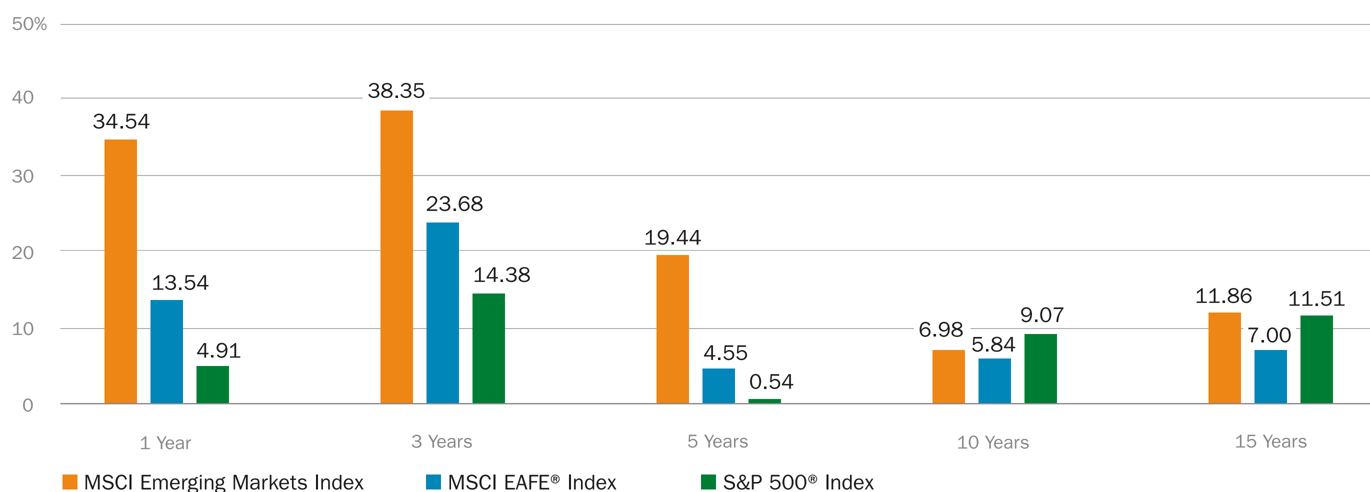
Emerging Markets Revisited

A Q&A primer on emerging markets investing with AIM's international team

Overshadowed in the late 1990s by a powerful U.S. stock market, emerging markets are starting to shine in the new century. Seasoned investors may wonder about the sustainability of this current rally. Could the volatile market cycles scenario that has periodically impacted emerging markets in the past recur? In the following Q&A, members of AIM's international team—senior portfolio manager Steve Cao, senior portfolio analyst Mark Jason, portfolio manager Borge Endresen and senior international client portfolio manager Andrew Pringle—discuss recent fundamental improvements in emerging markets and answer questions about this intriguing and sometimes misunderstood asset class.

Average annual total returns of emerging markets vs. developed international and U.S. markets, as of Dec. 31, 2005

For four of the five standardized performance periods of the past 15 years, emerging markets have outperformed both developed international and U.S. markets. Past performance is no guarantee of future results.



Sources: Lipper Inc., Standard & Poor's, Morgan Stanley Capital International Inc.

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Countries with emerging markets

As of Dec. 31, 2005, the following 26 emerging markets were included in the MSCI Emerging Markets Index, a free float-adjusted capitalization index that is designed to measure equity market performance in the global emerging markets.

Argentina	Colombia	India	South Korea	Pakistan	South Africa
Brazil	Czech Republic	Indonesia	Malaysia	Peru	Taiwan
Chile	Egypt	Israel	Mexico	Philippines	Thailand
China	Hungary	Jordan	Morocco	Poland	Turkey
				Russia	Venezuela

Source: Morgan Stanley Capital International Inc.

The following Q&A should help you understand more about emerging markets

Q What is an emerging market?

Although there are many ways to distinguish between an emerging and a developed equity market, we follow Morgan Stanley's classification criteria, which include:

- Income per capita. Usually, a country is considered to be "emerging" if the income per capita is below $10,000 U.S. per year.
- Political situation and stability.
- Capital constraints and liquidity.
- Corporate governance.
- Deregulation/privatization.

Q The Asian financial crisis of 1997 is still fresh in some investors' minds. What caused the crisis?

This crisis resulted from a domino-like series of events. We believe the underlying root cause was a period of major overinvestment in the region, which resulted in significant deficits for many emerging Asian economies. At the time, these currencies were pegged to the strengthening U.S. dollar, and this made their goods and services increasingly more expensive (and hence less competitive) in the global economy. As economic pressures grew, these countries attempted to defend their currencies by raising interest rates, which proved unsuccessful. Eventually the countries had to let their currencies float (unpegged from the U.S. dollar), leading to the devaluation of many Asian currencies.

