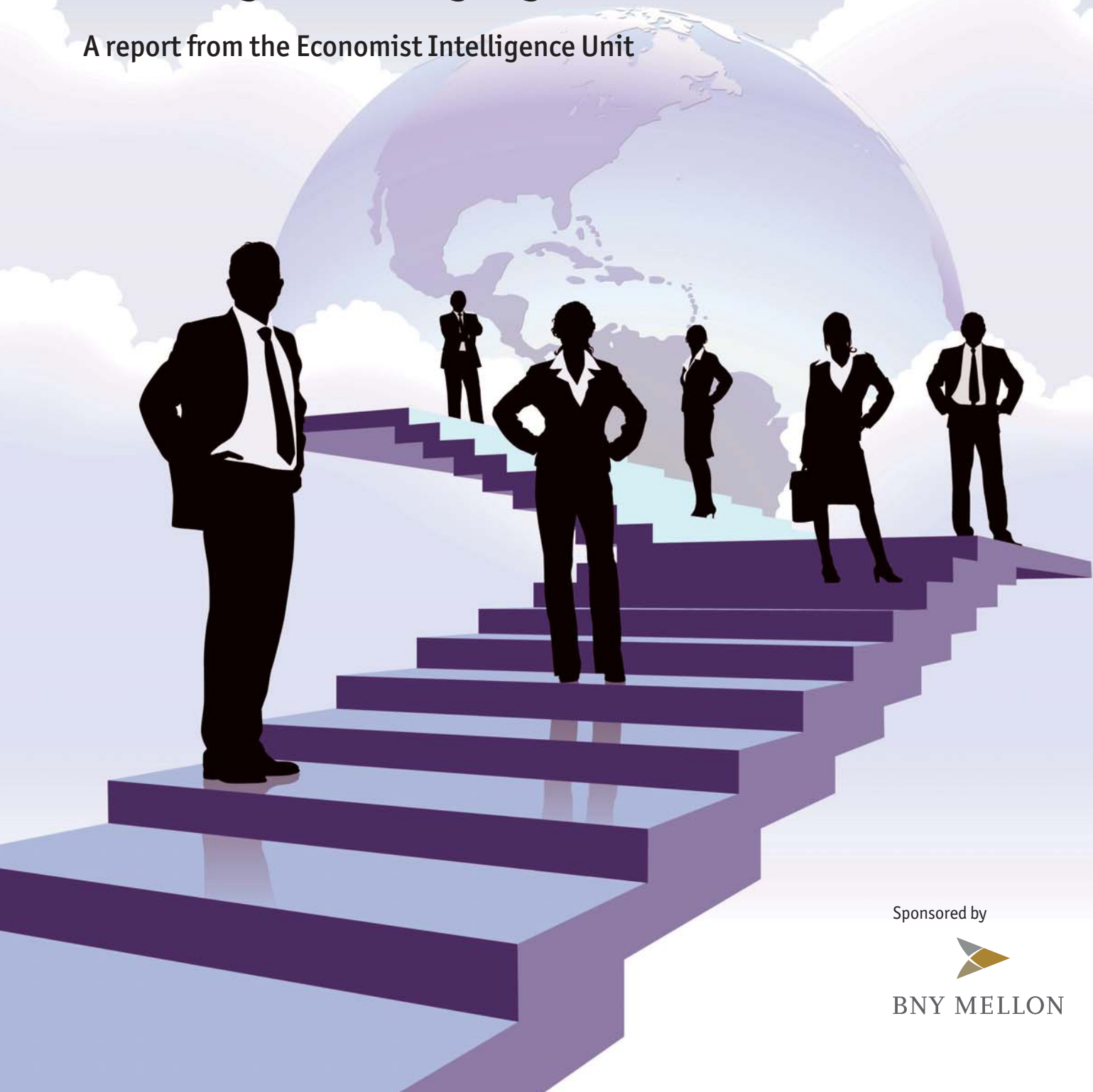


The search for growth

Looking to emerging markets

A report from the Economist Intelligence Unit



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Preface

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About the research

In this report, produced by the Economist Intelligence Unit and sponsored by BNY Mellon, we examine how investors, faced with a dearth of investment opportunities in developed markets, are approaching emerging markets. This is the second of two follow-

up papers to *The search for growth: Opportunities and risks for institutional investors* report, published in June 2011, which, based on a global survey of almost 800 institutional investors and corporate executives, examined the prospects for market growth across a range of sectors, regions and asset classes. The first follow-up paper, *The search for growth: Rethinking asset allocation*, was published in October 2011.



