at 31st December 2007. ■*



NOMURA

Nomura Asset Management investment specialist Peter Jenkins believes the whole structure of emerging markets means it is an area where disciplined investors can add value

Where is the alpha?

Investing in emerging market equities rewarded investors with solid returns in 2007 and has produced excellent returns over a longer period (+390pc in a five year period to the end of 2007). Looking forward, the short-term outlook is somewhat cloudier. Newsflow from developed economies and markets will likely determine market direction and in any global market downturn emerging markets look ripe for profit-taking as investors lock in profits wherever they have them. For those investors that have been well weighted in this asset class for any length of time, there are temptingly big gains to be taken. It is for this reason that in times of crisis markets move together; correlations tend towards one.

In essence Nomura believes that, over the longer term, equity markets follow the growth of economies and corporate earnings and both are likely to be significantly greater in the case of emerging markets than in developed markets. From our studies we expect trend growth of 6pc-7pc per annum in emerging markets, a figure two to four times greater than in G7 economies. Against this backdrop of robust growth, emerging market valuations remain attractive; the forecast price/earnings ratio (PER) on 2008 earnings is less than 11 times, only slightly above the five year average, and a substantial discount to developed markets.

Despite the fact the growth profile and valuations are attractive, and emerging markets have been receiving strong fund inflows we believe that they are still under-represented in investors' portfolios; G7 investors and savers are structurally underweight this asset class. This is all the more surprising given that global equity indices generally carry neutral emerging market weights at well below 10pc. This under-exposure augurs well for the future.

An additional attraction of emerging markets is the opportunity afforded to significantly outperform what we already expect to be an outperforming asset class. We believe the whole structure of emerging markets means it is an area where disciplined investors can add value over and above the movement of indices; they can add alpha. Alpha is a measure of the difference between a fund's actual returns and its expected performance, given its level of risk against market indices as measured by beta. In this sense it is a good

measure of the value added by a manager over and above movements of the market.

Firstly, the global emerging market universe allows for a much wider degree of diversification over and above that which can be achieved through a spread of investments across developed markets. Emerging markets embrace a wide range of countries in different geographical locations with different economic structures and at different levels of development. They range from giant resource rich economies such as Russia and Brazil through to manufacturing based economies such as Korea; from countries at a very basic level of development to countries as developed and wealthy as Taiwan; from relatively open economies such as Chile, to those with much state intervention and restricted capital accounts, such as China; and from states which have freely floating exchange rates to those that actively manage or even peg their currencies.

The case for diversifying portfolios through emerging market exposure is captured in the relatively low correlations between emerging markets and developed compared to those between developed markets. For example, the 15-year correlation between the S&P 500 index and the FTSE 100 index is 0.73 compared to 0.61 between the MSCI Emerging Markets index and the FTSE 100.

Consequently, skilful asset allocation between emerging markets enables investors to focus on those markets where the growth and corporate profiles are best for any stage in the economic cycle.

For example strong global growth may well lead to greater outsourcing by first-world companies and prime beneficiaries of this trend such as India and China could be over weighted. On the other hand when commodities are strong Russia and Brazil might look more attractive.

As a recent example of asset allocation opportunities: from the beginning of the 2008 to February 13, the MSCI World fell by 9pc in dollar terms, and although emerging markets on the whole have fallen more sharply, dropping 11pc. The only region where equities have risen over this period has been the emerging region of the Middle East. Benefiting from high energy prices, gainers include Jordan, Oman, Qatar

and Kuwait, where the market rose 9pc.

Secondly, within emerging markets there are excellent opportunities for stock selection. The main drivers of most emerging markets are foreign fund flows. Overseas investors tend to focus their attention on the representative, larger capitalisation stocks within each market. Consequently the most attractive investment opportunities can often be found outside the larger names for those investors who are prepared to expand their investment horizons accordingly.

Thirdly, emerging markets present more opportunities than developed markets by virtue of their greater volatility. On a five year view the standard deviation of returns of the MSCI Emerging index is 5.3 compared to a figure of 2.9 for the MSCI World index or 2.6 for the S&P 500. Some of this volatility can be accounted for by greater fluctuations in underlying economies, currency movements or pure market size but an additional factor is the structure of the market. In global portfolios individual emerging markets often represent relatively marginal positions.

Consequently foreign investors can be very heavily overweight or cut exposure to nothing depending on their attractiveness at any specific time; resulting in some extreme money flows. Local investors too can be somewhat fickle in their investment activity. Compared to developed markets local institutions are usually more marginal players in the market; domestic insurance funds, pension funds and alike are usually in their infancy and hence do not have the same clout and are correspondingly less of a stabilising influence on the index.

This leaves retail investors as a more significant factor than is the case in developed markets and this also adds to volatility. As a result stock prices tend to get pushed to the limits of valuations. Such volatility presents opportunities for the cool-headed, well-researched investor.

So not only do the prospects for the emerging market asset class look good but there are also significant opportunities to outperform within. The key for the foreign investor is to structure an investment approach to take full advantage of the considerable opportunities that currently exist and to produce alpha.



Stephanie Spicer talks to Nomura Asset Management global emerging markets specialist David da Silva about the challenges facing the market

Safety in numbers

Nomura Asset Management global emerging markets specialist David da Silva is the first to admit that managing a global emerging markets mandate is a challenge. With three main regions to choose from, 27 countries in the MSCI Index, many non-benchmark options, and over 900 stocks in the MSCI benchmark as at December 2007, it takes some covering.

What is perhaps more of a challenge is getting access to investors just what they can expect from emerging markets. Da Silva acknowledges emerging market investing is frequently mentioned in the press as a source of strong but risky returns, and he believes it is important to define just what emerging markets encompass.

Da Silva says: "Emerging markets can broadly be defined as being those markets located outside the established markets of North America, Europe, Japan and Australia. For ease of reference these can be considered the stock exchanges of developing countries."

The point to note however, says da Silva, is that what is being referred to here are the stock exchanges rather than the underlying economies of these countries and this can explain a few exceptions. For example, he says, Korea, Taiwan and Israel are included in the emerging markets universe, whereas on a number of criteria these economies could be categorised as developed.

He adds: "As a result within this investment universe a broad range of underlying economies are represented, from poor primary producers to relatively prosperous modern industrial economies. This gives the fund manager the opportunity to invest in a very wide range of industries and themes."

Despite this da Silva says it is worth noting that emerging markets only have a combined weight of about 11pc of the MSCI World Index and around 50pc of this capitalisation is concentrated in the BRIC countries, i.e. Brazil, Russia, India and China.

He says: "There are an additional



23 countries in the MSCI EM index, however there are many other markets which do not meet the minimum requirements for index representation but contain investible opportunities. We have seen a significant increase in the weight of emerging markets in global indices, both from new entrants and from growing existing country allocations.

"Highlighting this point is that the MSCI EM index has more than doubled its weight in the MSCI World index in the past eight years. We see this percentage growing in response to the strength and breadth of the markets involved."

What investors want to know of course is which countries will be entering the official indices in the future, so that they can be there investing ahead of the pack.

Trustees may anyway be wondering how they need to perform – or outperform in emerging markets. Indeed, in the current market can they be expected to perform let alone outperform?

"Emerging markets have performed strongly versus developed markets in the recent past and we believe that this outperformance is set to continue over the long-term based on the favourable economic fundamentals underpinning these markets," says da Silva.

"Performance so far has been driven by the rapid expansion of emerging

economies with rising levels of GDP per capita.

"This has been accompanied by growing domestic demand within these countries and also by growing trade links between emerging countries and the developed world and notably among emerging countries themselves."

According to da Silva these markets have typically been characterised by less efficient information flows in terms of market fundamentals and in terms of stock specific news, all as a result of less comprehensive coverage of stocks and sectors.

He says: "Although it is true that the largest stocks are generally well researched, this coverage is not exhaustive and there are many opportunities to add value by those prepared to research companies more in-depth. Our emerging market philosophy is based on this premise, that having the resource to specialise on stocks in emerging markets places an investor in the best position to add alpha."

"Of course doing this with a global remit is a challenge, so we have employed a regional approach, whereby specialists run the respective regions Latin America, Asia and Europe, Middle East and Africa [EMEA]. It could be argued that taking this a step further to employ country specialists would also be beneficial,

however we have reservations about the resource and governance structure required to employ multiple country managers to run a combined global mandate.”

When we come to consider how emerging markets have been performing in recent years it is hard to escape the fact that they have exhibited more volatility than developed markets over the long run. While this is apparent if you look at a rolling five-year standard deviations, da Silva says it is probably more important from an investment perspective to consider how much performance has been achieved in conjunction with this risk.

The table below highlights the returns and risk levels achieved on the MSCI World, S&P 500 and MSCI Emerging Markets Indices. The higher the figure in the “Return per unit of risk” columns the better.

Look-back period	3 years			5 years		
	Returns (%)	Standard deviation (%)	Return per unit of risk	Returns (%)	Standard deviation (%)	Return per unit of risk
MSCI World	8.7	9.5	0.9	13.8	9.9	1.4
S&P 500	5.3	8.6	0.6	10.0	9.1	1.1
MSCI EM	26.2	20.0	1.3	30.2	18.3	1.7

Source: Datastream, Nomura. Monthly data as of 31/01/2008

The return per unit of risk figures above highlight that for a given level of risk over 3 and 5 year periods an investor would get more return from an emerging investment than for example the S&P 500 or MSCI World.

