Q4 2009 Commentary:
A Case for Investing in Emerging Markets

By Bob Marshalla
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Introduction

Economies worldwide appear to be in the early stages of economic recovery. But across different countries the strengths of the turnarounds and the prognoses for the future vary significantly. In the United States and other developed markets the bursting of the housing bubble blew down the house of cards that had been formed by excessive consumer debt, flaky investment securities and over-leveraged corporate balance sheets. As a consequence, these economies are now facing massive deleveraging processes that will likely persist for years. This will provide formidable headwinds to economic growth, and keep us from springing back from this recession as rapidly as we have from most other recessions in our lifetimes. But another group of countries, conveniently grouped under the rubric “emerging markets”, have already resumed growing at relatively robust rates and face brighter projected economic futures as well. Many of these countries, including China, India and Brazil, were already exporting like crazy, as well as developing their own local economies at impressive rates, before the financial crisis hit. Now they have generally come through the crisis in better shape than the developed world, and have the huge added benefit of <u>not</u> facing the deleveraging headwinds we do. They have large currency reserves and they don’t have massive debts to pay down. After all, they are our creditors!

I have decided to further increase our portfolio allocations to emerging market equities. This is the third time I have done so in a little over a year. The reason for this article is to explain my reasoning as well as to provide a little more background about these economies and markets.

After better defining what we mean by emerging markets, I will discuss the case for investing in them as well as the special risks they entail. This will be followed (1) by a summary of emerging markets equities’ recent and historical performance and forward looking expectations, (2) an explanation of how much I plan to invest in them, and (3) a discussion of the type of investment approach we will be utilizing.

What Are Emerging Markets?

People have long divided the world into developed and less developed economies and investment markets. In fact, we used to call the lesser group the “less developed countries” or LDC’s. This was changed to “emerging markets” over a decade ago. The change was probably initially for political correctness, but nowadays it is definitely a more descriptive term. These countries are definitely more than just “less developed”; they are truly “emerging” and some are on the cusp of being added to the “developed” category.

Although the terms “developed” and “emerging” are often used as imprecise adjectives, there are very specific market benchmarks, managed by Morgan Stanley Capital (MSCI), that define exactly which countries are included in which groups for investment purposes. The MSCI Emerging Markets index includes 22 countries, as listed in the middle of Table 1. The most commonly used non-U.S. developed country benchmark is the MSCI-EAFE index (for "Europe, Australia and Far East"). The EAFE index covers 21 developed countries. These are listed under the Europe and Pacific headings in the left hand side of the table. All are in Europe except for Japan, Hong Kong, Singapore, Australia and New Zealand[1].

Table 1 – MSCI Worldwide Regional Indices

MSCI International Equity Indices — Country & Market Coverage

Developed Markets

Americas	Europe	Pacific
Canada	Austria	Australia
United States	Belgium	Hong Kong
	Denmark	Japan
	Finland	New Zealand
	France	Singapore
	Germany	
	Greece	
	Ireland	
	Italy	
	Netherlands	
	Norway	
	Portugal	
	Spain	
	Sweden	
	Switzerland	
	United Kingdom	

Emerging Markets

Americas	Europe, Middle East & Africa	Asia
Brazil	Czech Republic	China
Chile	Egypt	India
Colombia	Hungary	Indonesia
Mexico	Israel	Korea
Peru	Morocco	Malaysia
	Poland	Philippines
	Russia	Taiwan
	South Africa	Thailand
	Turkey	

Frontier Markets

Americas	Central & Eastern Europe & CIS	Africa	Middle East	Asia
Argentina	Bulgaria	Botswana[2]	Bahrain	Bangladesh[2]
Jamaica[2]	Croatia	Ghana[2]	Jordan	Pakistan
Trinidad & Tobago	Estonia	Kenya	Kuwait	Sri Lanka
	Lithuania	Mauritius	Lebanon	Vietnam
	Kazakhstan	Nigeria	Oman	
	Romania	Tunisia	Qatar	
	Serbia		Saudi Arabia[1]	
	Slovenia		United Arab Emirates	
	Ukraine			

1. The MSCI Saudi Arabia Index is currently not included in the MSCI Frontier Markets Index but is part of the MSCI Gulf Cooperation Council (GCC) Countries Index.
2. The MSCI Bangladesh Index, the MSCI Botswana Index, the MSCI Ghana Index, and the MSCI Jamaica Index are currently stand-alone country indices and are not included in the MSCI Frontier Markets Index. The addition of these country indices to the MSCI Frontier Markets Index is under consideration.

The emerging markets group covers a broad and heterogeneous list of countries spread over five continents. They include the two largest countries in the world by population, China and India, down to relatively tiny countries like Peru and Israel. The four most important for investors are Brazil, Russia, India and China, which have come to have their own acronym, "BRIC". The BRIC countries now even have their own BRIC benchmark, plus specialized ETF's and mutual funds that invest in them. According to the Financial Times, three quarters of new emerging equity market fund inflows last year went into these four countries. From an investor's perspective, the next most interesting emerging markets are probably South Korea, Taiwan, South Africa and Mexico. After this second group of four countries there is a significant decrease in market capitalization, even though the others in the index include some countries with very large populations like Indonesia and Malaysia.

