LAZARD

Investment Research

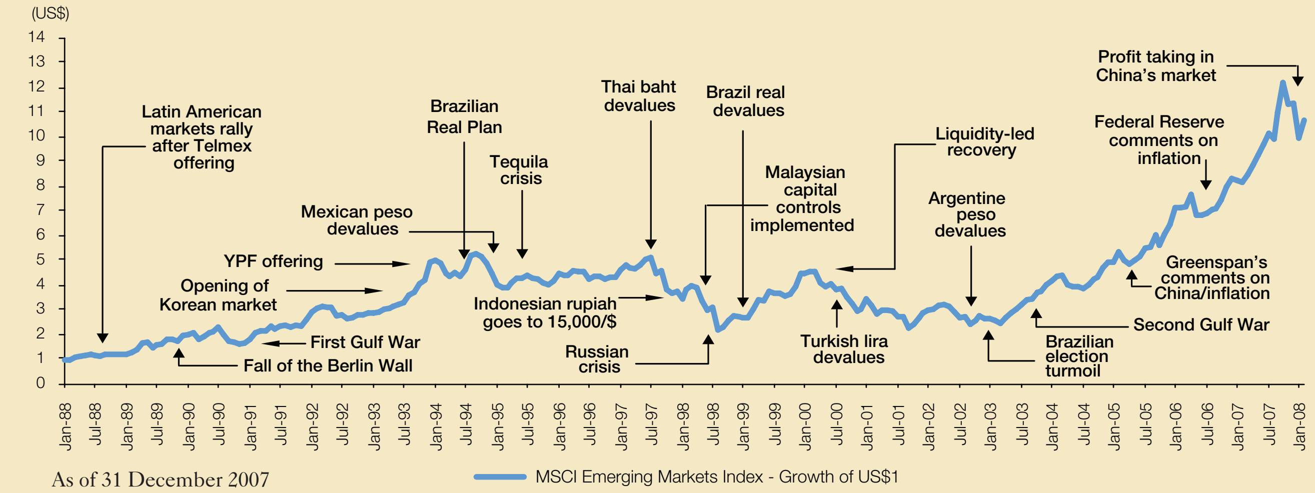
Evolution of the Emerging Markets Equity Asset Class: No Longer "One Size Fits All"

The year 1981 was an eventful one. Ronald Reagan took office as the 40th president of the United States, Pope John Paul II survived an assassination attempt, and "Video Killed the Radio Star" launched MTV. A development that, not surprisingly, did not generate as many headlines was the coining of the term "emerging market" by Antoine W. van Agtmael, an economist at the International Finance Corporation (IFC), part of the World Bank. Over the last 25+ years, this term has not only entered the common vernacular, but it has also seen many new siblings develop—such as "frontier markets"—to describe the many variations within this asset class that have developed over the course of its evolution.

Growing Pains on the Path to Maturity

While the broad and generally accepted definition of an emerging market has remained unchanged since van Agtmael first introduced the term—a low- to middle-income economy typically undergoing substantial economic and political reform—the asset class itself has evolved considerably. The event that enabled emerging markets to step out as an investable asset class was the establishment of an emerging markets database and benchmark by the IFC in the 1970s. The legacy of this pioneering work resides today in the form of the Standard & Poor's/International Finance Corporation Global Index. This index serves as a rival to the more widely used MSCI Emerging Markets Index, which was launched at the end of 1987 and originally featured just 10 countries,

EXHIBIT 1: THE HISTORY OF EMERGING MARKETS



As of 31 December 2007
Source: FactSet, MSCI

including Greece and Portugal, two long-standing members of the European Union that have long since graduated to developed market status. The fledgling MSCI Emerging Markets Index also featured a number of Latin American countries, although the economies of Latin America were, with the exception of Colombia, largely no-go areas for global investors in the 1980s; this was a period known as the "lost decade" in the region, after many countries failed to service the huge foreign debts they borrowed to assist with industrialization and infrastructure programs.

