

## A Case For... Emerging Markets

*Emerging markets can offer good risk/return potential, attractive valuations, vigorous fundamental growth, significant diversification benefits and a broad range of opportunities not often available to investors in developed markets. While investing in emerging economies does involve some unique risks, they may potentially offer suitable investors a long-term investment horizon to capture added-value and improve the performance of their traditional portfolios.*

### EMERGING MARKETS: DEVELOPING, BUT NOT SMALL

The terms “emerging markets” and “developing countries” are sometimes used interchangeably. Generally defined, emerging markets are countries that are experiencing rapid economic growth and financial and economic liberalization, prompted by policy reforms. Typically, they have immature capital markets and only partially developed institutions. Frequently, these countries are undergoing rapid economic, political and social transformation.

Generally, the per capita incomes and gross national income (GNI) of emerging markets are just a fraction of those of developed world economies. The World Bank classifies countries into four income categories. A majority of emerging countries fall within the bottom three categories and have a GNI per capita income of below \$10,725. By comparison, the United States 2007 GNI per capita was about \$43,560.<sup>1</sup>

A few countries, Korea and Israel for example, fall within the high income category; but from an investor’s perspective, they may be considered to be “emerging” due to specific structural and political issues.

**FIGURE 1: COUNTRIES CLASSIFIED AS “EMERGING”**

Brazil	Chile	China	Colombia
Czech Republic	Egypt	Hungary	India
Indonesia	Israel	Korea	Malaysia
Mexico	Morocco	Peru	Phillipines
Poland	Russia	South Africa	Taiwan
Thailand	Turkey		

Source: MSCI International Equity Indices, [www.msicibarra.com](http://www.msicibarra.com) as of April 30, 2009.

Emerging markets are not all small countries. China and India, for example, are the two most populous nations in the world; and their inexpensive—and increasingly skilled—labor makes them attractive areas for direct investment. Their tremendous human capital has been a hot bed for labor-intensive as well as technological outsourcing over the past several years. Brazil and Russia, two additional emerging countries, are resource-rich locales benefiting from the world’s escalating need for energy and natural resources.

Despite the physical size and large populations of emerging countries, their equity markets have historically been underdeveloped. To illustrate this point, the combined population of all emerging markets, as defined by the MSCI Emerging Markets Index, totals more than 4.4 billion people—that’s roughly 65% of the world’s entire population. In contrast, the total market capitalization of the equity markets for these emerging countries represents only 11.32% of the world’s total equity markets.<sup>2</sup> There are some complex issues behind this simple comparison. However, assuming underlying conditions remain favorable over the long-term, emerging equity markets clearly have room to grow and increase their share of the global opportunity set.

### WHY EMERGING MARKETS?

Now that we understand what constitutes an emerging market, why should investors consider allocating a portion of their portfolios to emerging markets?

### GROWTH OF EMERGING COUNTRIES

According to the World Bank, emerging countries are likely to continue to grow more rapidly than the developed world in the decades ahead. Many emerging markets countries have a stronger Gross Domestic Product (GDP) growth outlook relative to developed markets.<sup>3</sup>

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Also, burgeoning population growth, the emergence of younger and more educated workforces, and increasing infrastructure demands should provide a favorable environment for the asset class.

In addition to the growth fueled by domestic demand, the better-run emerging markets companies may continue to expand their activities in developed markets. Names such as Samsung Electronics and TEVA Pharmaceuticals are examples of companies located within developing markets that have world class products, first-rate management and potential competitive advantages derived from either natural resources or human capital. As trade barriers fall (e.g., WTO entry, accession to the EU), these better quality emerging markets companies may see expanded growth opportunities.

### LONG-TERM RETURN POTENTIAL

Emerging markets possess the potential to exceed developed market returns over the long term. Rapid economic growth tends to translate into stronger company earnings growth and, thus, higher stock prices.

**FIGURE 2: PERFORMANCE AS OF 6/30/2009**

	QTD (%)	YTD (%)	1 YEAR (%)	3 YEARS (%)	5 YEARS (%)	7 YEARS (%)	10 YEARS (%)
S&P 500® INDEX	15.93	3.16	-26.21	-8.22	-2.24	0.92	-2.22
MSCI EAFE® INDEX	25.85	8.42	-30.96	-7.51	2.79	5.26	1.59
MSCI EMERGING MARKETS (EM) INDEX	34.84	36.22	-27.82	3.27	15.09	16.33	9.02

Source: Zephyr StyleADVISOR, SSgA Strategy & Research, as of 6/30/2009.