Introduction

It is a daunting time to be an institutional investor. Capital markets have been lurching from tailspin to feeble recovery and back towards stagnation as investors worry about sovereign debt and renewed recession. The search for growth in these conditions demands risk-taking at a time when risk is profoundly unappealing. Yet pension funds, governments and other institutional investors will have to find new sources of wealth if they are to support the ageing populations that rely on them for income and services. The proportion of people over 65 years of age is expected to triple in the first half of this century and will be growing at 3.5 times the rate of the global population as a whole by 2030, according to the UN.

In recent years, the growth in emerging markets has been an obvious answer to the dearth of investment opportunities in so much of the developed world. Assets under management in emerging markets jumped by 31% to US\$4.2trn between 2007 and 2010, according to Boston Consulting Group. This means that a lot more investors are a lot more attentive to these markets' volatility, inflation and potential to overheat, and their ability to escape the carnage if demand from developed markets shrivels.

There seems to be broad consensus about the longer-term opportunity offered by emerging markets. As the global economy experiences historical rebalancing over the next decade and beyond, the emerging world, particularly behemoths like China and India, will continue to constitute a growing share of global GDP and global demand. Two-thirds of respondents to our global survey of 800 senior executives worldwide, conducted in March 2011, agreed that emerging markets in general—and equities in particular—offer strong growth potential. However, nearly one-half believed that the optimism about emerging markets' potential over the near term had become overdone. Renewed bouts of risk aversion since then have pummelled emerging-market stocks, bonds and currencies. This has alleviated some of the concerns about overheating and created entry points for some longer-term investments, according to interviews conducted for this report.



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Following the opportunity

“Mature markets are swimming in debt and struggling to grow, while many emerging markets have good balance sheets and are growing.”

James Hille, chief investment officer, Texas Christian University endowment fund

“Mature markets are swimming in debt and struggling to grow, while many emerging markets have good balance sheets and are growing,” notes James Hille, chief investment officer for Texas Christian University’s endowment fund. The US\$1.1bn fund began investing in emerging markets about seven years ago and now has about 10% of its assets in them.

CalPERS, the largest public pension fund in the US, has more than doubled its emerging-market exposure since 2007. Like many large institutions, CalPERS invests for the long term. “We have the liquidity and patience to ride out the market’s ups and downs,” says a spokesman, Wayne Davis.

Joseph Dear, the fund’s chief investment officer, recently told its board that CalPERS is “looking at selective expansion of our emerging-market exposure”. Indeed, the US\$228bn fund increased its investments in emerging-market assets in August, when prices were dropping. “We don’t just chase the performance numbers that have come out in the last year, or the last quarter, or even the last three years,” says Mr Dear.

Even Japan’s cautious Government Pension Investment Fund, the world’s largest with about US\$1.3trn in assets, announced in August that it would begin selecting managers this year for its first foray into emerging markets.



A naysayer's heyday

Despite an apparent abundance of emerging-market bulls, equity returns so far this year seem to be vindicating the sceptics. By the end of the third quarter, the MSCI Emerging Markets Index was down by 23.5% for the year-to-date in US dollar terms, making the 13.8% drop in the MSCI World Index, which does not include emerging markets, seem almost attractive by comparison. Major equity indices in the BRICs (Brazil, Russia, India and China) also staged double-digit retreats in the third quarter as the global economic outlook dimmed and investors grew increasingly risk averse. "When returns are good, emerging markets are great. But when the momentum turns in global stocks, they'll give back a lot of their gains," comments Mr Hille.

Certainly, those looking to history for cautionary tales will find no shortage. More than a decade of hyperinflation and economic free-fall destroyed years of economic and investment progress in Brazil during the 1980s and early 1990s. Russia defaulted in 1998 and Argentina crashed just a few years later.

These days, investors have short-term concerns about liquidity and inflation. They also have more long-term worries about India's lack of infrastructure and concerns that China will be old before it gets rich: by 2050, 25% of China's population will be over 65—a higher proportion than in Japan today—and the country has little in the way of institutionalised medical or retirement services.

