Built to Last

Two Decades of Wisdom on Emerging Markets Allocations

Juliana Bambaci, Chin-Ping Chia and Billy Ho

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Executive Summary

Many investors have argued that emerging markets today are quite different from what they were in 1988. When the MSCI Emerging Markets Index was first developed, it was represented by 10 under-developed but fast growing economies. Today, the opportunity set consists of 21 markets of different economic development status. In fact, the dramatic processes of economic development and deepening of financial markets have redefined the characteristics of emerging markets to such an extent that emerging markets today are a key contributor to global economic growth. The changing nature of emerging markets means that the investment rationale underpinning the mandate allocations and the approaches to implementation have also evolved over time. The motivation for investing in emerging markets 20 years ago focused on gaining market exposure to an uncorrelated source of equity growth premium and was arguably often seen as an allocation outside the core portfolio. Today, many investors are seeing emerging markets as a core allocation in their portfolio.

Not surprisingly, the last decade has seen a prolific increase in the approaches to emerging markets investing. On one end of the spectrum, emerging markets are increasingly being viewed as an integrated part of global equity allocation alongside developed markets equities. In this configuration many investors are moving towards a framework defined by the MSCI ACWI Investable Market Index (IMI), a global equity index consisting of developed and emerging markets countries across the large, mid and small cap size segments as the basis for global equity allocation. On the other end of the spectrum, the acronym style of emerging markets investing, such as BRIC, N11, CIVETS, MIST and many others, which seeks a more targeted exposure within emerging markets has also gained considerable attention. Clearly, the investment beliefs underlying these approaches are quite different. While the former approach seeks to reflect the broad diversity and dynamic nature of emerging markets, the latter approach is established on a very different investment footing based on country selection. Country selection strategies purport that emerging markets is a heterogeneous segment and because some countries are likely to grow faster than others, it makes sense to have an active country view. The emergence of these alternative mandate configurations begs the questions: ***Is the emerging markets concept dated? Does broad-based emerging markets investing remain an appealing way to capture economic growth premium?***

We argue that in spite of the wide array of emerging markets mandate configurations and implementation options available to investors, the broad emerging markets concept based on the MSCI Emerging Markets Index and broad-based emerging markets investing are as relevant as ever. Why? There are four observations that suggest that the traditional broad-based emerging markets mandates continue to provide the desired access to the economic growth premium.

1. Emerging markets are inherently dynamic. The broad-based emerging markets notion has been effective in capturing the dramatic transformations of emerging economies and markets over the last twenty years. Importantly, while growth remains abundant within the segment, it is not static across countries. Gaining exposure to a broad-based emerging markets portfolio allows investors to ride the changes in the underlying sources of economic growth premium.

2. Country selection strategies attempting to "pick the winners" among emerging markets have varied substantially in terms of their track records over time and across strategies. A static approach to country selection that ignores equity market valuation and growth expectation assumes substantial active risk.

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3. An analysis of the product landscape reveals that dedicated emerging markets continue to be the configuration of choice for most investors.
4. The performance of average active emerging markets managers is positively correlated to the breadth of benchmark, pointedly highlighting the value of having a broad exposure to emerging markets.

This paper is organized in the following sections. Section I describes the main trends in emerging markets investing. Section II discusses fundamental changes that have taken place in emerging markets and validates the notion that emerging markets are a dynamic concept. Section III examines the merits and trade-offs of the most common approaches now being used to gain exposure to emerging markets as well as their relative performance track records. Section IV presents historical risk and returns of the different approaches. Section V looks at the extent to which investors have adopted the different approaches. Section VI examines the empirical results of active implementation by mandate types. Section VII concludes.

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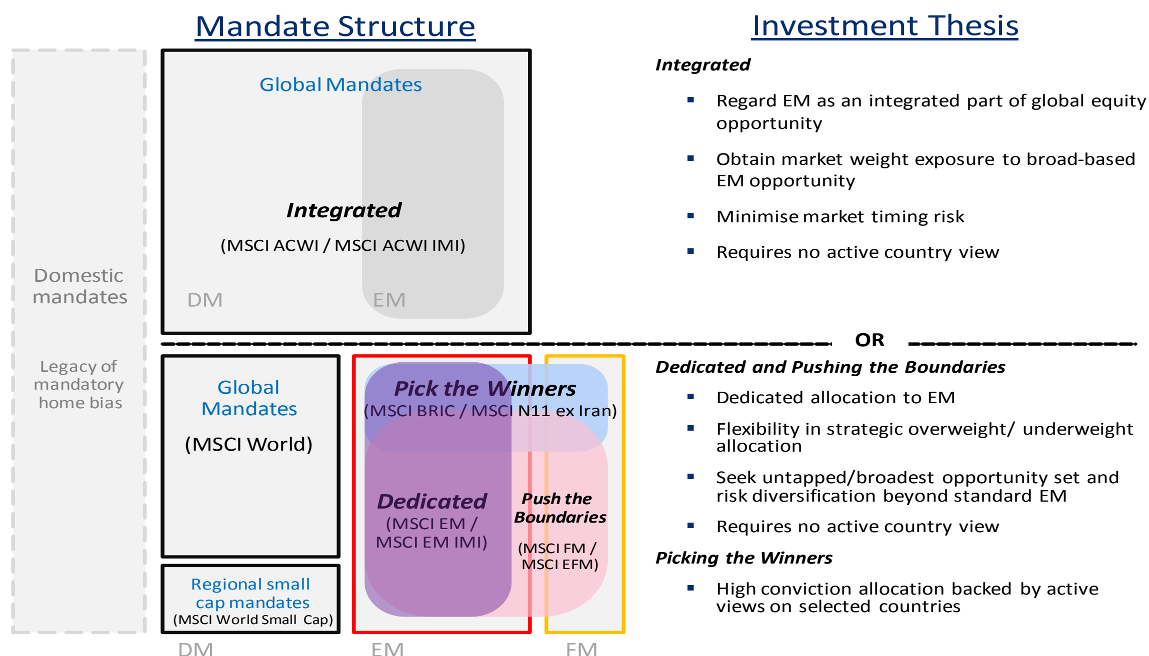
I. Main Trends in Emerging Markets Investing

