



Rising Correlations: Do Emerging Market Investments still offer Diversification Benefits?

Precise in a world that isn't:

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Introduction

What do investors look for in an asset class?

- Return potential (with acknowledgment of risks)
- Diversification benefits

Strong investment case for Emerging Markets should drive returns over the long-term

Conventional wisdom is that diversification is the key driver in choosing EM

Is this still the case?

Asset Class Performance

Asset Class Performance and Volatility (10 years ending 31 Aug 2011, in Euro)

Name	YTD Return (%)	3 Year Return (% annualised)	Std Dev 3 Yrs (%)	Sharpe Ratio 3 Yrs	10 Year Return (% annualised)	Std Dev 10 Yrs (%)	Sharpe Ratio 10 Yrs
Gold	20.22	30.57	22.41	1.25	15.41	16.97	0.78
Emerging Markets Debt (Local)	1.04	12.02	9.05	1.14	-	-	-
Global High Yield Bonds	-4.06	13.04	15.35	0.78	4.84	11.90	0.24
Emerging Markets Equity	-14.79	5.83	23.52	0.30	10.72	22.03	0.46
Asia-Pac Equity	-12.84	7.83	21.88	0.39	8.69	20.02	0.39
Global Investment Grade Bonds	0.53	8.57	9.24	0.81	2.38	6.59	0.01
Commodities	-5.60	-3.79	16.29	-0.23	-	-	-
US Equity	-8.48	1.29	16.18	0.08	-1.92	15.58	-0.21
Real Estate	-8.36	1.83	24.37	0.14	4.04	18.24	0.17
European Equity	-11.67	-3.57	19.87	-0.15	0.20	16.92	-0.05
Japanese Equity	-15.58	-2.81	17.26	-0.15	-2.66	17.23	-0.22

Source: Morningstar Direct, TR in Euro, as of 31/8/2011. Asset classes represented by: London Fix Gold PM (PR), MSCI EM (NR), MSCI AC Asia-Pac ex-Japan (NR), JPM GBI EM Global Diversified (TR), BarCap Global High Yield (TR), DJ Global World Real Estate (TR), MSCI Europe (NR), DJ UBS Commodity (TR), BarCap Global Aggregate (TR), USD S&P 500 (TR), MSCI Japan (NR)
Sharpe Ratio: calculated in Euros. Risk free rate is 1 month Euribor.



Asset Class Correlations Pre-Financial Crisis (2005 - 2008)

Asset Class Correlations (Sep 2005 – Aug 2008)

	European Equity	US Equity	Japanese Equity	Emerging Markets Equity	Emerging Markets Debt (Local)	Gold	Global Investment Grade Bonds	Global High Yield Bonds	Commodities	Real Estate	Asia-Pac Equity
European Equity											
US Equity	0.82										
Japanese Equity	0.71	0.66									
Emerging Markets Equity	0.84	0.60	0.72								
Emerging Markets Debt (Local)	0.52	0.61	0.53	0.58							
Gold	-0.08	-0.17	0.16	0.21	0.17						
Global Investment Grade Bonds	0.01	0.39	0.24	-0.05	0.42	-0.07					
Global High Yield Bonds	0.65	0.90	0.67	0.43	0.61	-0.12	0.58				
Commodities	0.06	-0.09	0.27	0.33	0.06	0.56	-0.11	0.01			
Real Estate	0.83	0.85	0.71	0.64	0.59	-0.03	0.26	0.80	-0.02		
Asia-Pac Equity	0.86	0.66	0.69	0.97	0.58	0.12	-0.01	0.48	0.27	0.69	

-1.0 – -0.75 -0.74 – -0.50 -0.49 – -0.25 -0.25 – -0.01 0 – 0.24 0.25 – 0.49 0.50 – 0.74 0.75 – 1.0

