Viewpoint

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In Pursuit of the Emerging Markets Consumer

Ralph Goldsticker, CFA, Senior Investment Strategist
Robert A. Jaeger, PhD, Senior Investment Strategist
BNY Mellon Investment Strategy and Solutions Group ("ISSG")[1]

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The investor who pursues the emerging markets consumer within the universe of emerging markets equities requires a double dose of courage: the courage to make a big bet away from the familiar capitalization-weighted performance benchmarks, and the courage to invest in a sector that looks potentially expensive.

The emerging markets are no longer emerging: they have emerged. Indeed, many sophisticated institutional investors believe that the emerging markets offer better investment opportunities than the developed markets.[2] They see more growth, more financial strength, and, most importantly, greater exposure to "the rising emerging markets consumer."

We agree that the emerging markets consumer is an important force in the global economy, whose presence will also be felt in the performance of multinational consumer companies. But the investor who pursues the emerging markets consumer within the universe of emerging markets equities requires a double dose of courage: the courage to make a big bet away from the familiar capitalization-weighted performance benchmarks, and the courage to invest in a sector that looks potentially expensive.

It's useful to divide the universe of emerging markets equities into four main themes: Commodities, Manufacturing, Consumption, and Investment.[3] The first two themes capture the export-driven sectors of the economy, while the last two capture the inward-facing sectors of the economy. Generally speaking, the case for emerging markets equities has evolved over the years from a story of export-led growth to a story of inward consumption and investment.

These four themes are more closely linked to real-world investment rationales than the more familiar focus on countries, regions, and "super-countries," such as Brazil-Russia-India-China. For example, Brazil's and Russia's stock markets are both dominated by the Commodities theme, while the stock markets of India and China are both dominated by the Investment theme (Exhibit 1).

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2 See, for example, "The Search for Growth: Opportunities and Risks for Institutional Investors," Economist Intelligence Unit, 2011.

3 For more information on BNYM Mellon ISSG's research on thematic investing in emerging market equities, contact Jeff Saef at jeffrey.saef@bnymellon.com for a copy of "Next Generation EM Equities: Harnessing the Power of Thematic Drivers of Return."

Although we think of China as a manufacturing powerhouse, manufacturing accounts for only 11% of the market capitalization of the Chinese stock market (though a larger portion of Chinese GDP).[4]

Exhibit 1 – Thematic Exposures by Country

(The values for the three countries with the largest exposures in each category are highlighted)

	Thematic Exposure of Country				Country Weight in Thematic Portfolio				
	Commodities	Manufacturing	Consumption	Investment	MSCI EM Index	Commodities	Manufacturing	Consumption	Investment
China	25%	11%	7%	57%	*18%*	*16%*	*10%*	10%	*25%*
Korea	16%	*54%*	8%	22%	*15%*	9%	*42%*	10%	*8%*
Taiwan	16%	*58%*	2%	25%	11%	6%	*33%*	2%	7%
India	19%	9%	*33%*	39%	6%	4%	3%	*17%*	6%
Malaysia	17%	9%	13%	62%	4%	2%	2%	4%	5%
Indonesia	17%	*22%*	9%	52%	3%	2%	3%	2%	4%
Thailand	44%	0%	8%	48%	2%	3%	0%	1%	2%
Philippines	4%	22%	9%	66%	1%	0%	1%	1%	1%
Total: Asia	**20%**	**31%**	**9%**	**40%**	**60%**	**42%**	**94%**	**47%**	**59%**
Brazil	*45%*	3%	14%	38%	*15%*	*24%*	2%	*18%*	*14%*
Mexico	16%	3%	*40%*	41%	5%	3%	1%	*16%*	5%
Chile	21%	11%	18%	51%	2%	1%	1%	3%	2%
Colombia	28%	0%	8%	63%	1%	1%	0%	1%	2%
Peru	*66%*	0%	0%	34%	0%	2%	0%	0%	0%
Total: Lat Am	**36%**	**3%**	**19%**	**41%**	**23%**	**30%**	**4%**	**37%**	**23%**
South Africa	36%	5%	19%	40%	8%	10%	2%	13%	8%
Russia	*72%*	0%	2%	26%	6%	*16%*	0%	1%	5%
Poland	29%	0%	5%	66%	1%	1%	0%	1%	2%
Turkey	10%	11%	14%	65%	1%	0%	1%	1%	2%
Czech Republic	0%	0%	0%	*100%*	0%	0%	0%	0%	1%
Egypt	0%	0%	0%	*100%*	0%	0%	0%	0%	1%
Hungary	33%	0%	*22%*	46%	0%	0%	0%	1%	0%
Morocco	0%	0%	0%	*100%*	0%	0%	0%	0%	0%
Total: EMEA	**43%**	**3%**	**11%**	**42%**	**17%**	**28%**	**3%**	**17%**	**19%**
Total: EM	**28%**	**20%**	**12%**	**40%**	**100%**	**100%**	**100%**	**100%**	**100%**
Asian Tigers & Cubs	17%	44%	7%	32%	36%	22%	80%	19%	27%
Cap Wt BRICs	38%	7%	9%	46%	41%	57%	16%	31%	48%
Eq Wt BRICs	40%	6%	14%	40%					
S&P 500	18%	21%	37%	24%					

