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BARCLAY ROUNDTABLE

Emerging Markets Funds Rally; Fair Value or a New Bubble?

As Investor Risk Appetite Returns to Normal, Frontier Markets are Now Poised for Growth

Oh, what a difference a year can make! This time last year the global markets were on the verge of Armageddon, and investors could not pull their capital out of any risk-based asset class fast enough, let alone one of the riskiest asset classes, emerging markets.

The aggregate emerging markets were hit particularly hard, with equity losses of more than 50% on $50 billion of fund outflows. It would seem that investors had finally had enough of the frivolous risk taking that has all too often driven many a market to bubbly proportions. Fast forward nine months, however, and emerging market equities have advanced more than 60% year-to-date through September, and fund inflows have returned to a breakneck pace. It's not overly evident where the steam for this recent rally is coming from – whether it's the few trillion dollars of global stimulus spending, a serious case of investor amnesia, or a sense of urgency to win back the investment losses from 2008.

Perhaps the emerging markets were just simply oversold and may not be susceptible to the lingering economic downturn and eventual hangover effects of a few trillion dollars' worth of debt. Whatever the cause, it appears that the emerging markets are set to post spectacular returns for all of 2009, although a keen eye may be critical to determine the inflection point between fair value and a new and improved bubble. To review the opportunities and risks in emerging market investments, we have assembled a panel of experts with hands on experience in the sector. Our panel includes;

Ajay G. Jani, Gramercy LLC. Mr. Jani is a managing director and portfolio manager at Gramercy, an emerging markets asset manager established in 1999 and currently managing $2.5 billion in assets. Mr. Jani manages the firm's emerging markets macro fund and additionally works on designing and implementing macro hedges for the existing emerging market credit portfolios. Prior to joining Gramercy, Mr. Jani managed emerging market macro portfolios at London Diversified Fund Management and at BNP Paribas. Mr. Jani holds a bachelor's degree in international economics from UCLA, and an MBA from Columbia University where he graduated Beta Gamma Sigma.

Gavin Joubert, Coronation Fund Managers. Mr. Joubert heads up Coronation's Global Emerging Markets unit, which manages both a long-only and long/short global emerging fund. Coronation is based in Cape Town, South Africa and has been managing South African equities for 15 years since the firm was founded. It currently has over $20 billion under management. Mr. Joubert has been with Coronation for over 10 years and has 13 years of investment experience. At Coronation he managed a range of South African equity and absolute return portfolios before starting to focus on global emerging markets three years ago. He is a Chartered Accountant and a CFA charterholder.

Ian McCall, MSc, Argo Group Limited. Mr. McCall is a Director at Argo. He began his career in emerging markets in 1989, financing trade between Western Europe and the former Soviet Union. He has also worked as a Tokyo-based investment analyst and a London-based portfolio manager and has held various sales positions based in Madrid and London. Prior to joining Argo, he was Senior Investment Advisor at Rainbow Advisory, and prior to that he was head of West European Emerging Market Debt Sales for ING. Ian holds bachelor's degrees in business administration and economics from the University of Regina, Canada. He also holds an MSc in finance from The London Business School.

Q: Emerging market stocks have led the global stock market rally in 2009, earning a year-to-date return of 29.80% though September. How much of this rally has been driven by attractive valuations and favorable economic prospects within various emerging markets, as opposed to blind risk appetite and return chasing? What are the key factors that can sustain or derail the rally at this juncture? Which countries appear to be strongest? Which countries would you avoid or look to take net short exposure?

Jani: Favorable valuation without risk appetite is akin to firewood without a match. You need confidence in the financial system to induce investors to part with their cash hoard and purchase risky assets. Once the fire is lit, the results depend on the quality of the wood, the surrounding conditions, and the supply of extra matches or accelerant if needed. At the prices we witnessed during Q4 2008 to Q1 2009, emerging market valuations became very attractive across all asset classes: interest rates, credit, foreign exchange, and equity. So during the depths of the crisis we had lots of

firewood, but no matches. Rapid infusions of liquidity and equity capital into the global financial system by central banks and governments gave participants the matches and some accelerant to boot, and the results are stunning. From the lows in October 2008 until the end of Q3 2009, emerging market sovereign and corporate bonds returned 56% and 68% respectively. The MSCI EM equity index doubled in USD terms, while a basket of EM currencies returned 22%. Local currency bonds also soared after plunging in October 2008, so the rally has been broad based both geographically and across the asset classes that we track.