In fact, Figure 2 above shows us that for the ten years ending June 30, 2009, the MSCI Emerging Markets (EM) Index posted a 9.02% return, versus a 1.59% return for international developed markets (MSCI EAFE Index) and a -2.22% return for US markets (S&P 500 Index). However, emerging markets are also considered riskier than developed markets, with increased potential for losses.

### DIVERSIFICATION BENEFITS

Emerging markets, generally, have not moved in tandem with those of the developed world in recent past. As a result, for suitable investors, emerging markets may be used as a diversification and risk management tool to augment traditional portfolios.<sup>4</sup>

**FIGURE 3: CORRELATIONS MATRIX  
JUNE 1994 – JUNE 2009**

	1)	2)	3)
1) MSCI EMERGING MARKETS (EM) INDEX	1.00		
2) S&P 500 INDEX	0.72	1.00	
3) MSCI EAFE INDEX	0.80	0.81	1.00

Source: Zephyr StyleADVISOR; SSgA Strategy & Research, as of 6/30/2009.

**FIGURE 4: DIFFERENCES IN SECTOR WEIGHTS**

	MSCI BRAZIL PORTFOLIO WEIGHT (%)	MSCI CHINA PORTFOLIO WEIGHT (%)	MSCI KOREA PORTFOLIO WEIGHT (%)	MSCI EAFE PORTFOLIO WEIGHT (%)	S&P 500 PORTFOLIO WEIGHT (%)
CONSUMER DISCRETIONARY	2.05	3.78	11.06	10.04	8.96
CONSUMER STAPLES	5.86	3.37	5.78	10.02	11.97
ENERGY	30.55	17.36	2.71	8.65	12.43
FINANCIALS	21.61	39.09	16.32	24.56	13.60
HEALTH CARE	0.00	0.20	0.66	8.35	13.98
INDUSTRIALS	1.84	8.75	16.71	11.34	9.86
INFORMATION TECHNOLOGY	1.47	4.04	27.50	5.20	18.34
MATERIALS	26.45	5.25	13.22	9.37	3.23
TELECOMMUNICATION SERVICES	3.77	16.27	3.74	6.04	3.54
UTILITIES	6.41	1.90	2.30	6.42	4.09
TOTAL	100.00	100.00	100.00	100.00	100.00

Source: FactSet, SSgA Strategy & Research, as of 6/30/2009.

The potential diversification benefits emerging markets provide may increase even further as emerging markets develop sector mixes that are very different from those of developed markets. As illustrated in Figure 4 (on previous page), there are significant differences in sector weights between emerging countries and the developed world in the construction of the respective indexes. Emerging markets tend to be more focused in the basic materials, energy and telecommunication sectors. Alternatively, developed markets, as represented by the S&P 500 Index and MSCI EAFE Index, typically are more focused in the financials, industrials, health care and consumer discretionary sectors.<sup>5</sup>

### **VOLATILITY AS OPPORTUNITY**

For some investors, emerging markets conjure up volatility nightmares. Investors may remember when, in 1994, Mexico devalued the peso and local equities cratered; a financial bubble burst in Thailand in 1997 and waves of selling washed across the Pacific Rim; Russia defaulted on its own Treasury bills in 1998 and Russian stocks plummeted 90% from their highs. Given the volatility of emerging markets, why bother to invest in them? Investors who can tolerate the additional volatility may potentially be rewarded with higher returns over time. The higher potential for extreme market events may translate into greater opportunity for suitable investors, but also present greater risk of loss.

Such events in developing countries often can be mechanisms of positive fundamental change, creating compelling investment opportunities that are difficult to uncover in the developed world.

### **A WORD ABOUT RISKS**

As already alluded to, EMs do present unique risks. Like all asset classes, they carry market risk. However, they are also predisposed to three risk elements which do not raise concerns for traditional domestic investors.

- A lack of information standards within the country and/or region
- The risk that the currency of the stock exchange where the investment is located may depreciate against the US dollar
- Political risk long considered by many to be the dark side of emerging markets may prove cumbersome because the impact of political events on investments is extremely difficult to measure.
- These risks are reflected in the higher volatility in EMs, as well as the increased risk of loss.

### **CONCLUSION**

The emerging markets of today are not the same as those of ten years ago. As we've seen already, some of the largest countries in the world are classified as emerging market economies. And while volatility will always be a part of emerging markets investing, the Asia crisis of 1997-1998 was so severe in some countries that it propelled a fundamental rethinking of economic policies. The emerging markets crises of the 1990's initiated structural reforms that promoted increasing financial transparency and reduced the likelihood that the contagion effect we saw then would recur again. Today, there is general consensus that developing countries are in better fiscal shape, have more flexible currency policies, smarter central banks and greater prudence in borrowing. Likewise, emerging markets investors have become more sophisticated in their ability to assess risk and have more tools at their disposal for doing so.

