Cartica Market Notes

Emerging Markets: Taking the Plunge

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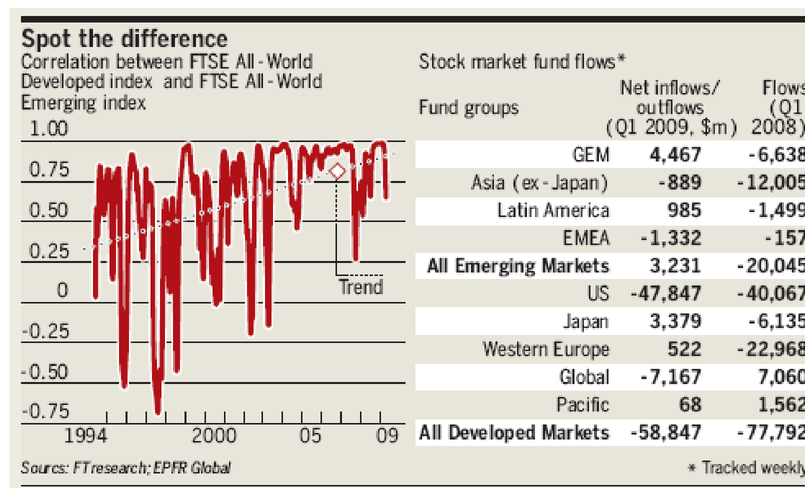
In the past, an astute investor dipped his toe into the Emerging Markets in order to balance his portfolio with a low correlation asset, but now he is likely to go swimming. Over the last fifteen years, the world has changed and EMs demand to be regarded as a core holding. The asset class can now be viewed as a significant source of absolute return, not just a fillip in a portfolio diversification exercise.

On April 8, 2009 the Financial Times published the "news" that the Emerging Markets were no longer a low-correlation play. In 1994, one of the banner years for EM performance, the correlation between EMs and Developed Markets (DMs) was zero. In 1997 it fell to nearly minus 0.75 – a diversifier's dream, you might say. The trend line, however, is toward convergence. During the current financial crisis, correlations went all the way to 1. At the moment they have fallen back to 0.65 as EMs rose in the first three months of 2009 while Developed Markets (DMs) kept falling to their March 9 bottom. But that does not gainsay the secular trend toward convergence.



Stock market fund flows*

Fund groups	Net inflows/ outflows (Q1 2009, $m)	Flows (Q1 2008)
GEM	4,467	-6,638
Asia (ex-Japan)	-889	-12,005
Latin America	985	-1,499
EMEA	-1,332	-157
All Emerging Markets	3,231	-20,045
US	-47,847	-40,067
Japan	3,379	-6,135
Western Europe	522	-22,968
Global	-7,167	7,060
Pacific	68	1,562
All Developed Markets	-58,847	-77,792

Sourcs: FTresearch; EPFR Global

* Tracked weekly

FT. LEX. April 8, 2009

In making the case for taking the plunge into EMs, one starts with the growth story. The **GDP growth trajectory** is well known. In 1999 EMs accounted for 19% of global GDP and in 2008 that figure rose to 24% and in another five years it will be 37%. This year, the IMF expects DM GDPs to sink 3.8% while the EMs will grow at a newly-respectable 1.6%. And this growth has been and will be achieved with relatively little leverage. While the US required $5 of debt to drive $1 of GDP growth in the last decade,

most EMs required only the low levels the US had in the 1960s – around $1 dollar of debt to drive $1 dollar of growth. Growth in developing countries has come in part from increased prices for the commodities they produce, in part from manufactured goods they sell locally and export to the richer countries, and in part from local consumer demand for an increasingly diverse range of goods and services. Most are moving up the classic development pyramid from agriculture to manufacturing to services. And some, like India, have confounded the traditional growth paths by starting with a revolution in services that led to increased skill in manufacturing and is now leading to a second "green revolution" in productive agribusiness.

Then there is the wave of the future: the **productivity revolution** in the EMs. The decade since the 1998 Asia crisis has set the stage for big leaps in productivity growth ahead. This has been an era of significant reform on all levels. Macroeconomic reforms have given us reasonable monetary and fiscal policies throughout the EMs from Brazil, to Indonesia, to Ghana. The average fiscal deficits in EMs are 0.4% versus 8.8% of GDP for advanced economies for 2009. Industrial policies have undergone a veritable revolution with the fall of tariff and other competitive barriers, the elimination of red tape to set up or wind up a company, and improvements in property rights. For example, the Cartica focus countries (12 countries: three in Latin America, two in Middle East, three in Africa, four in Asia) have reduced the number of days it takes to set up a business from 79 to 45 days over the last five years. And on average, they have cut out 2.5 procedures required. Everywhere we go in the developing world, the markets are becoming more contested with more entrants knocking at the door, ready to pounce on competitors with high margins and sloppy cost controls.