Source: MSCI, Datastream, ISSG, as of December 2011. Due to rounding, not all country weights sum to 100 and some rankings are based on levels of precision not shown in the rounded numbers. The Asian Tigers & Cubs include Indonesia South Korea, Malaysia, Philippines, Taiwan and Thailand.

4 ISSG research, based on data from the Chinese stock market as of December 31, 2011.

The standard capitalization-weighted market benchmarks are dominated by the Investment theme and are very light on Consumption. For example, the weights in the MSCI EM Index are as follows: Investment, 40%; Commodities, 28%; Manufacturing, 20%; Consumption, 12%.[5] The investor in pursuit of the emerging markets consumer should not be interested in a passive, index-based strategy or even an index-oriented active strategy.

Consumption is not the dominant theme in any of the emerging markets countries. This contrasts sharply with the U.S., where Consumption is the dominant theme, accounting for 37% of equity market capitalization.

Investment is not only the dominant theme in the index, it is also the dominant theme in 16 of the 21 countries included in the MSCI EM Index, including China and India. In 11 of those 16 countries Investment represents more than 50% of stock market capitalization (which is not the same as 50% of GDP).[6]

Commodities are the dominant theme in Russia, Brazil, and Peru, while Manufacturing is the dominant theme in Korea and Taiwan. That leaves Mexico and India, where Consumption is not the dominant theme but runs a close second to Investment. In other words, Consumption is not the dominant theme in any of the emerging markets countries. This contrasts sharply with the U.S., where Consumption is the dominant theme, accounting for 37% of equity market capitalization (and a much larger portion of the economy).[7]

The investor who wants to pursue the emerging markets consumer could build a Consumption-oriented passive portfolio, i.e., a capitalization-weighted index of consumer-oriented stocks from the MSCI EM Index. That portfolio would have 84% of its assets spread across six countries (in descending order of exposure): Brazil, India, Mexico, South Africa, China, and Korea, as Exihibit 1 shows.

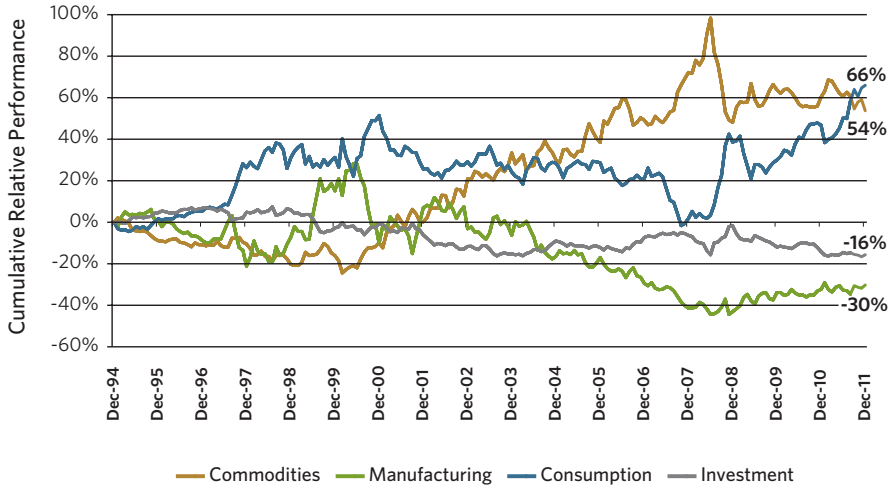
Our analysis shows the Consumption portfolio has performed very well relative to the other three themes (Exhibit 2). But it also looks potentially expensive. If you look at P/E multiples since late 2003, the Commodities theme has tended to trade at a slight discount to the broad emerging markets universe, while Manufacturing and Investment have tended to trade in line with the broad universe. Consumption, on the other hand, has traded at a 50% premium on average, and that premium has risen sharply since the middle of 2009, despite a recent sell-off (Exhibit 3). The Consumption theme is not cheap.