Constant evolution within the asset class has seen countries enter and exit the emerging markets arena. Today, the emerging markets equity asset class encompasses a broad sweep of economies from across almost all continents: 25 countries are featured in the MSCI Emerging Markets Index, with representation from Latin America, Africa, Asia, the Middle East, and Europe. Future changes to the composition of the index can also be expected: South Korea and Taiwan are likely candidates to make the step up to the developed world indices in the near future. Meanwhile, according to Russell Global Indexes data, emerging markets companies increasingly account for a bigger share of the global large-cap universe: The float-adjusted market capitalization of emerging markets as a proportion of global markets increased from 3.5% in 2001 to 10.2% in 2007.[1]

Long-standing investors in emerging markets equities have experienced not only periodic changes to their investment universe, but also, over the past couple of decades, a number of major market episodes. Courtesy of the phenomenon known as contagion—when a sell-off in one emerging stock market (following a domestic political or economic crisis, for example) drags down stocks in other emerging markets unaffected by these events—these episodes have dramatically affected the returns of the broad asset class. However, most observers believe that contagion no longer carries the potency it once had, due to a great degree to the fact that few of those emerging economies now need or have currency pegs to maintain economic stability. The muted response of emerging stock markets to the Argentine peso crisis of 2001–2002 is cited as a recent example of contagion's dwindling influence, and it is indicative of the greater maturity of the asset class and its more established investor base.

Examples of emerging markets crises include:

Mexican Peso Devaluation and Tequila Crisis (1994–1995)

A sudden and sharp devaluation of the Mexican peso by President Zedillo's newly elected administration caused investors to rapidly exit the Mexican market and plunged the country and, to a lesser degree, the Latin American region into economic crisis. A US$12.5 billion rescue plan reached with the U.S. government supported Mexico's faltering banks while imposing strict austerity measures.

Asian Financial Turmoil (1997)

The turbulence that struck the East Asian financial markets in the summer of 1997 had its origins in the Thai government's decision to float the baht after extensive efforts to preserve its currency peg with the U.S. dollar failed. The ensuing collapse in Thailand was followed by currency pressures and economic weakness in Indonesia, Singapore, Hong Kong, South Korea, the Philippines, and Malaysia.

Russian Debt Default (1998)

A sharp decline in the price of oil, coupled with nonpayment of taxes by energy and manufacturing companies, led to a foreign reserves crisis at a time when the Russian government was already suffering from a chronic fiscal deficit exacerbated by the war in Chechnya. With the pegged Russian ruble under immense pressure, foreign investment poured out of Russia, followed by a flight of capital. The Russian government was forced to devalue the ruble sharply, declared its intention to restructure all official domestic debt obligations by the end of 1999, and imposed a 90-day moratorium on the repayment of private external debt.

Argentinean Peso Devaluation (2001–2002)

From 1999 to 2002, hamstrung by an uncompetitive fixed exchange rate that pegged the peso to the U.S. dollar, the Argentine economy entered a deep recession that led to massive unemployment. With a collapse in investor confidence and a run on local banks, a flight of money out of the country ensued before the Argentine government bowed to the inevitable and abandoned its long-standing fixed one-to-one peso-dollar parity policy.

