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Highlights From
The Case for Diversified
Emerging Markets Exposure

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Highlights From The Case for Diversified Emerging Markets Exposure

The following text provides highlights from Cambridge Associates' research report on diversifying emerging markets exposure. The full report is available only to clients of Cambridge Associates.

Many investors believe, as we do, that emerging markets offer a more compelling long-term growth story than do developed markets, and that portfolios should be tilted toward such regions to participate in this growth. However, before committing more funds to the area, investors should first re-evaluate how they allocate their exposure. While most allocations currently consist of long-only strategies that use the MSCI Emerging Markets Index as a benchmark (or invest in the index itself), such strategies tend to be overly concentrated in certain regions and countries; further, they often provide exposure to large multinationals (e.g., Gazprom, Petrobras, and Samsung) as opposed to smaller firms more directly exposed to emerging markets economies. In simple terms, most investors in emerging markets are essentially invested in large multinationals based in the BRICs (Brazil, Russia, India, and China), while many of the most compelling opportunities are to be found elsewhere, whether in smaller markets and/or companies, or different asset classes such as debt or even currency.

Thus, while current allocations are fine as far as they go—in essence, they provide a decent amount of emerging markets beta and generally require relatively little oversight—investors considering larger allocations (e.g., significantly more than 5% of the total portfolio) should look to implement an emerging markets strategy with broad exposure across several asset classes. Such allocations, while still incorporating emerging markets beta, should also include managers seeking to add alpha (e.g., hedge funds and private investments) as well as different asset classes, such as the local currency debt markets. A comprehensive program would

include traditional public equity investments, hedge funds, private investments, debt, cash, and currency exposure.

In short, such a program should more closely resemble the portfolio's developed markets investments, with the goal of generating equity-like returns at lower volatility over the long term, and more meaningfully exploiting inherent inefficiencies in the emerging markets universe.

While the basic premise is similar to that of diversification in developed markets, emerging markets diversification is also intended to expose investors to other sources of return more correlated with the underlying economies. In other words, investors with a long-only large-cap emerging markets portfolio could conceivably be right on the emerging markets growth thesis, yet fail to capture much of this growth due to holding mainly large multinationals that simply happen to be *based* in emerging markets.

Further, certain parts of emerging markets remain less accessible than their counterparts in developed markets, so investors need to think more creatively about their approach. For example, while institutional investors have long used private equity structures to access illiquid investments in developed markets, choices are far more limited in emerging markets; track records are also short and political risk looms large. As a result, a growing number of emerging markets funds specialize in small, locally focused companies whose fortunes are tied more to organic emerging markets growth than developed market exports. While not an exact match for private equity, such funds provide

investors with far different exposures than those reflected in the MSCI Emerging Markets Index, and should be less sensitive to global economic trends. That said, investors should certainly not write off private equity—while most such emerging markets managers are not institutional quality, a growing number have proven themselves capable of producing significant alpha; indeed, assuming emerging markets continue to broaden and deepen, we would expect this trend to continue. We believe investors can use emerging markets hedge funds in a similar manner to developed markets programs—to provide equity-like returns with less volatility. This will get easier as the hedge fund roster continues to expand.

Most investors view US\$-denominated emerging markets sovereign debt as a high-risk/high-return asset class, but its profile has changed fairly dramatically in recent years. While US\$ emerging markets sovereigns¹ have trounced other asset classes since 1993 (Exhibit 1), this was mainly due to outperformance from 1993 to 2002; returns since 2002 for emerging markets debt have been far more subdued, even as emerging markets equities have soared (Exhibit 2). Even still, emerging markets debt has proved a solid diversifier over this period—Exhibit 3 shows rolling one-, three- and five-year returns for a number of different asset blends, and it is clear that the inclusion of emerging markets debt in an emerging markets portfolio over the past decade or so would have generally tamped down volatility without sacrificing much return. Much of this, of course, is due to the better fiscal and economic conditions of emerging markets over this period, and we would expect emerging markets debt to continue to play a similar “volatility-reducing” role unless and until such conditions no longer prevail. (And obviously we will not see a repeat

¹ Technically the index includes non-local currency denominated emerging markets debt, though in practice most of the debt issues included in the index are denominated in U.S. dollars.

of 1990s returns given current yields.) Emerging markets corporate debt, meanwhile, remains a fractured and difficult-to-access market, particularly in the local currency space. Thus, investors with an interest in the sector should either hire a dedicated emerging markets debt manager or a multi-asset class emerging markets manager.