A twenty year evolution has brought about many changes in the investment philosophies and approaches to emerging markets investing. The motivation for investing in emerging markets in the past focused on gaining market exposure to an uncorrelated source of equity growth premium that was often seen as an allocation outside the core portfolio. Today, investors seeking equity exposure to emerging markets employ a broad range of mandate configurations. These can be classified into four categories:

1. *Integrated*
2. *Dedicated*
3. *Pushing the Boundaries*
4. *Picking the Winners*

Each approach intersects different opportunity universes and is backed by different investment rationales. The *Integrated* approach regards emerging markets as an integrated part of the global equity opportunity set and allocates a market cap-weighted exposure to emerging markets. This approach does not require any active country view and does not seek to time the market. On the other hand, the *Dedicated* and *Pushing the Boundaries* approaches carve out the emerging markets as a dedicated segment. By doing so, they provide investors with the flexibility to strategically over- or under-weight their emerging markets allocation. They differ mainly in the definition of the opportunity set with the former including only emerging markets and the latter adding on frontier markets. Lastly, the *Picking the Winners* approach focuses on a specific subset of the countries within emerging markets with are believed to have a better growth trajectory. Exhibit 1 presents the different approaches to emerging markets investing in the context of the New Classic equity allocation framework (Kang, Nielsen and Fachinotti, 2010).

Exhibit 1: Approaches to Emerging Markets Investing in the Context of the "New Classic"Allocation



Source: MSCI

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The most common approaches are *Integrated* and *Dedicated*. These approaches are supported by the trend whereby investors across the globe are increasingly adopting the New Classic framework as the basis for their global equity allocation. Under this framework, the default starting point for a global equity allocation is one that includes large, mid and small cap securities from both developed and emerging markets.

An *Integrated* mandate structure provides exposure to the global equity opportunity set by combining developed and emerging markets equities in a single portfolio. Examples include portfolios based on the MSCI ACWI or the MSCI ACWI IMI Indices. In *Integrated* mandates, the influence of emerging markets in the portfolio varies with changes in its market capitalization and the correlation of returns among and between emerging market and developed market stocks. An investor adopting this approach in 1988 would have had less than 1% exposure to emerging markets. However, this exposure would have grown to around 13% by 2012. Typically, investors who adopt the *Integrated* mandate configuration are motivated by the broad diversity of global equity opportunity set. They prefer a market neutral exposure to emerging markets and do not wish to incur active market timing risk.

The *Dedicated* approach, such as the one based on the MSCI Emerging Markets Index, focus solely on the emerging markets segment, either as a large and mid-cap mandate or,more recently, including MSCI Emerging Markets IMI mandates where small caps are included as part of the emerging markets opportunity set. A *Dedicated* emerging markets mandate allows for flexibility in the allocation, as investors may strategically over or underweight the segment relative to its weight in the global opportunity set. Such a mandate structure works well for investors who wish to implement an active asset allocation view. However, it may incur market timing risk as investors rebalance their portfolios.

The *Pushing the Boundaries* approach seeks to further expand the opportunity set by taking exposure on the broadest array of non-developed market stocks, including nascent frontier markets, such as those found in the MSCI Frontier Markets Index and the MSCI Emerging and Frontier Markets Index. These mandates provide exposure to an expanded opportunity set and cast a broad net around growth economies globally. The main rationale for including frontier markets is similar to the original idea of emerging markets investing, i.e. capturing untapped economic growth prospects, potential low correlation with other equity markets, and the premium sometimes associated with relatively under-owned and under-researched stocks. However, like emerging markets, frontier markets are not a homogeneous economic block. For example, several frontier markets countries, in particular in the Middle East and Eastern Europe, have already achieved high levels of economic development, as measured by GDP per capita, while others are still at early stages of development.

The *Picking the Winners* approach has a very different rationale than the first three. Instead of capturing the growth premium via a broad-based exposure to emerging and frontier markets, it seeks to capture growth through active country selection. The basis for this approach is twofold. On the one hand, there is substantial variation in the fundamentals, macroeconomics, growth prospects, and performance across emerging markets. While some emerging markets have had stellar economic development such as the BRIC (Brazil, Russia, India and China) countries, others are still in the process of catching up. These differences offer opportunities for investors with high convictions regarding what the best performing countries will be. Following on the popularity of the BRIC concept developed in 2001, this space is now populated by a large number of strategy variants whose acronyms span most of the emerging and frontier markets universe. Examples are Next 11, Growth Economies, MIST (Mexico, Indonesia, South Korea and Turkey), CIVETS (Colombia, Indonesia, Vietnam, Egypt, Turkey and South Africa), CAPPT (Chile, Argentina, Peru, Philippines and Thailand), MINT (Mexico, Indonesia, Nigeria and Turkey), and the list continues… Each one of these acronyms represents an active investment view regarding expected

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performance in these equity markets. Exhibit 2 summarizes the various approaches, investment rationales and characteristics of mandate structure to emerging markets investing.