An Attractive Asset Class

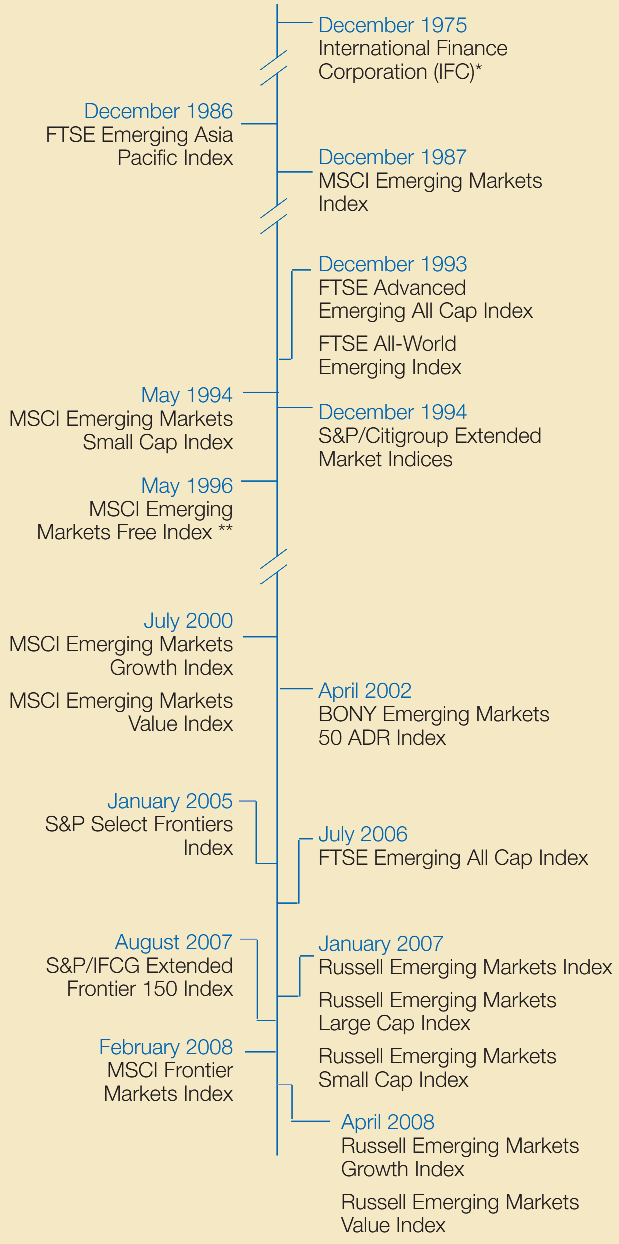
Among the most important elements for emerging economies looking to grow and graduate to a “developed” status are the strength of economic and political institutions (such as the rule of law, regulatory controls, and enforcement of contracts) and a broad distribution of wealth.[2] Countries like India and China may appear as sophisticated as North America and Europe when looking at capital formation and fixed asset investment, but, in our opinion, the picture is different when considering the low reliability of contracts (even if India is further along than China in this regard), the scarce disposable income in households, and the uneven distribution of wealth. China experienced one of the greatest shifts out of poverty in modern history between 1965 and 2003, when GDP per capita grew from approximately US$100 to more than US$1,300.[3] However, household income in urban coastal cities today is approximately 10 times higher than that of rural areas. Despite these and other challenges, portfolio managers around the world are increasingly interested in emerging markets, for many different reasons.

First, globalization appears unavoidable. World financial markets are growing more and more integrated, and emerging markets represent an ever-increasing portion of the world market capitalization. Many U.S.-based investors may still be reluctant to invest abroad, preferring instead to obtain international exposure via U.S. multinational companies. However, historical results show that these companies tend to behave almost exactly as does the S&P 500 Index.[4]

Second, while China and India might still appear expensive when looking at metrics like price-to-book (P/B) ratio, return on equity (ROE) and price-to-earnings-to-growth (PEG) ratio, the United States and developed Europe are not cheaper than many other developing countries in Eastern Europe, Latin America, and Africa. Also, in the past 20 years global correlations within developed countries and sectors have strengthened, so many of the diversification benefits once available have been lost. Emerging markets in general, and frontier markets (defined as the least developed of developing markets) in particular, are the places to look for diversification today. Furthermore, investors need only go past the negative headlines to see how some emerging and frontier countries—Chile and Estonia for example—are starting to exhibit respectable scores on metrics such as economic freedom and corruption. From this perspective, we believe frontier markets are continuously improving.

Finally, emerging and frontier countries represent a true global investment opportunity, due to their powerful population demographics and growing middle classes.

EXHIBIT 2: EMERGING MARKETS INDICES AND THEIR INCEPTION DATES



December 1975
International Finance Corporation (IFC)*

December 1986
FTSE Emerging Asia Pacific Index

December 1987
MSCI Emerging Markets Index

December 1993
FTSE Advanced Emerging All Cap Index

FTSE All-World Emerging Index

May 1994
MSCI Emerging Markets Small Cap Index

December 1994
S&P/Citigroup Extended Market Indices

May 1996
MSCI Emerging Markets Free Index **

July 2000
MSCI Emerging Markets Growth Index

MSCI Emerging Markets Value Index

April 2002
BONY Emerging Markets 50 ADR Index

January 2005
S&P Select Frontiers Index

July 2006
FTSE Emerging All Cap Index

January 2007
Russell Emerging Markets Index

Russell Emerging Markets Large Cap Index

Russell Emerging Markets Small Cap Index

August 2007
S&P/IFCG Extended Frontier 150 Index

February 2008
MSCI Frontier Markets Index

April 2008
Russell Emerging Markets Growth Index

Russell Emerging Markets Value Index

* Monthly data. Weekly data available from 1988. Daily data available from 1995. Later acquired by Standard and Poor’s.