Over one, five and 10-year periods to the end of January 2008, emerging markets have outperformed their developed counterparts by a significant margin.

Over 20 years, since the inception of the MSCI Emerging Market Index in January 1988, the index has delivered a massive 895pc return, this is over 450pc better than the S&P 500 return and a massive 650pc better than the MSCI World. Figures to end of January 2008.

“However, possibly of greater importance to many investors is that emerging markets have exhibited a relatively low correlation to their developed market counterparts and consequently there are clear diversification benefits to be harnessed,” da Silva says.

“Although, it is true to mention that in times of crisis we often see correlations increasing, so in a sense diversification deserts you when you

need it most, however this probably holds for most equity investments.”

When it comes to where schemes and funds would have invested in emerging markets 10 years ago and how the different the emerging markets scene is today, da Silva says anecdotal evidence is that allocations to emerging markets by institutional investors are rising, although he concedes exact figures are hard to come by.

He says: “In many instances pension funds have granted their international or global managers the ability to invest in emerging markets. And these allocations have assisted in delivering outperformance, so much so, that many schemes have opted to farm out their emerging exposure to dedicated managers to participate more in these markets.

“We think that in the UK pension funds currently have on average 5pc

corporate debt remains at modest levels. This picture stands in marked contrast to the deteriorating positions we are witnessing in a number of the developed economies.

“Although for the moment they are dependent on trade with the developed world, going forward we will see emerging markets benefiting from rising domestic demand and growing trade between emerging economies. This development will increasingly insulate them from any broader slowdown.”

That said, da Silva concedes in times of severe market turmoil globally, such as witnessed in January, investors will take profits where they are available. The strong performance of emerging markets in recent years has enabled a lot of gains to be taken.

“In this sense the selling of emerging markets might be characterised as ‘technical’ in that it is a pure market reaction and not an indication of more fundamental problems. Distinction should be made between economic and market decoupling. Markets tend to move together in any sell-off but over time they should reflect the underlying earnings (and economic growth picture) and we remain optimistic,” he says.

Part of this optimism stems from what Nomura sees as its solution to the challenges to the emerging markets fund manager.

“The greatest inefficiencies in emerging markets exist at the individual stock level – however country fundamentals must be supportive,” says da Silva.

“We believe that combining the skills of three specialist regional managers, one for each region, should permit greater depth of research of the region. This should produce a better understanding of the regional country and stock influences and permit greater individual sector and company research to be conducted.

“Greater focus should result in better information and this should produce better decisions and in turn more alpha.”

“Based therefore on our core emerging Asia competency we have identified and hired Charlemagne Capital as the specialist for the EMEA region and Gartmore Investment Management for Latin America. Nomura manage the product in London and in this way investors can enjoy the benefits of three specialist managers, but deal only with one.”

in emerging markets and that this percentage is rising.”

Recent research from Intersec Research and Greenwich Associates supports the fact that there is a similar trend in the US. However, it is wo at these allocations are well below the levels indicated by GEM’s weight in global indices, which suggests that current allocations could easily double if institutions wanted to match global benchmarks.

Da Silva and his team at Nomura are optimistic going forward on emerging markets as an asset class, despite recent market turmoil.

“Emerging markets have been affected by the recent global market pullbacks and in recent weeks have fallen more sharply than their developed counterparts,” da Silva agrees.

“Despite this however we retain a positive long-term view on the asset class based on strong fundamentals. Emerging economies are now in a far healthier economic position than they have ever been.

“Many economies now have current account surpluses, governments have tightened fiscal controls and

All about emerging markets investing

Expert David da Silva answers all your questions

WHAT IS EXACTLY MEANT BY INVESTING IN EMERGING MARKETS?

From an investment perspective, we consider emerging markets to be all markets outside the developed economies (predominantly the US, Canada, the largest European economies, Japan and Australia). These are often classified by the major index providers into emerging market indices, however these listings invariably only capture the top stock markets in terms of liquidity and turnover. There are many other markets which don't meet the minimum requirements for index representation but contain investible opportunities. In general, emerging markets tend to be rapidly expanding economies, albeit that they are starting from a low base, and are characterised by low, but rising, levels of GDP per capita.

WHAT IS THE DIFFERENCE BETWEEN INVESTING IN NON-EMERGING MARKETS? IS IT MORE RISKY?

Emerging markets tend to exhibit greater volatility than developed markets. However strong returns on long term risk adjusted basis have justified their inclusion in investment portfolios. In addition, emerging markets offer diversification benefits for investors in developed markets.

IS INVESTING IN EM SOMETHING TRUSTEES SHOULD CONSIDER AS A SHORT-TERM OR LONG-TERM STRATEGY AND WHY?

We would advocate that investing in emerging markets is a long term strategy. About 80% of the world's population resides in emerging countries, while their share of global GDP is still very low at less than 40%, according to figures released last year by the Economist and the IMF. We view that this imbalance will be addressed going forward, as developing countries embrace market friendly policies, improve fiscal and corporate governance, increase education and skills levels and participate more in

global trade. As a consequence we see that they will constitute an increasing share of global GDP, and this will be accompanied by increasing weight in global indices. From our experience many institutional investors are structurally underweight emerging markets and, as this improves to a more representative level, we foresee an increase in the demand for emerging stocks. So we see strong long term reasons for emerging market investment both from a fundamental and a technical viewpoint.

WHAT SORT OF PENSION FUNDS IS EM INVESTING MOST SUITABLE FOR? (IE WELL FUNDED OR IN DEFICIT, STRONG SPONSOR OR WEAK SPONSOR, PRIVATE SECTOR OR LOCAL AUTHORITY)

A pension fund that invests in the emerging markets should be able to bear a greater volatility than that in developed markets. This translates to an investment time horizon of at least 5-10 years; over this period, the portfolio should be able to deliver enough return to compensate for the volatility. Having said this, the declining correlation between emerging markets and the rest of the world could make them suitable for diversification purposes, reducing the risk of the total portfolio of the pension fund. We believe that an investment across emerging markets globally, rather than single countries/regions can yield more diversification benefits for the investor.

WHAT ARE THE DIFFERENT WAYS OF GOING ABOUT INVESTING IN EM?

When investing in emerging markets you could invest directly into companies listed on local stock markets. You could hire a global emerging markets manager, or alternatively, given the diversity of these markets, you could consider hiring regional specialists to cover the three main regions: Emerging Asia, EMEA (Emerging Europe, Middle East and Africa) and Latin America. Other alternatives are to opt for specific country exposures, sometimes combined into BRIC(S) (Brazil,

Russia, India, China and South Africa) funds, however, we consider that there is a risk that these funds focus on the most popular markets and might ultimately miss opportunities from newly developing economies where the returns might be greater. Finally, one can go passive but we believe this means missing most of the opportunities that can be exploited by active managers.

IS NOW A GOOD TIME TO INVEST IN EM FOR THE FIRST TIME?

We view emerging market investing as a long term strategy and we consider that now remains a good time to invest. Emerging markets in general have strong balance sheets and healthy corporate earnings growth, although it is true that valuations have risen over the past few years, we believe that long term valuations are still reasonable given the growth advantage. In addition emerging markets as a share of global indices have been increasing and we expect this trend to continue, providing a long term technical support for new flows into the asset class. To put this in context, in the MSCI All Country World Index for example, emerging countries have a weight of around 11%. This compares with Japan at 9%, as an example.

WHAT QUESTIONS SHOULD I ASK A PROSPECTIVE EM INVESTMENT MANAGER?

Managing a global emerging market mandate is a challenge for any manager. This is on account of the complexity and diversity of the markets included in the universe. For example in the MSCI EM Index there are 27 countries spread across three distinct regional groupings with their own languages, cultures and political considerations. Acknowledging this, we believe that a global mandate is best handled by a combination of regional specialists. The following are key issues to consider when selecting an emerging market manager. Do they have proven emerging markets experience? Do they have sufficient resource to cover the markets and stocks adequately? Do they have appropriate regional and global coverage?



By David da Silva, CFA
Global Emerging Markets
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How best to access emerging market alpha



Global Pensions gathered key industry experts in Amsterdam to discuss alpha generation in emerging markets, pension fund appetite for the asset class, and issues of capacity and manager selection

Alex Beveridge: To kick off today's debate Alberto from Nomura will present some research from Mercer Oliver Wyman, commissioned by Nomura, on emerging market alpha generation.

Alberto Miazzi: This analysis was to assess whether, from an alpha generation perspective, it is better in the emerging markets space to opt for a global emerging markets manager or a combination of regional specialists. Effectively, do the regional specialists add value over the best global managers?

To analyse this, Mercer Oliver Wyman examined a raw universe of some 1,000 funds, mostly global and some regional. They then excluded funds that weren't live for more than three years, and narrowed down the analysis to exclude those funds that were non-equity focused. Another screen was applied to the new universe of 633 funds to eliminate funds which were duplicated due to listings of different share classes. The final sample comprised about 450 funds, with about half consisting of the regional specialists, meaning Asia Pacific, Latin America and Emerging Europe.

There was a small issue with South Africa and I will briefly touch on this later. These 450 funds cover about US\$200bn of assets under management and should thus be very representative of the main players that are investing in the emerging market space. As for the methodology, with the global managers it was fairly straightforward to identify the top quartile over three years and hence identify the average return of this group.