Different investors will prefer different strategies and implementation options based on risk tolerances, capacity to implement illiquid investments, ability to access the top managers, and available resources for managing a complex portfolio. The traditional portfolio shown in Exhibit 4 is a fairly typical structure designed to capture diversified beta through long-only managers—it is focused solely on public equity exposure, and although it allocates 20% of its total to both a regional and small-cap manager, the objective is clearly to capture emerging markets beta. On the other hand, the “broad approach” portfolio, which assumes an allocation twice the size of the original, is designed to tamp down volatility while still achieving equity-like returns. In short, it is quite similar to most institutional allocations to developed markets.

Thus, the broad approach portfolio has an identical equity exposure to the first portfolio in absolute terms, buttressed with investments in debt, hedge funds, and emerging markets cash. Importantly, this should *not* be considered a specific recommendation, but rather one example of a broad emerging markets mandate.

As mentioned, this is merely one way to approach this issue. Much as investors have different allocations to long-only managers and hedge funds in developed markets, there is no “right” answer for how to approach an expanded allocation to emerging markets. But for investors looking to expand their allocation to emerging markets, this structure would at the very least provide a solid jumping-off point.

Risks to Our Approach

There are, of course, risks to the approach promulgated here. While the main risk to *not* going this route (i.e., continuing to use standard emerging markets equity managers) is that you are not getting “true” emerging markets exposure, investors that implement a more complicated manager structure expose themselves to a number of potential problems. Hedge funds and private equity managers are by definition less liquid than long-only funds, in large part because they hold less-liquid securities. This raises two (related) issues—first, investors in such strategies could get stuck holding “frozen” securities (or have managers “gate” or otherwise restrict investments), and second, lack of liquidity could restrict investors’ ability to be nimble and react to changing market conditions. To be clear, we are *not* saying that investors should (or need to) be less nimble² with diversified emerging markets portfolios than with developed markets portfolios, but simply pointing out that liquidity may be more fleeting in emerging markets. Indeed, since many of the markets alluded to in this paper are, by definition, smaller and less liquid than those that make up the MSCI Emerging Markets Index, the risk of getting trapped in less liquid investments is heightened. This highlights the need to hold a significant allocation to standard emerging markets managers or index funds as noted above.

On a related note, a diversified emerging markets strategy by definition involves greater complexity and higher fees, as well as more active manager risk. As many of these managers have relatively short histories, the risk that they will not outperform their high fees is an important consideration.

² In other words, tilt the portfolio to where relative values are most attractive within emerging markets, or reduce/increase emerging markets equity beta when valuations are rich/cheap.

Another potential pitfall is the relationship (or lack thereof) between economic growth and equity returns. Indeed, investors often overlook the difference between *economies* and *markets*. Said a different way, the key determinant of returns is not the future rate of economic growth, but the *price paid for that growth* (assuming it flows through to corporate profitability in a predictable manner). As counterintuitive as it may seem, studies have actually shown equity market returns have a *negative* correlation with GDP growth, likely due in part to investors anticipating such growth and bidding up assets in advance. Further, equity dilution tends to sap returns for investors—particularly foreign investors—over time, and the inherent difference between equity market composition and underlying economic growth means *any* investment strategy will have some “tracking error” relative to growth rates.

While such analysis also applies to developed markets, most investors in emerging markets (and particularly those considering outsized allocations) are specifically looking to capitalize on the long-term economic growth story. Thus, it is important to emphasize, as noted earlier, that investors could be right about future emerging markets economic growth, yet fail to fully participate in this growth through an expanded emerging markets allocation. Indeed, while such issues are of course magnified for portfolios that only include public equities, they apply across asset classes. In other words, an investor that diversifies exposures as suggested here *could nevertheless fail to capitalize as expected on emerging markets growth*. While we believe a diversified program makes sense, partly because it should mitigate such issues, the reality is that capitalizing on economic growth is a difficult and unpredictable process, and there is no guarantee that an expanded emerging markets program will deliver returns commensurate with underlying economic growth.

