

# Lazard Insights

## Conference Call Series

16 June 2009

# Summary

## Rethinking Emerging Markets

Featured Speaker: James Donald, CFA, Managing Director, Portfolio Manager/Analyst

### Emerging Market Fundamentals

Emerging markets have changed dramatically over the past decade. For the last seven or eight years, emerging market economies have been relatively stable. GDP growth rates from 2001 through 2007 ranged from approximately 4% to 12%, mainly due to effects from intensive industrialization in China. Because of this growth, emerging economies have been able to attract dedicated capital, both internationally and from investors within their own countries.

These factors have led to the atypical situation of emerging markets supplying capital to the more developed economies, as illustrated in Exhibit 1.

### Valuations and Financial Productivity

When comparing valuations of emerging versus developed

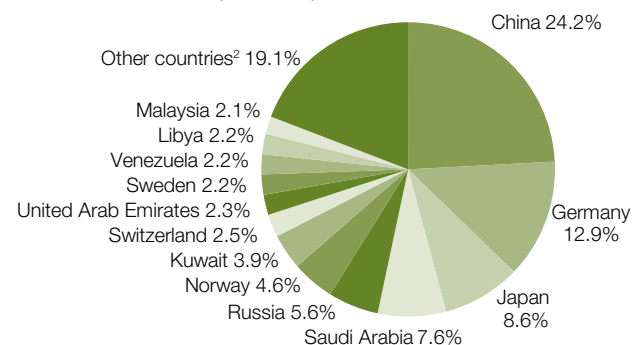
markets, emerging markets still trade at a discounted valuation on a price-to-earnings basis relative to the industrialized world, despite the fact that emerging markets have recorded 28 consecutive quarters of higher profitability and a better earnings per share growth profile.

### Divergence Between Emerging and Developed Markets

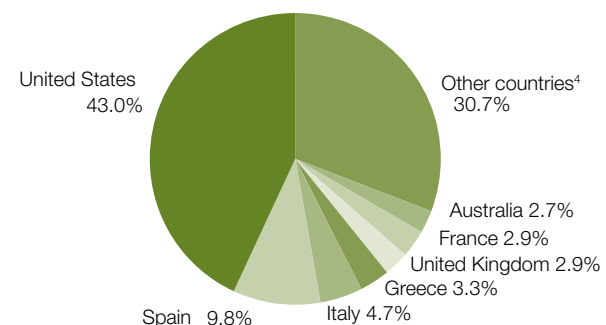
There is a noticeable difference in growth of emerging markets versus growth of the developed world. This is partly due to domestic demand growth, which has been much stronger in emerging relative to more mature markets for some time. In fact, a greater percentage of economic activity comes from domestic demand in emerging markets than it does in advanced markets. This can be an advantage, especially during the current global downturn.

### Exhibit 1

#### Countries that Export Capital <sup>1</sup>



#### Countries that Import Capital <sup>3</sup>



Source: IMF, World Economic Outlook database as of 16 April 2009.

1. As measured by countries' current account surplus (assuming errors and omissions are part of the capital and financial accounts).
2. Other countries include all countries with shares at total surplus less than 2.1%.
3. As measured by countries' current account deficit (assuming errors and omissions are part of the capital and financial accounts).
4. Other countries include all countries with shares at total deficit less than 2.7%.



### Differing Degrees of Exposure to the Credit Crunch

Over the past decade, there has been high credit growth in parts of Western Europe, Ireland, Spain, the Netherlands, and especially Iceland. Emerging markets, on the other hand, have experienced relatively low credit growth, though there are exceptions in the Baltics (Latvia, Estonia, Lithuania) and in Bulgaria. However, most emerging markets have had either very modest or even negative credit growth, and also boasted high domestic savings, which help to cover short-term external debt payments. This is a dramatic change versus the late 1990s, when many emerging countries didn't have this type of savings to defend themselves during periods of economic distress.