Exhibit 2: Common Approaches to Emerging Markets Investing

	Integrated	Dedicated	Pushing the Boundaries	Picking the Winners
Examples	Global Integrated: MSCI ACWI /ACWI IMI Regional integrated: MSCI Asia ex JP	MSCI EM	MSCI FM, MSCI EFM	BRIC, N11, Growth Markets, single countries
Investment Rationale	- Comprehensive capture of global opportunity set - No market timing	-Dedicated allocation to EM -- Flexibility in strategic OW/UW allocation	- Seek the untapped / broadest opp set & risk diversification beyond standard EM	- High conviction allocation backed by active view on selected countries
Mandate Structure	Integrated	Dedicated Allocation	Dedicated Allocation	Country Selection
Targeted vs. Diversification	Diversified	Diversified	Diversified	Targeted
Investability /Accessibility	Moderate to high	Moderate to high	Low	Moderate for BRIC & Growth Markets Low for N-11
Capacity Constraint (Index Market Cap)	ACWI: USD 29.8 tr	EM: USD 3.6 tr	FM: USD 0.1 tr	BRIC: USD 1.7 tr GM: USD 2.5 tr
# of Securities	ACWI: 2,409	EM: 820	FM: 151	GM: 504 BRIC: 327
Main Driver of Returns *	Country, Style, Sectors	70% Country	Country	60% Country for BRIC, N11 and GS Growth
Product Availability	High	High	Low	Medium

* Main drivers of returns are the common factors that explain the largest portion of returns variation.

Source: MSCI

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II. Emerging Markets is a Dynamic Concept

When the MSCI Emerging Markets Index was first conceived in 1988, it had only 10 countries: Mexico, Argentina, Brazil, Chile, Greece, Jordan, Malaysia, Philippines, Portugal and Thailand. The combined market capitalization of the countries comprised less than one percent of the global equity opportunity set, represented by the MSCI ACWI Index, a global equity index consisting of developed and emerging market countries (see exhibit 3). Within a short span of ten years, the MSCI Emerging Markets Index constituents had expanded to just under seven percent in the MSCI ACWI before being unsettled by the Asian Financial Crisis in 1997.

Exhibit 3: Composition of the MSCI ACWI Index, 1987-2012

Country	1987	1992	1997	2002	2007	2012
Developed Markets						
Australia	1.20%	1.48%	1.22%	1.88%	2.79%	3.31%
Canada	2.42%	2.29%	2.29%	2.20%	3.67%	4.30%
Europe	21.14%	26.00%	30.04%	28.47%	30.23%	22.82%
Hong Kong	0.76%	1.56%	1.25%	0.64%	1.05%	1.09%
Israel						0.21%
Japan	40.15%	22.69%	11.26%	8.44%	8.60%	7.50%
New Zealand	0.19%	0.17%	0.13%	0.07%	0.06%	0.05%
Singapore	0.49%	0.77%	0.41%	0.33%	0.48%	0.71%
USA	32.75%	40.44%	46.56%	53.99%	41.80%	47.45%
Developed Markets Total	99.10%	95.41%	93.16%	96.02%	88.68%	87.44%
Emerging Markets						
Argentina	0.01%	0.19%	0.29%	0.02%	0.05%	-
Brazil	0.19%	0.47%	1.02%	0.27%	1.51%	1.64%
Chile	0.08%	0.34%	0.25%	0.06%	0.13%	0.24%
China	-	-	0.03%	0.26%	1.80%	2.23%
Colombia	-	-	0.06%	0.00%	0.03%	0.16%
Czech Republic	-	-	0.06%	0.02%	0.09%	0.04%
Egypt	-	-	-	0.01%	0.09%	0.04%
Greece	0.04%	0.09%	0.17%	-	-	-
Hungary	-	-	0.08%	0.05%	0.09%	0.04%
India	-	-	0.40%	0.20%	0.94%	0.79%
Indonesia	-	0.09%	0.11%	0.04%	0.19%	0.36%
Israel	-	-	0.17%	0.13%	0.24%	-
Jordan	0.02%	0.02%	0.01%	0.01%	0.01%	-
Korea		0.72%	0.20%	0.86%	1.62%	1.94%
Malaysia	0.29%	0.82%	0.36%	0.22%	0.28%	0.46%
Mexico	0.08%	1.19%	0.81%	0.31%	0.51%	0.63%
Morocco	-	-	-	0.01%	0.03%	0.01%
Pakistan	-	-	0.05%	0.01%	0.02%	-
Peru	-	-	0.08%	0.02%	0.07%	0.08%
Philippines	0.03%	0.09%	0.09%	0.02%	0.06%	0.12%
Poland	-	-	0.03%	0.05%	0.19%	0.17%
Portugal	0.08%	0.09%	-	-	-	-
Russia	-	-	0.37%	0.19%	1.15%	0.76%
South Africa	-	-	0.67%	0.56%	0.76%	1.01%
Sri Lanka	-	-	0.01%	0.00%	-	-
Taiwan	-	-	1.14%	0.51%	1.12%	1.34%
Thailand	0.08%	0.41%	0.10%	0.07%	0.15%	0.27%
Turkey	-	0.07%	0.20%	0.05%	0.19%	0.21%
Venezuela	-	-	0.10%	0.01%	-	-
Emerging Markets Total	0.90%	4.59%	6.84%	3.96%	11.32%	12.56%
ACWI Total	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%

For year 1987 to 2007, data is as of year end. For 2012, data is as of July 31, 2012

Source: MSCI

The relative importance of countries and regions continued to vary. By 1992, Mexico overtook Malaysia to become the largest emerging market. Latin America became the largest region within emerging markets and Korea was included for the first time in the index. Note that Russia, China and India were

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not even part of the investable emerging markets opportunity set in the early days. Fast-forwarding to 20 years later, the underlying composition of the MSCI Emerging Markets Index has evolved to one that encompasses securities from 21 equity markets with varying degrees of economic development and represents about 13% of the global equity opportunity set. Currently, the size of emerging markets within Asia is three times that of Latin America, with the largest markets being China, South Korea, Brazil, Taiwan and South Africa.