To get a comparable number for the combination of the regionals, what Mercer Oliver Wyman did was weight the performance of the top quartile regional managers in each region [according to] the MSCI weightings. The way they did that was, using this three year example, to sort the performance of all the specialists over three years and then take the top quartile over this period.

Using the same sample, they started from year one and gave them MSCI weightings, extrapolated the data to the end of the year and then re-weighted back to MSCI weightings. By doing this they were able to create a synthetic portfolio return to represent what a combination of the best regional managers would have pro-

duced over the period. As for the Middle East and Africa, they didn't manage to gather a lot of information on those funds, as there were very few specialists investing in the Middle East and Africa, and since it is quite a small part of the MSCI emerging market index, the weight of these managers in the overall portfolio is quite small. So instead of using this data, Mercer Oliver Wyman used the index return from that particular region.

Alex Beveridge: What is the weighting to South Africa in the index?

Alberto Miazzi: It is about 8%. It is also worth mentioning that this is an example over three years. Later on we will look at the five-year analysis, but bear in mind that it's not exactly the same sample, it depends on how the underlying managers performed during the period.

Anton Kramer: How do you do that then in Asia, where you have a lot of Pacific funds that also include some developed countries?

Alberto Miazzi: In this analysis, the Asia funds did include some wider Asia Pacific ex Japan funds, as well as dedicated emerging Asia managed funds, but the analysis shows this acted to reduce the alpha generation, so we don't think it distorts the results.

The regional specialist portfolios were put together in this way and they tried to draw some conclusions to assess whether the specialist approach adds value over a global emerging markets approach. The analysis over five years revealed that on average the combination of the regional specialists produced a return of 25% a year.

Looking at what the index returned during that period, the MSCI EM index return was 27% per year over five years. If you compare these with the average top quartile global emerging markets managers, they got a return of 30.4%, which is about 3% alpha over the benchmark per annum. But looking at the average top quartile performance of the combination of the regional specialists, they achieved a return of 33.5%

on an annual basis, which is a 3% alpha per year over the global managers.

Over three years, there were similar conclusions. The index returned 31% per annum, the global managers returned 33.6%, and the portfolio of the regional specialists produced 34.4%. So looking at these numbers, it seems that employing a combination of regional specialists pays off.

Wim van Iersel: Is it true that you can say that the outperformance of, let's say the higher alpha of the regional funds, goes for every region in the world? Meaning that there's an outperformance of on average three percentage points versus the global markets in Asia, in Latin America and emerging Europe? Is it the case across the regions or is it the case in general?

Alberto Miazzi: It depends also on the way you weight the portfolio in the different regions. I would say they are quite uncorrelated. Sometimes we have a lot of alpha coming from Asia, the following year we might have a lot of alpha coming from emerging Europe, and another year we have a lot of alpha coming from Latin America. So on average, you're right, it makes sense to say that it comes from everywhere.

Kristian Nammack: I was at a hedge fund conference recently and they were talking about the recent few months in the investment world generally, and someone made a comment about emerging markets and investment into commodities, and the way that institutions invest.

A few years ago, a pension fund might have wanted commodity exposure and perhaps followed the Goldman Sachs index, buying commodities indiscriminately. There was a larger correlation among the performance of different commodities because of this index approach, but that's starting to decouple.

Commodity performance in August showed wheat was up, while other commodities were down. They made the same comment about the performance for different emerging markets. Five or six years ago, a lot of fund flow would go indiscriminately into increasing emerging market exposure, whereas today it's more discriminate, region by region, country by country, so you're seeing a further decoupling of the performance based on fund flows only.

Alex Beveridge: After hearing that evidence, should pension funds look for region-specific managers or can some managers truly call themselves global experts? Wim, which do you look for?

Wim van Iersel: Regarding our emerging markets portfolio, we've got three global managers in place. Looking at the performance numbers since inception, and some of them go back ten years, they all achieved outperformance. With regard to emerging markets, the first approach was to look at them from a global point of view. We do think it's interesting to have a closer look if it makes sense to select managers that have a regional focus. It is our fiduciary duty.

Anton Kramer: I agree, because although this study shows that in general it's worth looking at the regional specialist; that still does not mean that there are no good global managers in the universe. It's a matter of picking the right manager and the way we've done it in our emerging markets pool is to have both, so we have regional managers looking at Latin America, Asia and EMEA, and we also have two global emerging markets managers.

Mark Roxburgh: One of the reasons that we were interested in commissioning that research was that I came back from a trip to the US where a large US consultant had told me that of the 25 emerging market managers they'd used over the last five years, 20

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had closed to new business on capacity grounds.

That made me think; if there is an issue for people who want to invest in global emerging market mandates and good quality managers, of which lots are clearly not available for business, what is the alternative?

Is the regional combination an opportunity for people who haven't invested but do want to get into emerging markets?

Joseph Mariathanas: I've heard the same from people like Russell as well. One of the big distinctions they make in emerging markets is between those managers that are closed to new business and those that are open, because historically everyone has been going for global emerging markets managers.

The fact is that most of the decent ones are closed to new business or, if they're not, they should be, because they obviously need some sort of capacity constraints to be successful.

Erik van Dijk: To some extent I agree with what Anton said, you need to look at them as two separate pools. The regional top players are basically those that go for a concentrated approach, they really know how to pick the right stocks in a specific market, so bottom up components are more important.

Whereas the global top players are playing a game with sensitivities to specific factors that work in a specific region. I would say that in the end you should always have a mix, so in that respect I like the multi-manager approach, because for the average pension client the allocation is still too small to go for four or five managers to capture emerging markets.

Joseph Mariathanas: Maybe it's worthwhile also mentioning here the other extreme, which is to go passive. If you look at a firm like Dimensional Fund Advisors, they've got a global emerging markets fund with 1,500 stocks in it, and in their value portfolio they just buy the top 30% of stocks that are cheapest.

Anton Kramer: A point that relates to this question is if you think you can add value by over/underweighting the complete region because that can be an advantage of a global emerging markets manager.

Mark Roxburgh: That was something that the

Mercer Mercer Oliver Wyman research touched on, because we were keen to find out where the alpha was being generated, and they said that based on their research, some 20% to 30% of the total alpha would come from the region allocation decision.

So the majority didn't and we thought; if you've got good regional managers who are going lower down the market cap spectrum and they have potential to generate more alpha because it's a more inefficient market, then that should make up for the fact they're not doing any regional allocation, so that was the trade-off we saw as having great potential.

Alex Beveridge: What characteristics do you look for in your managers?

Mark Roxburgh: When we were putting the strategy together, we weren't looking for any particular style, we simply said we wanted something that works in the region, because if you ask a global manager whether they apply their investment philosophy globally they'll say yes, but you tend to find they'll adapt it to what works on a regional basis.

So we were looking for people who had a proven investment philosophy and process that had worked over time and was consistent. We weren't looking for any correlation with other managers in the different regions.

Joseph Mariathanas: What do you think is a capacity constraint for your strategy Mark?

Mark Roxburgh: Alberto's just finished a fairly long exercise actually where we've asked each of the managers to do some detailed work and we've looked at the liquidity on the portfolios, and have come up with a figure of US\$5.5bn for the total emerging market exposure across the three managers.

We think that's realistic but it also gives us a point at which we can say, 'We're approaching that figure, we've got to think about closing the strategy.'

Kristian Nammack: Someone mentioned having a multi-manager approach on a global basis as opposed to regional specialists.

The idea in my mind behind a multi-manager approach is that you pick man-

agers who differ in style, but when it comes to global emerging markets and you're buying a few global managers, do you actively look for a growth manager, a value manager, a large cap, a small cap, a trend, a quant?

Also, has the asset management industry evolved enough in that space to have these different styles? I've heard it said that the emerging markets, by their definition, are growth-biased.

That's the top down idea behind emerging markets, they have a higher economic growth rate than developed growth rates, and perhaps the companies are also growth-like companies so you should have a growth bias.

Joseph Mariathanas: Well that then gives you the opportunity to go for Asian income funds or something like that, because the best Asian companies are now realising it actually pays to pay dividends, so there's something to be said for going for value companies.

Wim van Iersel: Looking at the three managers we have in place, we indeed have a quant manager, a growth style manager and a player looking not only at stock-specific components, but also at macro themes. Three different styles, three different processes and they are all coming up with decent results.

Alex Beveridge: Was that a conscious decision when you were building the portfolio?

Wim van Iersel: Yes, indeed it was.

Joseph Mariathanas: What concerns me slightly, when you say they've all done well, is you're comparing them against an index. To my mind the indices themselves are rather artificial constructs and if you look at MSCI, 50% of it is concentrated in about four countries.

As soon as you compare yourself with an index, you're assuming the index has some real value, and I would argue most emerging market indices are no value at all, because they have absolutely no relationship to your liabilities, they have no relationship to any economic theory and they are really just a collection of countries that are put together in terms of some arbitrary market weighting factor.

Wim van Iersel: It's true, but that's also the case for developed markets.

Joseph Mariathanas: Yes, but the problem is people are comparing their own portfolio with an index as the minimum risk position, or they're comparing alpha against that. I agree you could argue the same thing with developed markets, but in actual fact the US market is a different case, it's one marketplace in many senses.