The devaluations were a major blow to the Asian banking system, significantly raising the cost of servicing large amounts of debt payable in U.S. dollars. The large number of defaults that followed placed immense pressure on the banking system, caused economies to stall and pushed Asia into recession after years of strong growth.

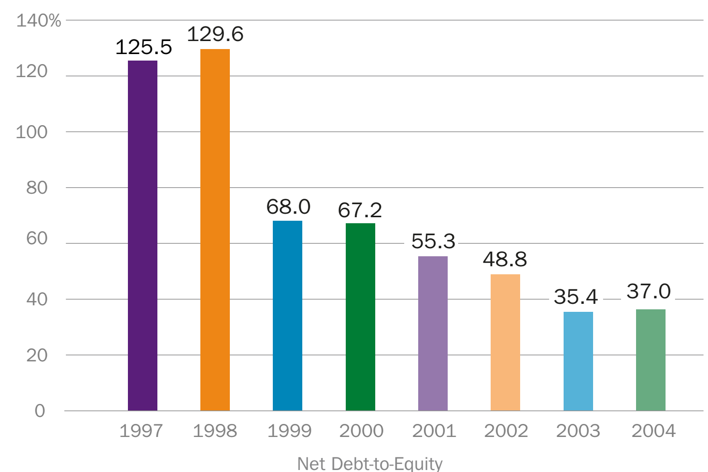
Q Emerging markets appear healthier and more sustainable today than in 1997. What improvements have emerging economies made recently?

We believe these economies have been significantly transformed since the late 1990s. In the wake of the 1997 crisis, many emerging economies have made fundamental improvements including:

- **Free floating currencies.** Most currencies are no longer pegged to the U.S. dollar.
- **Reduced corporate debt.** Companies of emerging economies continue to de-leverage and improve their balance sheets. For example, Asia ex-Japan's debt-to-equity ratio has fallen by more than half from its level at the time of the Asian crisis.

Asia ex-Japan has continued to reduce debt levels

As of Dec. 31, 2004, Asia ex-Japan's debt-to-equity ratio has fallen more than 60% from its peak in 1998.



Source: Goldman Sachs

- **Current account surplus.** During 1997–1998, many emerging economies had current account deficits. Today that trend has reversed, and the majority of emerging economies are showing surpluses.
- **Decreased inflation.** Inflationary pressures have eased significantly. In 1998, inflation was 84% in Russia and 18% in Mexico. Today it's approximately 11% and 4%, respectively.
- **Increased privatization and deregulation.** Emerging economies have become increasingly more competitive and capitalistic. State-run countries, such as China, are now selling stakes in formerly government-controlled companies to foreigners.
- **Improved profitability.** Return on equity (ROE)—a measure of corporate profitability—has improved significantly for emerging markets since the 1990s, and it is now comparable to that of developed markets.
- **Accelerating free cash flow/increased dividend payouts.** We believe companies have now become more disciplined in terms of how they spend their money. For example, capital expenditure, as a percentage of sales, has fallen sharply since the period of overinvestment that led to Asia's problems in 1997. In addition, free cash flow is now running at record highs.

According to a Goldman Sachs report …

- China could be the world's largest economy by 2041.
- India's gross domestic product (GDP) could exceed Japan's by 2032.
- The size of Brazil's economy could overtake Italy's by 2025, France's by 2031 and the U.K.'s and Germany's by 2036.
- Russia's economy could overtake Italy's in 2018, France's in 2024, the U.K.'s in 2027 and Germany's in 2028.

Source: Dominic Wilson, Roopa Purushothaman. Global Economics Paper No. 99. "Dreaming with BRICs: The Path to 2050." Oct. 1, 2003.

Q The rise of the emerging BRIC (Brazil, Russia, India and China) economies has turned into a mega-trend for the 21st century. What are some of the new developments in these countries?

- **Brazil.** With very strong export growth and infrastructure improvements, we've witnessed several new developments in Brazil. Minority shareholder rights are being addressed with the creation of the Novo Mercado—a new market with only common shares. There are still many preferred shares in Brazil that carry no voting rights, but as new companies are listed, the government is strongly urging them to join the Novo Mercado, given its improved shareholder rights.
- **Russia.** Since 1998, Russia has enjoyed very strong growth, which has allowed it to sharply reduce its foreign debt and build significant foreign currency reserves. The Russian economy—now the world's second largest oil exporter—continues to be resource dependent, and that success is starting to filter through other segments of the market. Real personal incomes have grown more than 10% annually since the lows in 1998, benefiting a host of sectors, such as mobile telephones, banking and retail.
- **India.** Information technology (IT) companies in India continue to benefit from the U.S. outsourcing trend. With just 2.5% of global IT market share, we think the outlook for higher market penetration in India remains good. India also recently announced that it will allow increased foreign participation in its telecommunication companies.
- **China.** The Chinese government and corporate sector appear committed to moving toward capitalism. Companies in China used to be completely controlled by the government, but now the private sector controls more than 50% of the economy. We see a large movement toward a free market economy. The Chinese government is selling stakes in telecommunication, banks and oil companies to foreign investors and there has been a spate of new issue announcements.