This evolution is reflective of changes in economic development, deepening of financial markets and accessibility of capital markets to international investors. For the most part, the last twenty years have been a period of extensive opening up of capital markets to international investors. The MSCI Emerging Markets Index reflects the progressive inclusion of countries in the global equity opportunity set. Some countries have graduated to the developed market category, like Greece, Portugal and Israel. Other countries, such as Argentina and Pakistan have moved in an opposite direction, dropping out of the MSCI Emerging Markets Index as a result of imposing capital restrictions on international investors. As a matter of fact, member countries in the MSCI Emerging Markets Index share more commonalities in terms of their level of market accessibility than their economic development status.

The dynamic nature of emerging markets is likely to continue generating changes in the future. Today, most international investors gain exposure to China, the world's second largest economy, mainly through securities of Chinese companies listed offshore in Hong Kong. As of July 2012, the MSCI China Index had a weight of 18% in the MSCI Emerging Markets Index. However, Chinese companies listed domestically in the form of A shares are still restrictive to a majority of institutional investors.[1] This opportunity set as measured by the MSCI China A Index could represent a sizeable weight of the MSCI Emerging Markets Index, should it become fully accessible. Another interesting case is Saudi Arabia, which is currently one of the largest equity markets still closed to international (ex-Gulf Cooperation Council to be precise) investors. The potential opening of Saudi Arabia could also bring significant investment implications to international investors.

From an investment angle, the dynamic nature of emerging markets has been reflected in changes in the role of its allocations in investors' portfolios. Originally, emerging markets allocations had two clear objectives. Emerging markets allocations provided investors with: 1) a source of diversification and 2) growth prospects from some fast growing but under-developed economies. However, as the global economies and capital markets became more integrated, the benefits of emerging markets exposure for portfolio diversification also became less pronounced. This follows naturally from the evolution of emerging markets economies to more closely resemble their developed counterparts. It is not surprising that the main focus of investors in emerging markets has somewhat shifted as well. Today, the objective of exposure to economic growth is arguably more prominent than the quest for portfolio diversification.

Granted, investors do not invest in emerging markets simply because it is a dynamic concept. Considering all the changes that have taken place over the last two decades the question is: is emerging markets still associated with an economic growth premium? Over the past two decades, the number of emerging economies achieving the above average growth has consistently matched or exceeded developed economies. Exhibit 4 shows the average MSCI ACWI annual GDP growth rate and number of countries that grew above the average growth rate[2] between 1990 and 2010. Throughout the period, above-average-growth is concentrated predominantly among emerging market economies. The only exception is during the several years following the Asian Financial Crisis. The developments over the last ten years have skewed the balance further in favor of emerging markets.

[1] Only approved Qualified Foreign Institutional Investors (QFII) with a granted investment quota are allowed to invest in China A shares.

[2] The above average growth is defined in the context of constituent countries of the MSCI ACWI.

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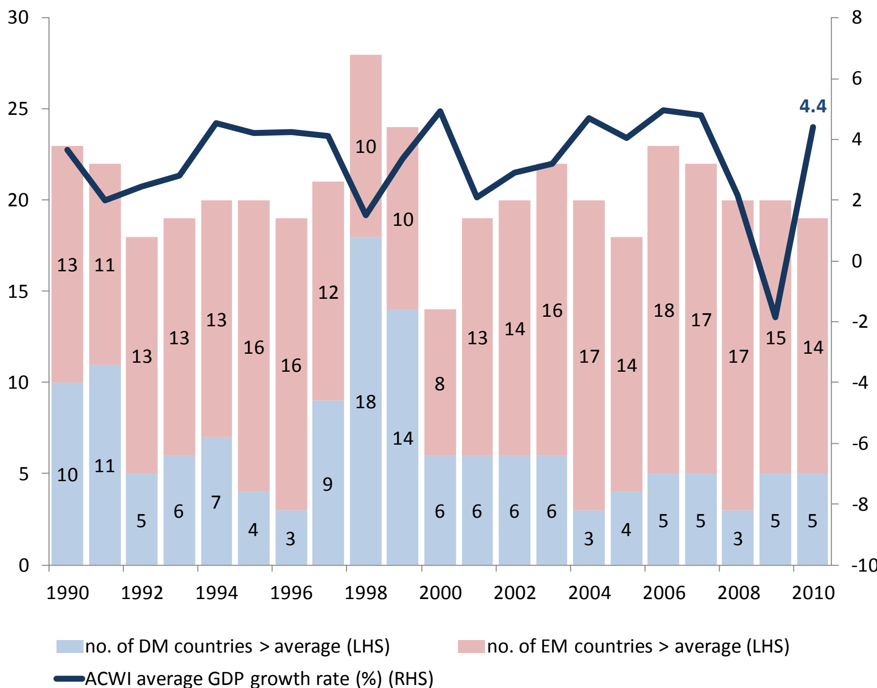
Exhibit 4: GDP Growth in Developed and Emerging Countries, 1990-2010



Source: World Bank and MSCI

Exhibit 5: GDP Growth and Equity Returns in Developed and Emerging Markets, 1990-2010

1990 - 2010	Average Annual GDP growth	Annualized Equity Return
DM	2.4%	4.0%
EM	4.2%	8.3%

Source: World Bank, MSCI. Price return in USD

Exhibit 5 shows that on average emerging markets have been growing at a much faster pace (almost double) than developed markets for the last twenty years and this corresponds to more than double the returns for emerging equity markets. However, it is important to note that the list of emerging countries that actually generate above average growth is not static. Only China has managed to achieve above average growth consistently throughout the period of observation. Across emerging markets there is also a substantial variation in GDP growth rates. Some of the emerging markets have grown phenomenally. Others have fallen short of expectations.