If you look at emerging markets, you've got indices where 50% is in four countries, and yet there're another 40 countries to invest in, so I would argue that people need to move away completely from that sort of index mentality and start afresh.

Wim van Iersel: I agree. When you select managers it depends on whether you want to be benchmark-driven or benchmark-aware. Benchmark-driven for active management is, in many cases in developed and emerging markets, not the way to act. Being benchmark-aware means you take the benchmark into account.

Alex Beveridge: Anton, how do you construct your managers? Have you got different styles?

Anton Kramer: Yes, we have three regional managers, all three are mostly bottom-up stock-pickers, although two of the three regional managers also have a top-down view. These three managers of course have



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their own process for selecting stocks.

For the two global emerging markets managers we definitely look at whether they fit together. One is more of a bottom-up investor with a large diversified portfolio and the other one is a concentrated stock-picker, which does not pay a lot of attention to country or benchmark weights. They use a very different style and their portfolio holdings are very different.

Kristian Nammack: Certainly what I've seen in this product from Nomura is that obviously since you rebalance back to the regional index weights once a year, there's no betting on the three regions.

Within each region the managers do diverge from the country weights if they want to, but performance is primarily driven by stock selection. The volatility of countries is enormous, it's unforecastable risk – it is often political, weather risk and event risk, so my bias has always been managers who do stock selection as their primary way of producing return.

Alex Beveridge: I am interested in the BRIC phenomenon. Some people have suggested that perhaps the concept is a bit tired and we should be looking beyond this BRIC horizon. What's your view Joseph?

Joseph Mariathasan: Some people have come out with another concept called CEMENT, Countries in Emerging Markets Excluded by New Terminology, which is essentially all the emerging markets except the BRIC countries, the argument being of course, that you need both CEMENT and BRICs to have a solid portfolio. BRIC is a great marketing concept and has some important dynamics in terms of analysis; the danger is when people try to turn it into a product.

There's no doubt that those four countries are going to become incredibly important going forward. Of the four, I suspect Chindia – China and India – is probably more important than Russia and Brazil, for all sorts of reasons and, arguably, if you were going to take that concept you'd be better off just looking at China and India rather than including Brazil and Russia, because then you have to include Mexico and maybe a couple of other countries.

Erik van Dijk: I think it is here to stay. Looking at the portfolio concept, the overall portfolio in the region is still relatively small, it will be around 5% to 10% maximum, and I don't think it's a bad concept, especially for smaller and mid-size plans. Joseph, you're right, China and India are probably in the long term more important, but I don't find it to be a bad marketing concept.

Alex Beveridge: Wim, as a pension fund, are you invested only in the BRIC countries or is the allocation much broader?

Wim van Iersel: We've invested almost 20% of our equity portfolio in emerging markets. We found that looking at emerging markets in general there was more to be gained in terms of performance.

That was the reason for us to step into a larger allocation to emerging markets. Second, if you look at the BRIC countries' performance numbers, it's been a wonderful theme and not only from a marketing perspective, but the question is, of course, is it here to stay? If you look at what the Russian government is doing with raw materials, there might be some cracks in this theme.

Anton Kramer: If you have the possibility to invest in other countries aside from these four, then as an investor you

should always do that because you can diversify your risk and take up other opportunities in your portfolio.

Kristian Nammack: I haven't heard the term BRIC used in a while. I've seen a frustrated attempt at investing in single-country products, especially China and India. I know of one large institutional investor that had a bad experience in that he was convinced that China was the future, as many of us were, or even are, and bought a China-only fund and suffered its volatility, and it scared that pension fund off a lot of emerging markets.

Joseph Mariathasan: I'm absolutely amazed. I launched a China fund ten years ago and it's done incredibly well.

Kristian Nammack: Presumably it did see some volatility?

Joseph Mariathasan: Yes, we did see some volatility.

Kristian Nammack: BRIC as a concept is well understood by a lot of people, but I've seen people go either one way or the other.

Mark Roxburgh: As Anton and Wim pointed out, why restrict yourself when there are 30-odd countries that you can potentially invest in that can give you good alpha opportunities?

Alex Beveridge: So what other countries should our readers be looking at?

Joseph Mariathasan: You have the middle ranking countries in emerging markets, but you also have the frontier markets, and what's interesting now is that some firms and managers are looking at frontier markets. Arcadian in the US is offering frontier funds, and an emerging market fund-of-fund manager called Old Square Capital is looking at countries like Botswana, Bangladesh and so on.

That's really where emerging markets were 15 years ago, so do you want to be in those? I suspect people may want to have a very small allocation to those sort of markets. Old Square Capital itself tries to find the best country and regional managers available to tap into the whole universe of emerging markets, not just the frontier markets.

Alex Beveridge: Anton, from a pension fund point of view, do frontier markets scare you or are you considering them?

Anton Kramer: We do not restrict our managers to investing only in the countries that are part of the MSCI universe, so for example our manager in EMEA is, within Africa, not restricted to only investing in South Africa, but also has the ability to invest in countries in Central Africa as well. It is obviously much more difficult to get a meaningful exposure in these markets though.

Joseph Mariathasan: The problem is a lot of these markets are so small that when you get a large amount of foreign cash going in, it will just wind the market up, and when they pull it out they wind the market down again.

It's probably fine for small amounts, but capacity is just so low that I'm not too sure it's going to be a significant proportion of any institutional investor fund.

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Kristian Nammack: I have a question for Wim. The Dutch are among the leaders of socially responsible investing, demanding high levels of corporate governance and so on, and when it comes to emerging markets certainly



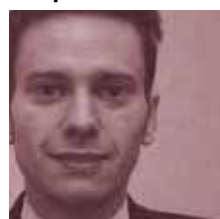
Alex Beveridge



Anton Kramer



Joseph Mariathasan



Alberto Miazzi



Kristian Nammack



Mark Roxburgh



Erik van Dijk



Wim van Iersel

Alex is the editor of *Global Pensions*. Prior to joining the magazine, he was a news and website editor for Charterhouse Communications, where he covered the UK mortgage market. Alex has a degree in politics and communications studies from the University of Liverpool and a post graduate diploma in journalism from the Journalism Training Center in London.

Anton is a portfolio manager at TKP. TKP is a 100% subsidiary of AEGON, a fiduciary manager for pension funds. Clients include the pension funds of KPN and TNT. AuM stands at €10bn, invested using a multi-manager approach. Anton started working for TKP in 2000. He is responsible for manager selection in Asia and emerging markets. He graduated in economics from the University of Groningen. He is a CFA charter holder.

Joseph is an independent consultant and investment specialist. He has a close association with StratCom, a research-based strategy consultancy focussed on financial services, and is also a consultant and advisor to Vermilion Partners. Joseph has worked for Shell International, Kleinwort Benson, Aviva (Morley Fund Management), and GMO, in a variety of technical and senior management and business development roles.

Alberto is the product specialist for the Nomura Global Emerging Market equity strategy. Alberto is primarily responsible for analysing Global Emerging Markets at Nomura Asset Management UK and was previously involved in research of European fund managers at Watson Wyatt.

Kristian is the director of Polaris Consultants LLC, a consulting firm focusing on giving strategic advice to pension funds, family offices, and other investors. Polaris also occasionally advises asset management firms on strategic issues. Prior to this, he was head of the Alpha Team at Skandia Liv Asset Management in Stockholm, where he worked with investing their €30bn portfolio.

Mark heads up both the business development and client service operations of Nomura Asset Management UK (NAM UK). He has been with NAM UK since 1999. Prior to this, Mark held a number of senior client relationship and business development roles at Morley Fund Management.

Erik is CIO and partner at Compendeon Pension and Investment Management in Bunnik, the Netherlands. Before this he worked in the US on Asset Allocation Systems and in the Netherlands for Palladyne Asset Management as CEO and partner, in addition to Fortis Investments as head of quantitative strategies. Erik has also written a book on quantitative investments and supplied articles for magazines and journals.

Wim is currently responsible for fiduciary asset management at SPF beheer. He started at SPF beheer ten years ago. His responsibilities include selecting and monitoring external managers for fixed income, equities and alternative products on behalf of current clients. Solutions are also provided for potential clients.

things are getting better, but when it comes to frontier markets, does your pension fund have an SRI policy? And how does that impact your investments in emerging markets?

Wim van Iersel: The policy is currently under investigation. On corporate governance we ask our managers to vote on every company they hold in their portfolio. Meaning we have an active voting policy.

Alex Beveridge: Anton, is SRI a consideration for you?

Anton Kramer: Yes, and I think it is for every Dutch institutional investor these days. We do a screening of the holdings in our portfolio each year using an external adviser and we then make a list of stocks that are excluded from where our investment managers can invest in.

Alex Beveridge: Eric, is this a question that comes up a lot?

Erik van Dijk: Yes, definitely, and more now especially in the emerging markets than elsewhere. My experience is that at the moment it's mainly a concern on a company level rather than a country level.

Alex Beveridge: Mark, from an asset manager's point of view, is this something you've come up against?

Mark Roxburgh: Yes, we've seen it on a number of searches where there's an external SRI adviser providing some form of screening. Particularly in the US market, it's very popular for some of the big pension funds over there to literally have no exposure to a particular country, which creates challenges for the manager, but is just part of the way the world is these days. As long as the manager isn't too restricted, it's not a particularly big issue.

Anton Kramer: The corporate governance issue is not only related to emerging markets though, because there have been scandals in the developed markets as well.