Source: Morningstar Direct, TR in Euro, Sep 2005 – Aug 2008. Asset classes represented by: London Fix Gold PM (PR), MSCI EM (NR), MSCI AC Asia-Pac ex-Japan (NR), JPM GBI EM Global Diversified (TR), BarCap Global High Yield (TR), DJ Global World Real Estate (TR), MSCI Europe (NR), DJ UBS Commodity (TR), BarCap Global Aggregate (TR), USD S&P 500 (TR), MSCI Japan (NR)



Asset Class Correlations Since Peak of Financial Crisis (Sep 2008 – Aug 2011)

Asset Class Correlations (Sep 2008 – Aug 2011)

	European Equity	US Equity	Japanese Equity	Emerging Markets Equity	Emerging Markets Debt (Local)	Gold	Global Investment Grade Bonds	Global High Yield Bonds	Commodities	Real Estate	Asia-Pac Equity
European Equity											
US Equity	0.93										
Japanese Equity	0.83	0.81									
Emerging Markets Equity	0.85	0.76	0.67								
Emerging Markets Debt (Local)	0.87	0.82	0.77	0.67							
Gold	-0.38	-0.14	-0.30	-0.17	-0.28						
Global Investment Grade Bonds	-0.40	-0.06	0.19	-0.34	0.31	0.49					
Global High Yield Bonds	0.53	0.61	0.62	0.67	0.73	0.17	0.22				
Commodities	0.78	0.79	0.64	0.67	0.70	-0.13	-0.67	0.20			
Real Estate	0.93	0.93	0.85	0.81	0.89	-0.35	-0.61	0.38	0.76		
Asia-Pac Equity	0.92	0.9	0.77	0.87	0.89	-0.38	-0.69	0.33	0.79	0.92	

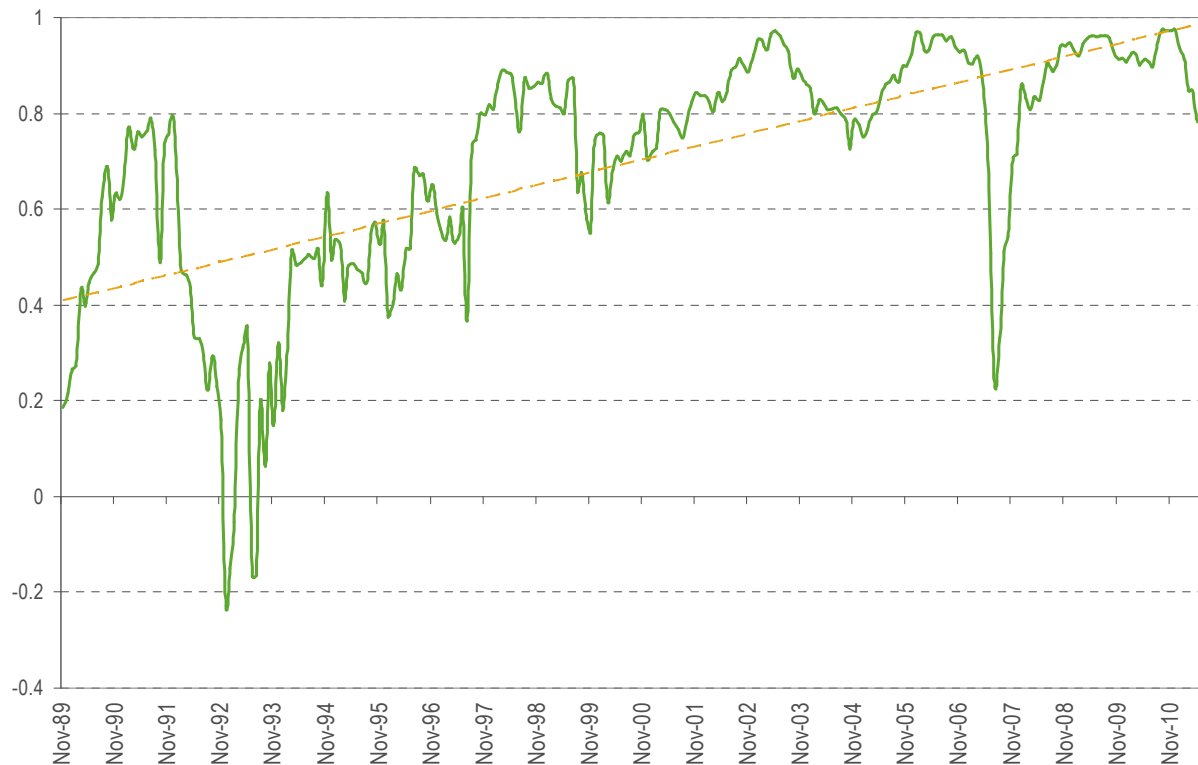
-1.0 – -0.75  -0.74 – -0.50  -0.49 – -0.25  -0.25 – -0.01  0 – 0.24  0.25 – 0.49  0.50 – 0.74  0.75 – 1.0 