Going forward, the keys to sustaining the rally are similar to those that have brought us this far: investor faith that markets still offer value combined with the willingness of authorities to insure that liquidity continues to flow as needed to stabilize and turn around the real economy. Emerging markets have several added advantages in the near term. For the most part, these countries entered the crisis with the best fundamental underpinnings in several decades. During the worst economic crisis since the 1970s (or perhaps the 1930s), most emerging nations came through with flying colors and are now viewed as battle tested. From a policy perspective, many emerging nations still appear to be working at the margin towards liberalizing their economies, contrary to policy direction in G-7. The emerging market demographic picture generally remains favorable. Finally the global investor base is still very underweight in emerging market assets relative to the perceived opportunity. In Asia, many equity indices are unchanged or even lower than they were at the end of the last emerging market equity boom in December 1993 when priced in U.S. dollars. Examples include Taiwan, Korea, Indonesia, and Malaysia. The MSCI China equity index measured in US dollars is down nearly 54% since the end of 1993. So while the markets have enjoyed a tremendous rebound, there is still some value out there for those intrepid enough to seek it out.

In the near term we continue to find opportunity in emerging market securities across many asset classes. Ideas in distressed corporate and sovereign credit have been particularly fertile fields in 2009, but we are still finding plenty of opportunity across the board. Our concerns at this point are focused on a few select countries where the market has yet to price in real risks, or where the risks have been acknowledged but not yet dealt with. Mexico finds itself in a difficult situation. It has continued to lose manufacturing competitiveness to China, and is also suffering from the drop in US consumer demand. At the same time, Mexico's oil production is deteriorating rapidly, and the constitution prohibits opening much of the energy sector to foreign expertise and capital. On current trends, Mexico will become a net oil importer by 2015, which would be catastrophic for a budget that derives approximately 1/3 of its revenue from oil production. Tax reform is on the congressional agenda, but the result will likely be short-term triage rather than a fundamental change in the long-term budget framework. Dubai in the UAE is another area where we are concerned that the full repercussions of a debt fuelled asset and real estate bubble have yet to be fully recognized. Much of the debt was via "Sukuks" or Islamic bonds, and the restructuring process for this form of indenture has not yet been tested. The bursting of the oil bubble puts additional pressure on the region, reducing the liquidity necessary to help facilitate debt restructurings. The Baltics are also under severe economic pressure. While the problem is widely acknowledged, the markets are hesitant to invest in the region in anticipation that one or more of these nations will break their currency pegs.

Ajay G. Jani
Gramercy LLC

"Favorable valuation without risk appetite is akin to firewood without a match."

Joubert: Emerging markets were sold off significantly during 2008 – more so than developed markets. In many cases it appeared that technical factors (outflows, deleveraging) were playing more of a role than fundamental factors, and as a result many emerging market stocks declined to simply ridiculous levels. The appreciation of emerging markets in 2009 therefore needs to be considered in this context – the base was low. In our view the primary reason for the rally this year has therefore been very attractive valuations and favourable economic prospects rather than blind risk appetite and return chasing. More recently, however, risk appetite appears to be playing a larger role, in particular within the commodity stocks which we feel now offer very little value and in many cases are overvalued. Structural overvaluation across the board in emerging markets would of course make them vulnerable to a sell-off. We don't believe we have reached this point yet – there is still good selected value to be found within emerging markets, particularly amongst the more defensive businesses which have lagged significantly.

From an economic point of view, Brazil and China stand out as countries that have recovered well, and Russia on the other hand is still struggling and vulnerable. Our investment approach is strictly valuation based and stock specific, so we wouldn't necessarily be long the strong countries and short the weak countries – in fact the opposite is quite typical as poor short term outlooks often provide opportunities on the long side for investors with a long-term time horizon, and positive short-term outlooks often mean that valuations are unattractive as everyone wants to be there. On a valuation-based, individual stock basis, we happen to be net short Chile and South Africa, but this is due to stock specifics, not to a negative outlook for those two

particular countries. We also have a few shorts amongst Brazilian and Russian stocks, but we are overall net long these two countries.

