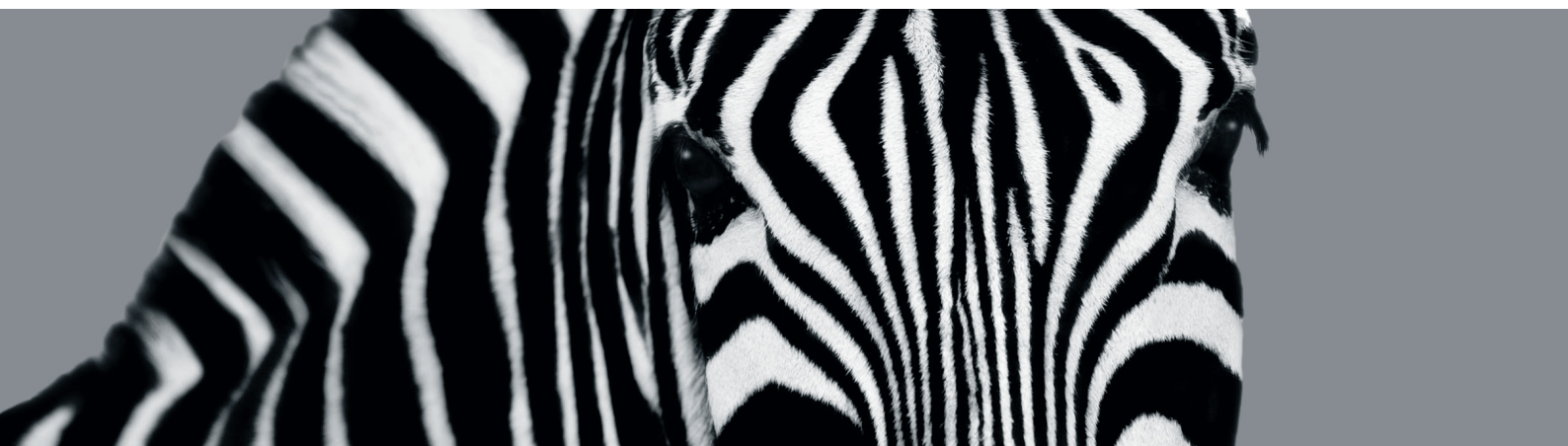


Emerging markets review: A change of gear in emerging markets investing

January 2014



Out of the Ordinary[®]

 **Investec**

Asset Management

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About Investec Asset Management

Investec Asset Management is a specialist investment manager, providing a premier range of products to institutional and individual investors. Employees are equity stakeholders in the firm. Established in 1991, the firm has been built from start-up into an international business managing over US\$110bn* on behalf of third party clients. We have grown from domestic roots in Southern Africa and the UK to a position where we proudly serve a growing international client base from the Americas, Europe, Asia, Australia, the Middle East and Africa. We employ over 150 investment professionals. The firm seeks to create a profitable partnership between clients, shareholders and employees, and to exceed clients' performance and service expectations. Investec Asset Management is a significant component and independently managed entity within the Investec Group, which is listed in London and Johannesburg.

*as at 31.12.13

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The views expressed in this document are those of the authors and may not reflect the views of all the investment professionals at Investec Asset Management.

Executive summary

Investec Asset Management has been active in emerging markets ever since our inception in 1991. In the Autumn of 2013 the firm conducted a comprehensive review of the investment landscape and put forward a revised framework for emerging market allocations for institutional investors.

This report is a distillation of the main conclusions arising from this review.

Reasons for investors to allocate to emerging markets

1. Emerging economies are undergoing a process of new capital creation on an unprecedented scale, providing investors with a large, diverse and expanding range of opportunities.
2. The quality and accessibility, not just the quantity, of economic growth will be an important driver of future asset returns. This will be a key focus of our research going forward.
3. Improvements in the quality of local institutional structures and the development of domestic savings pools to finance the necessary level of domestic investment are crucial to the sustainable development of emerging economies.
4. We expect the long-term trend of real exchange rate appreciation to continue, albeit with sharp and potentially long setbacks and increasing dispersion between countries.
5. Emerging market opportunities are systematically under-represented in core global equity and bond programmes and are likely to continue to be so.

Structuring a sensible approach to an allocation

1. There is little consensus on the definition of an emerging market. An understanding of income levels, corporate governance, political institutions and market access can help to form a useful conceptual framework for analysis and portfolio construction.
2. Conventional equity indices constitute a poor representation of the emerging market opportunity, so passive investment vehicles are likely to be an inadequate means of capturing it. The capped, diversified indices in emerging market debt are better, but harder and more expensive to replicate.
3. Investors should continue to treat emerging and developed market equities and bonds as separate and distinct asset classes.

Why adopt an active approach

1. We believe that there are clear advantages in taking broad asset class exposure across emerging markets.
2. Over the last decade, simple beta strategies have represented an adequate way of participating in the emerging market opportunity. However, this can largely be explained by factors that are unlikely to be repeated.
3. Greater market inefficiencies, dispersion and diversity across emerging markets, compared with developed markets, can create superior opportunities for alpha generation.

Deciding on the level of allocation

1. We believe that accessing emerging market exposure through companies listed in developed markets that generate a high or rising proportion of their revenues from emerging economies is a useful complement to, but not a substitute for, direct emerging market exposure.
2. We believe a total emerging market allocation for an unconstrained return-seeking portfolio of at least 15-20% is justifiable, including exposure to both equity and debt. This is in addition to any indirect exposure from developed market equities.
3. Short and medium term risks must be factored into emerging market allocations, including volatility, currency and macroeconomic factors.
4. Periods of cyclical weakness, as at present, provide investors with attractive entry points for strategic allocations which can enhance returns over the longer term. Emerging markets will continue to be more cyclical than developed markets.

An exceptional era of wealth creation

The dismantling of the Iron Curtain and the collapse of communism in Eastern Europe was not just a major political event but an economic one too. Centralised command-and-control economics, which had stifled enterprise, incentives and economic growth, gave way to market economics, as governments sought to mimic rather than confront the accepted wisdom in the West. In China, communism survived, but its leadership had already realised that the surest route to stability and international influence lay in adopting a modified form of capitalism. In the rest of Asia, in Latin America and in Africa, political and economic change was not far behind.

The result has been not just a long period of sustained economic growth, which has raised living standards, reduced poverty and accelerated social and political advances for most of the emerging world, but also an exceptional era of wealth creation comparable to the second half of the 19th century for the US, and to the post-war period for Europe and Japan. Economic growth, which averaged 2.5% in emerging economies in the 1970s and 1980s compared to 3.3% for developed economies, has risen to an average of 5.9% since 2000 compared with 1.9% for developed economies. Emerging economies accounted for just 16.8% of the global economy in 1990, but now account for over 50%.

As Figure 1 shows, investors have benefited. The compound total return for the MSCI Emerging Markets Index from the start of 1990 to the end of 2013 has been an annualised 9.3%, comfortably ahead of the 6.9% annualised compound return of the MSCI World index of developed markets. Similarly, from 1994 (when the data series started) to the end of 2013, the JPMorgan Emerging Markets Bond Index returned an annualised 9.8%, well ahead of the Citigroup World Government Bond Index, which returned 5.5%¹. The outperformance has been far from steady, with both indices displaying considerable volatility and sustained periods of underperformance.