Alex Beveridge: Has the recent volatility in global markets led to a reassessment of global emerging market allocations?

Kristian Nammack: A number of people I speak to are putting on hold any major decisions, but they're also looking for potential opportunities.

If you believe that part of what happened this summer was just a liquidity crunch that created indiscriminate selling of assets to raise cash to pay margin calls, then obviously it creates some opportunities.

Where the dust settles and where you will find the bargains is yet to be determined, but I have specifically heard people talking about emerging markets as being one place where the fundamentals have not changed.

Wim van Iersel: We increased our weighting in emerging market debt and equities as a result of the global credit crunch.

Mark Roxburgh: Emerging markets seem to have held up very well compared to developed markets, and if you look at the fundamentals, they're probably in a much better position than they've ever been in terms of being able to ride out the volatility. They're up about 18% in US dollar terms this year, so it's still a very good result if you're taking a long term view, which obviously pension funds will be.

Alex Beveridge: Over the last four or five years, have pension funds become more

receptive to the idea of an allocation to emerging markets?

Mark Roxburgh: In the US, definitely, they're much more aware of the alpha opportunity in emerging markets. A survey published earlier in the year looked at the global equity ex-US managers, in terms of where the alpha was coming from on such mandates, and by and large it was coming from their emerging markets exposure.

Across Europe emerging markets are still quite popular. Some of the large consultants have identified it as a return-enhancing asset, so we're seeing more recommendations from big

“BRIC is a great marketing concept and has some important dynamics in terms of analysis; the danger is when people try to turn it into a product. There's no doubt that those four countries are going to become incredibly important going forward”

Joseph Mariathan

consultancy firms to include emerging market exposure in global equity mandates or indeed as standalone mandates so yes, there does seem to be more institutional appetite for it going forward.

Joseph Mariathan: People have become overawed by the whole idea of efficient markets; Harry Markowitz, the founder of Modern Portfolio Theory, which was extended to incorporate the idea of efficient markets by Eugene Fama, certainly does not believe in efficient markets and has spent part of his career trying to find ways of beating the market. Over many years people have taught in business schools that markets are efficient, and therefore if you invest in equities your lowest-risk allocation should be the market capitalisation portfolio, which is about 50% US.

If you throw away the whole idea of market efficiency, you're not going to put 50% in the US because it's the market cap, you'd be thinking, 'What are the growth prospects of each marketplace and what are the risks?' and you would allocate that way.

Pension funds as a whole are being sold this market efficiency idea, and as a result they're hooked on the market cap portfolio as the one that they should be basing their decisions on. That means emerging markets have always got a much lower percentage than they should have. I'm delighted to hear you have a 20% allocation, Wim, because that implies that you don't have that philosophy.

Wim van Iersel: I completely agree with you. In the early 90s, Japan had a 40% weighting in the MSCI. There was no reason for us to have a 40% weighting in Japan, and right now that's the case for the US too. What we try to do is find out where performance can be made for the long run.

Kristian Nammack: I'm also seeing quite a lot of pension funds specifically talk about de-risking their portfolio, so moving a large chunk of assets into index-linked bonds and other securities. Then whatever bit they want to play with moves to much higher risk assets with the expectation of higher return, and there people talk more about emerging markets.

Joseph Mariathan: This whole idea of risk is fascinating, because if you look at what happened in the late 90s, a typical UK pension fund would have had 70% of it assets in equities, half of it would have been in UK equities, and of that Vodafone

was 13% of the FTSE 100 index. So a typical UK pension fund would have 5% of its total fund in Vodafone, more than they had in the whole of the emerging markets, and they all think that they weren't taking risk.

Erik van Dijk: I'd like to use a metaphor from one of my pastime activities, chess. I'm a member of the board of the Dutch Chess Federation. If we, as an experiment, played a tournament of chess and we were all amateurs, then probably on average all of us would produce an average result, which is efficiency, with some volatility, because sometimes you're lucky and sometimes you're not.

Now, if somebody had knowledge or information, then the likelihood of us producing the same result reduces. So if in chess one person can be better than the others, why can't an asset manager? The likelihood of that happening is larger the less information there is about the market, so the inefficiencies in the emerging markets make it more likely that the real alpha generators are in that type of market. I agree with Joseph that because emerging markets are still so inefficient you should incorporate them in any portfolio.

Alex Beveridge: Anton, do you think there is greater interest now in emerging markets than in the past?

Anton Kramer: Yes, simply because the returns have been great in the last five years. For our clients, we've been investing in emerging markets almost since we started in 1989. Most of our clients made additional allocations to emerging markets a couple of years ago, so in that sense there was more interest in investing in emerging markets, for the same reasons we've been discussing earlier, the higher expected returns.

Alex Beveridge: Something that always comes up when you talk to pension funds about emerging markets is whether there is more or less political risk involved in investing in emerging markets today.

Erik van Dijk: Obviously it's a lowly correlated group of countries and you need to be aware of what happens locally. Then again it's a little bit less than it was ten years ago, with the Asian and Russian crises, simply because, as a result of them now being more focused on international trade, they're in a way more tied into the world community.

But my metaphor when using the chess world is a good example; I wouldn't dare to invest in Russia without knowing the managers that I know and my friends from the Russian Chess Federation who are often political insiders. Without those two relatively uncorrelated sources of information I would consider myself to be too uninformed when it comes to political risk factors.

Joseph Mariathan: Even in mainland China I'm always fascinated by the fact that the rule of law is becoming much more important to everyone and you don't get the political interference in companies that you're seeing in Russia, so I would make a huge distinction.

Wim van Iersel: If you look at the world you see other risks evolving, meaning that there is a transfer of economic, political and military power to emerging markets.

The balance of power shifts. This means that we will encounter additional risks between regions going forward.

Anton Kramer: The managers we hire are obviously paying attention to it, but it's more their decision to invest in certain countries or to not invest in certain countries. It's true that most of the emerging markets do not have much debt anymore, unlike ten years ago, so they are more

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self-sustaining, but on the other hand, like we saw in Thailand, there still is political risk.

Alex Beveridge: Mark, does this play to what you're doing here as a specialist?

Mark Roxburgh: All the managers have a political filter at their final decision-making stage. They may like some great stocks in some lovely countries, but when they add the political element, they may not be able to invest there at all.

So I agree with the consensus, there is less political risk than there was certainly five or ten years ago. It's still there, but we're talking about quite a broad basket of countries, so diversification should be able to reduce that quite a bit.

Kristian Nammack: I'd echo that final comment. At the end of the day, the way most of the people I speak to mitigate political risk is to invest in emerging markets globally, whether that's through regional managers or global managers, but not to make big bets in any one country.

Alex Beveridge: If we turn our attention to liquidity, Joseph, you mentioned you were fairly comfortable with the liquidity in many of the markets now.

Joseph Mariathan: Yes, apart from the frontier markets where there are big issues. If you're a 20- or 30-year pension fund, illiquidity should be your friend not your enemy, because you should be able to take an illiquidity premium, so you're crazy looking for liquid markets, you're better off looking for illiquid markets and benefiting from other investors who can't afford to take that sort of a time horizon.

Kristian Nammack: I completely agree.

Wim van Iersel: I also agree.

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Mark Roxburgh: That's the advantage of a long term view.

Anton Kramer: The only thing you should avoid is the investment managers that create their own market, that might happen in frontier markets but also in the mid and small cap areas in emerging

markets.

Joseph Mariathan: Again this comes back to the global versus regional. I'd be wary of a global manager that launched a mid cap or small cap fund, because I'd be wondering how they do the research in that depth and whether they are all going to be picking the same stocks? It's a bit like the problems we had in the quant funds where over the summer all the quant funds were using similar processes and found they were all shorting the same stock. So the danger is that you end up going for certain types of managers who are using similar processes, who are essentially buying the same stocks and then may try to get out at the same time.

Kristian Nammack: It's also hard to know how much performance in less liquid asset classes comes from fund flows versus changes in fundamental opinions, and if we all start agreeing that global emerging markets are a worthy asset class and we all start to allocate 20% instead of 5%, and you see huge fund flows into this area, it could artificially boost the return on some of these stocks.

Mark Roxburgh: The figures I saw most recently suggested still strong positive flows into emerging markets this year and quite a significant outflow in US equities from international investors. So there is quite a lot of money moving into emerging markets.

Kristian Nammack: It also brings up the issue about capacity in global emerging market managers, as Mark mentioned earlier. Many good managers are closed to new assets, and that's an issue for investors, especially very large investors or public pension funds of certain countries and certain states in the US.

Alex Beveridge: Do people settle then for second tier managers?

Joseph Mariathan: Most of us would probably agree that you don't have to settle for second tier global managers if you can get first tier regional and country managers.

Anton Kramer: Yes, but on the other hand if the first tier regional manager is successful then you also end up with capacity issues, possibly some

time further down the road compared with the global emerging market managers.

Mark Roxburgh: What you've got to be wary of is that the average global manager underperformed the benchmark by nearly 2%. The average global emerging market manager is not someone that you'd want to select.

Alex Beveridge: Wim, you've got a big allocation to emerging markets, have you had to wait to invest some of that money to get the manager you wanted?

Wim van Iersel: No, it took a long time to select them, about six months or so, but the opportunity arose and we were fine with the manager in place. We were able to allocate the money very quickly. But we didn't say, 'You have to be invested tomorrow.'