Investors hope that emerging nations will successfully create stable economies fuelled in large part by their own domestic consumption, but not all of them will succeed. Many developing nations face stubborn impediments to growth, including sketchy infrastructure, poorly educated workforces and ubiquitous corruption. Even in successful countries like South Korea, the process is likely to seem smooth only in retrospect. Although South Korea may have escaped the so-called middle-income trap that has snared the likes of Argentina, the Philippines and Malaysia, it went through extensive restructuring and reforms of both its corporate and financial sectors after the Asian financial crisis in 1997-98. The export-oriented automotive and consumer electronics sectors lead its current economic success, but those sectors did not take off until a painful series of post-crisis reforms tempered the dominance of South Korea's large conglomerates and allowed medium-sized enterprises to participate more fully.

In the near term, investors worry that demand from foreign investors will simply exceed the supply of emerging-market investments available. Although emerging markets represent nearly one-half of global GDP on a purchasing power basis, many institutional investors in developed markets maintain single-digit exposure. If investors expand those exposures, they may trigger price bubbles and boom-and-bust cycles.



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“Short of a true global depression, who in their right mind would want to hold long-term treasuries?”

Allan Martin, partner, NEPC

In addition, the assets publicly available in some emerging markets reflect only narrow slices of the underlying economy, which limits their usefulness for investors interested in capitalising on a range of scenarios. Furthermore, emerging-market governments, wary of excessive foreign influence and overheating in capital markets, may impose regulations or taxes unfavourable to foreign investors, as was the case in Brazil in 2009.

The recent plunge in emerging-market asset prices reflected all these concerns, along with the fear that inflation in the developing world could crash head-on with a double-dip recession in the US and the euro zone. Nonetheless, some investors see the recent stumble as a buying opportunity in markets that have powerful long-term sources of growth.

“You are going to have these snap backs, but over the long term these things have made quite a lot of money for us,” says Ronald Lataille, president and chief investment officer of Verizon Investment Management Corp, which has about US\$50bn in assets, mostly from Verizon’s pension fund. The US telecoms giant has been investing in emerging markets since the 1990s and maintains a 4-5% position in emerging-market equities.

“Short of a true global depression, who in their right mind would want to hold long-term treasuries?” says Allan Martin, a partner at NEPC, a firm based in Cambridge, Massachusetts, that advises institutional investors. “It’s hard to make the case that, strategically, emerging markets aren’t attractive investments. Given the recent drop in prices, I feel a lot better about buying them now than I did six months ago.”



More growth, less debt

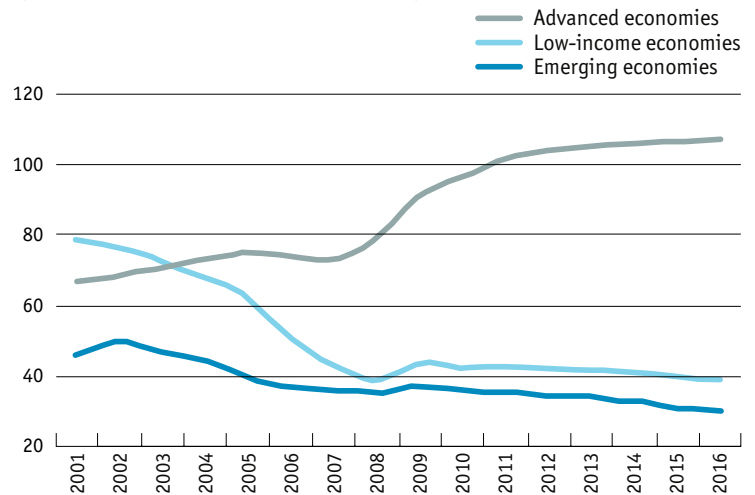
Few institutional investors are so naïve as to think that emerging markets could be immune to a full-scale recession in the US and Western Europe. Emerging nations are major investors in developed-world debt and equities, so their investments would suffer at the same time that demand from their developed-world customers dried up. But even in a worst-case scenario, it seems plausible to many investors that emerging markets will fare better than developed markets.

A recession or depression in the US or the euro zone would slow growth in emerging markets. The Economist Intelligence Unit lowered its 2012 growth forecast for the BRICs and most other emerging markets in October 2011 to reflect a slowdown in the West. But as many emerging markets had been at risk of overheating, to some extent the slowdown is a normalisation after a stimulus-driven period in 2009-10.