Emerging economies have undergone an exceptional period of wealth creation

Investors, too, have benefited

Figure 1: Emerging market outperformance: 15 years, 1999-2013 US\$ Total Returns



Source: Bloomberg, December 2013

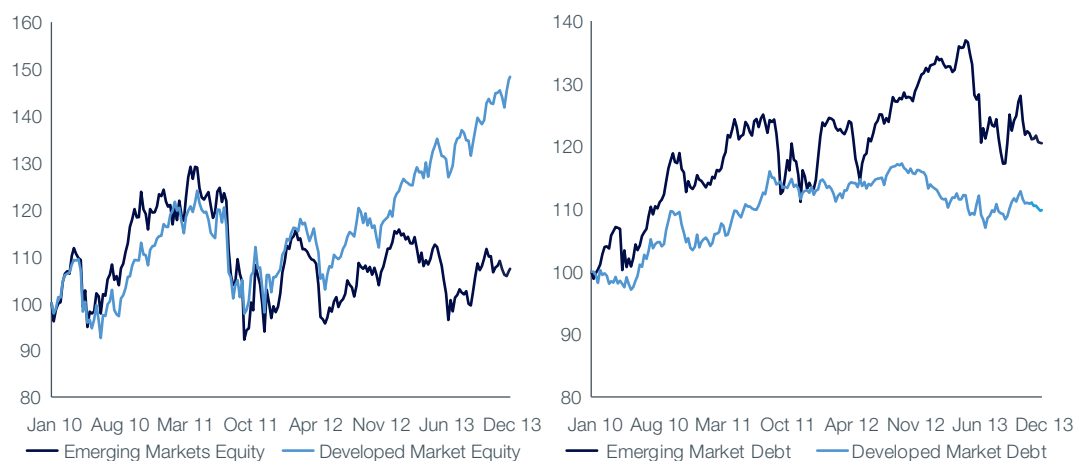
The transition of emerging economies from stagnation to growth has not been easy. Plenty of mistakes have been made along the way; often the result of poor advice from developed market experts. These mistakes culminated in a major crisis for economies, currencies, equities and debt in the late 1990s, recovery from which was hampered by turbulence in developed economies and markets in the early years of the new millennium. In total return terms, the emerging market equity index doubled relative to the developed markets index between 1990 and 1995, but then fell by two-thirds by early 1999. The subsequent nearly 12 year period included two of the worst four bear markets since 1900 for global equities. In this time emerging markets quadrupled relative to developed markets.

Progress has not been easy with plenty of mistakes made along the way

¹All market data (returns, market capitalisation, asset class sizes) sourced from Bloomberg and Factset unless otherwise noted. All data as at 31 December 2013 unless otherwise stated.

As the left hand chart in Figure 2 shows, between the end of December 2010 and the end of December 2013, emerging market equities underperformed again, this time by 33%. The sharp rise in both developed market bond yields and emerging market spreads combined with significant currency weakness have made many investors fear that emerging markets are repeating the crisis of 1997/8.

Figure 2: Emerging market performance: 2010-2013



Source: MSCI, JPMorgan. EM Debt: JPMorgan GBI-EM Global Diversified, DM Debt: JPMorgan GBI Global, December 2013, in US\$

We are firmly of the opinion that this view is far too alarmist. We believe emerging economies and markets are merely undergoing a periodic setback, which re-establishes sound long-term value. This will be helpful in encouraging emerging economies to accelerate the process of market, economic, political and social reform that has been so successful for 30 years, but which has faltered or slowed in many countries in recent years. We believe that emerging economies are still at the early stages of a multi-generational 'catch-up' with the developed world. This process is being driven by a variety of factors – most notably the diffusion of technology, broad improvements in political governance and stability and greater reliance on market mechanisms.

Emerging economies and markets are merely undergoing a periodic setback

Emerging economies have made significant progress

- The World Bank projects that by 2030, developing countries will increase their percentage of global capital stock from 33% today to 50%, a total of \$150 trillion from \$50 trillion today².
- In 1980, Chinese GDP per capita was 6.7% that of the United States (\$2,800 vs. \$37,000). Today, it is 20% that of the United States (\$9,280 vs. \$50,000). Between 2000 and 2013, China increased its share of global GDP from 4% (\$1.2 trillion) to 12% (\$9 trillion).
- The stock market capitalisation of the Indian equity market increased over 400% from 2002-2013 while that of the Chinese market increased over 800%. The market capitalisation of both markets is still less than 20% that of the United States.
- While emerging markets only account for 11% of the MSCI All Countries index, they account for 32% of the total issued equity, 75% of the world's population, 55% of world GDP at purchasing power parity and 42% in dollar terms.
- Emerging market debt accounts for less than 5% of the Barclays Global Aggregate Bond Index, but emerging markets' share of global government debt is expected to exceed 20% (\$14.5 trillion) by 2022. Including corporate debt would significantly increase this estimate.
- Successful entrepreneurs, such as Aliko Dangote, Dhirubhai Ambani, Carlos Slim and Johann Rupert, have created extraordinary wealth for their shareholders in countries as diverse as Nigeria, India, Mexico and South Africa. These examples will only multiply in both size and scale as others follow their example.
- The global poverty rate (defined at \$1.25 per person per day) halved from 1990 to 2010 from 43% to 21%³.
- Infant mortality has more than halved in the developing world since 1990. Life expectancy in Turkey, Chile and South Korea improved by 20 years or more over the period of 1960-2009. Average life expectancy gains in a broad sample of emerging economies has improved on average by 15.5 years since 1960, v. 8.8 years in developed economies⁴.
- Enrollment in primary education in developing regions reached 90% in 2010, up from 82% in 1999. The number of out-of-school children dropped from 102 million to 57 million from 2000 to 2011. From 1999-2009, there has been an increase of over 135% in higher education enrollment rates in emerging economies⁵.
- Mobile phone penetration rate has reached approximately 50% in emerging markets, with over 1.5 billion people having easy access to mobile telephony. This is the most rapid adoption of a new technology in modern history⁶.
- By 2020, analysts estimate the global middle class to include approximately two billion people with overall consumption at \$20 trillion, twice the current US aggregate consumption⁷.
- Median GDP per capita (PPP basis) has increased 7 times since the 1980s in the emerging world and only 4 times in the developed world. This broad-based growth has been supported by improvements in health, education and living standards around the world (see Figure 3).

²World Bank Research. *Capital for the Future: Saving and Investment in an Interdependent World*. 2013

³World Bank Human Development Index.

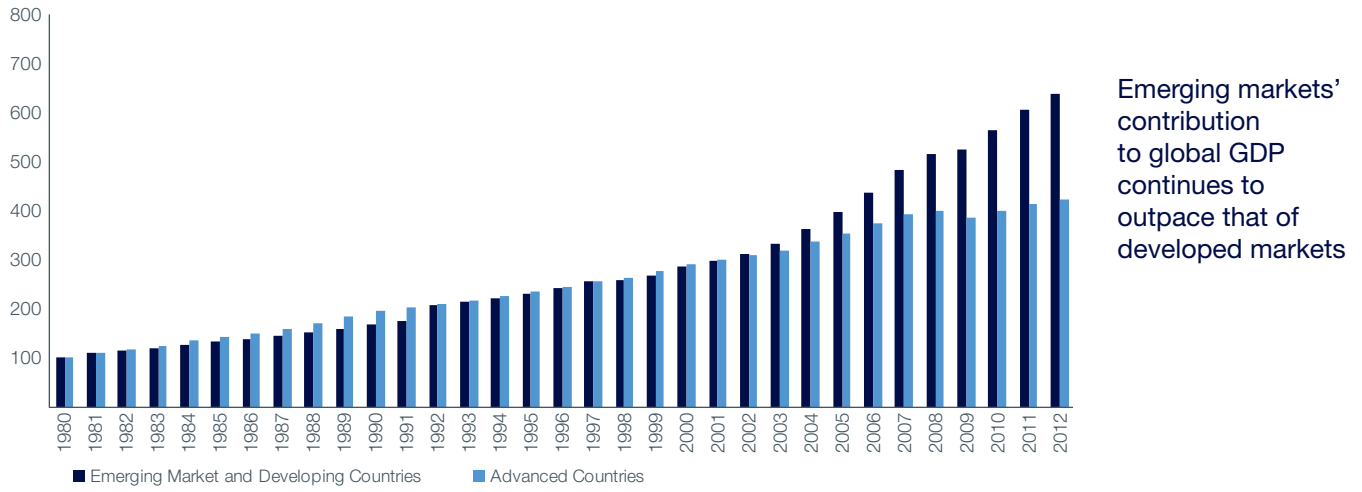
⁴OECD.

⁵UN Human Development Indicator.

⁶McKinsey & Co. *Capturing the promise of mobile banking in emerging markets*. February 2010.

⁷McKinsey & Co. *Capturing the world's emerging middle class*. June 2010.