Alex Beveridge: Anton, have you come up against capacity issues?

Anton Kramer: It's something that we always look at when we're selecting managers and especially when we conducted the search for global emerging markets managers. Apart from diversification, that was another reason why we selected more than one manager, we now have more flexibility in case of inflows in our Emerging Markets fund.

Alex Beveridge: I just wanted to touch on the issue of correlation. How closely correlated are the emerging markets today, as it certainly used to be the case that if one struggled then the others would struggle too?

Joseph Mariathan: It's interesting looking at emerging market debt, where the 1997 Russian crisis sent shock waves throughout the whole debt market, yet since then there have been a number of mini crises which had nowhere near the same effect, so there isn't this knee-jerk reaction now.

If something dramatic happens in Argentina, people don't go and sell Turkey, which was the case in the past. So clearly correlations have gone down at the country level. I suspect at the stock level there's probably much higher correlations with the global sectors than there used to be.

Kristian Nammack: I agree. The anecdotal evidence is that different countries are a lot less correlated as opposed to being a block of emerging markets. What I'd like to study is whether there are sub-regional correlations among countries based on what drives their economy. There are probably correlations within regions, but certainly it's breaking down on a global basis.

Erik van Dijk: Professor Bruno Solnik, who is now in France at HEC School of Management and in the past was at MIT, has done a lot of research on correlations, and Joseph is right about the stock level versus the country level, but the tricky thing with country levels is that when things are going well in a country, or the world, or the combination of both, people tend to care less about what's going on elsewhere. But the moment something bad happens, they will then concentrate on what effect it will have on their portfolio and the markets with the large betas, which are still the emerging markets, will be the first ones to be beaten up.

In the last three or four years, these markets have done tremendously, so in a way the real test is; is this a new world with truly increased global correlations for emerging markets, or is it just a phase that we're in? A bad period of two or three years in a row is what we need in order to find the answer.

Alpha spurs on emerging markets



As pension funds seek to globalise their portfolios, emerging markets are forming an increasingly large part of their asset allocation. **Alex Beveridge** reports on how this sector is seeking to meet the needs of pension funds

In September Greenwich Associates released a report revealing that institutional investors had been “moving into international equities at a rapid and consistent rate for the past 24 months.” It said US institutions had doubled their Latin American holdings to over US\$20bn between 2005 and Q1 2006.

While Greenwich’s study reported less frenetic movement from European pension funds, it did find that many expressed an intention to increase international equities.

The two reasons given for this shift were the growth in demand for alpha and a desire for diversification. These twin desires of pension funds are of course nothing new and account for the general growth in interest in alternative investments. However, it is becoming increasingly clear that emerging market managers are latching on to the needs of pension funds and are promoting themselves as the natural providers of these much sought after investment goals.

As John Colon, consultant at Greenwich pointed out: “International equities, with their superior performance over the past several years and their relatively low level of correlation to domestic equities and fixed income, appear to fit the bill on both counts.”

Given the long term liabilities of most pension funds, an allocation to emerging markets would seem prudent. These markets have the most potential for growth and given that many are fast developing into fully fledged developed economies it could be argued that it would be risky not to at least have some exposure to them.

However as the recent military coup in Thailand has demonstrated, things can change very fast in these countries. Political risk, liquidity, and corporate governance are all areas of concern when looking to invest in emerging markets. While some analysts see events such as the Thai coup as a buying opportunity, it is understandable if some pension fund members are spooked by such occurrences.

Another key concern which has been raised by consultants in the field is that of capacity constraint. With a rise in popularity in the asset class there is the temptation for good managers to take on too many assets. Also, some investors, feeling left out of what appears to be a lucrative sector, could compromise on the quality of managers simply to gain access to the market.

There is also the matter of what is known as the frontier states. These are countries which are, as yet, not on the map for most emerging market investors but which could form an important part of a portfolio in the future.

First Sate Investments recently flagged up Vietnam, Kazakhstan, Botswana and Zambia as frontier states.

According to David Gait, senior portfolio manager for Asia Pacific (ex-Japan) at First State Investments, pension funds should be aware that some of the so-called BRIC (Brazil, Russia, India and China) countries, which have enjoyed huge popularity with investors, were not even classed as emerging markets 10 years ago.

While admitting that liquidity was a key challenge in these countries, he said he believed that if an investor was willing to allocate capital over a three to five year period there were good opportunities to be had.

Stock picking and fundamentals

A key debate which is opening up across the emerging markets sector is that of bottom-up stock pickers versus a more macro economic top-down approach to investing in these markets.

Arguably the debate has been ignited by the recent success of the bottom-down practitioners who have seen their approach well rewarded of late. The reason for this success is best typified by events in South Africa. There, those taking a macro approach have benefited from large infrastructure

investments, as the country prepares itself to host the 2010 World Cup Football tournament. Meanwhile, some of the bottom-up stock pickers have been badly mauled.

Bottom-up practitioners, meanwhile, believe there is a value in taking a long-term view of a company. They argue that a company which is well embedded in a local economy is better placed to withstand cyclical shocks or sudden shifts in currency valuations.

Some consultants argue that from the viewpoint of a pension fund it could be better to be diversified across a number of different strategies and global sectors, in much the same way investors seek safety when investing in private equity or hedge funds by gaining access via a fund of funds.

Scott Crawshaw, portfolio manager for emerg-

ing market equities for Russell Investment Group, commented: “In our view you can be successful using a variety of different methods, either bottom-up, top-down or something in between.”

The Merseyside experience

One UK pension fund which has recently made a significant (around 2%) allocation to emerging markets is the Merseyside Pension Fund.

“We have been involved in emerging markets for a while, but we used to do it via pooled vehicles,” explained Leyland Otter, senior investment manager at the fund.

The fund invested in the Nomura GEM product, which bundles together the expertise of three emerging market managers in an attempt to max-

imise the regional specialties of each firm. The Nomura vehicle was the first time that Merseyside had gone out on its own with an allocation to emerging markets.

Mark Roxburgh, executive officer, head of marketing and client services at Nomura Asset Management, explained how the GEM product came into being. “We had a belief that a combination of three specialist regional managers would, when combined and managed with some overall investment controls and constraints, provide some very good opportunities in the emerging market space.”

He said Nomura accepted that it did not have the skill set in-house to do the EMEA or the Latin American block.

Realising it had the majority of the asset base – around 50% of emerging market stocks are Asian – Nomura decided to hire two external firms who were proven in their particular area. The idea was to combine the managers’ track records to see what they looked like.

Charlemagne Capital was appointed for the EMEA sector, and Gartmore won the Latin American brief. A study was then carried out by Mercer Oliver Wyman to review the statistical case as to why three regional managers would produce performance to rival global managers.

The Mercer study showed the new hybrid product competed with the best first quartile global equity managers.

“One of the things the consultants were telling us was that if you look at the last couple of years most global emerging market managers were really good at one region, average in a second, but they were weak in the third. This was because trying to stretch competence over 27 emerging markets is really too much for most people,” explained Roxburgh.

The other key part of the Nomura hybrid is that it does not take any regional bets in terms of allocation. Roxburgh said: “Most of the alpha is generated at the stock and sector level, which led us to decide to be neutral to the regions, only rebalancing if they get more than 3% out of alignment with the benchmark weighting.”

Merseyside’s Otter said while the bottom-up/top-down debate was interesting, “we tend to go for good stock pickers, irrespective of their style.”

He added: “These things have runs, but I guess if you look at the very long term then it tends to revert to the mean. So, ultimately the name of the game is picking good stock, no matter what you follow.”

He said there had been a move to diversify because of the concentration of the UK stock market: “You can be investing in a highly concentrated portfolio if you are tracking the FTSE100. For example you are heavily into oil stocks, which is not great from portfolio diversification point of view.”

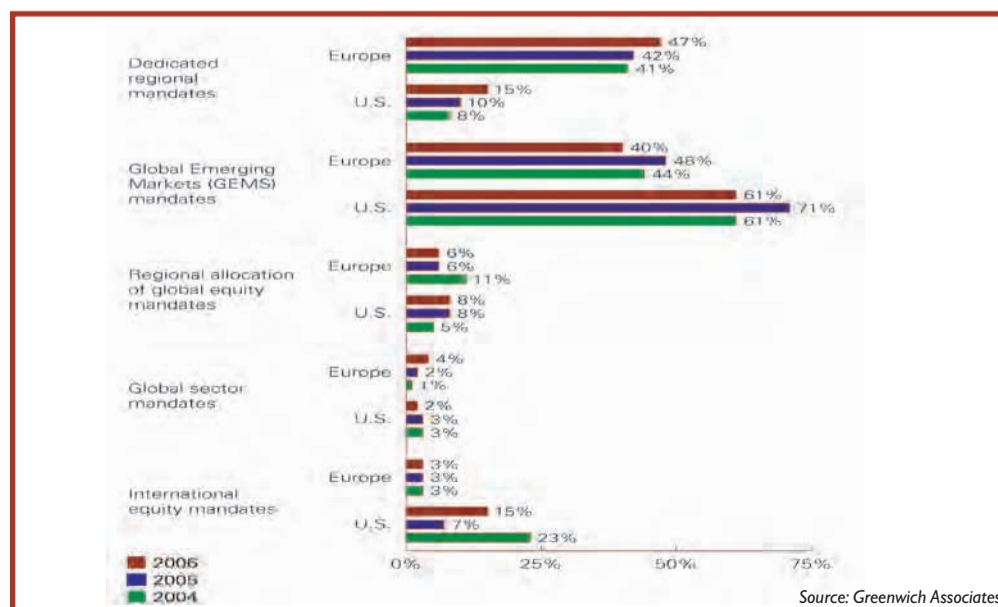
According to many pension fund investment professionals there is a belief that trustees are more comfortable with understanding an emerging market portfolio than perhaps they are with some hedge fund strategies.