It is obviously difficult to predict from the outset which countries can achieve superior economic growth on a consistent basis.[3] It is arguably even harder to predict in which countries this growth will be translated into equity returns. In fact, some academics argue that in the long run the one to one contemporaneous predictive power of economic growth onto equity returns is weak, at most (Dimson et al., 2002). Nonetheless, investors can take into consideration the empirical evidence that emerging markets as a group has historically outpaced their developed markets counterparts in terms of growth

[3] See Gokhale (2009) for a discussion of systematic errors in GRP forecasts.

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and investment returns despite the changing opportunity landscape. An allocation to a broad-based emerging markets portfolio can help to capture the underlying market evolution and allow investors to participate in these changes. Importantly, having a broad exposure to emerging markets may ensure that investors can continue to capture the growth premium in a dynamic way without necessarily having a specific investment view regarding country performance or taking active risk. It also helps to capture potential winners neglected by hard-coded country selection strategies and minimize market timing risk associated with active country selection.

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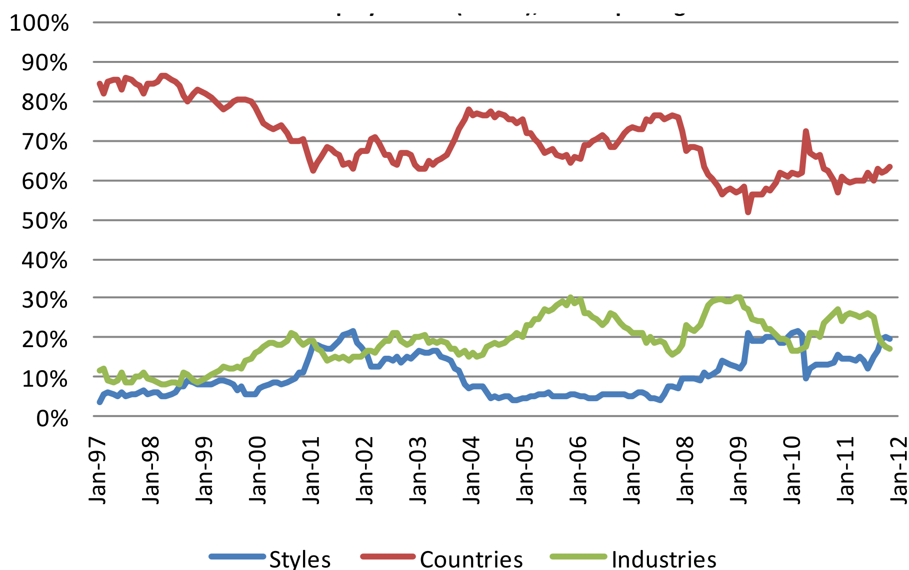
III. Has Picking the Winners Paid Off?

In this section, we examine the merits and trade-offs of common mandate structures used in emerging markets allocations and their performance track records. There are many similarities among the *Integrated, Dedicated and Pushing the Boundaries* approaches. All these approaches seek broad-based exposure to emerging markets and are founded on the value of diversification. The *Integrated* and the *Dedicated* approaches are the most liquid and accessible and have high capacity (as proxied by index market cap). The *Pushing the Boundaries* approach offers slightly higher capacity, diversification and arguably better growth prospects relative to the *Dedicated* approach but at the expense of less liquidity and accessibility. Importantly, the common denominator across these approaches is their ability to capture the dynamic nature of emerging markets.

In contrast, the *Picking the Winners* approach can be seen as a much more targeted approach to emerging markets investing. This approach seeks to discriminate among emerging markets by taking on active risk relative to a broad emerging markets index. Obviously, this requires investment conviction and active research. Some of these strategies "hard code" country overweights and underweights while others provide a more dynamic approach in picking the countries based on a specific set of criteria.

In retrospect (*ex post*) active country selection works well in emerging markets. Exhibit 6 shows the contribution of three different systematic sources – country, sector and style – to returns in the MSCI Emerging Markets Index. The explanatory contribution of the country factor to cross sectional volatility remains above 60% for most of the period between 1997 and 2012. From a risk perspective, these *ex post* results suggest that it might be useful to consider country-based active strategies in emerging markets.

Exhibit 6: Contribution to Risk Factors to Explained Cross Sectional Volatility, BARRA Global Equity Model (GEM2), USD cap weighted



Source: MSCI

However, two key questions remain. The first is whether it is possible, *ex ante,* to predict countries with relatively high GDP growth. An extensive body of literature in growth economics, starting with Adam Smith, has shed light on the determinants of long-term economic growth. However, the existence of macroeconomic cycles and GDP growth regime changes suggest that picking winners requires

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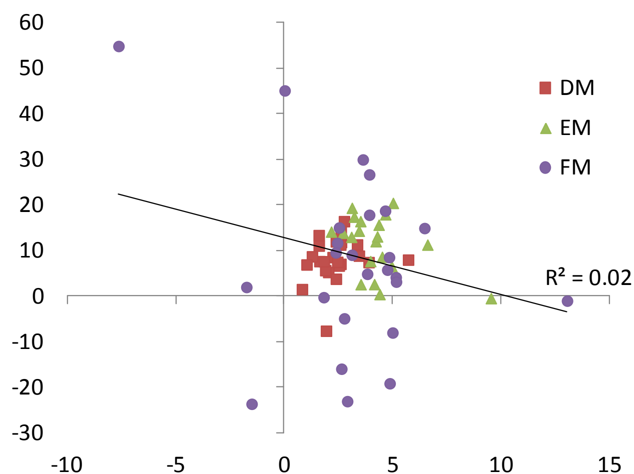
continuous research and reexamination. Short term macroeconomic cycles and shocks make forecasting GDP growth much more elusive. Examples abound. Consider growth projections before and after the current European Sovereign Debt Crisis, the Global Financial Crisis of 2008, the Asian Crisis of 1997 or before and after the burst of the bubble in the Japanese economy of the 1990s. The second question is whether and to what extent it is possible to identify the markets for which GDP growth will effectively translate into equity returns. Note, for example, in exhibit 6, that the country factor (which summarizes differences in GDP growth and a variety of other variables) declines by over 25 percentage points from 1997 to 2012. Country-based explanations, while still higher for emerging markets than for developed markets, are not as strong as they used to be.