Figure 3: GDP based on purchasing power parity (PPP) per capita GDP



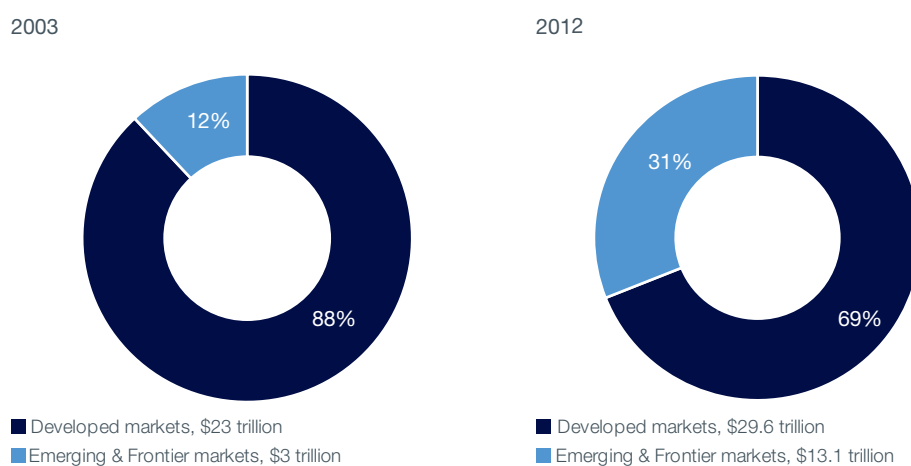
Source: IMF, April 2013

Reasons to allocate to emerging markets as an institutional investor

1. Emerging economies are undergoing a process of new capital creation on an unprecedented scale providing investors with a large, diverse and expanding range of opportunities (Figures 4 and 5).

a. The number of investable emerging market stocks is 7000, the market capitalisation of which is increasing at approximately 10% a year. Global investors have been slow to adopt emerging market exposure, despite its inclusion in the broader global equity benchmark. We should not underestimate the domestic or developed market bias of global equity managers.

Figure 4: Global equity market cap



The emerging market investable universe remains wholly underestimated and under-represented in global portfolios

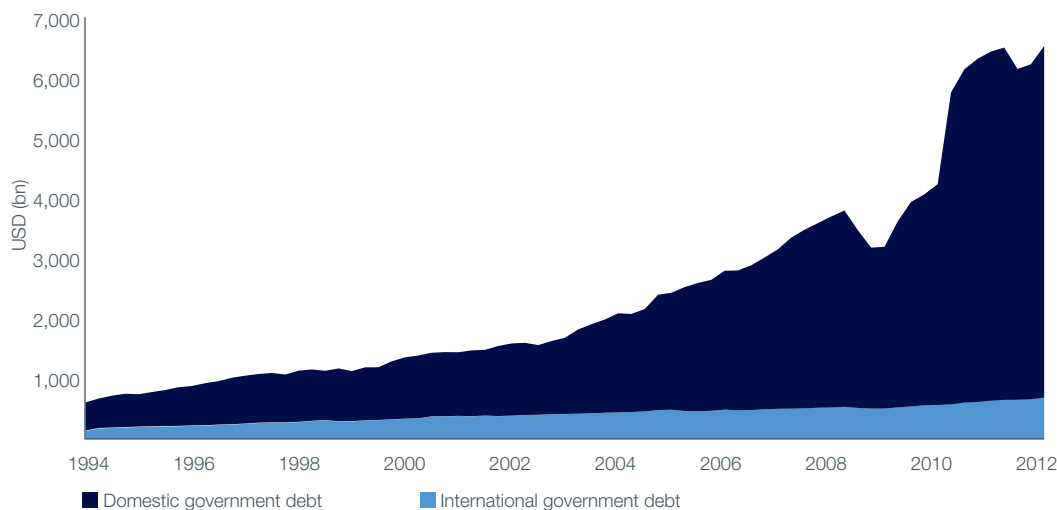
Source: BIS, Investec Asset Management calculations

b. Emerging markets bonds constitute 17% of global sovereign debt stock, which we expect to increase to over 20% in the next decade. There are now over 60 countries issuing debt, a significant increase from 31 countries ten years ago. New forms of issuance will broaden this opportunity set even further⁸.

c. As income per capita reaches threshold levels in individual emerging economies, consumer demand in categories regarded as basic in developed markets, such as dairy products, cars, household durables and insurance can take off, creating exceptional opportunities in sectors that are more mature in developed economies.

⁸Investec Asset Management *Emerging Market Debt: the next 10 years*, Paper VII, May 2012; IMF, JPMorgan

Figure 5: EMD outstanding issuance

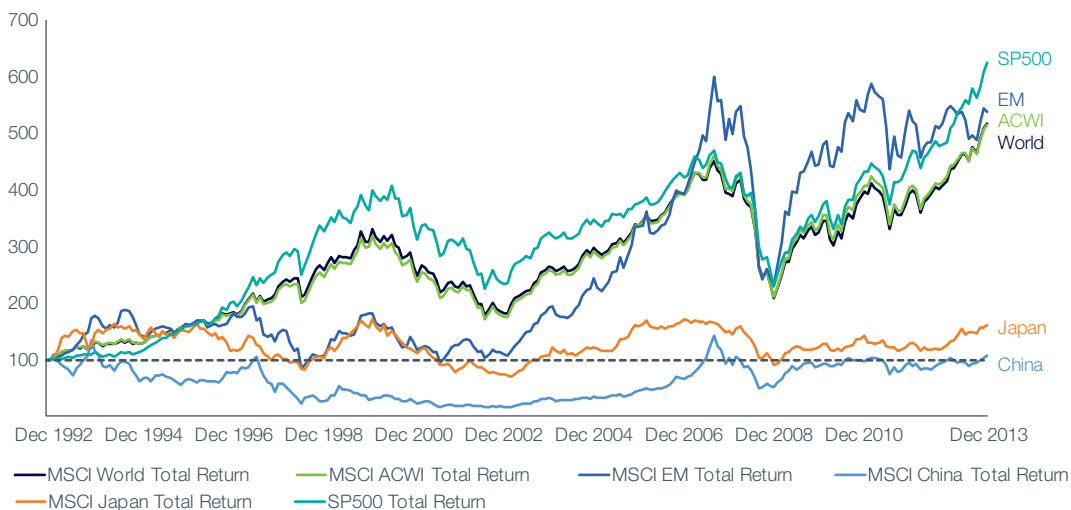


Source: BIS, Investec Asset Management calculations. March 2012

2. The quality and accessibility, not just the quantity, of economic growth will be an important driver of future asset returns.

a. Quantity: economic growth is not a sufficient driver of equity performance, particularly not by country, region or in the short to medium term. Figure 6 shows an investment of \$100 in China A shares in 1992 would only be worth \$107 today in nominal terms, and a loss in real terms, despite 20 years of 10% per annum economic growth.

Figure 6: An investment of \$100 in China A shares in 1992 is now worth \$107



There is little correlation between economic growth and equity performance

Source: Bloomberg. Returns in USD, December 2013

There are clearly many other factors involved. However, in the long term, GDP growth should increase corporate revenues and hence growth in profits and cash flows. It should also be noted that some of the best businesses in emerging markets remain private or are locked up inside large global companies.

– There is no statistical relationship between GDP growth and population growth ($r^2 = 4\%$), while the benefit from young populations is doubtful. For example, the populations of China, South Korea and Russia are all aging⁹.

– There is scant evidence that urbanisation, by itself, has been a significant driver of growth and returns. An increase in urban populations is a consequence of development which, in turn, creates further growth opportunities. The example of urban slums exhausting poor infrastructure in cities such as Dhaka show that urbanisation can cause severe problems if it significantly outstrips development.

b. Accessibility: different stages of economic development provide different opportunities for minority shareholders. Investment-led growth – for example the building out of a nation’s physical infrastructure – provides significant economic gains that are not necessarily easily accessible to foreign investors.