** New weighting of MSCI Emerging Markets Index

Source: Bloomberg, MSCI Barra, Russell Investments

In summary, emerging markets are more of an asset class today than they were in the past. Not all the companies in emerging markets are created equal, though. In order to take full advantage of the potential opportunities and benefits offered by this asset class, it is essential to understand the differences between its various indices and styles, as discussed later.

Navigating the Different Emerging Market Indices

Exhibit 2 lists some of the most widely used emerging markets equity indices, ordered by inception date.

While this list is purposely not comprehensive, it highlights the importance of understanding the different methodologies used by benchmark providers to create their indices. These methodologies are not static. As equity markets and investment processes around the globe evolve, synchronized patterns of results have developed across styles and sectors, prompting the providers to enhance their calculation methodologies. Exhibit 3 summarizes the main differences among them.

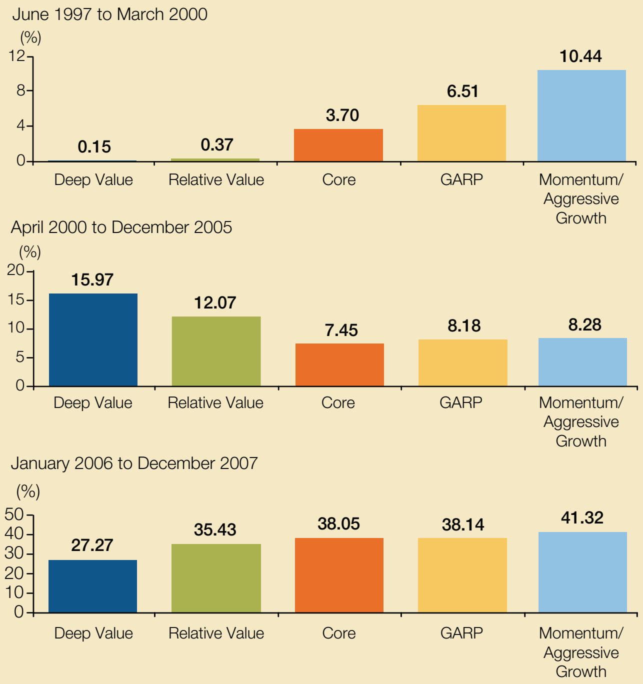
The availability of these indices makes it possible to analyze the performance of different strategies within the broader emerging markets asset class. By looking at historical patterns of returns, volatilities, and correlations, it is possible to evaluate whether style and size matter in emerging markets and show how investors can achieve significant diversification benefits.

EXHIBIT 3: EMERGING MARKETS INDICES METHODOLOGIES FROM FOUR MAJOR PROVIDERS

	MSCI	S&P	Russell	FTSE
Market Cap Segmentation	Large: Minimu US$5,982 million	Large: The top 70% market capitalizatic each country index	Global Large: All companies who rank above the 85th	percentile
	Global Large: Companies at above 68% of	the index universe k capitalization	Mid: Minimum US$2,031 million	Mid: The following 20%
	Global Mid: A companies who rank below thi 60th percenti	Global Mid: Companie ranked below 68% by capitalization but w the top 86% of the i universe	Small: Minimum US$185 million	Small: The bottom 10%
	Global Small: companies who rank below th	90th percentile	Global Small: Companies ranked below the top 86% c	the index universe, but within the top 97% of the regional universe and valued at US$100 million or
greater by market capitalization		Large MidCombination of the large- and mi segments	Global Mega: All companies who rank above the 55th percentile	
Market/Style Segmentation	Offers growth and value options for s	of its emerging indi	Offers global indic a broad market indicator, and	investable indices for stocks that are more readily available to investors
Offers growth and va options for each of emerging indices	Offers advanced emerging and secondary emerging options	Target % of Emerging Markets Equity Universe Covered	99%	70-80%

As of 31 March 2008
Source: FTSE, MSCI Barra, Russell Investments, Standard and Poor's

EXHIBIT 4: ANNUALIZED RETURNS ACROSS DIFFERENT EMERGING MARKETS EQUITY STYLES



Source: eVestment Alliance, Lazard Asset Management

The charts above represent the average annualized returns of 25 managers by investment style as categorized by eVestment Alliance. Past performance does not guarantee future results.