McCall: To say that the valuations emerging market investors were presented with in early 2009 were very compelling is a dramatic understatement. In my experience of investing in emerging markets, living through the Asian crisis/Russian collapse and the Argentine default/Brazilian real crisis, the experience of the credit crisis has been very special indeed. P/Es had collapsed below their long term averages, numerous companies' market capitalizations were lower than the cash on their balance sheets, and lightly-levered sovereign and corporate bonds were priced to indicate a very high probability of default. Using US risk assets with their long histories of recorded data as a proxy for emerging markets illustrates the point precisely. The lowest recorded historic P/E valuations would have produced an S&P 500 of around 500 in Q1 2009, versus the 666 that it fell to in March. USD High Yield Bonds were priced to imply default rates of 69% versus the average default rate since 1970 of 19.3%. USD High Yield default rates "only" reached 45% during the worst 5 years of the Great Depression. High yield bonds had sold off so dramatically that never previously experienced default rates were implied in the price! So we see clearly that the starting point for the rally in emerging markets, particularly in credit, was that assets had been sold down to levels that had little connection with reality.

Emerging markets were not able to decouple from the crisis. However, they entered the crisis in much better economic shape than developed economies. Emerging economies growth rates have outpaced the G-7 every one of the last ten years. In 2006 the accumulated FX reserves of emerging economies surpassed those of developed economies. They are currently $4.4 trillion, almost double the $2.4 trillion of developed economies. Public sector debt as a percent of GDP is running at close to 110% in the G-3, while for emerging economies the average is approximately 40%. Very importantly, unemployment in the emerging markets has already begun to decline, while in the developed economies it is still rising. We are seeing the best risk/reward in Eastern Europe while spreads in LATAM and Asia are very tight.

Couple these extremely depressed prices with the fact that the source of the crisis did not originate in the increasingly robust economies of the emerging markets but in the developed markets, and you had the necessary conditions in place for a dramatic rebound by emerging markets. The risk appetite is therefore far from blind; on the contrary, there is now better connectivity between the perceived risk of emerging markets and its real risks.

Gavin Joubert
Coronation Fund Managers

"On a valuation-based, individual stock basis, we happen to be net short Chile and South Africa..."

Q: Frontier markets have become an investment buzz word over the past few years and have spawned specialized indices as well as numerous focused products that invest in these regions. To what extent has the globalization of economies and markets blurred the line between developed and emerging markets to the extent that the frontier markets have become synonymous with the emerging markets of old? How much return potential and what accompanying level of risk are intrinsic to the frontier markets? To what extent should risk and reward expectations of the "old" emerging markets be revised?

Jani: The line has clearly blurred between developed and emerging, and in some cases several "emerging" economies are ranked higher in terms of freedom and flexibility than some well established developed nations. The genie is out of the bottle, and it's no longer a secret how to create a dynamic, thriving economy. The result of having two separate economic systems run side by side for many decades conclusively demonstrated which method works better. So at this point, progress on the economic front is driven primarily by political will to establish the proper economic framework rather than by winning the debate on which system is better. It is ironic that many developed nations have forgotten these lessons at precisely the time when emerging nations are working hard to capitalize on them.

In terms of frontier markets becoming the new emerging, there is probably some truth to that; but there are many risks involved. These markets and economies by definition are much less developed, and this engenders more volatility in both the real economy and asset prices. The legal framework is less developed, and investor rights are often amorphous. Volatility and return opportunities are still quite high in the "old emerging" markets relative to their developed counterparts while liquidity is superior to the "frontier" markets. There are selective opportunities out on the edge but we would advise caution on entering positions where the doors often seem to allow only one way traffic.

Joubert: Emerging markets have come a long way over the past several years, and in many ways the line between developed and emerging markets has blurred. However, the risks (particularly political risk and also currency risk in some cases) in emerging markets are still higher than those in developed markets, and one should therefore incorporate this into investment decisions by requiring a higher rate of return (and therefore use a higher discount rate in valuations) from emerging markets than from developed markets. That said, too many investors appear to still ignore emerging markets – this is becoming more difficult to justify given that emerging markets now make up almost half the world's GDP on an adjusted purchasing power parity basis

and also make up 25% of the world's market capitalisation. Many investors still use the MSCI World Index as their benchmark/reference point, which is in our view seriously flawed, as it significantly understates the size and relative importance of emerging markets. Frontier markets is a very general term, but what is clear is that over time certain emerging markets mature and begin to resemble developed markets (South Korea, Taiwan, and Israel, for example). At the same time, other emerging markets become bigger and more important within an emerging market context (Indonesia for example). So the universe of emerging markets will evolve over time.