Source: Morningstar Direct, TR in Euro, Sep 2008 – Aug 2011. Asset classes represented by: London Fix Gold PM (PR), MSCI EM (NR), MSCI AC Asia-Pac ex-Japan (NR), JPM GBI EM Global Diversified (TR), BarCap Global High Yield (TR), DJ Global World Real Estate (TR), MSCI Europe (NR), DJ UBS Commodity (TR), BarCap Global Aggregate (TR), USD S&P 500 (TR), MSCI Japan (NR)



Historical Correlation Emerging Market Equity vs. Developed Market Equity

MSCI Emerging Markets vs. MSCI World (Correlation, trailing 12 month returns)

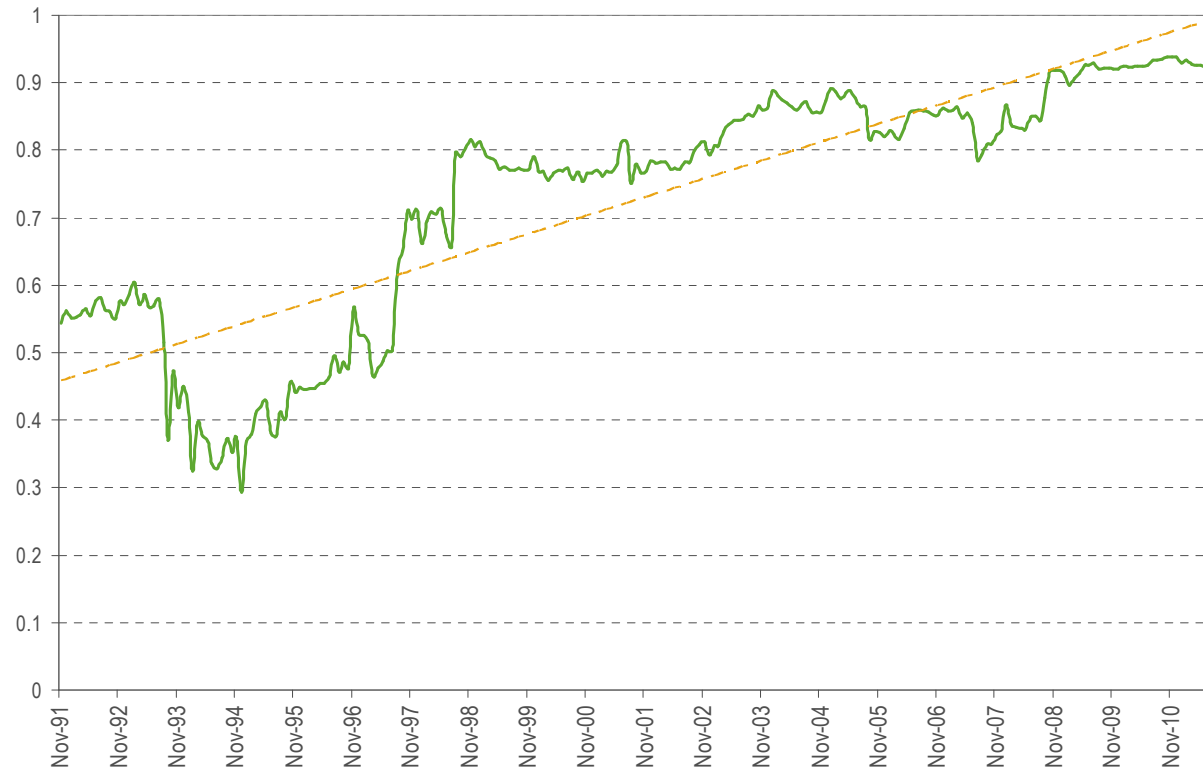


Source: FactSet, Correlation of USD 12 month returns, MSCI EM Index (Gross) vs. MSCI World Index (Gross), 1989 - 2011



Historical Correlation Emerging Market Equity vs. Developed Market Equity

MSCI Emerging Markets vs. MSCI World (Correlation, trailing 36 month returns)

