NS PARTNERS

EMERGING MARKETS

MONEY MOVES MARKETS

The market capitalization of emerging markets was US$3,368 billion at June 30, 2012, representing 12.5% of the world equity capitalization. Yet many pension plans and their investors have no direct exposure to emerging markets, and while they may allow their international and global equity managers to invest in emerging markets, the combined equity allocation falls well short of the 12.5% that emerging markets represents of the world stock market. Why are investors still wary of investing in the highest growth area of the world stock market?

This note provides background on global emerging markets and seeks to highlight the opportunities still to be captured and why some common fears refer to the past, not the present.

The highlights include:

Greater Growth	International Monetary Fund (IMF) forecasts imply that emerging economies will be responsible for 70% of global growth over the five years to 2017.
Political and Economic Risk	There is greater diversification by country within emerging markets. Lower levels of debt and higher foreign exchange reserves than the developed world suggest risks have reduced in aggregate.
Rising Returns	As emerging markets shift from manufacturing to more value added industries, returns will rise for investors.

BACKGROUND

Emerging markets can be characterised as countries with growing economies and middle classes. Many still have high rates of poverty and often there is significant social and political change taking place, hopefully for the better. Focus has shifted down the list to include what are termed "frontier markets" which are at an earlier stage of development but are beginning to offer opportunities to investors. The poorest nations of the world can be defined as pre-emerging and provide few opportunities for investors at their current stage of development.

The MSCI Emerging Markets Index is made up of 819 stocks in 21 countries from the largest, China at 17%, to the smallest, Morocco at 0.1%. The countries are normally grouped into three regions, Emerging Markets Asia, Emerging Markets Latin America and Emerging Markets Europe, Middle East and Africa. The asset class is often seen as commodity related but the weightings in energy and materials are not too different from the US and international equity developed market indices.

Financials represent a quarter of the asset class, but loan-to-deposit ratios are generally lower in emerging markets allowing room for asset growth. Developed world banks remain constrained by their need to shrink or re-price their assets.

GIC SECTOR	MSCI EMERGING MARKETS	S&P 500	MSCI EAFE
Energy	12.6%	10.8%	8.4%
Materials	12.5%	3.4%	9.6%
Industrials	6.8%	10.5%	12.5%
Consumer Discretionary	7.8%	11.0%	10.6%
Consumer Staples	8.5%	11.3%	11.9%
Health Care	1.1%	12.0%	10.1%
Financials	24.8%	14.4%	22.6%
Information Technology	13.8%	19.7%	4.5%
Telecommunication Services	8.2%	3.2%	5.6%
Utilities	3.9%	3.7%	4.2%

Source: Thomson Reuters Datastream

Many emerging market stocks are already household names: Samsung, China Mobile, Hyundai Motor and TATA. The largest single weighting in the MSCI Emerging Markets Index is Samsung at 3.4%.

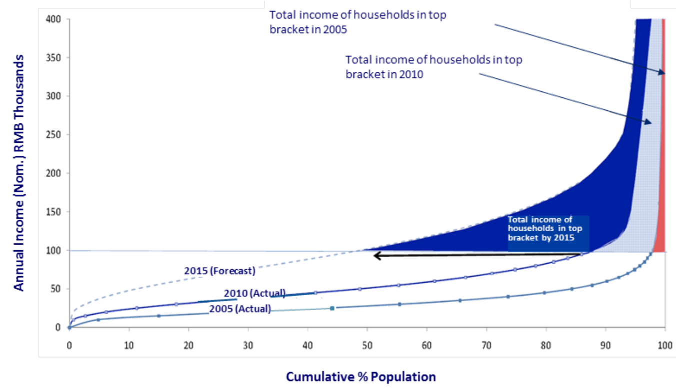
Pension fund provision is a relatively recent development in many emerging markets so companies and governments don't have to deal with the challenges of underfunded pension liabilities on or off their balance sheets that developed market companies have to deal with. However the evolution of domestic savings industries is providing a major catalyst for improving standards of corporate governance.

EMERGING MARKET BENEFITS

While emerging markets represents a "different" opportunity set, does "different" imply a good opportunity? Consider these potential benefits:

Growth Opportunity	Emerging and developing countries account for 38% of world gross domestic product (GDP) measured at market exchange rates and 50% based on purchasing power parity. Emerging markets are forecast by the IMF to grow at an average annual rate of 6.2% in the five years to 2017 versus expansion of 2.5% in developed economies. This highlights why they will be responsible for 70% of global growth over this period. Extrapolating current trends, the combined industrial production of the seven largest emerging economies will surpass that of the "Group of Seven" major economies in 2014. Emerging and frontier equity markets account for 12% of world capitalisation, but this understates the importance of emerging economies for global investment trends because of the significant and rising proportion of developed market earnings directly and indirectly linked to their growth.
Re-rating Opportunity	Normally high growth assets are priced at a premium. Traditionally emerging market stocks have traded at a discount to developed world valuations, but this is changing as political and economic risks decline. Social repression is increasingly unsustainable and economic growth the best route to stability. Investors remember the Asian crisis or the latest bust in Argentina, but the economic fundamentals for emerging markets as a whole have improved thanks to better politics and macro management. The fiscal situations, current accounts and foreign exchange reserves are generally better than developed world economies and they don't have the hidden liabilities of pension fund provision.
Improving Returns	Emerging firms are no longer content to simply do the grunt work of western companies but instead want to develop their own identity. Non-brand margins can often be around 3% to 8%, branded firms around 15% and they have loyal followers. Many emerging market companies are expected to shift away from manufacturing to higher value added areas using brands and technology. Individual company analysis can eliminate from a portfolio companies that don't generate sufficient return on their invested capital, which typically leads to companies with strong brands being favoured. Return on Invested Capital (ROIC) should rise for many emerging market companies as they develop world class brands, which is another reason for optimism for the asset class.
Consumer "Take Off"	Income per capita is at a tipping point in many emerging markets where consumption is likely to grow rapidly for burgeoning middle classes as many luxury items become a reality rather than an aspiration. *See chart opposite which highlights expected increase in income in India.*

Number of households with over RMB100,000 income to increase significantly by 2015



Source: Deutsche Bank

NOT WITHOUT RISKS

Emerging market equities are not without their risks. While active managers can mitigate some of these risks through research and careful selection of individual stocks, investors should consider the following:

Political and Social Risk	The changes taking place in emerging markets can occur in ways that create uncertainty. The Arab Spring may bring about desirable change but the uncertainty creates volatility and the danger of contagion to other emerging markets.
Information and Liquidity Problem	The quality of data and accounts has vastly improved but getting good information can still be occasionally challenging in emerging markets. Liquidity can also be a problem in some and currency controls remain in a small number.

CASE FOR EMERGING MARKETS

While risk management is at the forefront of most investors' minds, generating sufficient return from the growth component of a portfolio is still an important task. Many investors are underweight emerging markets relative to its representation in world markets, yet emerging markets are forecast to be responsible for the majority of global growth over the next five years. Emerging markets provide investors the potential to benefit from a broader opportunity set and a higher return potential.

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