Emerging Markets

Industry Overview
What are Emerging Markets?

Emerging Markets:

- **Economy:**
  - Experiencing rapid growth and industrialization
  - Possess securities markets that are progressing toward, but have not yet reached, the standards of developed nations
  - Often dependent on natural resources

- **Government:**
  - EMs have more robust governmental infrastructure, economy and bureaucracy than “frontier markets.”, but less mature than developed countries
  - Classic definition: transitioning from dictatorship to democracy
Emerging vs Frontier Markets
Developing Nations
Newly Industrialized Nations
Performance of Emerging Markets (MSCI)

- Since 1950, emerging market equities return 12.5% /year compared to 10%/year for developed markets
- 13.3% in past 15 years
- 12.1% in past 10 years
  - Only small and mid cap US equities come close to matching EM returns (Over 10%)
- Down 3.3% last year
BRIC[S/M/T/E]

- Brazil, Russia, India, China, [South Africa/Mexico/Turkey/Eastern Europe]
- Group of Emerging Markets that traditionally draw most attention from investors
- Mainly fall into ‘newly industrialized’ category, less risky than developing nations
How Do You Get Exposure to Emerging Markets?

- Equities
- Debt
- ETFs
- Currency
- Commodities
- Derivatives
Investment Thesis
Correlation Between GDP Growth and Equity Market Returns

- Traditional thesis for EM investments: accelerated GDP growth compared to developed markets should accelerate growth of equity markets
- Intuition: Makes sense, GDP growth should imply growth of capital markets
- Doesn’t always hold: GDP/capita especially is misleading, slowest growing nations often have best returns
Diversification of Portfolio

- 60% of world’s population and 45% of GDP are from Emerging Markets
- Fund is barely allocated at all into Emerging Markets (Emerging Markets ETF tracks S&P with correlation .87 since 2003)
- Diversification distributes risk, moves us closer to efficient portfolio
Potential for Arbitrage

- Emerging markets draw much less attention than developed ones, much higher likelihood of mispricing
- Growth stocks often overpriced compared to distressed assets
Increasing Globalization

- Global markets are increasingly linked, making domestic companies increasingly exposed to EMs
- Domestic companies increasingly focused on targeting Emerging Markets
Investment Risks

FX Risk
- Russian Ruble devalued in 1998
- Argentine Peso devalued by 15% in Jan 2014

Political Instability
- Sanctions in Russia affects businesses and FDI
- Warfare in Middle East

Credit Risk
- EM governments more willing to default on debt
- Russia defaulted in 1998, Argentina in July 2014
Investment Risks

Governance and Regulatory Risks
- Corruption more rampant in EMs (e.g. Indonesia, China)
- Insider trading laws in 80% of EMs vs. 100% in developed markets; lower level of enforcement in EMs (2005)

Reliability and Usefulness of Historical Data
- Long-term data not available as EM stock markets are younger
- Historical data loses relevance quickly as EMs are markets in transition
- Financial reporting not standardized as many EMs have not adopted International Financial Accounting Standards
Investment Risks

**Price Volatility**

- Inherently greater fluctuations in stock prices in emerging markets
- Comparison of standard deviations of daily returns since 2010:

<table>
<thead>
<tr>
<th>Country</th>
<th>US (Dow)</th>
<th>Russia (RTS)</th>
<th>China (SCI)</th>
<th>South Africa (NQZA)</th>
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<tbody>
<tr>
<td>Std. Dev.</td>
<td>0.890%</td>
<td>1.672%</td>
<td>1.081%</td>
<td>1.430%</td>
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When Should You Invest in EMs?

- Don’t have adequate exposure to global markets
- Want to move up risk/return curve
- Believe you have potential for arbitrage
Example Markets
Mexico

Population: 120 million
GDP: $1.260 trillion

Drivers of Growth +
Investment Areas:
Manufacturing, Transportation,
Raw materials
Russia

Population: 140 million
GDP: $2.1 trillion

Drivers of Growth +
Investment areas:

Oil, Gas...
China

Population: 1.39 billion
GDP: $9.240 trillion

Drivers of Growth +
Investment Areas:
Manufacturing, Railway Equipment, Raw Materials, Retail and Electronics
South Africa

Population: 53 million
GDP: $350 billion

Drivers of Growth + Investment Areas:
- Raw Material, Precious Metals, Footwear and Other Manufactured Products
The Middle East

Kurdish guerilla forces preventing development in SE

Civil war and ISIS

Oil crisis and export fallout

Suez Canal expansion

Less aid from Saudi and UAE

Rejection of oil price talks; deny attempts to force Iran & Russia into deficit

Economic collapse possible due to political gridlock

Kurdish gov.'t approved creation of oil company

China says it will double energy investment in Iran

Iran opens gold plant to combat nuclear sanctions

House prices in Dubai increase 30% in past year

Massive investment boom due to 2022 World Cup

Faltering leader Sultan Qaboos bin Said

Iran opens gold plant to combat nuclear sanctions

Massive investment boom due to 2022 World Cup
Emerging Markets Oil Dependency

- Emerging markets GDP highly dependent on oil
- Increasing demand for oil in emerging markets as countries industrialize
- Highly sensitive to political turmoil
  - Russia’s Gazprom deal with China
- Decreasing oil costs increases Western purchasing power which could increase exports from emerging markets, boosting their economies