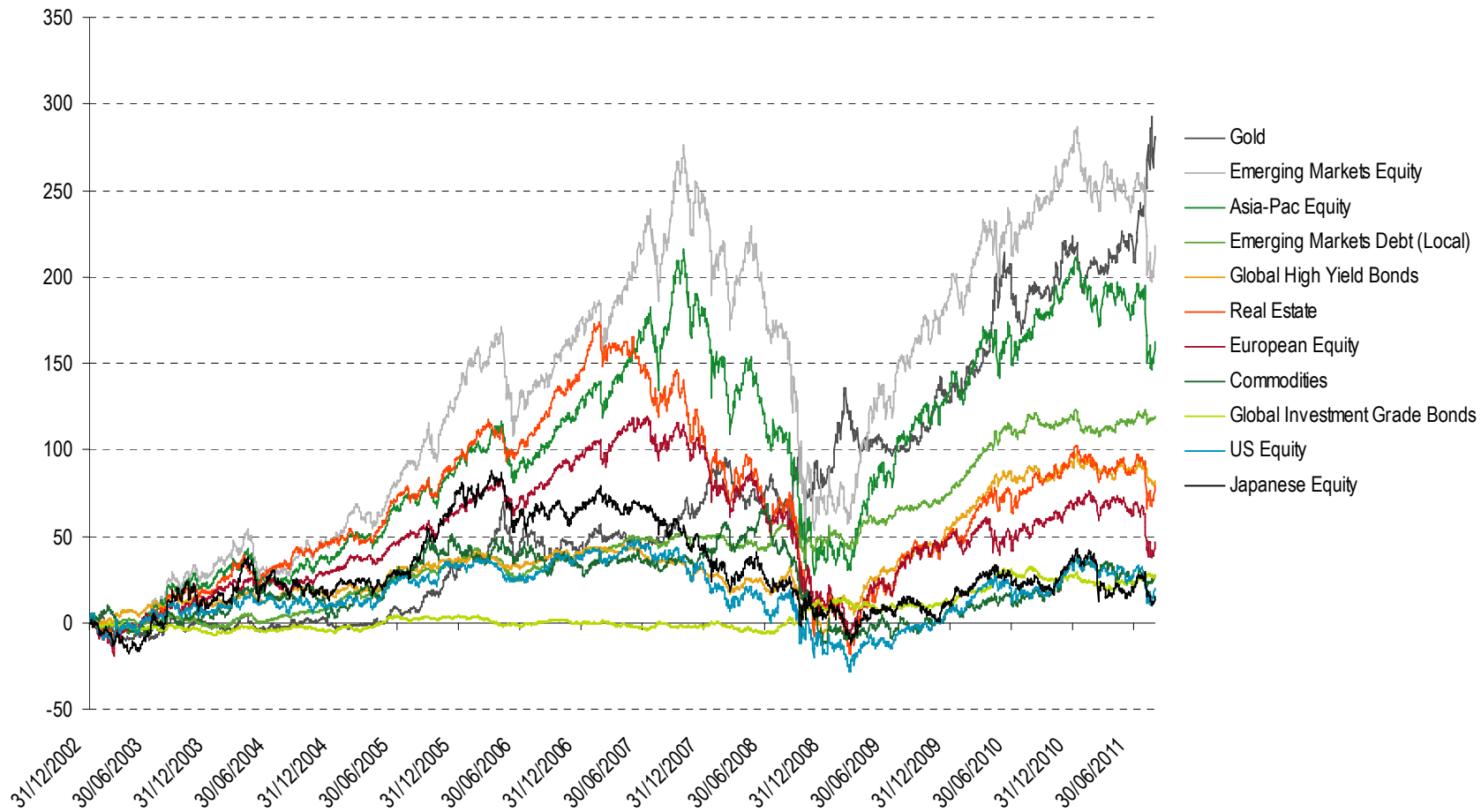


Source: FactSet, Correlation of USD 36 month returns, MSCI EM Index (Gross) vs. MSCI World Index (Gross), 1991 - 2011



Asset Class Performance

Asset Class Performance (2003 – 2011) % return in Euro



Source: Morningstar Direct, TR in Euro, 31/12/2002 – 31/8/2011. Asset classes represented by: London Fix Gold PM (PR), MSCI EM (NR), MSCI AC Asia-Pac ex-Japan (NR), JPM GBI EM Global Diversified (TR), BarCap Global High Yield (TR), DJ Global World Real Estate (TR), MSCI Europe (NR), DJ UBS Commodity (TR), BarCap Global Aggregate (TR), USD S&P 500 (TR), MSCI Japan (NR)



The Case for Emerging Market Equities

Emerging market investment case:

- superior growth profile
- favourable demographics and an emerging consumer class
- global companies
- lower government debt
- diversification benefits...

Rebound from the Great Recession has been sharp, led by growing domestic demand and stimulative policy