A related risk is that, despite the positive fundamental changes discussed earlier, emerging markets

are likely to continue to boom and bust *even if* the long-term growth story remains intact. In other words, the transition from export-oriented economies to strong local markets is unlikely to be smooth. While diversification should help to some degree, a significant downturn could easily swamp such efforts and test the resolve of even the most committed emerging markets investor. Along similar lines, an expanded emerging markets allocation can also expose an investor to a good deal more currency risk. While many investors today view such exposure as a positive—e.g., as a way to hedge a sharp decline in the U.S. dollar, euro, or yen—it was not so long ago (for example, Mexico in the early 1990s and Asia in the late 1990s) that foreign investors took substantial hits from sudden currency devaluations in such markets. Further, currency hedging for many emerging markets remains prohibitively expensive (if it is even available) due to lack of forward contracts.

Another risk, of course, is that emerging markets equity prices rise sharply, and traditional, high-beta BRIC strategies outperform portfolios “held back” by hedge funds and emerging markets cash products. Further, smaller-cap stocks and smaller markets could underperform the BRIC-dominated strategies. However, more diversified portfolios should outperform *over the long term*—in other words, exposure to a wider opportunity set is worth the risk of short-term underperformance.

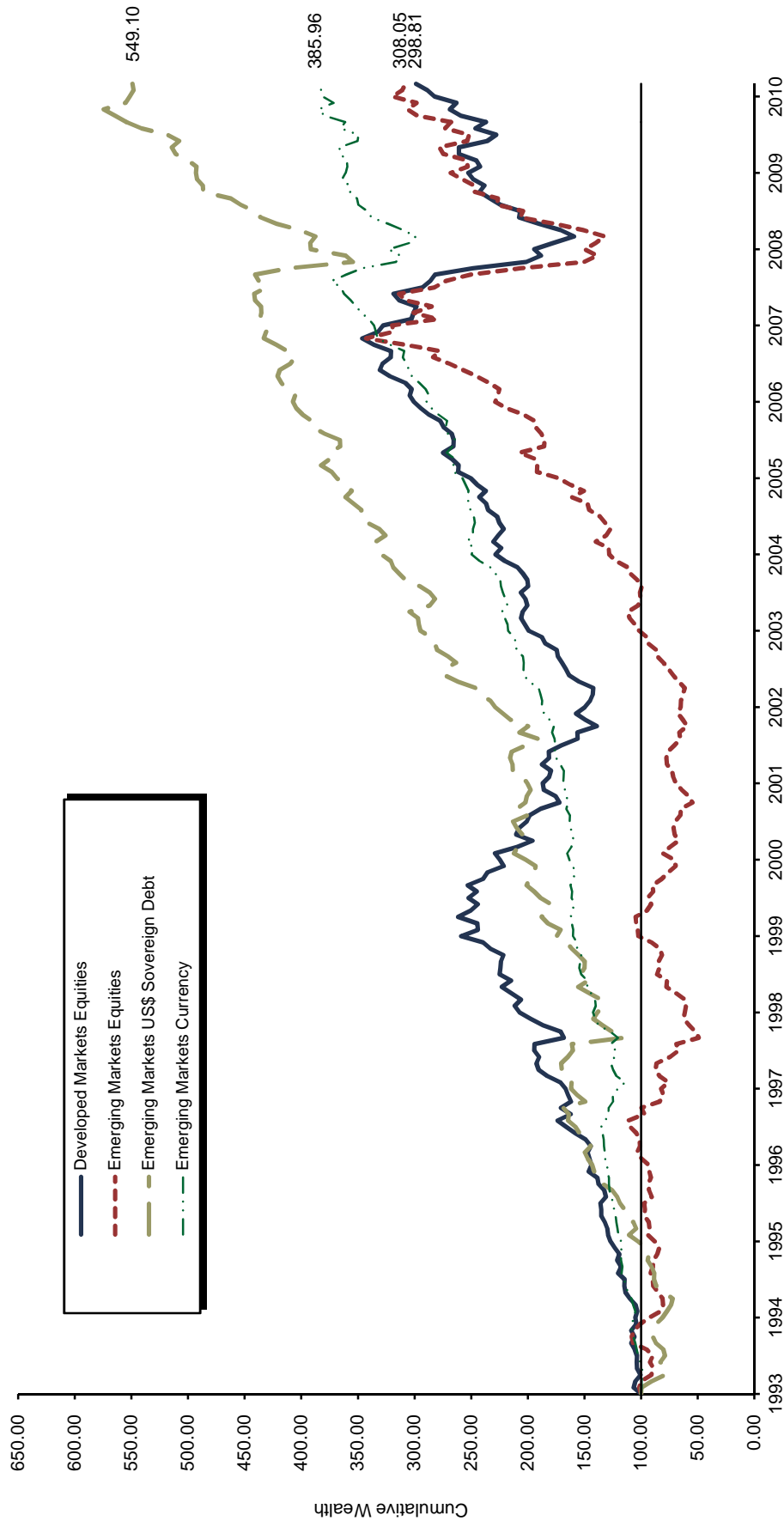
Finally, while manager options have multiplied, they remain far less numerous than those available to investors in developed markets, and a dramatic increase in the number of investors pursuing such strategies could easily overwhelm this relatively small universe.