Despite the unique risks associated with investing in emerging markets, which can be substantial, investors who have never considered investing in the asset class—or who previously have only opportunistically invested—should take a closer look and earnestly consider the asset class' potential advantages in helping investors to achieve their strategic asset allocation objectives.

Although emerging markets present higher risk than developed markets, they potentially offer suitable long-term investors attractive potential to capture excess return and diversify traditional, developed market portfolios, ultimately increasing portfolio efficiency and improving overall performance.

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## INDEX DEFINITIONS

### S&P DEVELOPED EX-U.S. UNDER USD2 BILLION

The S&P® Developed Ex-U.S. Under USD2 Billion is a market capitalization weighted index that defines and measures the investable universe of publicly traded companies domiciled in developed countries outside the U.S. The Developed Small Cap Index is “float adjusted,” meaning that only those shares publicly available to investors are included in the Developed Small Cap Index calculation.

### S&P 500® INDEX

The S&P 500® Index is composed of five hundred (500) selected stocks, all of which are listed on the Exchange, the NYSE or NASDAQ®, and spans over 24 separate industry groups.

### DOW JONES U.S. TOTAL STOCK MARKET INDEX

The Dow Jones U.S. Total Stock Market Index<sup>SM</sup> is a float-adjusted market capitalization weighted index that reflects shares of securities actually available to investors in the marketplace.

To be included in the Index, an issue generally must be all of the following: (i) an equity issue (common stock, REIT or limited partnership); (ii) a security that has its primary market listing in the U.S.; and (iii) a U.S. headquartered company.

### RUSSELL 1000® INDEX

The Russell 1000® Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 90% of the U.S. market.

### S&P MIDCAP 400 INDEX

The S&P MidCap 400 covers over 7% of the U.S. equities market, and is part of a series of S&P U.S. indices. Included in the index are companies with market cap in the range of US\$ 1 billion to US\$ 4.5 billion. This range is reviewed from time to time to ensure consistency with market conditions. The index also includes companies that should have four consecutive quarters of positive as-reported earnings, where as-reported earnings are defined as GAAP Net Income excluding discontinued operations and extraordinary items.

### S&P SMALLCAP 600 INDEX

The S&P SmallCap 600 includes 600 companies and represents about 3% of the U.S. equities markets. Companies eligible for addition to the S&P SmallCap 600 have market capitalization between US\$200 million and \$US1.0 billion.

### DOW JONES U.S. LARGE-CAP VALUE TOTAL STOCK MARKET INDEX<sup>SM</sup>

The Dow Jones U.S. Large-Cap Value Total Stock Market Index<sup>SM</sup> is a float-adjusted market capitalization weighted index that reflects the shares of securities of the large cap portion of the Dow Jones U.S. Total Stock Market Index<sup>SM</sup> actually available to investors in the marketplace. The Large-Cap Value Index includes the components ranked 1-750 by full market capitalization and that are classified as “value” based on six factors: (i) projected price-to-earnings ratio (P/E), (ii) projected earnings growth, (iii) price-to-book ratio, (iv) dividend yield, (v) trailing revenue growth, and (vi) trailing earnings growth.

### DOW JONES U.S. SMALL-CAP GROWTH TOTAL STOCK MARKET INDEX<sup>SM</sup>

The Dow Jones U.S. Small-Cap Growth Total Stock Market Index<sup>SM</sup> is a float-adjusted market capitalization U.S. Total Stock Market Index<sup>SM</sup> actually available to investors in the marketplace. The Small-Cap Growth Index includes the components ranked 751-2500 by full market capitalization and that are classified as “growth” based on six factors: (i) projected price-to-earnings ratio (P/E), (ii) projected earnings growth, (iii) price-to-book ratio, (iv) dividend yield, (v) trailing revenue growth, and (vi) trailing earnings growth.

### MSCI EAFE® INDEX

The MSCI EAFE® Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. As of June 2007 the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

### MSCI EMERGING MARKETS (EM) INDEX

MSCI Emerging Markets Index: An index created by Morgan Stanley Capital International (MSCI) that is designed to measure equity market performance in global emerging markets. The MSCI Emerging Markets Index is a float-adjusted market capitalization index.



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<sup>1</sup> Source: WorldBank.org

<sup>2</sup> Source: U.S. Census Bureau, International Database, and The World Factbook, 3/31/2008; FactSet, 3/31/2008, SSgA Strategy & Research, 12/31/2007.

<sup>3</sup> WorldBank Global Development Finance: 2009 Outlook Summary.

<sup>4</sup> Diversification does not protect against loss.

<sup>5</sup> Source: FactSet.

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