Emerging Asia is now 2nd largest economy in nominal GDP terms

Latin America recovery has been strong, benefitting by recovery in commodities

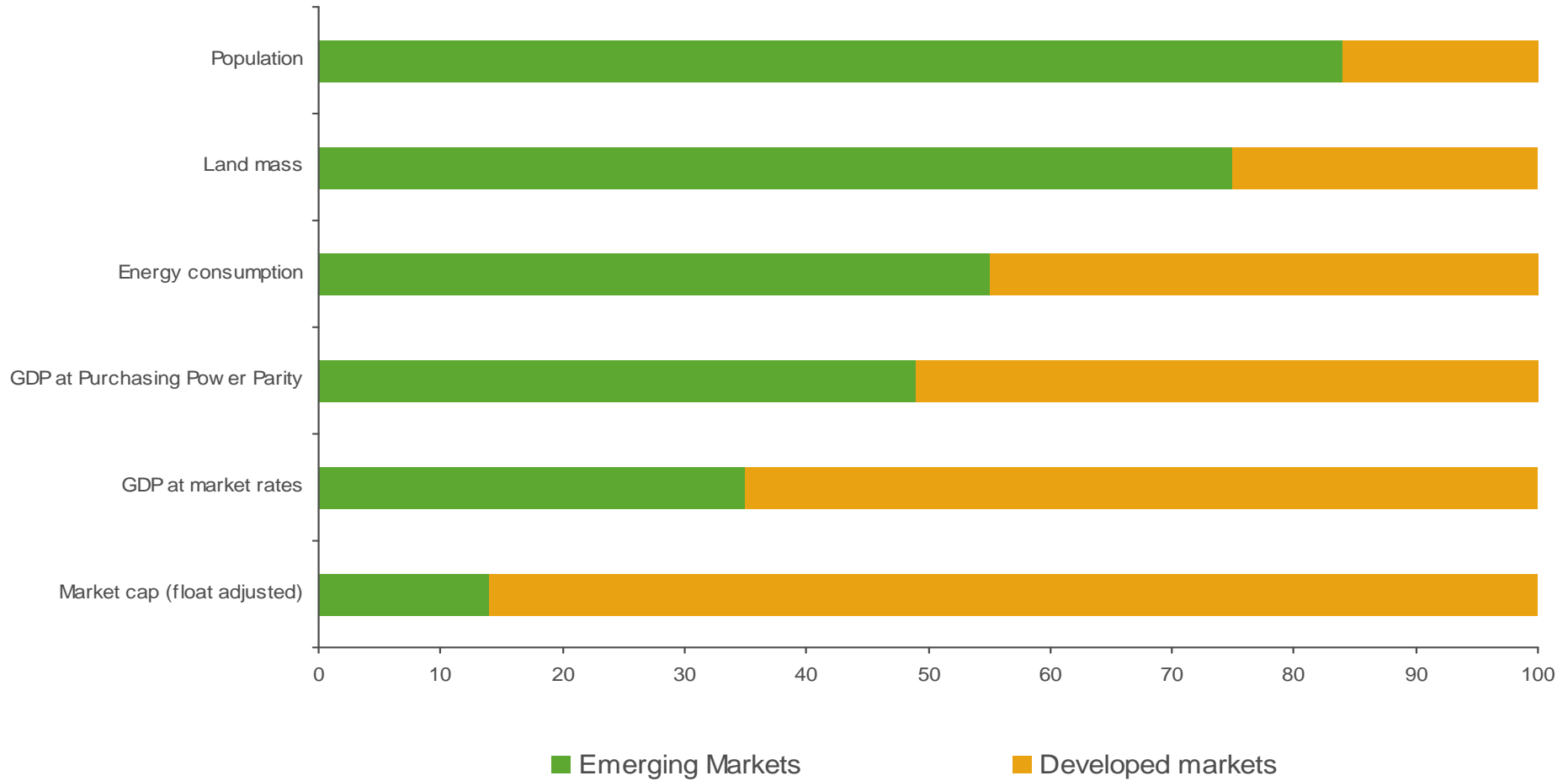
2011 EM growth expected to be 5.8% versus 2.3% for the developed world

EM equities are at 9 times next 12-month earnings, 1 standard deviation below L-T average

Risks include: oil prices (Asia), political risk (Middle East and Africa), inflation (Global EM), severe US/Europe recession