### Flexible Foreign Exchange Regimes Accommodate Adjustment

During 2008, a huge unwinding of the carry trade occurred, which caused many emerging market currencies to decrease significantly. We feel, following the recent drop, that these currencies are relatively attractive at this stage; we anticipate fairly moderate currency appreciation over the coming years in many emerging market currencies, even if at a controlled pace to maintain competitiveness.

We feel that the gap between the emerging and developed world will become more and more noticeable to investors, as we do not expect economic growth in the developed world, but do expect growth (though slightly muted) in the emerging economies.

## The Evolution of Emerging Markets

### Correlation Between Emerging and Developed Equity Markets

The correlation between emerging and developed equity markets, though unpredictable, has been increasing, as illustrated in Exhibit 2.

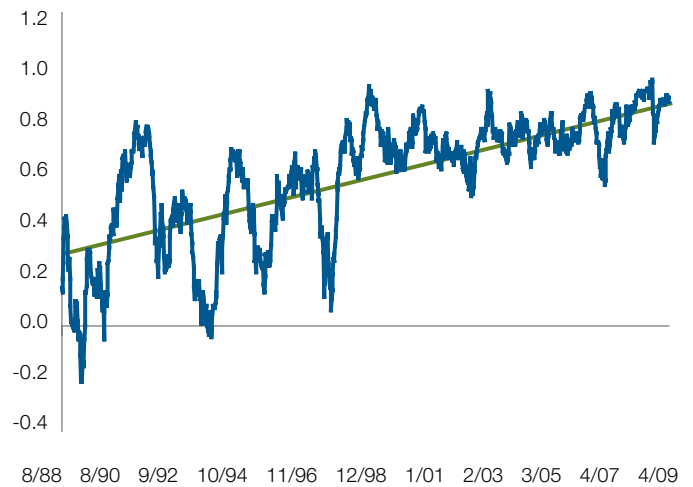
Moreover, the range of correlation in the more recent periods has been smaller, indicating that the correlation has been stabilizing. However, the correlation illustrated in Exhibit 2 is between indices. A tailored investment strategy may have far more attractive characteristics in terms of correlation with different indices. Focused approaches may fulfill precise goals or needs of investors.

### Skill Matters in Emerging Markets Equity

When considering the dispersion of returns in the MSCI Emerging Markets Index versus the dispersion of returns within the MSCI Developed World Index, as shown in Exhibit 3, an investor can clearly note the broader dispersion within the emerging markets. This dispersion offers active managers an even greater opportunity to add value in emerging market equities versus developed markets, therefore reinforcing the idea that skills matter when investing in emerging markets.

## Exhibit 2

Correlation of the MSCI Emerging Markets Index and the MSCI Developed World Index



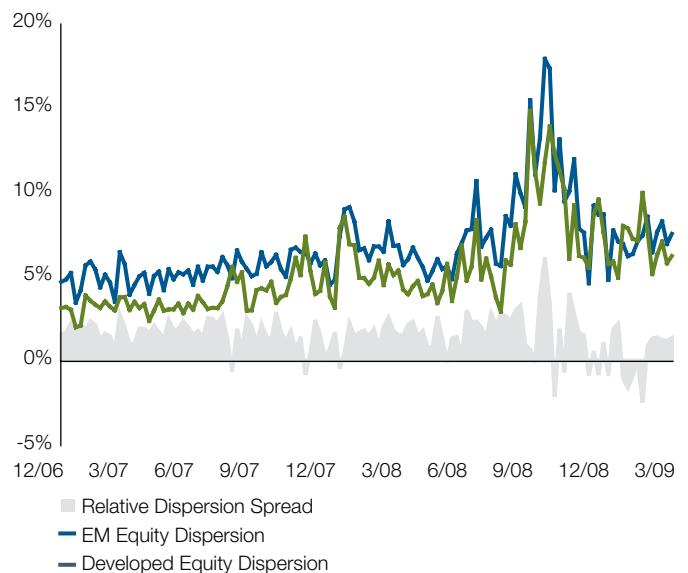
As of April 2009

Source: Lazard Asset Management, MSCI, Bloomberg.<sup>1</sup>

Shows 26 week trailing correlation between the MSCI EM Index and the MSCI Developed World Index.<sup>1</sup>

## Exhibit 3

Dispersion of Returns Within the MSCI Emerging Markets Index versus Dispersion of Returns Within the MSCI Developed World Index



As of April 2009

Source: Lazard Asset Management, MSCI, FactSet, Bloomberg.<sup>1</sup>

Dispersion is measured as the difference in weekly return between the 25th percentile return of stocks in the Index and the 75th percentile return.