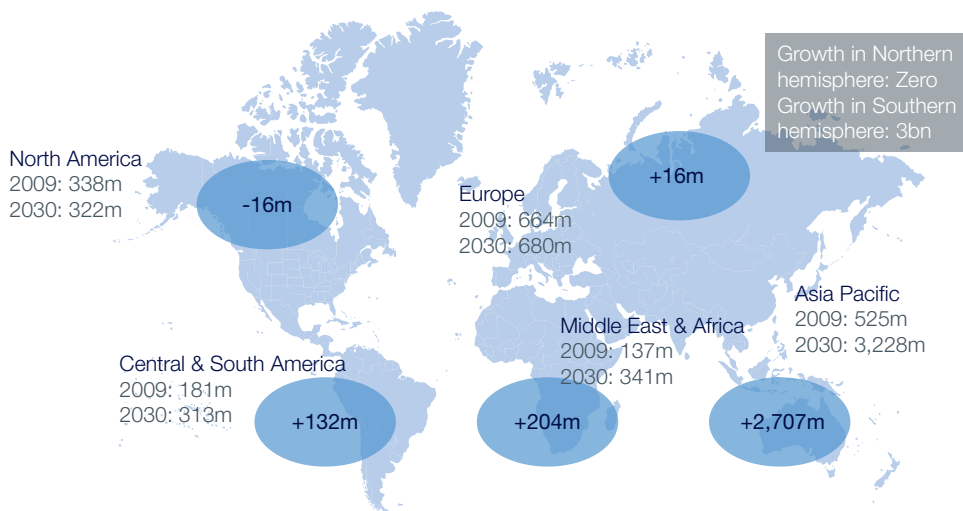
c. Quality: we believe quality of growth has three inter-related drivers: 1) broad-based participation: development expands and empowers a middle class, which encourages growth, reform and drives consumption (see Figure 7 below); 2) improvement in governance: a slow-down in economic growth may lead to positive improvements in public policy and corporate governance; and 3) development of local capital markets: effective institutions that channel domestic savings are needed to dampen volatility throughout emerging markets (Figures 8 and 9). This will be a key area for further research by Investec Asset Management.

d. Emerging market companies have often over-invested in growth and returned insufficient free cash-flow to shareholders, as illustrated by the Chinese example (see 2a and Figure 6). This is at least a partial explanation of the poor performance of emerging market equities in recent years, when investors have focused on cash returns.

e. This is likely to change as emerging market companies pay more attention to cash returns while developed market companies raise investment levels.

The quality rather than speed of growth is likely to be a key determinant of future returns

Figure 7: Projected growth of global middle class



89% of projected growth in the global middle class should come from the Asia Pacific Region

Source: Commonwealth of Australia, Prime Minister’s Office, 2009 - 2030

3. Improvements in the quality of local institutional structures and the development of domestic savings pools to finance a high and sustainable level of domestic investment are crucial to the sustainable development of emerging economies.

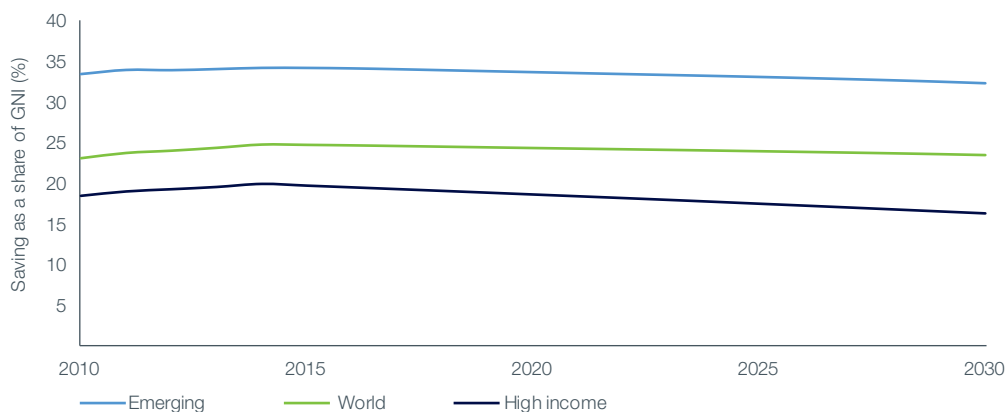
a. Higher volatility in both debt and equity is a consequence of insufficient domestic ownership of securities, though this varies across countries and is generally growing. This makes emerging markets dependent on developed market capital flows that are volatile and influenced by developed economies’ monetary policies.

Sustained local investment financed by domestic saving creates a virtuous circle

⁹Milestone Asset Management. ‘Is Japan Back?’ Presentation to Federal Reserve Bank of San Francisco. May 2013

- b. The introduction of funded national pension funds in developing countries, the first of which was introduced in Chile but which have spread to much of Latin America and other emerging economies, is a significant positive but the absence of domestic long-term capital is a contributor to low valuations and market volatility in countries, such as Russia, which have been more reluctant.
- c. The development of sustainable capital markets was a defining element of the emergence of Asia from the 1998 financial crisis.
- d. The development of broad-based pools of long-term domestic savings has been shown to create virtuous circles of improving credit quality, lower real interest rates and reduced volatility. Bonds that are regarded as higher risk growth assets by international investors may be lower risk defensive assets for domestic investors.

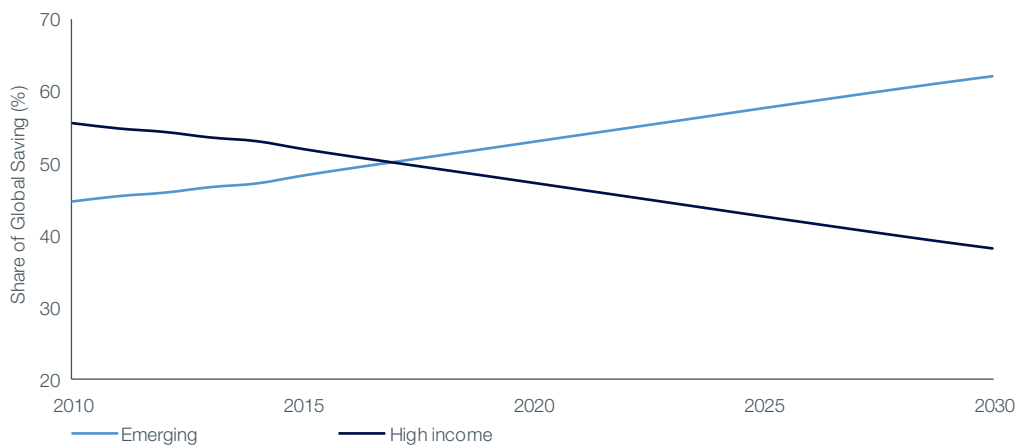
Figure 8: Global savings rates



Saving rates in the emerging world are set to exceed those of the developed for decades to come.

Source: World Bank Group. Capital for the Future: Saving and Investment in an Interdependent World, 2013

Figure 9: Growth in the emerging world's share of global savings



Towards the end of this decade savings in emerging economies should exceed those of the high income world

Source: World Bank Group. Capital for the Future: Saving and Investment in an Interdependent World, 2013

4. We expect the long-term trend of real exchange rate appreciation to continue, albeit with sharp and potentially long setbacks and increasing dispersion between countries.

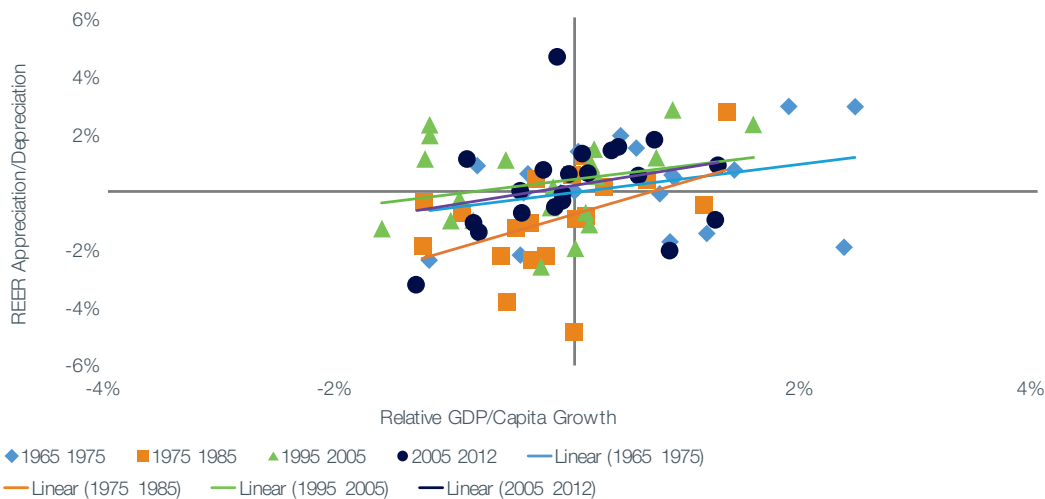
a. The theory of purchasing power parity, which compares the purchasing power of different currencies based only on traded goods, is an unreliable guide to currency trends.

b. The Balassa-Samuelson theory (see Figure 10), which states that countries with higher productivity should enjoy higher real exchange rates, is more useful. As productivity increases, the knock-on effects, particularly with regard to wages, are felt by both the tradable and non-tradable sectors. For example, between 1965 and 1995, per capita GDP in Japan grew by 190%, almost double the gain made by high income countries. The consequence was a real appreciation of its currency of some 130%¹⁰.

c. While this provides a generalised tail-wind for emerging market currencies in the long term, there are considerable differences between countries and cyclical interruptions of the trend. The pace of productivity gains for any country varies over time and the long-term trend can be interrupted by a broad range of internal and external short-term factors. Central banks are usually active in capping currency appreciation. This creates a considerable opportunity for adding value through active management.