Q What are some of the risks of investing in BRIC or other emerging markets?

- **Political risks.** Although there have been reforms in some countries, emerging markets in general carry more political risk than developed markets. The friction between Pakistan and India is one example. Another example is the Bali bombings in Indonesia offsetting its election success. Although governmental reforms can be delayed, many emerging countries seem increasingly committed to deregulation and moving toward a more capitalist society.
- **Fluctuating commodity prices.** Since some emerging economies are dependent on their natural resources, there is a risk associated with changing commodity prices. Brazil and Russia, in particular, are rich in materials and oil. With recent high commodity prices, these economies have been doing well. But should that trend reverse, these economies may be negatively impacted. That said, we believe that weakening in the secular commodity cycle may be offset by the continued growth of countries, such as China and India.
- **Rising oil prices.** This risk mainly affects oil importers such as Thailand, India and Korea. If the price of oil were to stay above $65 a barrel for an extended period of time, there could be deterioration of current account surplus in some countries, which may lead to rising inflation and higher interest rates. However, it's important to

note that high sustained oil prices may negatively affect every market in the world. As we mentioned earlier, most emerging markets, such as the Asian countries, have current account surpluses and strong currency reserves to deal with the high oil prices.

- **Fed rate hikes.** Higher U.S. rates may impact the global economy and the export sector in emerging economies. With rising interest rates, the U.S. consumer sector may slow its spending and cause a slow down in demand for exports from other countries. However, in the past year, many emerging markets' stock markets have sustained a strong performance record despite the numerous Fed rate hikes. We attribute this to fundamental economic improvements in the asset class. Many emerging markets are also in a different phase of the economic cycle than the U.S. For instance, Turkey, Mexico and Brazil all cut rates recently, while China has had a modest increase in rates.

Q Which sectors offer the best growth opportunities in emerging markets?

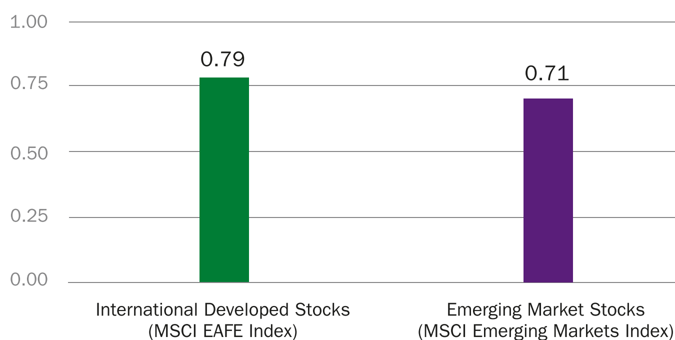
- **Consumer discretionary and financials.** We believe consumer and financial stocks will continue to thrive. Rapid job creation and rising real incomes should drive sustainable consumer spending. Financial stocks are tied to the consumer sector. When consumers are doing well, they buy more cars and houses and need credit. We believe banks will continue to see strong revenue growth as a result of this ongoing trend. The low penetration of credit and insurance products in these markets suggest that financial products, as a whole, may outgrow the overall economy.
- **Energy/resource and technology.** Beyond benefiting from higher commodity prices, emerging market resource stocks have strong production growth and attractive valuations, differentiating them from many of their developed market counterparts. Technology companies continue to enjoy cost advantages, and some of these companies have R&D expertise which may allow them to become increasingly more specialized.

Q Given the recent strong performance of this asset class, do you think it is too late to invest in emerging markets?

We believe that, for investors with a long-term perspective, the outlook for emerging markets remains attractive. This view is based on the fundamental improvements discussed above, as well as the markets' overall strong economic growth prospects. Analysts expect accelerating growth for many emerging countries in 2006. At the corporate level, productivity has been improving, ROE has been high and dividend payouts have been increasing. In addition, many emerging market companies are striving to improve corporate governance, which, in turn, may increase shareholder value.

Even after their strong recent performance, emerging market stocks continue to trade at relative valuations that are below developed foreign market equities, despite faster structural growth. They also trade at discounts to where emerging markets have traded historically. In terms of diversification benefits, correlations to other asset classes remain relatively low. As the chart below indicates, emerging markets offer a lower correlation to U.S. markets than their developed market peers. For these reasons, we believe that having exposure to emerging markets as part of a diversified international portfolio should reward investors over the long term.