McCall: Traditionally, emerging market countries were not rated investment grade and were very heavily reliant on commodities exports with weaker domestic institutional frameworks. The underlying economies of many emerging markets have become very important to the global economy, and have been rated investment grade and strengthened their domestic institutional frameworks. This seismic shift is reflected in the rise in importance of the G-20 at the expense of the G-7. Many frontier markets have weak domestic institutional frameworks, particularly at a governmental level. These higher risks require higher rewards.

Q: MSCI recently announced that Israel would be upgraded to developed market status from an emerging market for index construction purposes. Other markets, such as South Korea, appear to have economic and capital market development on par with Israel, but have yet to be upgraded. What are the critical factors in differentiating emerging markets from developed markets? Are there any outright or arbitrage opportunities that may be inherent in a market upgrade and index change of this nature? What other markets do you expect may be poised for an upgrade?

Jani: Clearly in terms of economic and social development, physical infrastructure, and market liquidity, South Korea is a developed nation. Sometimes the assignment of labels masks the reality on the ground. However, MSCI evaluates several criteria when assigning countries to various indices. Among them are geopolitical risk, currency convertibility, market liquidity, and restrictions on capital flows. In the case of South Korea, MSCI highlighted market accessibility issues as the primary impediment to advancing to developed market status. These included lack of full currency convertibility and anti-competitive practices in disseminating real-time data among others.

MSCI is continuing the evaluate South Korea for its 2010 review due in June, and the government has expressed a willingness to address the issues. Taiwan suffers from similar issues, but is also on review for 2010. We believe that there is a high probability that one or both of these nations will be moved to the developed index in 2010. In addition, as previously mentioned, both of these markets are at or below levels seen 15-20 years ago when priced in US dollars, so there is still opportunity for outperformance there. Investors should also evaluate whether any nation is demoted from developed to emerging. We believe that Greece in particular is at risk. Generally downgrades are less frequent than upgrades. It is likely Greece will get the benefit of the doubt until at least 2011, but conditions continue to deteriorate on a number of fronts.

Ian McCall, MSc
Argo Group Limited

"It is now the case that many emerging market countries are rated investment grade and are largely indistinguishable from developed economy countries."

Joubert: Definitions of emerging markets vary substantially – what we are really trying to do in our funds is get exposure to countries that are still evolving and have a long way to go when seen in the context of developed market consumption metrics. Industrialisation and urbanization in these countries drive rising disposable incomes which in turn results in significantly increased consumption. China, India, Indonesia, Brazil, Mexico, Russia, and South Africa, for example, would fit this mold, whereas Korea, Taiwan, and Israel would not. We will invest in Korean, Taiwanese, and Israeli companies (and we are invested in a few); but generally speaking, given their more mature state, we find the prospects for companies in other emerging markets more attractive. Valuation is everything for us, though so we focus our time on understanding and quantifying whether or not this growth is priced in. We don't manage our funds against any index. We believe that trying to profit from index changes is a dangerous game not anchored by fundamentals, so we rather focus on buying undervalued businesses, not basing decisions on whether or not a country or company will fall in or out of an index. We would expect Korea and Taiwan at some point to be removed from the emerging markets indexes, and the natural beneficiaries would be the biggest five or so other emerging markets whose respective weightings would obviously increase – this would include China, Brazil, South Africa, Russia, and Mexico.

McCall: The traditional differentiation was that emerging market countries were not rated investment grade while developed economies were. It is now the case that many emerging market countries are rated investment grade and are largely indistinguishable from developed economy countries. There are often opportunities arising out of countries that are due to be upgraded, about to be included in an index, or otherwise mispriced versus countries of a similar profile.