“Diversifying your stocks and shares is an easy concept to understand, rather than some exotic hedge fund strategy,” said Otter.

Employing sector specialists is increasingly seen as the best way to benefit from emerging markets. As Wouter Pelsler, director of asset management at Dutch pension fund administration service MN Services said: “We shifted from traditional managers to boutiques. It’s about alpha, and that’s about skilled people.”

This belief was mirrored by an API spokeswoman, who said despite a recent performance slump, API remained confident in active emerging market equities. “We are moving to active management as we think it’s a market where you could create added value after costs if you are a good manager,” she said.

Investment approach for emerging market portfolios



emerging markets – special report

For some people, emerging markets offer the best of all worlds – high growth, billions of people, low costs and tons (or barrels) of commodities. For others, they flatter to deceive: potentially undermined by changes in government, cronyism and corruption and a corporate culture that values image (sales) over profits.

Of these two extreme opinions, which is the closest to reality? In our view, the former outweighs the latter view by some margin, although being aware of risk is one of the most important challenges facing a manager in this space.

What exactly are emerging markets?

Since the expression 'emerging markets' was first coined in 1981 by Antoine van Agtmael, then at the World Bank, it has been used differently by different people.

We prefer to define emerging markets negatively: ie. as those markets that are not developed. This includes countries represented in the MSCI Emerging Markets indexes as well as others which have become investable.

We use this even though the phrase is somewhat misleading. The word 'emerging' implies progress, which tends to be very uneven.

Believe it or not, Zimbabwe was considered by some an attractive proposition in the 1980s. This is surely a submerging market. Yugoslavia was once portrayed as an interesting 'third way' in Europe – but its collapse with the fall of communism led to a peak-to-trough fall in Serbia's GDP in the 1990s of an astonishing 85%.

Serbia has since recovered, but its per capita income is now on a par with Thailand rather than that of most of its neighbours.

Even the bigger emerging markets do not emerge in a straight line: recall the Asian crisis in 1997/8, or the tequila crisis in 1994, as well as individual instances (Russia in 1998, Brazil in 1999...). So countries emerge at different rates, if at all.

The fundamental case for the asset class is very simple: it's all around us. If you are reading this at work, look around your desk. Your phone, your PC, your mobile – all are either made, or assembled in emerging economies.

To look at it more broadly, the developed world accounts for a mere 16% of the world's population.

The rest live in emerging markets. If you look at raw GDP data, these numbers are neatly reversed: the 16% account for 84% of the world's income, while the 84% in emerging economies generate only 16%. Should investors concentrate only on the substantial majority? Well, no.

On a purchasing power parity (PPP) basis, the emerging market's share rises to over 38%. So the asset class is too big to ignore. And yet on the basis of market capitalisation, emerging markets account for little more than one-twentieth. It's a case of paying six and getting 38, which is a very attractive proposition.

The argument that the asset class is too big to ignore is emphasised when one examines individual countries.

It is widely known that China has for a while been the world's second largest economy on a PPP basis, but less well-known is that it is now more than twice as big as Japan, ranked third. India, currently fourth, is likely to overtake Japan in the next two years, while Russia's commodity-fuelled boom has propelled it into the global top 10.

Another misconception relates to labour: It is often thought that these countries add little value. However, productivity gains have been impressive. Estimates by JP Morgan suggest that labour-cost adjusted productivity, ie. output per hour worked, adjusted for labour cost, in Poland is twice the EU average. In Turkey, labour

Emerging from the shadows



Emerging markets have evolved significantly over the past quarter century and while some still see them as a poison chalice, **Julian Mayo** explains their attraction

productivity rose 50% in the first five years of the decade.

Looking at asset diversification

Emerging markets also play an important role in asset diversification. Whereas for much of the 1990s the sector languished while developed markets (ex-Japan) boomed, over the last five years the sector has massively outperformed relatively lacklustre US and European shares. Contrary to some suggestions, more recent correlations remain low.

Over the last year the correlation between MSCI Emerging Markets and MSCI World has only been 0.21, while the former has a negative correlation with US Treasuries and corporate debt. The sector is certainly not dependant on developed markets as some suggest. It is also virtually independent of the global earnings cycle.

The asset class also offers considerable diversification between regions and countries. While the Emerging Markets Bond Index (EMBI) spreads are a good measure of overall risk in the sector, economies vary considerably. Take commodities: Net oil exports account for almost 15% of Russia's GDP and close to 5% in the cases of Colombia and Malaysia.

By contrast, Korea and Thailand are net importers to the tune of 5% of national income.

A cursory look at this year's performance demonstrated huge disparity in performance: as I write leaders include Peru (up 111% in local currency), Russia (up 50%) and India (+30%), while laggards include Korea and Turkey, which are both down on the year, and Israel which has barely changed.

Shares in Jordan have fallen 25%. These countries are driven as much by domestic as global considerations – which should be a relief for any investor who believes that there is no longer such a thing as a non-correlated asset.

Despite this, there are broad cycles which need analysing. One is the trade cycle. With the benefit of hindsight, the crises in Latin America in 1994 and in Asia three years later could have been foreseen by investors looking at one variable only: the sum of the current account and net foreign direct investment (FDI).

When the first swings into deficit, as it did in both areas in the two years preceding the crises, this shows a country living beyond its means and increasingly uncompetitive exports.

A reversal of FDI flows suggests global businesses voting with their feet and keeping their money at home; and locals investing, as many Asian busi-

nesses did, in wasteful real estate investments as they saw diminishing returns on capital in their home markets. This may also be a time of curiously large flows into offshore bank accounts.

The situation now could not be more different: 2005 saw record surpluses, even if one removes China's massive near-\$150bn surplus including FDI. While these numbers will be lower this year, it is still encouraging to see a surplus in each region – Asia ex-China, EMEA (Europe Middle East and Africa), Latin America and, of course, China.

There is no doubt that, whatever corporate shenanigans occur at the likes of Enron and WorldCom, corporate malfeasance remains greater in emerging than in developed markets. Risk management is therefore critical in the asset class.

This means knowing the regulatory and legal framework of the markets, being aware of liquidity should you change your mind and knowing which countries, sectors and stocks within the portfolio your risk is coming from.

This also means getting your hands dirty and going out on the road – even if this has, in my case, involved a terrifying helicopter ride through a pass on the Kyrgyz-Kazakh border and a failed coup in Manila. But fund management is not merely another form of adventure tourism.

Experience counts. You have to ask the right questions of the companies you invest in, quarter after quarter, year after year, which is why at Charlemagne Capital we have an experienced team which spends a lot of time on the road.

Assessing the market

A qualitative assessment of the case for emerging markets must be combined with a valuation analysis. On this score, the message is currently mixed. That is, the bond market suggests that we are (almost) in the best of all possible positions, with EMBI spreads close to a record low.

This indicates investor appetite to 'risk' is not far from its peak. This in turn would point to high valuations in their equity markets, especially at a time when the outlook for earnings growth is still bright. UBS, for example, forecast 20.3% net income growth for 2007, compared to 13.5% for developed markets.

However, valuations as a whole remain modest. While there are, as ever, exceptions, the asset class in composite trades at only 10 times next years' earnings, compared to almost 13 times for the maturer world. Furthermore, the valuation gap between emerging and developed markets remains firmly in the former's favour.

Although the disparity has narrowed as a result of the bull market over the last couple of years, earnings growth has almost kept pace with market rises.

For example, Brazil has been one of the world's best performing markets in recent years – but valuations remain low partly due to 59% earnings growth last year. The consequence of all this is that the asset class trades at a forward discount of some 20% to the MSCI World, whilst for much of the 1990s it traded at parity and sometimes even at a premium.

The conclusion of this is that in my view investing in emerging markets is not so much an option as a necessity.

It may sound hackneyed to say that indexing is akin to driving with one's eyes fixed on the rear view mirror rather than on the road ahead. However, this is especially true when looking at emerging markets which, as noted earlier, are barely a fraction of global equity markets. Given the increasing scale of their economies and the quality and valuations of their companies, this is unlikely to remain the case for very much longer.

■ Julian Mayo is an investment director at Charlemagne Capital (UK) Limited

Investing in emerging markets is becoming the order of the day for many investment committees. Some are attracted by the high returns achieved by the asset class in recent years, others by the long term prospects of developing countries or the potential diversification benefits. Whatever the reason, asset flows into emerging markets continue to rise as the asset class heads into its fifth consecutive year of positive performance relative to developed markets.

Successfully investing in emerging markets however is no walk in the park. After all, emerging markets are one of the most complex equity asset classes: liquidity is limited in many countries and corporate governance standards are not yet fully developed. Trustees often face challenges opening the requisite custodial accounts that in turn allow a full opportunity set to their money managers. On top of that, the asset class is heavily capacity constrained and some of the managers with the best historical performance are already closed to new businesses.