Moreover, while it seems intuitive to assume that there is a positive link between GDP growth and equity returns, the empirical evidence casts doubt on this assertion. Many studies (Ritter, 2005; Vanguard, 2010; Dimson et al., 2001; MSCI, 2010; Ilmanen, 2011) have documented a weak link (if any) between equity returns and GDP growth. Our analysis confirms these studies. Exhibit 7 shows the relationship between long-term annualized GDP growth and equity returns from 1990 and 2010. The link is very weak: GDP growth explains only two percent of the variance in equity returns.

Exhibit 7: Annualized Equity Returns and GDP Growth, 1990-2010



Source: MSCI, World Bank, Taiwan National Statistics

This mismatch between GDP growth and equity market returns is better explained when considering a number of “intervening variables”. The main ones being:

1. **Valuation**: nothing (not even a fast growing economy) is attractive at any price. A high-growth country may have those higher expectations built into stock prices, thus providing relatively modest expected returns.
2. The role of consensus **expectations**: equity investors are forward looking and therefore growth expectations are typically incorporated in the price, so what will ultimately generate a change in price are ‘surprises’ (i.e. growth that occurs above and beyond what the market expects). Stocks in a country whose growth outpaces expectations could provide higher returns than a country whose growth rates disappoints.
3. The **extent to which the full economy is represented** in public equity markets, especially in those cases where growth generated by new or privately held companies.

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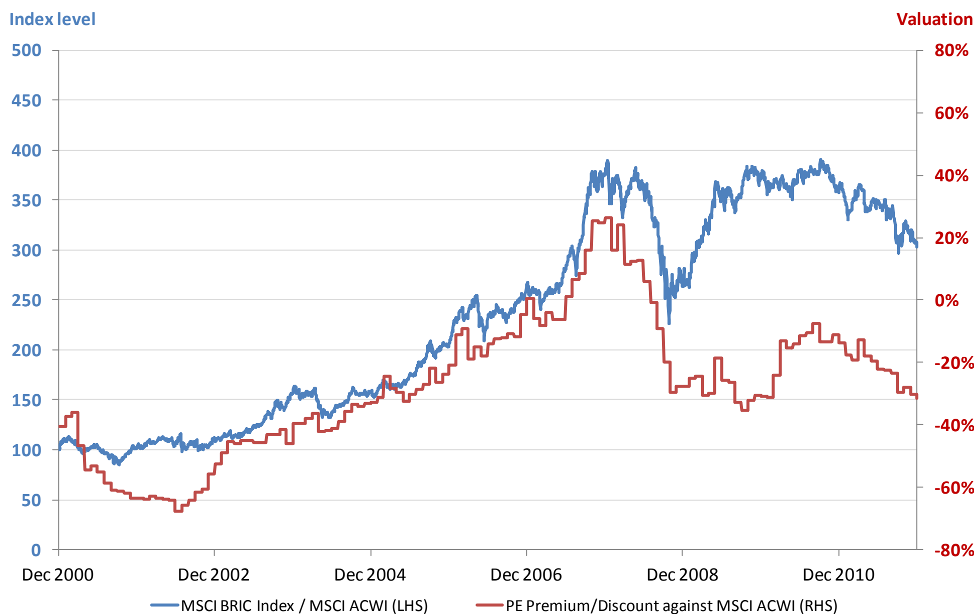
4. The increased level of globalization means that **growth can transcend geographical boundaries**. GDP growth may not be fully reflective of company growth.
5. The **new issuance of stocks may dilute shareholder returns.**

An important implication of the first two points above is that chasing growth without considering if market prices have already incorporated these growth expectations may potentially lead to disappointments. Exhibit 8 illustrates this point by contrasting the performance of the MSCI BRIC Index with its valuation relative to the MSCI ACWI. The exhibit shows that while an allocation to the BRIC countries had rewarded investors well during 2000-2007, it was followed by a drop in relative performance during which the relative valuations of these markets increased substantially. In addition, active country selection strategies can assume substantial market timing risk.

Exhibit 8: MSCI BRIC Index Performance and Relative Valuation vs. MSCI ACWI, 2000-2012



Source: MSCI

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IV. Choice of Mandate Configuration Matters

As we might expect, the four emerging market investment approaches outlined in section III have generated quite different return and risk characteristics, which in turn vary with the period of analysis. Exhibit 9 summarizes the risk and return profile of the various approaches proxied by the relevant MSCI indices over the period of 2002-2012. Note that for the country selection based category, the MSCI BRIC Index has produced the best performance over the period and seems to suggest that *Picking the Winners* is the most rewarding approach. However, it is important to highlight that the bulk of its over-performance was accumulated in the early 2000s. By focusing on the most recent periods, it can be seen that this particular version of *Picking the Winners* approach has underperformed the *Dedicated* and *Integrated* approach over the last one, three and five-year periods and incurred higher risk and higher maximum drawdown at the same time. In addition, not all *Picking the Winners* approaches produced the same result. The other variant depicted by the MSCI Next 11 ex Iran Index produced a visible different return pattern compared with the MSCI BRIC Index and underperformed the MSCI Emerging Markets Index for the full period. These simple comparisons highlight the active risk involved in adopting a static country view in such mandate configurations.