Q: Historically, short exposure and derivatives on emerging markets have been hard to come by. The maturity of a number of markets, however, along with continued development of deriva-

tives based on a number of emerging markets, has increased the opportunity to hedge emerging markets exposures. How effectively can a hedged emerging markets portfolio be employed today? What markets have the greatest amount of short stock interest and most liquid derivatives markets? What markets are still limited in these tools?

Jani: Hedging an emerging market portfolio is pretty straightforward at this point. Currencies have never been a problem to short, other than the potentially high carry costs. However, with rate convergence this is no longer a significant issue. The credit repo market is now well developed, and most liquid sovereign issues can be shorted with ease. In addition, the CDS market has grown exponentially in the past five years, opening another avenue to hedge credit exposure. Interest rate instruments are primarily traded via total return swaps, and for most liquid markets there are two way prices that can be dealt on. The exception remains equities, where idiosyncratic legal restrictions still remain in many markets. The development of liquid futures markets, along with the increase in number of depository receipts traded in New York or London and the high liquidity of the iShares emerging market equity index fund (EEM), means that this is becoming less of a hurdle to hedging portfolio exposures. Brazil's futures market is very liquid, and a recent agreement between the Bovespa and the CME will allow US futures traders to access this market. These types of agreements will expand in concert with the growth in demand for exposure to emerging market assets. We also find that there are many interesting opportunities for cross market hedging since asset correlations increase towards 1.0 during a crisis.

Joubert: Today there are more than enough places to look to in order to get short emerging market exposure or hedges. Many emerging market companies are listed in the US, London, and in Hong Kong, and these markets are well-developed and liquid in terms of borrowing stock. South Africa also has a relatively deep and liquid borrowing market as well as a liquid index futures and options market. One can also use Hong Kong and Bovespa (Brazil) futures to short/hedge. And lastly, one can short emerging market index ETFs. Other than the countries already mentioned, most other emerging markets still have a long way to go in terms of offering liquid stock borrow and derivative markets.

McCall: The deepening of local markets has been a very important contributor to recent emerging market development. The larger local markets like Brazil, Mexico, and Russia allow FX or interest rate swaps, while not surprisingly, smaller local markets like Ukraine or Vietnam do not readily offer these possibilities. In external markets, our options include single name CDS and Index CDS, along with the reverse repo of cash assets.

Q: A number of commodity-based emerging markets have benefited from the sharp rise in commodity prices over the past few years. To what extent have any of these countries shifted capital and resources in order to diversify their economic bases? How much steam is left in the commodity boom, and which countries are best poised to benefit most from a continued climb in prices? Of the non-commodity based emerging markets, which countries appear strongest, and what are their major economic drivers?

Jani: The responses of nations to their particular endowments have been varied. Nations such as Mexico were early in shifting from resource based economies towards value added manufacturing industries. The ability of Mexico to secure a free trade deal with the United States and Canada no doubt aided and accelerated this phenomenon. Colombia and Brazil are also working to improve economic diversification. In fact, Brazil is pursuing both opportunities at once, trying to grow manufactured exports while also working to become a major hydrocarbon exporter. However, at the opposite end of the spectrum, Russia and Venezuela seem to have pretty much given up trying to develop any significant manufacturing base and instead are betting on their mineral resource advantage to maintain living standards and increase geopolitical influence.

Joubert: The biggest beneficiaries of a commodity boom would obviously be those countries rich in natural resources and would include Russia, Brazil, and South Africa. Over the next 5-10 years we would expect commodity prices to increase on balance, but within this time period there will undoubtedly be both sharp rises and sharp declines in commodity prices. Commodities have always been cyclical and we see no reason why this will not continue to be the case. We also believe that the long-term outlook for certain commodities are more attractive than others, and we think that oil is among the best long-term prospects. We find it very hard to forecast what commodity prices will do over the shorter term, but in many cases commodity prices are now above what we believe are long-term normalized prices, and the equities are unattractively valued – copper, for example, would fall into this camp. Amongst the non-commodity based emerging markets, India and Indonesia have very good prospects in our view – however we believe that the equity markets in both these countries are on the expensive side, and we are currently not able to find many undervalued stocks in these countries.