Emerging Markets Impact on the World

Emerging Economies as % of Total World



Source: IMF IFS, Banc of America.Merrill Lynch, 2009



Institutional Ownership of EM Equities

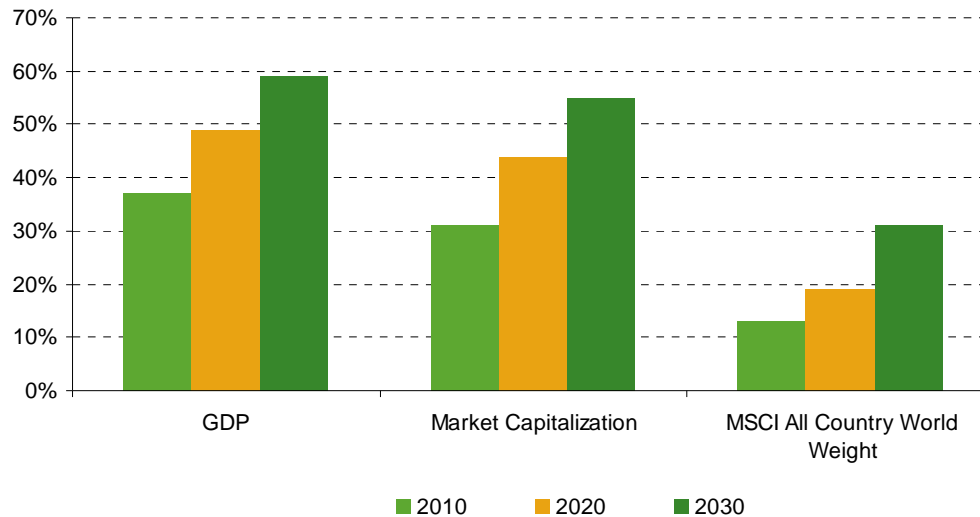
Fund Type	Total AUM (\$ trll)	Equity AUM (\$ trll)	Equity AUM split by DM Domicile			Share of Equity Assets Invested in EM
			US	Europe	Japan	
Pension Funds	24	7	70%	12%	18%	4%
Mutual Funds	18	9	71%	25%	4%	8%
Insurance Funds	15	2	17%	57%	25%	3%
Total	57	18	66%	22%	12%	6%