Conclusion

The broadening and deepening of emerging markets’ equity and debt markets, coupled with their much-improved—and superior to developed markets—fiscal positions, has changed the equation for investors. Whereas emerging markets formerly occupied a niche as a high-beta play on economic growth, both globally and within emerging markets, they have made strides to the point where they deserve a diversified investment program similar to developed markets. The concurrent improvement in manager options, meanwhile, has made implementation of such a program far less onerous, though as noted, monitoring for investors and managers will be more involved than with long-only programs. ■

Exhibit 1
Performance of Emerging Markets Debt Relative to Other Asset Classes

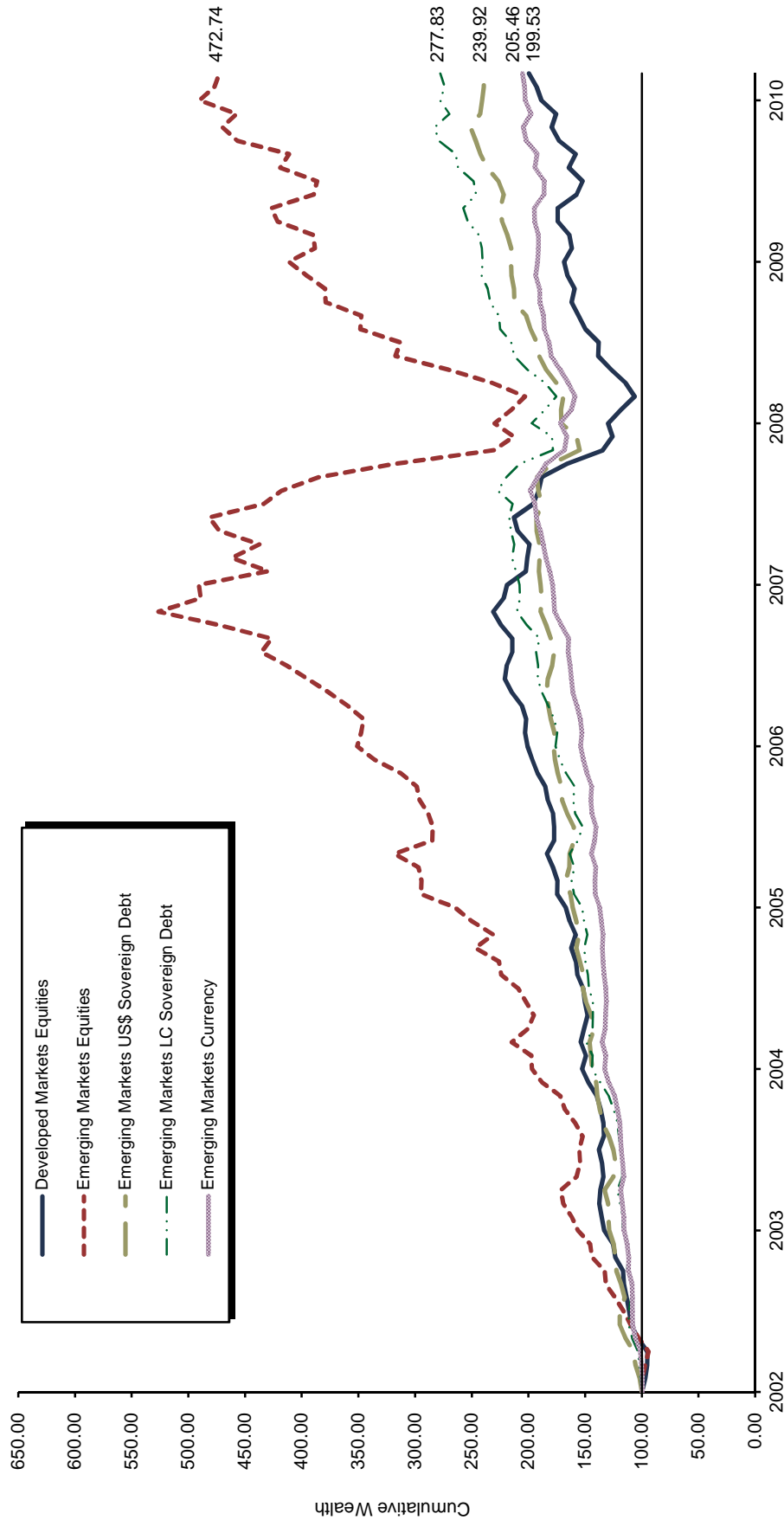
December 31, 1993 – February 28, 2011 • U.S. Dollar