Does Style Matter in Emerging Markets?

At this stage in the development of the emerging markets equities asset class, there seems to be relatively little indication of any emergence of intra-asset class style or size distinctions. Nevertheless, diversification by equity managers' style may result in sharply different performance, and diversification within the asset class may be advantageous.

To start, an analysis of the returns for the MSCI Emerging Markets Value and Growth indices from September 1997 to February 2008 produced a very high correlation (approximately 0.95 on average).[5] This may suggest that the returns of the two styles are extremely closely linked, but further analysis (discussed in the next section) showed that temporary divergences may occur.

Similarly, a comparison of returns for the broad MSCI Emerging Markets Index with that of the MSCI Emerging Markets Small Cap Index indicated a highly correlated positive relationship (approximately 0.93 on average).[6]

Finally, a review of the performance of multiple style cohorts, each encompassing the performance of four to six different equity managers over a number of time periods from 1997 to 2007, highlights significant divergences among the styles. Nor was one style a consistent outperformer. The rankings at the end of the first time period, for example, almost completely inverted in the second one; deep value went from worst-performing style to best, while momentum/aggressive growth lost its leading position (Exhibit 4). The main point here is that

EXHIBIT 5: EMERGING MARKETS EQUITY ASSET CLASSES AND REPRESENTATIVE INDICES

ASSET CLASS	REPRESENTATIVE INDEX	ABBREVIATION	AVAILABLE SINCE	# OF WEEKS AVAILABLE
Emerging markets equity	MSCI Emerging Markets Free Index*	MXEF	May 1996	626
Emerging markets equity value	MSCI Emerging Markets Value Index	EMVAL	July 2000	406
Emerging markets equity growth	MSCI Emerging Markets Growth Index	EMGRO	July 2000	406
BRIC equity value	MSCI BRIC Value Index	BRICVAL	December 2005	124
BRIC equity growth	MSCI BRIC Growth Index	BRICGRO	December 2005	124
Emerging markets equity small cap	MSCI Emerging Markets Small Cap Index	EMSMALL	May 1994	626
Emerging markets equity ADRs/GDRs	BONY Emerging Markets ADR Index	EMADR	April 2002	315
Frontier markets equity	S&P/IFCG Extended Frontier 150 Index	EMFRONTIER	August 2007	37

*New weighting of MSCI Emerging Markets Index

Source: Bloomberg, Lazard Asset Management, MSCI Barra, Standard and Poor's there are substantial differences in the performance of various managers' styles over certain periods of time.

Diversifying Within Emerging Markets

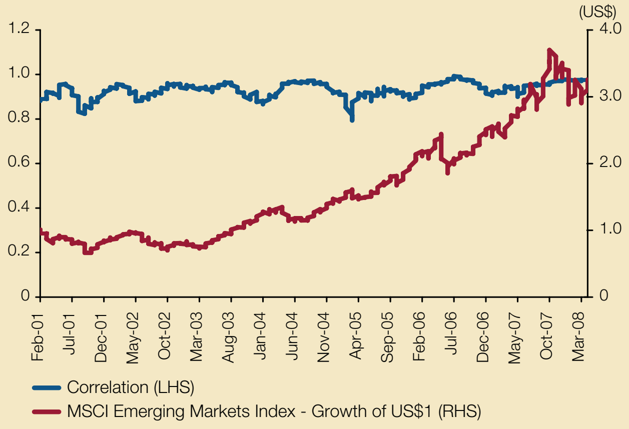
Despite the high correlations illustrated in the previous section, significant diversification benefits can be achieved within emerging markets. A deeper analysis of a set of indicative emerging markets asset classes (Exhibit 5) will help illustrate the point.