Source: IFSL, OECD, FactSet, Goldman Sachs Global ECS Research

Institutional investors are strategic buyers of the asset class

They will access the markets either through direct Emerging Market investments or through the broadening of equity mandates/ benchmarks (e.g. MSCI ACWI, MSCI ACWI IMI)

Emerging Market Share of the World (2010 – 2030)



Source: Goldman Sachs

Importance of Emerging Markets will grow significantly over time

What about Debt? The Case for Emerging Market Local Currency Debt

Government Debt in % of GDP – Data and Projections

Emerging Markets			
Government Debt in % of GDP	2005	2010	2015
Argentina	86.8	51.4	50.4
Brazil	69.2	67.2	54.1
Chile	7.3	4.4	3.2
Czech Republic	29.7	37.6	49.9
Colombia	38.8	35.1	32.3
Hungary	61.9	78.9	64
Indonesia	46.3	27.5	23.1
Malaysia	44.4	57.2	62.3
Mexico	39.8	44.5	42.4
Peru	--	26.7	19.7
Philippines	62.8	48	37.3
Poland	47.1	55	62.1
Russia	14.2	8.1	13
South Africa	34.6	34.7	35.7
Thailand	46.2	47.9	51.3
Turkey	52.3	44.5	43.5
Emerging G20	40.4	37	32.7

Developed Markets			
Government Debt in % of GDP	2005	2010	2015
Australia	10.7	19.8	20.9
Canada	71.6	83.3	71.2
France	66.4	84.2	94.8
Germany	68	76.7	81.5
Greece	100	133.2	140.4
Japan	191.6	227.1	250
Portugal	63.6	86.8	98.4
Spain	43	66.9	94.4
United Kingdom	42.1	78.2	90.6
United States	61.6	92.6	109.7
Advanced G-20	78.9	104.4	117.1

Rising Government Debt to GDP ratios of developed markets contrast with the situation/outlook for many EM economies



Recent Flows into Emerging Market Investments

European domiciled Global Emerging Market Equity funds attracted inflows of €26.5 billion in 2010, while Emerging Market Local Currency Debt funds experienced inflows of €16.5 billion

YTD 2011, Emerging Market Local Currency Debt funds attracted inflows of €5.5 billion, while Global Emerging Market Equity funds gained €1.6 billion

In 2010, over 25% of all institutional equity searches in Europe were for Emerging Market managers, with several pension funds investing in the region for the first time (Mandate Wire 2010 annual report)

‘It became clear that 2010 was really the year of emerging markets, if not yet by inflows at least in terms of investor sentiment. Pension funds across Europe started to look to those markets that had so long been regarded as unstable, inaccessible and vulnerable to interference... MandateWire counted 14 emerging market bond mandate wins during the year and seven tenders...’

Summary

Correlations between EM and DM equities have been rising over time

We recommend to focus on macro factors and underlying trends that continue to favour EM

EM equities have significantly outperformed DM equities over the last decade

EM equities have higher volatility relative to DM – but display a favourable Sharpe ratio

Many investors remain structurally underweight to EM equities – the region makes up approximately 13% of the MSCI ACWI and represents roughly 30% of global GDP; we expect investors will continue to increase allocation to EM over time

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