Generally, theory suggests emerging market currencies should appreciate in the long-term

Figure 10: The Balassa-Samuelson effect over various 10 year intervals



Source: The BIS, World Bank, IAM Calculations. Countries included in the analysis: Austria, Australia, Belgium, Canada, Switzerland, Germany, Denmark, Spain, Finland, France, Greece, Italy, Japan, Mexico, Netherlands, Norway, New Zealand, Portugal, Sweden, UK, US, December 2012

¹⁰Bank for International Settlements, World Bank, IAM Calculations

5. Emerging market opportunities are systematically under-represented in core global equity and bond programmes. Allocations are likely to continue to lag as weightings rise.

- a. In the 2000-2010 period global investors suffered significant opportunity costs from an enduring structural bias towards developed market equities and bonds.
- b. The domestic or developed market bias of global equity managers should not be underestimated (Figure 11); such managers often argue that the exposure gained through developed market companies is sufficient.
- c. For over-stretched investment managers, investing in emerging markets can be too complicated, too time consuming and too resource intensive.

Figure 11: Style analysis of core global managers to four poles of regional exposure



Investors have suffered significant opportunity cost from their managers' structural developed market biases

Source: Zephyr, Investec. Style analysis of managers (small black dots) to four poles of regional exposure, October 2013

In summary, with the ongoing domestic/developed bias of many global managers and their low weightings to emerging markets, we believe specialist dedicated exposure to both emerging debt and equity continues to be an appropriate approach for institutional investors.

Structuring a sensible approach to an allocation

1. There is very little consensus on the definition of an emerging market. A broad framework that identifies the key characteristics distinguishing developed and emerging markets is useful from both an asset allocation and portfolio construction perspective.

a. Economic development is the emergence of an economy from one of low or stagnant growth, primarily based on subsistence agriculture, to high growth based on industry and services. In theory, the transition is finite; when wealth and income per capita converges with levels in developed economies, as in Singapore and South Korea, the country can be regarded as developed.

b. Sustained emergence would normally require the evolution of political institutions, the expansion of trade, the opening of markets, the encouragement of private enterprise, access to capital and the improvement of legal, political and corporate governance.

c. Emergence is a volatile process for each country with regular setbacks and some countries, such as Argentina, appearing to go backwards for long periods of time. Emerging economies are rarely able to finance the level of investment they require internally and so are dependent on capital inflows, which are volatile. A shortage of capital can slow development, but an excess of it can be equally problematic, distorting economies, resulting in over-valued currencies and increasing volatility.

d. Investors find it convenient to differentiate between emerging and frontier markets on the basis of market liquidity, capital flows and corporate governance as well as on income per capita. We do not expect this to change.

Our analysis shows there is little consensus on what defines an ‘emerging market.’ The framework below helps clarify key issues.

	Developed markets	Emerging markets	Frontier markets
Market access	Fully open and liquid	Partially open and fairly liquid	Quite closed and illiquid
Wealth	High levels of per capita wealth (i.e. GDP P.C. >\$15,000)	Moderately wealthy and growing (i.e. GDP P.C. between \$5,000-\$15,000)	Quite poor (GDP P.C. < \$5,000)
Governance and institutions	Strong political and corporate governance structures	Average to poor governance	Poor governance

Source: Investec Asset Management

This framework helps reduce a historic reliance some investors have placed on emerging market indices to define investable universes, set research boundaries and construct portfolios.

2. Conventional equity indices are and are likely to be a poor representation of the emerging market opportunity over the next 10 years, and so passive investment vehicles are likely to be an inadequate means of capturing it. The capped, diversified indices in emerging market debt are better, but harder and more expensive to replicate.

a. There is significant variation in country and sector weights within emerging markets. For example, in 1987 Malaysia was over 30% of the MSCI Emerging Markets Index but today it is less than 5% (Figure 12). China’s weighting in the index is expected to have quadrupled between 2002 to 2015, due primarily to new issuance.

b. 25% of the MSCI Emerging Markets Index is accounted for by state controlled or directed companies¹¹.

c. Just seven countries account for 80% of the MSCI Emerging Markets Index.

d. The MSCI Index excludes companies based in developed markets with significant emerging market exposure.

¹¹Investec Asset Management analysis

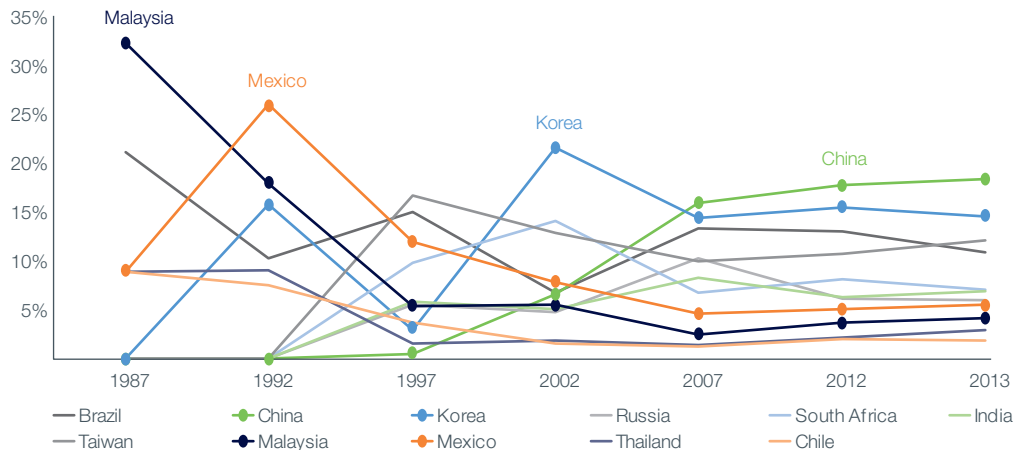
We expect investor differentiation between emerging and developed markets to remain

A framework is needed to help distinguish developed from emerging and frontier markets

Index composition reflects past performance, not the future opportunity

e. The overwhelming majority of emerging market bond and equity funds closely track their benchmarks with low to medium active ratios. Liquidity constraints are only a partial excuse for hugging the benchmark.

Figure 12: Key markets within MSCI Emerging Markets Index



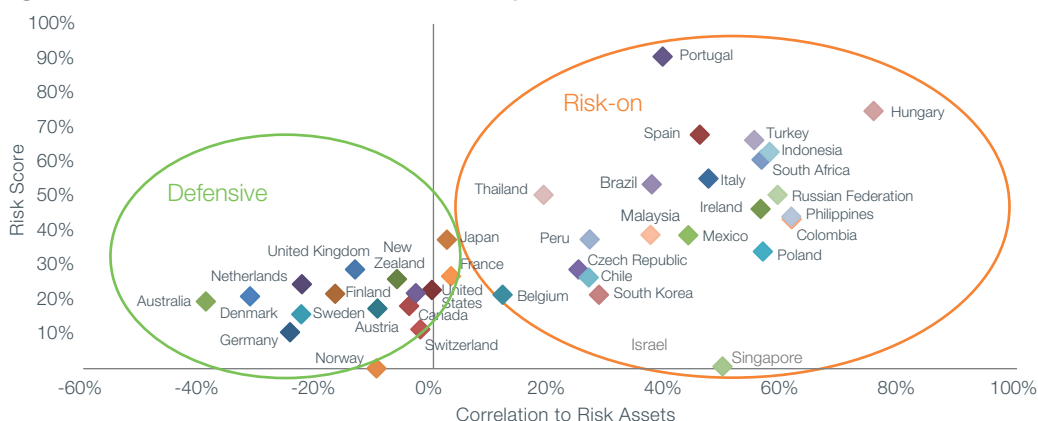
Source: MSCI, July 2013

3. Investors should continue to treat emerging market equities and bonds as asset classes separate and distinct from developed markets.