McCall: The policy goal of taking natural resource wealth and using it to diversify an economy so that it is not solely reliant on volatile commodity prices follows a well travelled path. In practice though, achieving this whether you are Russia, Venezuela, Canada, or Australia can be difficult. Russia has taken steps to diversify, to promote the development of a domestic automobile industry and the growth of its refining industry. Various Middle Eastern countries have aggressively pursued further processing at home of their oil and gas via investment in petrochemicals and fertilizer facilities.

Having said that, there is no escaping the place commodities occupy going forward as the underlying demographic trends that gave us the commodity boom remain firmly in place. Namely as the material wealth of the populations of emerging markets continues to rise (Brazil, China, India, and others), their new lifestyles require higher levels of commodity consumption. Couple this with the fact that commodity consumption levels in developed economies are staying relatively constant and the fact that producers of many commodities are struggling to replace their reserves as they are used.

Prime beneficiaries are Russia, Kazakhstan (lifting costs of only $5 to $6

barrel per barrel for onshore oil) Venezuela, Brazil, Colombia, Argentina, and the Middle East. China with its large population, diversified economy, and large accumulated FX reserves is strongest of the net commodity importers.

Q: The appetite for emerging market debt appears to be increasing among traditional and alternative fund managers. How has the liquidity profile in these markets changed over the past few years? What is the general risk-reward comparison between sovereign, corporate, distressed, and asset-based lending opportunities across the emerging markets? What are the most liquid and mature markets for credit default swaps, collateralized debt obligations, and other fixed income derivatives?

Jani: Liquidity in emerging market sovereign credit has improved considerably in the past 15 years, but continues to evolve away from the underlying bonds and into CDS. This was temporarily reversed during the crisis of 2008 but has reverted back to trend so far in 2009. It is much easier to get credit exposure in most sovereign assets via CDS rather than the underlying bonds. In corporate credit this is not yet the case and has a much higher hurdle to overcome. During crisis periods, liquidity disappears first from the corporate market, and using sovereign CDS to hedge a corporate exposure is at best imperfect and often dangerous. A recent example during 2008 was in Kazakhstan where those with exposure to Kazakh bank bonds rushed to buy default protection on the sovereign to hedge their positions. Lost on many market participants was the fact that Kazakhstan didn't have any foreign currency bonds outstanding that were referenced in the default protection contracts, and thus there was nothing to default on. After a brief panic induced spike, sovereign CDS spreads are back to the levels seen in early 2008 while many Kazakhstani bank bonds are in default and down 65 points or more during the same time frame.

CDX-EM, which tracks a basket of emerging market sovereign CDS, is by far the most liquid credit instrument. It is a good proxy to hedge a diversified credit portfolio with tight bid/offer spreads and multiple dealers providing liquidity in a standardized contract. In single name contracts, Brazil is the most liquid name in Latin America. In EMEA, Russia, and Turkey are both equally liquid high beta names, while Poland offers high liquidity for a lower beta name. Finally in Asia, China and South Korea are both good alternatives for investors seeking to hedge regional exposure. South Korea, Mexico, South Africa, and Brazil also have very liquid local interest rate derivative markets. We have generally been wary of asset-based lending because of the extremely poor liquidity and idiosyncratic credit risks which often cannot be hedged. In addition, assets seem to be less secure just when the collateral is needed, and we feel there are many opportunities with much better risk/return and liquidity characteristics within the emerging markets space.

Joubert: We hold only equity in our emerging market funds.

McCall: In line with the rollout of emerging markets' increasing economic strength and importance to the global economy has been a broadening of the universe of investors buying emerging market debt. This has been accompanied by a growth in the total volume of debt outstanding for investors to hold, counting both external and local debt.

Allocations by strategic and retail investors to emerging market debt rose from $23.4 billion in 2005 to $34.1 billion in 2007. The emerging market debt universe has expanded, and liquidity has improved. Sovereign assets and increasingly Tier 1 corporates offer liquid investment opportunities in both local and external markets. Tier 2, Tier 3 and distressed situations offer the prospect of very good returns for dedicated, research-driven emerging market investors. Post the Lehman collapse any esoteric asset saw its liquidity evaporate, a situation that is only recently starting to reverse. ◊

The organization of this roundtable was assisted by Jeffrey F. Kuchta, CFA, a consultant with Strategic Capital Investment Advisors.

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