5 MSCI EM Index as of December 31, 2011.

6 *Ibid.*

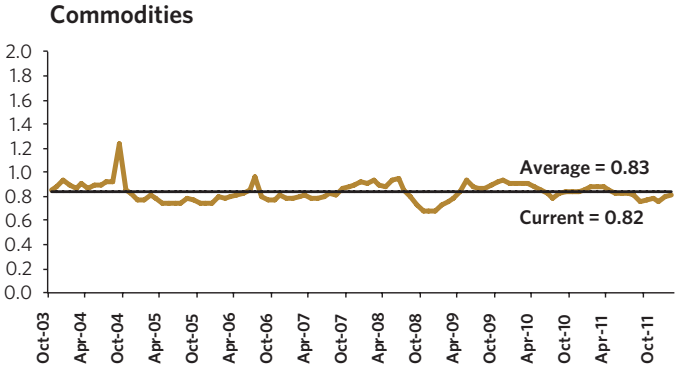
7 As shown in Exhibit 1.

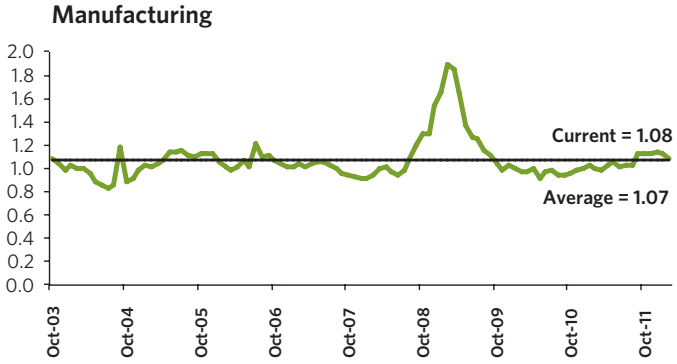
Exhibit 2 – Cumulative Relative Return of the Thematic Portfolios relative to the MSCI EM Index

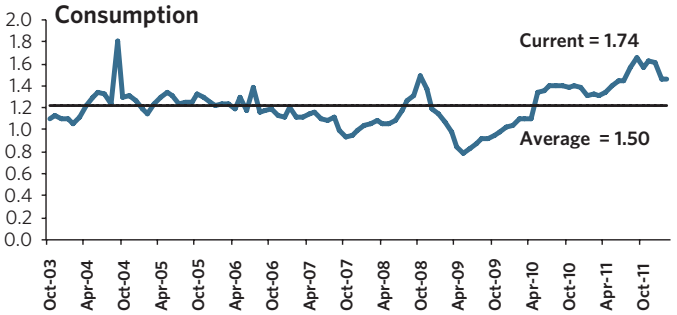


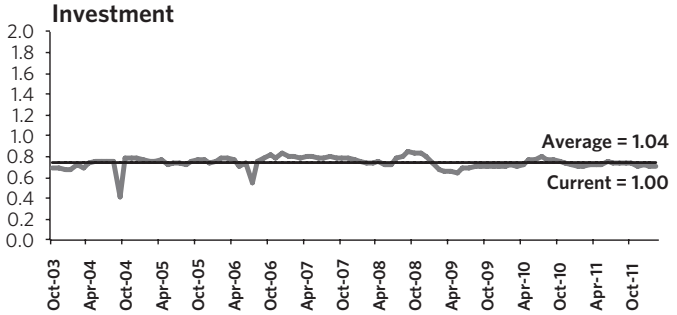
Source: Datastream, MSCI, ISSG. Data are from December 31, 1994 to December 31, 2011.

Exhibit 3 – Relative Forward 12-Month Price-to-Earnings Ratios for Thematic Portfolios









Source: Datastream, MSCI. Data are from October 30, 2003 to February 29, 2012. P/E valuations are relative to MSCI EM Index.

Today's index has little to do with the reasons for investing for tomorrow.

We agree with the conventional wisdom that emerging markets consumers will play an increasingly important role both in the global economy and in their local economies. But that view may well be reflected in current prices, so investors must decide whether their own bullishness is greater than what's already in the price. And if investors conclude that the Consumption theme is attractive even at today's prices, then they need to make some very big bets relative to the index. Today's index has little to do with their reasons for investing for tomorrow.

Index Definition

The **MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey. The index includes 825 large and mid-cap securities. The index is a trademark of MSCI and is used herein solely for comparative purposes. MSCI does not sponsor, endorse, sell or promote the investment strategies or products mentioned in this paper, and makes no representation regarding the advisability of investing in the products or strategies described herein.

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