Sources: J.P. Morgan Securities, Inc., MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
 Notes: Performance for developed markets equities is that for the MSCI World Index; emerging markets equities, MSCI Emerging Markets Index; emerging markets US\$ sovereign debt, J.P. Morgan Emerging Markets Bond Index (EMBI) Plus; and emerging markets currency, J.P. Morgan Emerging Local Markets Index Plus. The J.P. Morgan EMBI Plus is an index of non-local currency denominated emerging markets debt. Total returns for MSCI emerging markets indices are gross of dividend taxes. Total returns for MSCI developed markets indices are net of dividend taxes.

Exhibit 2 Performance of Emerging Markets Debt Relative to Other Asset Classes

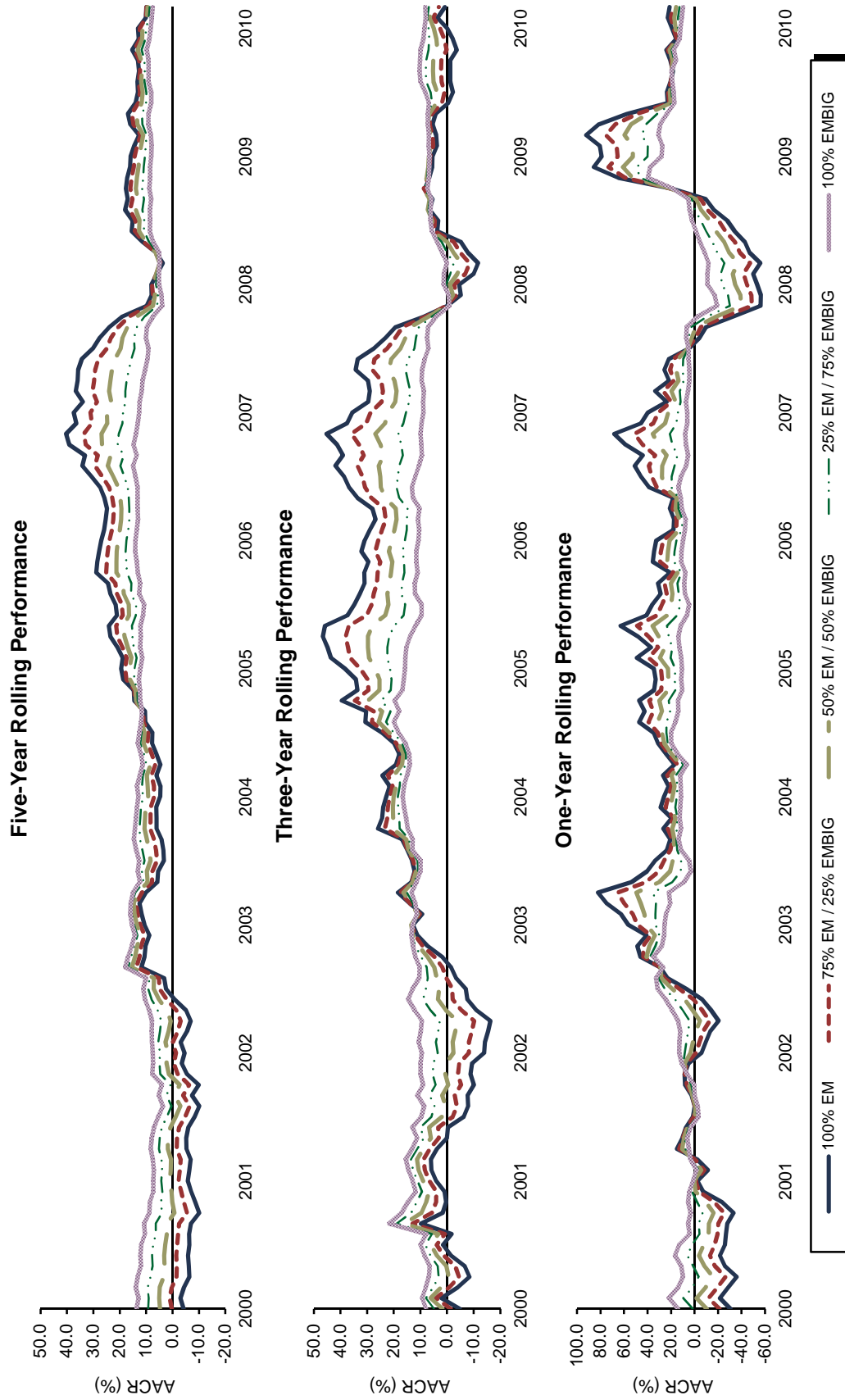
December 31, 2002 – February 28, 2011 • U.S. Dollar