- a. Despite some blurring of the lines, the emerging market universe still displays different characteristics to those of the developed markets.
- b. Equity investors in emerging markets need to be compensated with higher risk premiums for the combination of greater market volatility, lower liquidity, less transparency, less public information and lower governance levels. This means a higher cost of equity and higher required return on capital.
- c. Bond investors need to be compensated for higher economic and exchange rate volatility (as the price of higher growth) and greater political risk.
- d. While it makes sense in theory to invest in emerging alongside developed markets, it is easier and more convenient for investors to manage allocations, to select and monitor managers and to control risk if allocations are kept separate. Separate allocation also allows a broader spread of emerging market equity and debt than would be practically possible in a single global portfolio. The industry will continue to be slow to change.
- e. It is becoming more difficult to distinguish between fixed income markets at the margin, as some developed markets are becoming riskier than emerging markets however they broadly still behave as a distinct asset classes (Figure 13).

Treating emerging markets as a separate allocation to developed markets continues to make sense

Figure 13: Fixed income markets are on a spectrum



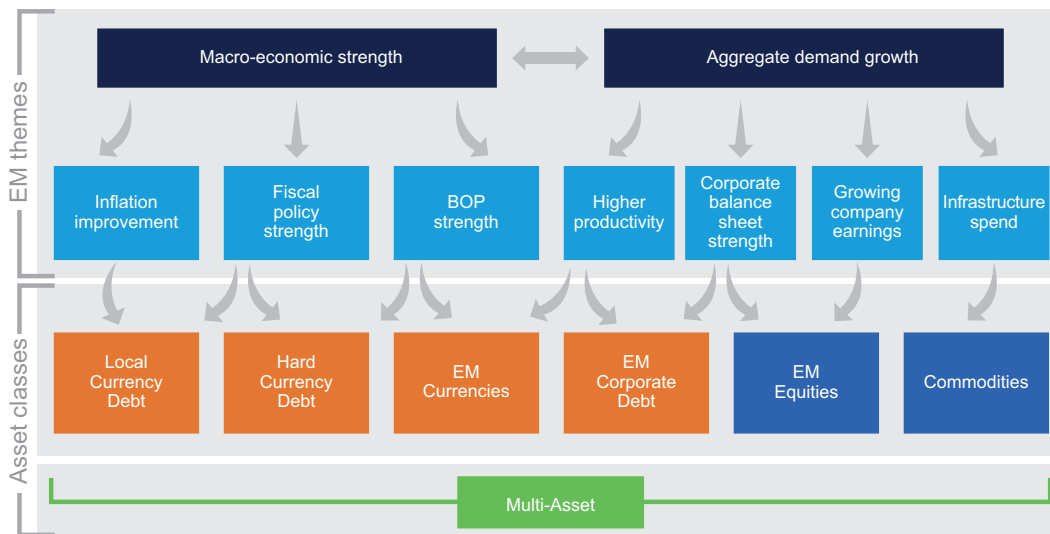
Source: Investec Asset Management, December 2013

Why adopt an active approach

1. There are clear advantages in taking a broad asset class exposure to emerging markets.

a. Emerging markets offer an increasingly broad array of asset choices including: listed equity, both established and frontier, local currency and hard currency sovereign bonds, listed corporate debt, private equity and debt, and real estate. Each of these asset classes key into a different aspect of the development of emerging market economies and companies (Figure 14).

Figure 14: Emerging market asset classes driven by broad and diverse themes



Source: Investec Asset Management

b. As a consequence, different emerging market assets will have different performance characteristics, so that there are efficiency gains in terms of risk-adjusted returns to be had from diversifying across some or all of these asset choices.

c. From 1998-2013, there has been only one occasion when the same emerging market sub-asset class (from large emerging market equity, small emerging market equity, frontier, emerging market sovereign debt, emerging market credit, emerging market hedge funds) out-performed the rest in two or more consistent years in a row (Figure 15).

There are efficiency gains to be had from diversifying across asset areas

Figure 15: Emerging market diversity lends itself to active decision making

1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013 YTD
-13.4%	82.7%	14.7%	10.4%	39.1%	62.1%	49.6%	38.7%	41.3%	46.6%	-10.2%	96.3%	34.1%	8.2%	23.7%	18.2%
-15.3%	61.7%	7.9%	4.8%	13.7%	55.6%	40.0%	29.2%	35.9%	45.5%	-33.2%	69.3%	22.8%	6.2%	18.3%	2.1%
-24.0%	55.9%	3.5%	4.4%	6.0%	39.9%	18.8%	21.0%	30.8%	32.1%	-37.3%	64.2%	22.1%	-7.3%	16.5%	-2.9%
-27.1%	23.6%	-10.7%	2.0%	3.7%	39.4%	18.4%	18.2%	24.3%	24.9%	-45.4%	40.3%	17.1%	-12.5%	15.5%	-3.3%
-33.0%	22.6%	-26.9%	-1.6%	-1.6%	30.0%	12.5%	12.0%	10.7%	6.4%	-53.7%	27.2%	12.5%	-14.0%	10.4%	-6.8%
N/A	-5.6%	-36.4%	-6.5%	-8.7%	27.6%	11.8%	8.8%	10.6%	3.0%	-56.1%	12.6%	11.4%	-15.3%	8.9%	-8.3%

Key

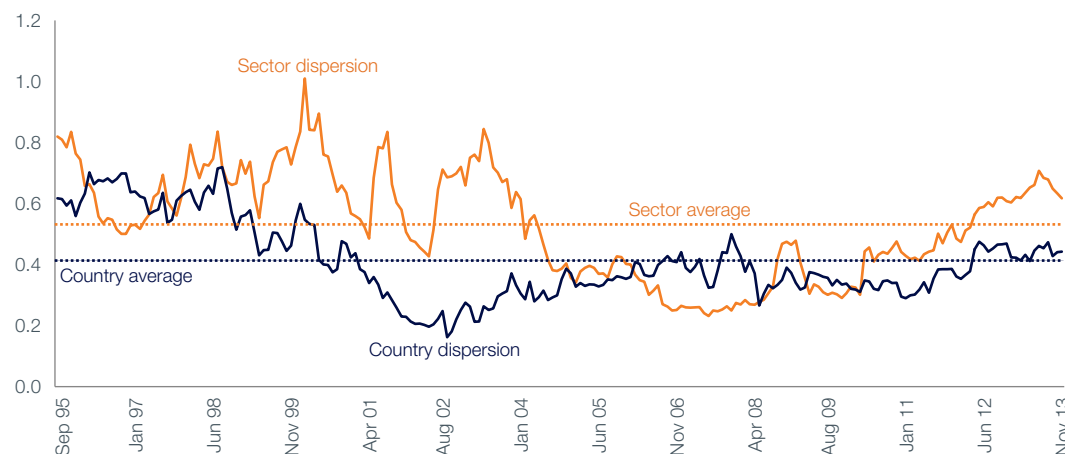
Frontier	EM Sovr	Small EM	Large EM	EM HF	EM Credit
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Past performance should not be taken as a guide to the future, losses may be made. Data is not audited

Source: Standard & Poor's & MSCI. Data to 30 November 2013. All returns for large emerging, small emerging and frontier markets are taken from the S&P indices for 1998 to 2010. From 2011 onwards data is for MSCI, these are comparable indexes. For Large Emerging and Small Emerging Markets Investec has simulated returns using country indices and historical market capitalisation. Large Emerging Markets are >5% of the MSCI Emerging Markets Index, Small Emerging Markets are <5% of the MSCI Emerging Markets Index, Frontier Markets comprise MSCI Frontier Markets Index constituents; EM Credit is BofAML Emerging Markets Corporate; EM Sovr is BofAML Emerging Markets Sovereign Plus; EM HF is HFRI Emerging Markets Hedge Fund (total) Index.