Once again, the first step is to calculate the historical correlations between any two of these asset classes.[7] As shown in Exhibit 6, over the period from February 2001 to April 2008 the correlation between the MSCI Emerging Markets Value and Growth indices was generally high and fairly stable, but it dipped to as low as 0.79 in March of 2005. At that level of correlation, a portfolio equally weighted between the two indices—which have annualized volatilities of 19.1% (value) and 21.0% (growth)—would have a blended volatility of 18.9%—significantly lower than either of the two constituents.

The first important conclusion, therefore, is that it is possible to improve the risk-adjusted performance of a portfolio by blending different styles within the emerging markets universe. This result can be confirmed by evaluating the information ratio (IR) (a measure of units of excess return per unit of excess risk) versus the MSCI Emerging Markets Index for a blend of two intra-asset-class emerging markets indices. In particular, Exhibit 7 shows the IR of 100 different possible combinations of the MSCI Emerging Markets Value and Growth indices, starting with 100% value, ending with 100% growth, and increasing the growth allocation by 1% in each consecutive test. As illustrated, the IR improves until the growth allocation reaches 46%, then drops off dramatically.[8]

EXHIBIT 6: CORRELATION BETWEEN THE MSCI EMERGING MARKETS VALUE AND GROWTH INDICES

30-Week trailing data, February 2001 to April 2008

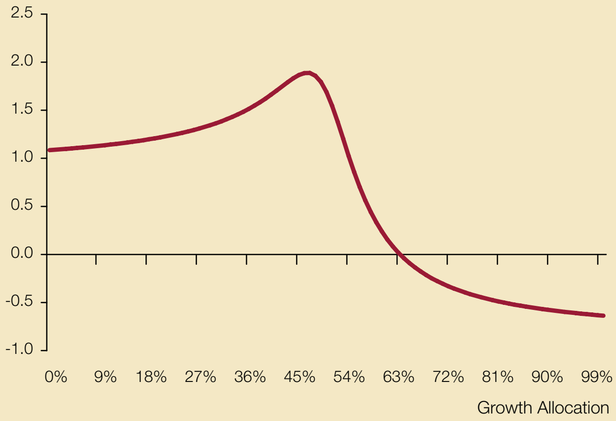


Source: Bloomberg, Lazard Asset Management, MSCI Barra

EXHIBIT 7: INFORMATION RATIO VS. THE MSCI EMERGING MARKETS INDEX

Blended emerging markets growth and value portfolios

Based on weekly data from May 2000 to April 2008



Source: Bloomberg, Lazard Asset Management, MSCI Barra

EXHIBIT 8: PAIRWISE CORRELATIONS OF EMERGING MARKETS INDICES

	MXEF							
EMVAL	0.98	EMVAL						
EMGRO	0.99	0.95	EMGRO					
BRICVAL	0.93	0.95	0.91	BRICVAL				
BRICGRO	0.94	0.92	0.94	0.94	BRICGRO			
EMSMALL	0.88	0.92	0.89	0.81	0.81	EMSMALL		
EMADR	0.87	0.85	0.86	0.85	0.87	0.74	EMADR	
EMFRONTIER	0.37	0.39	0.36	0.39	0.31	0.40	0.06	EMFRONTIER

Source: Bloomberg, Lazard Asset Management, MSCI Barra, Standard and Poor's

Such a significant result was obtained by blending two emerging markets asset classes that were, in fact, quite highly correlated to each other during the observation period, as we saw in the preceding. By extension, it is reasonable to expect that an investment strategy with access to many other asset classes within emerging markets may provide even better risk-adjusted returns, as the volatility would be further reduced through favorable correlations.

Going a step further, it is also possible to evaluate which asset classes may provide the highest diversification benefits. Exhibit 8 shows the correlation matrix for the set of indicative emerging markets asset classes listed in Exhibit 5.

By starting with an equally weighted composite of all asset classes, then removing each component in sequence, it is possible to observe the changes in the left tails of the return distributions of the resulting portfolios, as described by the 99% 1-week Value at Risk (VaR).[9] Comparing the VaR with and without each component measures the diversification impact of each asset class.