Sources: J.P. Morgan Securities, Inc., MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
 Notes: Performance for developed markets equities is that for the MSCI World Index; emerging markets equities, MSCI Emerging Markets Index; emerging markets US\$ sovereign debt, J.P. Morgan Emerging Markets Bond Index (EMBI) Plus; emerging markets LC sovereign debt, J.P. Morgan Government Bond Index Emerging Markets Global Diversified; and emerging markets currency, J.P. Morgan Emerging Local Markets Index Plus. The J.P. Morgan EMBI Plus is an index of non-local currency denominated emerging markets debt. Total returns for MSCI emerging markets indices are gross of dividend taxes. Total returns for MSCI developed markets indices are net of dividend taxes.

Exhibit 3
Performance of Emerging Markets Equities, Debt and Various Blends

December 31, 2000 – February 28, 2011 • U.S. Dollar



Sources: J.P. Morgan Securities, Inc., MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
 Notes: The first data point on the five-year graph represents monthly data from January 31, 1996, through December 31, 2000. The first data point on the three-year graph represents monthly data from January 31, 1998, through December 31, 2000. The first data point on the one-year graph represents monthly data from January 31, 2000, through December 31, 2000. Emerging markets equities are represented by the MSCI Emerging Markets Index. Emerging markets debt is represented by the J.P. Morgan Emerging Markets Bond Index Global, which is an index of non-local currency denominated emerging markets debt.

Exhibit 4
Emerging Markets Hypothetical Portfolios

Traditional Approach	
	<u>% of EM Exposure</u>
Core/Beta	60.00%
Satellites	40.00%
<i>Regional Specific</i>	20.00%
<i>Small Cap</i>	20.00%
Dedicated EM Broad Hedge	---
Emerging Markets Debt	---
Emerging Markets Cash	---
Total Emerging Markets Exposure	100.00%

Broad Approach	
<i>(assumes 2 times allocation of traditional approach)</i>	
	<u>% of EM Exposure</u>
Core/Beta	30.00%
Satellites	20.00%
<i>Regional Specific</i>	10.00%
<i>Small Cap</i>	10.00%
Dedicated EM Broad Hedge	30.00%
Emerging Markets Debt	10.00%
Emerging Markets Cash	10.00%
Total Emerging Markets Exposure	100.00%