Correlation vs. U.S. stocks for the 10-year period ended Dec. 31, 2005



Source: Zephyr Associates Inc.
U.S. stocks are represented by the S&P 500 Index. Correlation vs. the MSCI Emerging Markets Index is based on price-only returns.

Q Could the boom/bust cycle that has periodically impacted this asset class recur?

Emerging economies and equity markets, like the rest of the world, will likely continue to experience cyclicality and their equity markets may continue to be subject to swings in investor sentiment. It would be naive to expect otherwise. However, we believe emerging economies are still in the early phase of a recovery after a very difficult decade in the 1990s. In addition, we believe the fundamental improvements discussed in previous questions may help to reduce the severity of an economic downturn when one eventually happens.

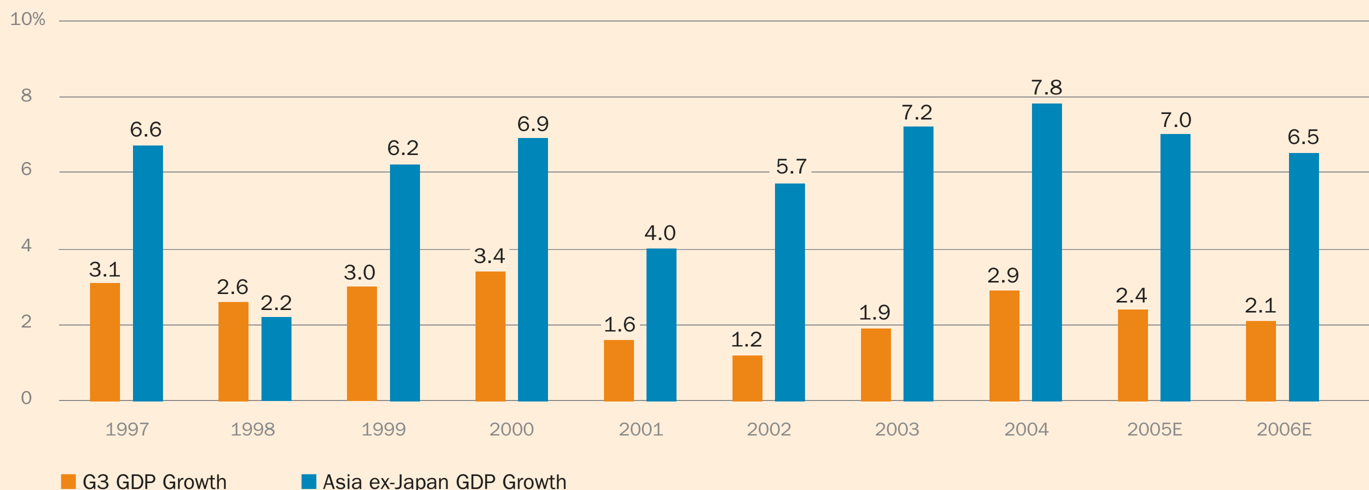
In summary

Emerging market economies represent a vast consumer pool with significant purchasing power. Investors may not be aware that emerging economies comprise more than 80% of the world's total population of more than 6 billion people. In fact just China and India together represent more than a third of this total global population. Emerging economies, on a purchasing power basis, also represent nearly half of global gross domestic product (GDP).

Given these statistics, investors may begin to ask themselves if they can ignore the long-term investment potential that emerging markets provide.

Asia expected to continue fast growth

The GDP growth of Asia ex-Japan is expected to exceed that of the G3—U.S., Japan and Euro-region—countries through 2006.



Source: Merrill Lynch

Why invest in emerging markets?

Here are four reasons why investors with medium to long-term time horizons should consider including emerging markets in a broadly diversified portfolio.

Strong economic growth. Emerging market GDP growth is approximately twice the rate of developed economies—5–6% vs. 3%, respectively.

Improving fundamentals. Macroeconomic and corporate improvements have occurred since the Asian Crisis in the 1990s. Many companies are now more efficient and profitable and have better balance sheets, corporate governance and improving business practices.

Strong valuation support. Emerging market valuations appear attractive by historic comparison in both absolute terms—11x forward price-earnings (P/E) ratio—as well as relative to developed markets at approximately a 20% P/E ratio discount.

Diversification. Emerging markets tend to have lower correlations to the U.S. equity market than do developed markets. Therefore, they may act as better diversifiers for an overall portfolio than developed markets.

A word about risk

Foreign securities have additional risks, including exchange rate changes, political and economic upheaval, the relative lack of information about these companies, relatively low market liquidity and the potential lack of strict financial and accounting controls and standards.

Investing in emerging markets involves greater risk and potential reward than investing in more established markets.

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Note: Not all products available through all firms.