The growth with productivity story sets the stage for the brass ring investors really care about: attractive **earnings per share (EPS)** and future **multiple expansion**.

In the last three years **earnings per share** for the S&P companies fell 20%. Sampling the twelve countries Cartica favors at the moment, we find EPS over the same time period was up 9%. Looking forward, we see top line revenues can grow in a period of global recession in cases where local dynamics trump global integration. Consumer goods are still growing in Peru, Brazil and Indonesia. Some Brazilian ports are keeping up revenues because the quantities of key imports stay steady even when – or because- the prices fall. Internet providers in Brazil and the Philippines continue to increase penetration of their potential customer base. And the cost of production in many places is falling as the slump in global demand has lowered cost of some inputs, including many commodities, although we appear to be in a period of upward commodity price pressure at the moment. EM governments are, for the first time, pursuing countercyclical policies, stepping up spending on infrastructure and social needs such as education and housing. And in many countries like Brazil, Turkey and South Africa, they still have room to lower interest rates.

In looking for **multiple expansion**, let's first start with multiples. Over the last five years, the S&P traded at 16.6 times earnings while EMs were only at 12.7 times earnings. Why the persistent discount?

EMs perennially suffer a discount as an asset class based on three risks perceived by investors: corporate governance risks, political uncertainty, and economic shallowness. These are all very real risks and, in sum, they constitute the basic rationale for treating EMs as an asset class. But they all offer the

alert investor – especially using active management approaches -- opportunities for alpha generation that one simply cannot find in the DMs.

First risk: corporate governance. One salient characteristic of the EMs is that there is relatively little free float and most listed companies are in fact controlled by a family, group or individual. To generalize, minority investors fear that they are likely to get less than their fair share of the company's profits while the controllers or insiders get "asymmetric benefits". While there are plenty of corporate governance codes around and some good securities laws, local enforcement is notoriously weak and securities commissions are perpetually under-resourced. Recourse to the local judicial system is not a viable option due to lack of speed and, in some cases, independence of the judiciary. Within the EMs, companies with below-average governance generally sell at a discount of about 30% to well-governed companies. This provides a far more exciting multiple expansion opportunity than the corresponding single-digit spread one finds in the US market, if a company can unlock that corporate governance discount.

Second risk: political uncertainty. By any measure, the democracies of North America, Europe, Japan, Australia and New Zealand provide more stable operating environments for their corporate constituencies. We have found, however, that thoughtful investors in the EMs can do very well by investing in higher risk countries which are in the process of becoming lower risk countries – another multiple arbitrage opportunity uniquely found in the EMs but which requires careful country selection.

Third risk: shallowness of economic institutions and capital intermediation. The economic institutions in EMs -- from policy making bodies to stock exchanges -- are clearly less robust and newer than in the industrialized countries. Most EM countries are still in the process of deepening some of their basic economic institutions and most have not yet truly understood the process of continual policy improvement that prevails in the DMs. We also have to account for an enduring EM characteristic: low liquidity, high volatility capital markets with relatively low market cap to GDP ratios. These markets are in the process of financial deepening which should be abetted over the coming years by the improved policy environment and the increased attention to developing local institutional investors. Again, one can invest in countries that are improving their policy environments and make healthy returns as they move from a lower development stage to a higher one. The IFC/World Bank has found that countries which improve their business environment, particularly on the "protection of investors" index have higher stock market returns in the ensuing few years.

Investors who have been standing on the shore during the 2008-09 crisis are beginning to wade back into investments. So far, it looks like the EMs are an enticing pond. A fresh $10b has flowed into EM dedicated equity funds in the last five weeks, as money has continued to flow out of the US and Europe funds. Morgan Stanley (4/13/09) suggests wealthy individuals and small institutions should be 2% in EM equities (for a moderate risk, strategic portfolio). That seems a bit like toe-dipping. David Swenson, on the other hand, says retail investors should allocate 10% to EM equities. This is much closer to the 13% of global market cap represented by the MSCI EM markets and seems more like swimming. Investors will have to be more informed about more markets to swim in the EM waters, but that will have to happen as they make it a core holding and look elsewhere to diversify risk.