- d. A broad asset class approach will warrant a larger allocation than a single asset exposure would. In addition it provides scope to change the asset mix over time as return expectations change, it creates the broadest possible set of asset choices with which to construct an emerging market portfolio and it permits the range of exposures to evolve as the asset classes develop.
- 2. Over the last decade, simple beta strategies have represented an adequate way of participating in the emerging market opportunity set. This can be explained by factors that are unlikely to be repeated.
 - a. Recovery from the 1997/8 crisis coinciding with a secular bull market in developed market bonds and bear market in equities. The rising dispersion between countries, sectors, stocks, bonds and currencies makes the search for alpha increasingly important.
 - b. Other unusual factors in recent years include liquidity injections and quantitative easing by central banks in developed markets, a rapid pace of domestic reform after the 1990s emerging economies crisis, the rise of China and a collapse in the dispersion between countries and sectors between 2003 and 2012 (Figure 16).

Figure 16: Emerging market sector and country dispersion



After a decade where beta has dominated returns, alpha should be increasingly important to returns

Source: Bloomberg, December 2013, Gavikal

- c. In the past, emerging markets were significantly fewer in number and smaller than now, while development was more homogeneous. As a result, capital flowing in and out of emerging markets was less discriminating than we believe it will be going forward.
- d. Economic growth in the last decade has been significantly higher than in any other post war decade, though this has not necessarily driven equity performance.
- e. More modest market trends mean that alpha is increasingly important to returns while the tracking error of many passive vehicles is high.

Figure 17: Emerging market consumer staples outperformance: 2008-2013



Investors have begun to differentiate more at the sector level

Source: Bloomberg, December 2013, Gavekal

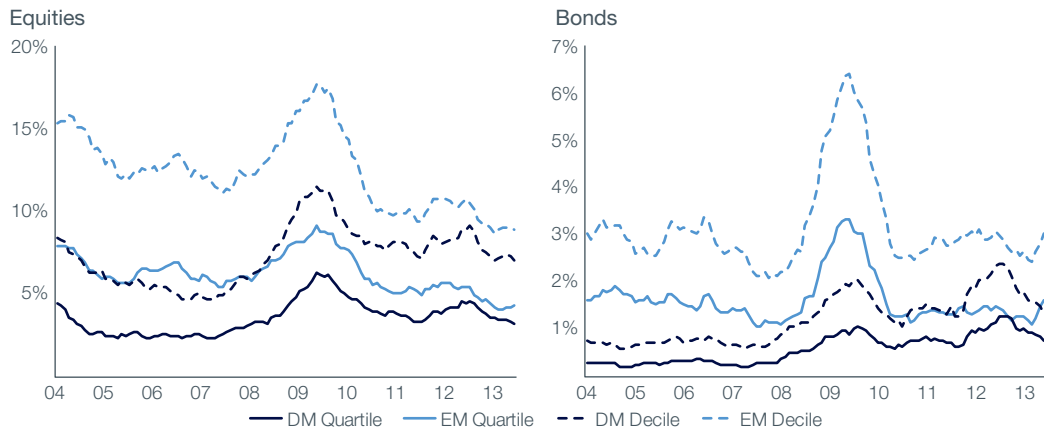
3. Greater market inefficiencies, dispersion and diversity across emerging markets, compared with developed markets, creates superior opportunities for alpha generation.

- a. Analysis of emerging market debt and equities is low and of generally low quality. There is less comprehensive sell-side analyst coverage of emerging market assets: approximately half of emerging market equities having zero or one research analyst covering them.
- b. Many market participants are not seeking to optimise returns; for example, central banks seek to manage their currencies and domestic pension funds by matching liabilities. Some state-owned enterprises and controlling shareholders may not have interests aligned with minority shareholders resulting in poor capital allocation decisions and differing objectives for business strategy.
- c. The overwhelming majority of emerging market bond and equity managers have low tracking errors relative to their benchmarks, but we believe less constrained and more selective strategies should generate higher returns to compensate for additional risks assumed.
- d. Since 2004, the average dispersion of monthly returns as measured by the average monthly difference in performance between the top and bottom quartile countries in emerging market equities has been 2.4% higher than in developed markets, while for debt the dispersion has been 1.3% higher¹².

We believe less constrained and more specialist strategies should generate higher returns

¹²MSCI, JPMorgan, Investec Asset Management calculations, November 2013

Figure 18: Dispersion of returns - range of monthly returns between top/bottom decile/
quartile



*Note: Dispersion of returns based on the monthly return differential between the top decile and bottom decile country in both bonds and equities for the period January 2010 – December 2013. Source: JPMorgan, MSCI, IAM calculations Source: Bloomberg

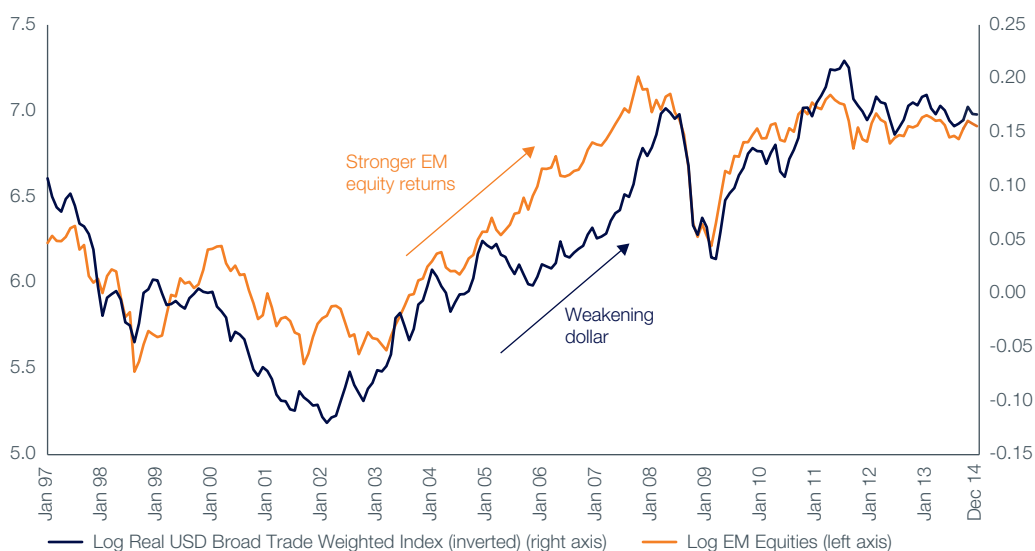
Deciding on the level of allocation

1. **Emerging market exposure through companies listed in developed markets that generate a high or rising proportion of their revenues from emerging markets is a useful complement to, but not a substitute for, direct emerging market exposure.**
 - a. True emerging market exposure of a typical global fund is higher than direct allocations suggest, with 6-15% of the MSCI World index revenues accounted for by emerging markets.
 - b. These developed market companies are likely to have better liquidity and corporate governance than emerging market companies, but are also likely to offer correspondingly lower returns. They will have higher correlations to developed market companies than their revenue streams would suggest.
 - c. According to our analysis, out of 60 emerging market funds that have publicly available stock-level data, the average fund has 14% in developed market equities.

2. **A potential framework for consideration: 15-20% of unconstrained return-seeking portfolio in emerging market assets.**
 - a. If one looks at GDP, emerging economies comprise over 50% (PPP basis) of global aggregate output and growth. Looking at the investable universe and emerging markets currently account for 32% of global equity issuance and 17% of global sovereign debt issuance. Rapid growth in emerging market corporate bond, property, and private markets over the next 10 years will significantly increase the investable universe further. However, given liquidity constraints and volatility, clients with shorter horizons may not warrant fuller exposure. Our quantitative modelling suggests a portfolio of return-seeking assets with 10.5% in emerging market equities and 12.7% in emerging market debt as a guide.
 - b. We must underline that this is not a specific recommendation but a potential framework. Clearly each client will have their own specific portfolio considerations and existing exposures, but we believe at least 15-20% exposure to emerging market assets is justifiable to access the opportunity.