The increasing role of domestic demand in many emerging markets does offer a level of insulation. The Economist Intelligence Unit forecasts 6.3% annual average growth in non-OECD countries in 2012-16, compared with just 1.9% for OECD economies. Many emerging-market exporters that once depended almost entirely on demand from developed countries have diversified their customer bases and now count on each other as important buyers. Brazil now sends 15% of its exports to China and 9% to Argentina, compared with 10% to the US, according to the US State Department.

Importantly for institutional investors, the debt problems that plague the US and the euro zone are far less severe in emerging markets. Developing-nation government debt is likely to average about 35% of GDP this year, compared with 102% in developed nations, according to the International Monetary Fund (IMF). Consumers are also less burdened, albeit less wealthy.

General government gross debt ratios
(% of GDP; 2009 PPP-GDP weighted averages)



Source: IMF staff estimates.



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Emerging is converging

“There is a growing realisation among investors that the disparity between emerging markets and developed-country markets has not only narrowed but has turned upside down.”

Jerome Booth, director of research, Ashmore Investment Management

While the notion that emerging markets have been “decoupling” from the shaky developed markets has been in vogue in recent years, it is potentially a misleading idea, according to some investors. Emerging markets have indeed shown resilience and growing independence from developed markets. But to say that they are decoupling tends to perpetuate the view that they are peripheral and overlooks globalisation, which is creating an increasing number of linkages and dependencies in the global economy.

“There is a growing realisation among investors that the disparity between emerging markets and developed-country markets has not only narrowed but has turned upside down,” confirms Jerome Booth, director of research at Ashmore Investment Management, a London-based firm that specialises in emerging-market investing for institutions. This is particularly the case with regard to risk, since developed markets have become distinctly more risky, while emerging nations have grown less so, he notes. Political dysfunction, once seen as largely a legacy of dictatorship and colonial rule, is now a clear threat in the US and the euro zone as those governments struggle with enormous debt problems, wobbling domestic economies and increasingly angry electorates.

As Mr Booth points out, in today’s market climate, risk and volatility are not the same. “The risk is now clearly greater in the developed markets and nobody who wants to reduce risk can credibly say they’re taking the necessary steps if they remain underweight in developing markets,” explains Mr Booth. “They are taking a massive gamble on the developed markets. Emerging nations have much more tractable problems to deal with, and they have the policy tools to do it.”

Indeed, after the Brazilian crisis and the Russian and Argentinian defaults, most emerging nations have abandoned the rigid currency policies that were leading causes of those disasters. This, along with far more competent and sophisticated central banks, has largely controlled hyperinflation and allowed for the development of relatively stable debt markets. For example, Mexico, which had bouts of triple-digit inflation in the 1980s, is now able to issue 30- and 100-year bonds. The share of investment-grade nations in JP Morgan’s Emerging Market Bond Index (EMBI) has gone from around 10% in the mid-1990s to almost 60% by September 30th 2011.

Pension funds, insurance companies and other institutions that sustain demand for these securities are multiplying rapidly in emerging nations, creating more sustainable domestic markets. And the presence of committed long-term investors, particularly large institutions, may help to blunt volatility over time,



the IMF also noted. More advanced developing markets, such as Turkey, have a range of investment options, including inflation-linked bonds and a wide variety of debt and equities that allow investors to participate fully in economic expansion and invest in a range of scenarios, notes Mr Booth of Ashmore.

Concerns remain about the possibility of a “hard landing” in China, the world’s second-largest economy after the US, but as of now, interviews with investors and their advisers conducted for this report suggest confidence in the Chinese government’s ability to control the country’s inflation while also supporting healthy, albeit somewhat slower, economic growth. With a new set of leaders scheduled to succeed the president and most other senior politicians in 2012, the government has a clear imperative to keep the economy stable.

Certainly not all investors who are bullish on emerging markets share Mr Booth’s view that they have in some ways become less risky than developed markets.

“There’s a maturity curve that the emerging markets still have to go through. They have substantially more risk, but that’s why you’re seeing much higher returns,” comments Mr Lataille of Verizon. He notes, however, that having emerging markets in the portfolio helps to lower its overall volatility because emerging investments do not always move in tandem with investments in developed markets.



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Points of entry

“The traditional way to get exposure to emerging markets was equity without any currency hedge. But now people are buying baskets of currencies or bonds.”