A crowded market

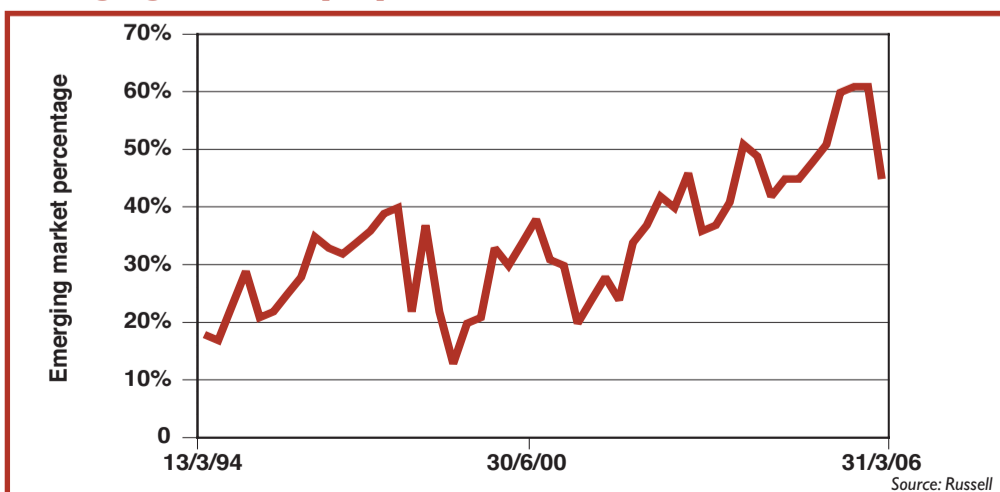
Specialist emerging markets managers are not the only group benefiting from the good prospects of developing economies. Many international money managers offer opportunistic emerging markets investment as part of their global and Europe, Australasia, Far East (EAFE) mandates. In many cases, these managers do not charge additional fees for including emerging markets exposure, effectively providing a cheap way of accessing the asset class. As the chart below demonstrates, the emerging markets portion of EAFE managers' mandates has increased significantly over the last decade.

Specialists or generalists?

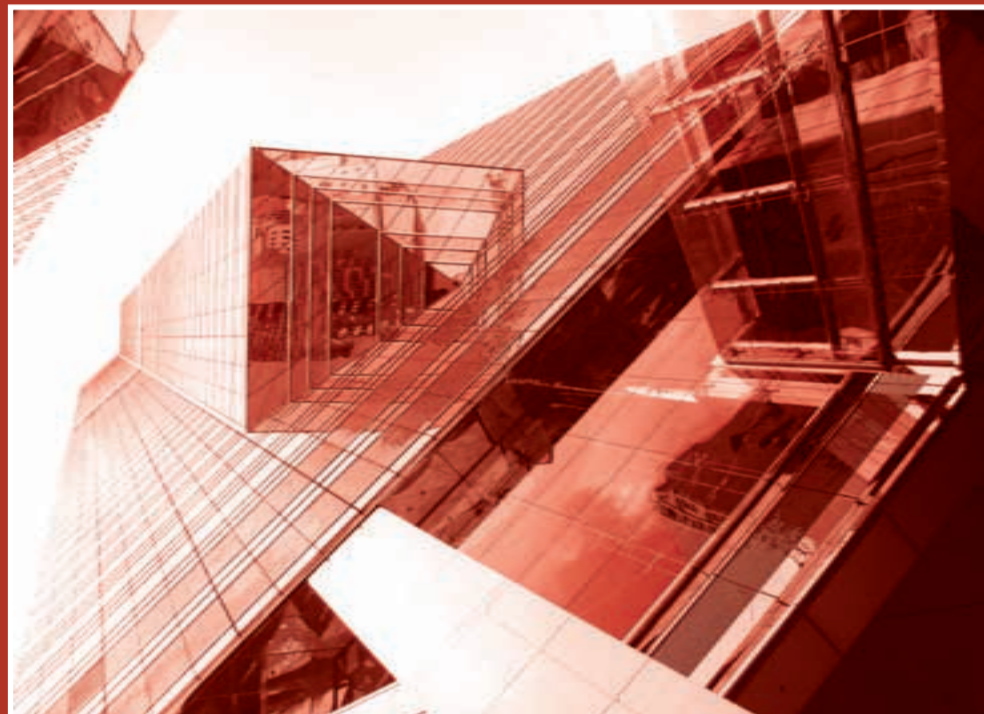
Russell Investment Group has conducted extensive quantitative research on its manager universes to assess the advantages and disadvantages of utilising specialist money managers for emerging markets. The conclusion from our research is that global and EAFE managers understandably tend to limit their investments to the more liquid stocks with larger market capitalisations; as a result, portfolios managed by specialists have provided better risk adjusted returns. In addition, large cap emerging markets stocks are more highly correlated with developed markets companies and, therefore, specialist managers provide greater diversification benefits. Our research also suggests that specialist emerging markets managers are better suited to identify country risks which are still a significant factor to consider when investing in the asset class.

Once the decision has been taken to use a specialist money manager, the next decision is whether to use regional or global emerging markets (GEM) managers. The main disadvantage of hiring a set of regional managers is that the trustee would be faced with the challenge of determining the appropriate regional allocation for their portfolio. By contrast, if the appropriate

Emerging markets proportion of EAFE mandates



Manager selection in emerging markets



Gustavo Galindo, explains how securing the right manager is the key to emerging markets investing

GEM manager is selected, he or she will have the skill to identify country and regional risks and then suggest an optimal asset allocation. As a result, many investors have opted for GEM managers.

Starting the selection process

A robust process for selecting managers relies on three fundamental principles: knowing the opportunity set, understanding the product and understanding the market. This information is pivotal in finding managers who implement a consistent investment approach within stable organisations and are therefore able to generate consistent, positive relative returns going forward.

The first step is to define a universe of managers (the opportunity set); the Russell emerging markets universe for example tracks the returns

of about 90 institutional equity products around the world. The second step is to determine whether an investment product qualifies to become part of the universe. This is because there are many managers that market themselves as global emerging markets managers; however upon closer inspection they lack investment coverage in important regions. Other managers might be excluded from the universe due to their use of derivatives, fixed income instruments, short positions or high cash balances.

Know your manager

Potential investors then need to develop a deep understanding of the managers in the universe. It is human nature to start with those that have generated the best returns. However, a quick look at a manager's marketing presentation can be useful to determine whether the people supporting the process are experienced and if they have a consistent investment approach – in short, the processes and people which increase likelihood of past return patterns being repeated in the future. It is also important to look for signs of commitment to the product. This may be found in the big name brands but equally in well-resourced emerging market boutiques which may have a strong local knowledge advantage. Together, these 'fundamental checks' may prove to be an important complement to a pure focus in past performance.

Quantitative and qualitative

When analysing individual managers, quantitative and qualitative tools are important. Data quality in

MSCI (1999-2006)

	MSCI Emerging Markets	MSCI World
1999	66%	25%
2000	-31%	-13%
2001	-2%	-17%
2002	-6%	-20%
2003	56%	34%
2004	26%	15%
YTD 8/2005	31%	16%

Source: Russell

emerging markets has improved recently; however, it is still difficult to draw conclusive evidence from quantitative analysis of a manager's portfolio alone. In many cases, the use of American Depository Receipts (ADRs) and Global Depository Receipts (GDRs) distort the picture. Equally, while investors may have confidence in some variables (eg. country exposures or number of stocks,) others (eg. I/B/E/S growth estimates) often need to be analysed with care. For that reason, qualitative analysis is especially important in emerging markets.

Qualitative analysis should focus on the investment philosophy, the quality of the investment team and the investment process. The investment philosophy is often articulated in marketing materials but it is only after interviewing the manager face-to-face that investors can really determine the guiding principles behind each process. Interviews with management are also important to develop an informed opinion on the investment team; while investors can often source CVs and similar credentials from marketing materials, it is only after discussing the markets and stocks in the individual manager's portfolio in person that we can gain conviction on them or identify any behavioural biases existing in the investment team.

Assessing the investment process is a key part of qualitative analysis. First hand interaction with managers helps unearth any anomalies between the 'implemented' process and the 'stated' process found in publicly available marketing materials. It is the implemented process which needs to be well suited to exploit some market inefficiency which will be a source for excess return.

To help us do this, we at Russell have developed a set of manager research 'best practices' for central elements of the investment process; these best practices – coupled with a broad view of the universe – help steer our evaluation.

No "model" approach

A thorough understanding of the market is vital in order to conduct a proper analysis of any investment product. It is important to understand the market inefficiencies available to investors. Equally, some knowledge in capital markets and individual stocks is useful to assess the quality of investment professionals' decisions. And of course, macro-economic factors will also impact manager return expectations.

But there is no "model" or "right" approach when selecting investment managers – investors will use different tools to examine different things, and certain areas of enquiry and research for one manager will differ from those usefully applied to another.

Our experience is that different processes and style biases tend to be rewarded at different times in the market cycle. If possible, it makes sense to invest across a variety of styles, to benefit from different market cycles and from investing with the best managers in their respective fields. Intelligent combination of a variety of complementary styles harnesses each investment managers' specific expertise, and leads to more stable return patterns. So good night...and good luck.

■ Gustavo Galindo is a research analyst, Emerging Markets Equities, Russell Investment Group

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