Exhibit 9: Risk and Returns of Emerging Markets Mandate Configurations, 2002 - 2012

Performance Jun 2002 - Jun 2012	Integrated	Dedicated	Pushing the Boundaries		Picking the Winners	
	MSCI ACWI	MSCI EM	MSCI FM	MSCI Emerging + Frontier Markets	MSCI BRIC	MSCI Next 11 ex Iran
Return (% pa)	6.3%	14.4%	8.2%	13.9%	17.6%	14.1%
Risk (% pa)	18.0%	21.6%	13.7%	20.9%	25.9%	24.9%
Risk adjusted return	0.35	0.67	0.60	0.66	0.68	0.57
Maximum drawdown	-58.1%	-65.1%	-67.4%	-63.9%	-70.5%	-67.7%
Active return vs MSCI EM (% pa)	-8.2%	-	-6.2%	-0.5%	3.1%	-0.3%
Active risk vs MSCI EM (% pa)	14.2%	-	21.0%	1.1%	9.4%	11.4%
Performance end June 2012						
1-year return (% pa)	-6.0%	-15.7%	-14.9%	-15.7%	-22.1%	-9.5%
3-year return (% pa)	11.4%	10.1%	0.1%	9.7%	3.7%	18.0%
5-year return (% pa)	-2.2%	0.2%	-10.4%	-0.1%	-1.7%	1.0%
1-year risk (% pa)	20.8%	22.6%	8.7%	22.1%	24.8%	26.0%
3-year risk (% pa)	17.2%	19.0%	10.0%	18.6%	21.0%	21.7%
5-year risk (% pa)	22.4%	26.5%	15.7%	25.6%	31.7%	29.0%
1-year risk adjusted return	-0.29	-0.69	-1.72	-0.71	-0.89	-0.37
3-year risk adjusted return	0.66	0.53	0.01	0.52	0.18	0.83
5-year risk adjusted return	-0.10	0.01	-0.66	0.00	-0.05	0.03

Source: MSCI

From the risk angle, the MSCI Emerging and Frontier Markets (EFM) Index had the lowest active risk over the whole period and in each of the sub-periods analyzed, underscoring the diversification benefits afforded by including frontier markets in *Pushing the Boundaries* strategies. From a tracking error perspective, relative to the MSCI Emerging Markets Index, the *Pushing the Boundaries* approach based on the MSCI Emerging Frontier Markets Index generates one percent tracking error while the *Picking the Winners* strategies (MSCI BRIC and MSCI Next 11 ex Iran) experience tracking errors close to 10%.

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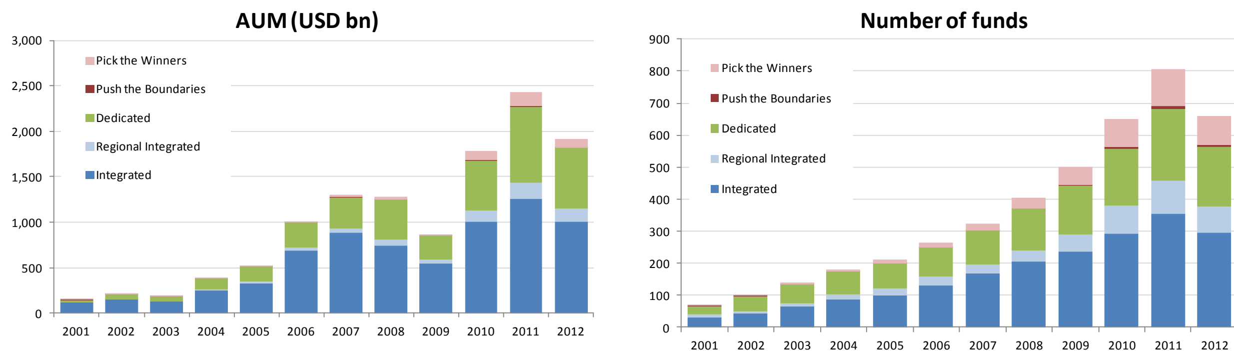
V. Dedicated Mandates Dominate the Product Landscape

Product availability is another important dimension in considering the most appropriate mandate configuration. Exhibit 10 shows the popularity and acceptance of the various emerging markets investing approaches based on data extracted from the eVestment database[4]. Of course different approaches have generated different amount of traction among investors. To start with, not all of them have been available for the same period of time.

At a glance, the numbers seem to indicate that the *Integrated* approach has the largest share of assets under management (AUM), however it is important to note the underlying AUM contains a significant proportion of developed markets assets (almost 90%). From the AUM perspective, this makes the *Dedicated* approach such as the one based on the MSCI Emerging Markets Index, by far, the most popular structure for getting emerging markets exposure. This may be due to the fact that the *Dedicated* approach has been available for a longer period of time. *Picking the Winners* currently represents about 12% of the total non-developed market AUM. Half of these are actually single country products. *Pushing the Boundaries* approach remains a small minority and this may in part reflect some level of investor discomfort in making specific country bets. A similar pattern emerges when looking at the number of funds in each category. The growth in the supply of products in the emerging markets segments is striking and has come about in all the different approaches discussed in this paper. Still the *Dedicated* approach to emerging markets has more than double the number of products than the *Pick the Winners* approach.

Exhibit 10: Emerging Markets Product Landscape



Source: MSCI, eVestment Alliance

These results underscore the fact that broad-based emerging markets mandate structures such as the *Dedicated* and *Integrated* remain the two most widely used approaches in allocating to emerging markets by institutional investors. The dominance of these two approaches reflects: 1) investors' preference to seek a broad-based exposure to emerging markets by not limiting themselves to a specific subset of investment opportunities, and 2) the fact that emerging markets are increasingly being viewed as an integrated part of global equity allocation. As global investors continue to embrace the New Classic equity allocation framework, the broad-based emerging markets approach could continue to flourish for some time.