Todd Petzel, chief investment officer, Offit Capital Advisors

Debt and currencies are also increasingly attractive to institutional investors, particularly now that more bonds are at or near investment grade and currency investing is no longer seen as the exclusive province of highly leveraged speculators, says Todd Petzel, chief investment officer at Offit Capital Advisors, a New York-based firm that advises institutional and private clients. “The traditional way to get exposure to emerging markets was equity without any currency hedge,” says Mr Petzel, “but now people are buying baskets of currencies or bonds.”

Institutional investors are becoming more accepting of debt issued in emerging nations’ own currencies. This might have been unthinkable only a decade ago, given currency implosions and bouts of runaway inflation. But by September 30th 2011, the local-currency debt market as measured by the JP Morgan Government Bond Index-Emerging Markets Global (GBI-EM Global) was valued at US\$812bn, which dwarfs the US\$436bn dollar-denominated EMBI.

While recent setbacks in emerging-market currencies have alarmed some and led to concerns that liquidity could evaporate fast if large investors pulled out, over the longer term local currencies are seen as likely to appreciate. Investors can use currency forwards or inflation-linked bonds to help offset inflation risks.

Texas Christian University has about 1% of its portfolio in emerging-market bonds. Buying some solid sovereign debt in emerging markets is an attractive substitute for some of the more rickety sovereign bonds from developed markets, according to Mr Hille. Local-currency debt can be highly attractive as “you get the double positive of falling interest rates—and thus rising prices—along with rising currencies,” he notes.

According to Mr Martin of NEPC, commodities also have a place in hedging against inflation, but with inflation seeming mostly tame at the moment, they are not the most attractive way of playing the emerging-market opportunity.

Publicly traded stocks remain the dominant vehicle for institutional investors, but private equity is also appealing. Both CalPERS and Verizon invest in emerging-market private equity. Verizon has made substantial private investments in companies active in shipping, real estate and infrastructure, confirms Mr Lataille. “There’s a lot of opportunity to get in on the ground floor, where we can be a larger player and participate more directly in the upside,” he says.



In public equity, some funds are opting for active management in emerging markets, while cutting costs with index investing in developed markets that they see as more transparent and efficient. “The opportunity to make money with active management is greater with emerging markets,” says Mr Martin. Putting emerging-market investments on autopilot is less attractive in part because avoiding asset-price bubbles is a particular concern.

Frontier markets are not currently a priority for most institutional investors, adds Mr Martin, who sees similar opportunities with less risk in emerging-market small caps and consumer-oriented stocks. Mr Petzel points out that large institutions also tend to be constrained by benchmarks, which exclude most frontier markets. Nevertheless, the opportunity is considerable and some institutional investors, including Verizon, are making forays. Mr Lataille of Verizon notes that big emerging markets like China are making sizeable investments in frontier markets, as are many global corporations. In March 2011 GE appointed Jay Ireland, the former head of its asset management division, as president and CEO of GE Africa.

Of course, it is possible to participate in emerging-market growth without ever leaving home—by buying shares of developed-world multinationals like GE that are extremely active in emerging markets. Industrial, tobacco and consumer goods companies are all finding revenue and profit growth in fast-growing developing markets. Moreover, with developed-world equity markets in disarray, many of these stocks can be had at bargain prices. The disadvantage to this approach is that the growth opportunities come in a diluted form—and from companies that are more fully exposed to the economic risks in developed markets.

“The opportunity to make money with active management is greater with emerging markets.”

Allan Martin, partner, NEPC



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Conclusion

Institutional investors appear to be moving inexorably into emerging markets—and perhaps beyond into frontier markets—as developing nations become increasingly powerful and equal players in the global economy. Exposure to these markets remains relatively modest, particularly considering the sheer size of emerging nations’ populations and projected contributions to global economic growth. Investors remain seriously concerned about inflation, asset-price bubbles, narrower capital markets and their own lack of insight into emerging economies. But the perception that developed markets are inherently safer and emerging markets are inherently more risky seems to be eroding.

Globalisation is likely to remain as fundamental a trend in investing as it is in other aspects of global commerce and culture. Even if growth in emerging markets slows, it seems likely to exceed that of developed markets for some time to come. So far, institutional investors seem prepared to ride out the inevitable volatility and setbacks in exchange for participating in emerging-markets’ superior growth.

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