3. **Short and medium-term risks must be factored into total emerging market allocation.**
 - a. Tapering may be negative for emerging markets due to: 1) a strengthening of US dollar and 2) a tightening of dollar liquidity and the subsequent impact on growth and balance of payments (BoP) financing.
 - b. Historically there has been a tight correlation between US dollar weakness and emerging market equity returns with emerging market equities generally performing better in scenarios where the US dollar is weaker (Figure 19).

Figure 19: US\$-emerging market equity correlation



Source: Bloomberg, November 2013

c. There are mitigating factors that investors should consider: 1) The market has already adjusted to a large degree to the prospect of tapering and 2) The US Federal Reserve (Fed) is distinguishing between ‘tapering’ and ‘tightening’, the latter of which is likely to be deferred given the sensitivity of the global economy to rising rates.

d. Other medium-term risks include the impacts of global rebalancing on emerging market economies, the prospects of capital controls, a worsening political atmosphere exacerbated by populist public policy and earnings disappointment (Figure 20).

Figure 20: Medium-term risks to emerging market assets remain

IAM’s degrees of certainty (1*= low level of certainty, 5* = certainty)

Risk	Explanation	IAM’s degrees of certainty (1*= low level of certainty, 5* = certainty)
Global rebalancing	Deleveraging developed market economies will consume less and growing emerging markets will consume more in the future (as percentages of GDP). This transition can cause significant challenges.	★★★★
Dollar strengthening	A secular bull market for the US dollar would drain capital from some emerging markets.	★★★
Capital controls	The search for yield is causing challenges for national central banks to control policy. Limited capital controls are being discussed.	★★
Adverse politics	Populism is taking hold in some key economies, which could translate into investment-discouraging and reform-preventing policies.	★★
Earnings disappointment	EM corporate earnings have stalled since 2011. Translating top-line growth to bottom-line growth is vital	★★

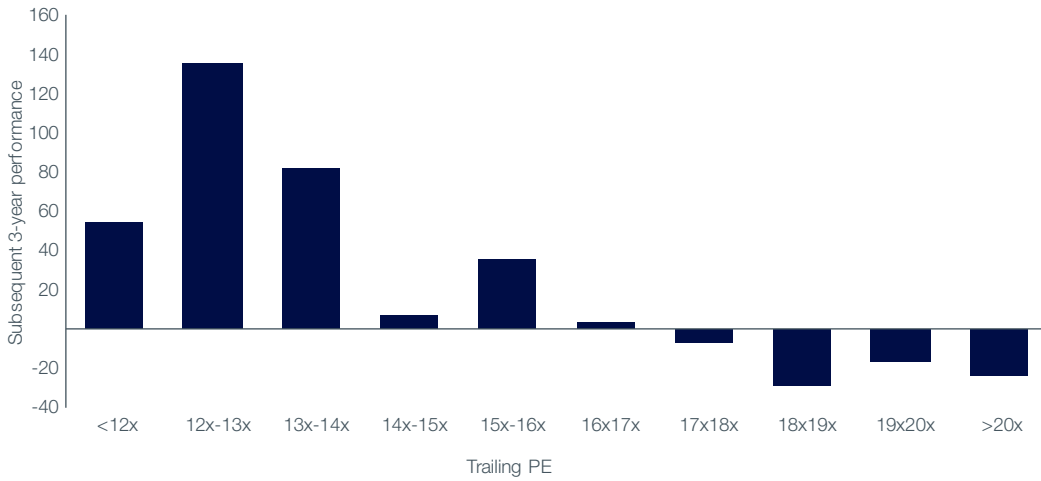
4. Periods of cyclical weakness, as is currently the case have provided investors with attractive entry points for strategic allocations. This can enhance long-term returns.

- a. We believe emerging markets will continue to be more cyclical than developed markets. A flexible approach to asset allocation between emerging and developed markets represents another opportunity to augment returns.
- b. The cyclical and volatility of emerging markets is the price of superior economic and market performance.
- c. Investors are irrationally fearful of a repeat of the 1997/8 crisis in emerging economies. Significant risks remain, which could cause further underperformance, but we feel much has been priced in.
- d. Emerging market equities currently trade on a 33% discount to developed markets on a price/earnings basis and 29%¹³ on a price/book basis. This is the lowest relative valuation since 2003.
- e. Local currency emerging market debt is currently trading at a 460 basis points premium over developed market debt. This has been an attractive entry or re-entry point into the asset class in the past¹⁴.

¹³Morgan Stanley, 16 December

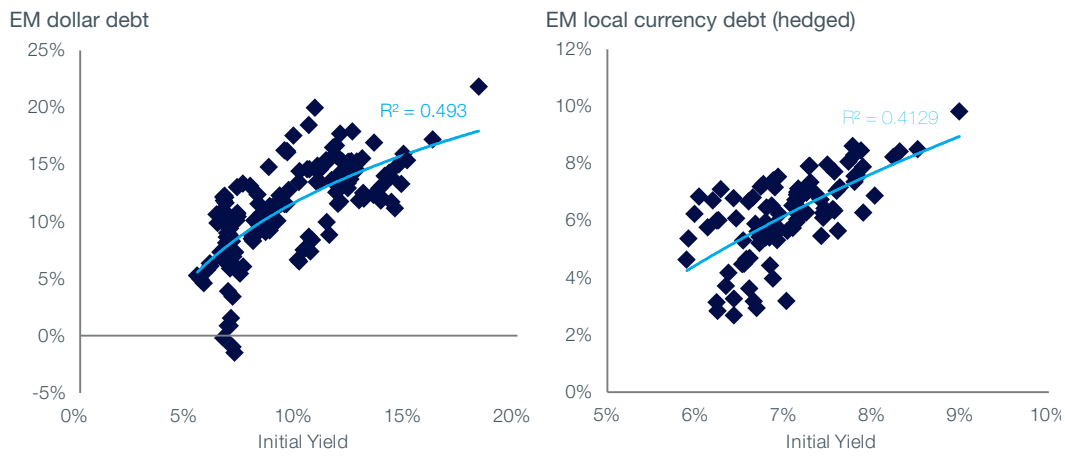
¹⁴JPMorgan, Investec Asset Management calculations, January 2014

Figure 21: Emerging market equity – subsequent 3 year performance vs. price to earnings entry point



Source: Morgan Stanley, December 2013

Figure 22: Subsequent 3 year returns vs. initial yield



Source: JPMorgan Emerging Markets Bond, December 2013

Source: JPMorgan GBI-EM Global Diversified, December 2013

Conclusion

The process of development in emerging economies is likely to be enduring, driven by the popular aspiration of rising living standards. The path of development will be neither smooth nor universal but, in most countries, any faltering or reversal of momentum should result in renewed pressure to accelerate market-based reforms. This will come not just from the international community but, more importantly, from populations increasingly able to compare their fortunes with progress in similar countries.

Sustained growth requires capital and capital requires a sufficient rate of return. Few emerging economies generate sufficient savings to finance the capital investment they require, which creates a long-term opportunity for foreign investors. The perceived risk and the volatility of capital flows, with their consequent effect on currency valuations, are likely to require returns comfortably higher than those in developed markets. Investor sentiment may be more volatile than the economic or market fundamentals of the countries concerned; this perception of risk as well as actual risk should be compensated for in premium returns.

With risk and volatility, perceived or real, being the price of the opportunity for excess returns, investors will need firm discipline. This means analysis country by country, sector by sector and company by company. It means recognition that the relationship between economic growth and both equity and bond returns is an uncertain one, and that the timing of investment and disinvestment, often contrary to the prevailing sentiment, is important. It requires thinking about emerging markets as much from a local as from an international perspective and understanding that it is in the long-term interest of investors that policy and practice is driven by domestic requirements, not by externally imposed solutions.

With the post-millennial period of high across-the-board returns unlikely to be repeated, optimising returns will require a change of gear in emerging market investing and a more active approach to investing. This in turn requires intensive desk research, analysis and due diligence combined with flexible asset allocation. This may deter investors hoping for the utopian world of easily earned premium returns, low risk, low cost, low volatility and high liquidity. For long-term investors who understand the changing investment opportunity, we believe fortune will continue to favour the bold.

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