[4] Data source: eVestment Alliance. Comprises all products (active and passive) available in the dataset excluding those that are DM only. The data also does not include segregated managed accounts and ETFs.

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VI. More Breadth Means More Opportunities

Another potential key argument why broad-based emerging markets continues to be the preferred mandate choices for investors draws on the Fundamental Law of Active Management (Grinold, 1989) i.e. the size of universe and cross section dispersion has an impact on the managers' ability to add value. Exhibit 11 presents the empirical track record of active management in the emerging markets space. The exhibit shows active returns, tracking error and information ratio relative to their chosen benchmarks for the universe of emerging markets managers available in the eVestment Alliance database.[5] Note that the sample size for the *Pushing the Boundaries* and *Picking the Winners* strategies is considerably smaller than for the other strategies as the number of actively managed products is limited.

Exhibit 11: Performance of Active Managers, 2002-2012

	Integrated	Regional Integrated	Dedicated	Pushing the Boundaries	Picking the Winners
Annual Active Return					
Upper Quartile	5.3%	5.6%	4.9%	8.4%	5.6%
Median	1.2%	1.3%	1.2%	5.8%	0.7%
Lower Quartile	-2.0%	-2.3%	-1.8%	3.8%	-4.3%
Annual Tracking Error					
Upper Quartile	6.1%	7.6%	6.2%	11.5%	11.0%
Median	4.3%	5.3%	4.3%	11.0%	7.9%
Lower Quartile	3.1%	3.7%	3.1%	10.4%	5.5%
Information Ratio					
Upper Quartile	1.21	1.05	1.09	0.66	0.78
Median	0.37	0.28	0.33	0.44	0.12
Lower Quartile	-0.47	-0.47	-0.42	0.22	-0.50
Min # of funds	*95*	*49*	*97*	*1*	*9*
Max # of funds	*287*	*111*	*228*	*8*	*49*

Period: January 2002 - March 2012

Please note that upper quartile Information Ratio does not equate to upper quartile active return divide by upper quartile active risk as these correspond to the performance of different investment managers.

Source: MSCI, eVestment Alliance

Matching the empirical manager performances with the various mandate structures, we found that mandates with higher information ratios are those managed against the broader benchmarks. The *Integrated* (such as the MSCI ACWI Index), *Pushing the Boundaries* (such as the MSCI EFM Index) and *Dedicated* ones (such as the MSCI Emerging Markets Index) have generated larger risk adjusted returns than the *Picking the Winners* approach. This is not a surprising result as a broad investment universe provides more opportunities for active managers to pick the best stocks as well as more opportunity to manage country exposures.

[5] Data source: eVestment Alliance and it comprises all products (active and passive) available in the dataset excluding those that are DM only. The data also does not include segregated managed accounts and ETFs.

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Another important observation which may not come as a surprise is that while the overall empirical track record of average active managers in emerging markets is positive, they can hardly be considered impressive, especially since these numbers are gross of fees. In addition, the variation across managers in emerging markets is significant. The annual active returns range from 8.4% achieved by the upper quartile managers from the *Pushing the Boundaries* approach to negative 4.3% by the lower quartile managers in the *Picking the Winners* approach. This huge dispersion in performance can be attributed to the diverse investment convictions and high active risk that managers are taking. Examining tracking error against the benchmark reveals a substantial dispersion ranging between 3.1% in the lower quartile of the *Integrated* mandates and 11.5% in the upper quartile of *Pushing the Boundaries* approach. While these results are hardly a surprise and are consistent with many empirical findings and anecdotal observations, it serves as a useful reminder that the choices of mandate configuration could have a substantial impact on the ultimate portfolio risk and return of investors.

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VII. Conclusion

The last twenty years have seen emerging markets gaining a central role in modern global equity portfolios. However, the dynamic nature of emerging markets often poses a big challenge to investors seeking the best way to approach this segment. This has led some investors to question the legitimacy of broad-based approach to emerging markets investing.

In this paper, we analyzed the trend of mandate configuration in emerging markets investing and evaluated the merits and trade-offs among the various approaches. We found that the *Dedicated* approach to emerging market investing has stood the test of time and remains as the most widely adopted mandate structure for emerging markets investors. Broad-based emerging markets mandates have been effective in:

1. Capturing the dynamic and changing nature of emerging markets and providing a broad coverage to the underlying diversified opportunity set
2. Picking up potential winners that are neglected by a hard-coded country view as valuation and expectation could influence the outcome of portfolio returns
3. Minimizing market timing risk associated with active country selection strategies
4. Facilitating greater alpha seeking opportunities

At the same time, the trend also suggests that both the *Integrated* and the *Picking the Winners* approaches have been gaining popularity in terms of the number of products. While the *Integrated* approach reflects the increased adoption of the New Classic equity allocation framework, the *Picking the Winners* approach is founded on the belief of country selection. It provides a more targeted exposure to emerging markets but comes at the expense of higher active risk and mixed historical performance. The *Pushing the Boundaries* approach seeks to provide additional exposures to frontier markets but the size of assets and product offering reflect that the concept is still at an early stage of adoption.

In summary, we believe that emerging markets as a concept and investors' approaches to investing will continue to be shaped and driven by the constant changes in the underlying opportunity set. This is reflected by the emergence of new approaches over the past decade. While the development in mandate configuration have provided investors with more choices in structuring their emerging markets allocation, it is important to understand the merits and tradeoffs of various structures and how they fit into the investment process. In the process of embracing new thinking and new approaches to emerging markets investing, it is important to know that the broad-based emerging market investing concept such as the one based on MSCI Emerging Markets Index has been tried and tested and remains as relevant as ever!

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[1] *As of June 30, 2011, based on eVestment, Lipper and Bloomberg data.*

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