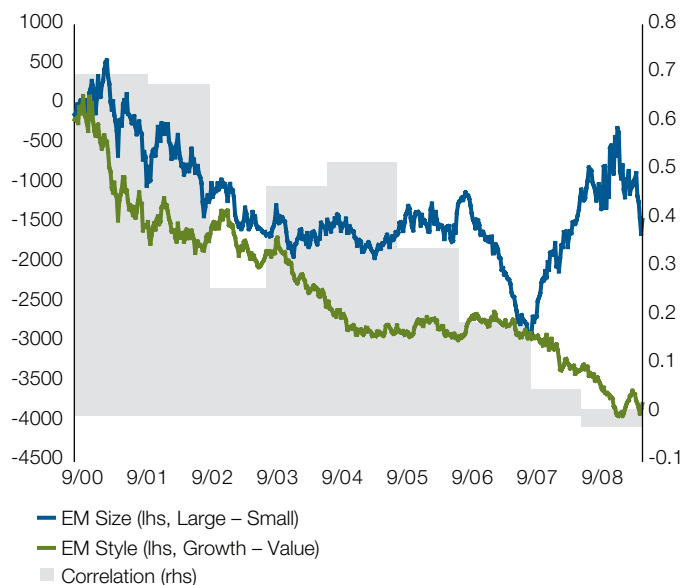
## The Many Roles of Emerging Markets

### Multiple Asset Classes Are Evolving Within Emerging Markets

Emerging markets style (growth/value) and emerging markets size (large/small) have become much more independent factors within the emerging markets asset class. Exhibit 4 shows basis points of outperformance of both the size (large – small) and style (growth – value) asset classes, as well as their correlation from August 2000 through April 2009. It is important to note that exposure to emerging markets growth was once similar to exposure to emerging markets large cap, and exposure to value was once similar to exposure to small cap. Recently, the correlation between these factors has decreased sharply, and now the two factors are, in effect, independent; we believe there are really four different asset classes, which probably could be split even further. A specialization of the emerging markets asset class appears to be occurring, which suggests more tailored options for investors.

### Exhibit 4

#### EM Style and Size Outperformance and Correlation



As of April 2009

Source: Lazard Asset Management, MSCI, Bloomberg.<sup>1</sup>

## One Role or Many Roles of Emerging Markets?

Many investors access the emerging markets asset class through equities only, and focus solely on performance data such as annualized returns, annualized standard deviation, and correlation to the MSCI World Index when weighing their allocations.

In our view, one size does not fit all within the emerging markets asset class. We believe that emerging markets are still evolving, and, in the future, will be viewed as a style-sensitive, complex group of asset classes. We challenge investors to consider the versatility of emerging market approaches, including those listed in Exhibit 5. However, we caution that emerging markets are still quite volatile, and remind that they might not be an option for all investors.

### Exhibit 5

#### The Many Roles of Emerging Markets

| Looking to access         | Portfolio Construction Approaches      | Labeled |
|---------------------------|--|---------|
| High beta equity          | Diversified, quant                     | EM      |
| Low-volatility high yield | Sovereign debt                         | EM      |
| Inflation protection      | Growth, large cap, local currency debt | EM      |
| Equity alpha              | Concentrated, value                    | EM      |
| Global carry trade        | FX                                     | EM      |
| Wealth redistribution     | Thematic, private equity               | EM      |
| Commodity exposure        | Regional strategies (BRIC)             | EM      |
| Uncorrelated beta         | Frontier, small cap                    | EM      |



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