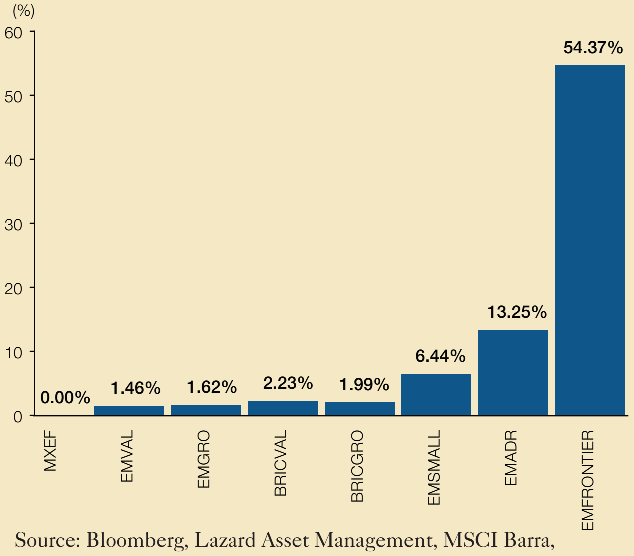
Exhibit 9 shows the results for that type of comparison. A high percentage means that the component is a good diversifier. For example, a score of 54.37% (frontier markets) means that 54.37% of that individual asset class's VaR is diversified away by the blend. (By extension, a score of greater than 100% would mean that the component reduces the VaR of the blend, as its diversification benefit would be higher then the VaR that is added to the portfolio by including the component).

As the chart shows, small caps, ADR/GDR, and frontier provide the most diversification within emerging markets in an equally weighted portfolio. Of course, in practice it is unlikely that any portfolio allocation would be equally weighted; when investors choose to optimize their portfolio allocations in some way, they directly affect the changes in VaR.

In summary, it can be asserted that diversification within the emerging markets universe provides the benefit of increasing risk-adjusted returns, due to the low correlations among its different asset classes. We believe the increasing availability of new and improved emerging markets indices will make it easier for portfolio managers and analysts to take advantage of this opportunity.

EXHIBIT 9: PERCENTAGE OF A PORTFOLIO COMPONENT'S VAR ELIMINATED DUE TO DIVERSIFICATION

Calculated on the longest available sampling period for each pair (from Exhibit 5)



Source: Bloomberg, Lazard Asset Management, MSCI Barra, Standard and Poor's

Conclusion

Although the evolution of the emerging markets equity asset class is still beginning, there appear to be opportunities for investors to combine strategies of both different capitalizations and styles to achieve better overall risk-adjusted returns, as well as long-term returns. As long as fundamentals do not dramatically deteriorate, it is reasonable to expect that many investors will seriously consider, and in many cases invest in, these new emerging markets areas. At first they will probably utilize a combination of different benchmarks, the dominant ones being determined only after some use is made by the main practitioners.

If this prediction comes true, many existing emerging markets managers will probably start introducing new strategies over the next few years. Barring a significant change in current fundamentals, we believe it is reasonable to expect this to be generally supportive of the asset class.

NOTES

1 Source: Russell Investments, "The Changing Global Capital Markets," November 2007.

2 "When Are Emerging Markets No Longer 'Emerging'?" *Knowledge@Wharton*, 5 March 2008.

3 "Building a Global Equity Portfolio," presentation by Lawrence S. Speidell, CFA, of Frontier Market Asset Management at the 2008 CFA Institute Annual Conference, 13 May 2008.

4 Ibid.

5 As of 29 February 2008. Source: FactSet, Lazard Asset Management.

6 Ibid.

7 The data observations used in the following discussion are taken at weekly intervals. Given that the index inception dates are different, pairwise comparisons were made using the longest available sampling period for each pair. Comparisons were made using the Spearman Rank correlation.

8 Over the period from May 2000 to April 2008.

9 Value at Risk, or VaR, provides an indication of the expected loss, over a determined time period, at a given level of statistical significance. For example, a 99% 1-week VaR of 0.25% means that there is a 99% probability that the weekly loss of the portfolio will not exceed 0.25% and a 1% probability that the weekly loss will exceed 0.25%.

IMPORTANT INFORMATION

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