Back in the 80's and 90's when emerging markets were called LDC's, they were very scary places to invest. Although they had great potential for development, many of them had unstable and/or anti-market governments plus incompetent and/or under-formed monetary systems. There was no local capital to finance capital investment, so they were dependent on foreign banks and currencies for

[1] People usually consider that adding the U.S. to the EAFE group completes the set of developed economies. But this is not true because EAFE does not include Canada, which is clearly one of the developed economies. There is a MSCI World ex USA index that covers all of the developed economies except the USA, including Canada. But for no good reason I can discern, it is seldom used in the investment community.

everything. And individual geo-political events could send their shares on incredible downward or upward tears, as consumer sentiment shifted with the winds. But since then there have been profound structural changes in emerging market countries and they have become much more politically and economically stable. They have progressed to the point where they are now key contributors to world economic growth, accounting collectively for 31% of global economic output.

But there remains another large set of countries that are still substantially behind the emerging markets countries in terms of economic and financial development. Many of them are making progress and they do have public companies and stock exchanges that allow U.S. investors to invest. I consider them to be more or less in about the same position that the emerging market countries were when they were called LDC's. Never wanting to miss an opportunity, benchmark providers and money management firms have now created names, indices and investment products for this group of countries as well. The have come to be referred to as the "frontier markets". And MSCI has even created a "Frontier Markets" index consisting of the largest companies in 25 of these countries. These are also listed in Table 1, on the right hand side of the table. Some of the notable constituents of this list include countries like Argentina, Pakistan, UAE, Ukraine and Vietnam.

As an investment advisor, I am not yet a fan of the frontier markets. There may be huge upsides in some of these countries and in some of their companies, but their economies and financial markets are still much too under-developed and volatile for my taste. So when I say I am relatively bullish on emerging markets and plan to increase our investments there, it is important to distinguish them from the more flighty – might I even say flaky – frontier markets.

The Case for Emerging Markets Investments

What makes emerging markets seem so attractive as to merit increasingly large portfolio allocations? To be succinct, it is growth combined with reasonable company valuations plus increasingly hospitable local environments, including the local economics, finance and politics.

Growth - Economic growth rates in the emerging markets countries have been much higher than in any of the developed markets for many years in a row, and every analyst, pundit, academic, money manager and taxi driver I have come across believes their growth rates will continue to be higher in the next year and next decade as well. This is not an indication that these are superior economic systems. It is a natural feature of the growth cycle for any developing economy, including our own in the past, that once development gets going, growth rates are much higher in the early part of the growth cycle than once the economy has matured. Now, on top of that natural advantage, there is the additional advantage that the emerging markets are not suffering from the same need to deleverage debt that is plaguing most of the developed markets. In addition, emerging markets growth rates are highly leveraged to growth in the developed world because these markets are so export driven. For example, the U.S. has seen its current account deficit cut roughly in half as a percentage of GDP since the recession began, and this is overwhelmingly due to a decrease in imports rather than an increase in exports. When growth resumes, our demand for imports is likely to pick up rapidly. So if developed markets grow faster than anticipated, the emerging market economies will likely enjoy even larger bump-ups in growth rates due to the increase in demand for their exports.

In the past five years alone, emerging markets share of total global economic output has grown from 21.6% to 31.1%. Looking forward, Table 2 shows the consensus projections of 58 economists for economic growth in the year 2010 for some selected emerging and developed markets countries. There is little doubt that growth rates will continue to be higher in the emerging markets for the foreseeable future.

Table 2 - GDP Forecasts for 2010

Inflation Adjusted

Consensus of 58 Economists*

Emerging Markets

China	9%
Indonesia	6%
Brazil	5%
Taiwan	5%
Malaysia	5%
Chile	4%
Turkey	4%

Developed Markets

United States	3%
Canada	3%
Australia	3%
Germany	2%
Britain	1%
France	1%
Italy	1%
Switzerland	1%
Japan	1%

* Bloomberg data as reported by Business Week, Jan.4, 2010, p 48

Valuation - Of course, a high growth rate is by no means enough to conclude that something is worth investing in. Valuation must always be a fundamental part of the analysis. The price at which we buy a stock always matters, no matter how good the growth prospects or economic moats or management of any company. If the prices of emerging markets stocks in aggregate already have more than discounted their anticipated higher future growth rates, then they would not at all be good places to invest. But happily, that does not seem to be the case, even in spite of the recent rapid ascent of emerging markets stock prices. I will not make this piece into a valuation analysis, but suffice to say that the key valuation metrics for emerging markets – including price to cash flow, price to book and price to earnings – are all pretty much equal to their values for the EAFE countries and the U.S., and to their longer run averages as well. The upshot is that if we own emerging markets stocks now, we get higher prospective growth rates for about the same prices in terms of valuation multiples that we would be paying for developed markets stocks. This seems like a very good deal in my book.[2]

Still, even a high anticipated growth rate combined with reasonable current valuations is not enough to make an investment a sure thing. Anticipated growth may fail to materialize and/or valuation metrics may deteriorate rather than stay constant or improve. To develop confidence in an investment thesis we should also evaluate the economic fundamentals, the financial infrastructure and the political stability of the markets in which these companies are operating. It seems to me that for the emerging markets as a group (though not necessarily in each instance) these factors are generally positive, or at least moving in the right direction. A few more words about this follow.

Macro Fundamentals - Emerging-market macro fundamentals have improved greatly. Exports have risen strongly over the past several years, helping many emerging-market countries improve their balance sheets. In other words, their current-account balances look healthier, they

[2] A fundamental truth for a holder of stock is this. If the valuation multiples like the PE ratio stay constant, then one's investment return from holding a stock will equal the growth rate of earnings plus the dividend rate. If GDP growth rates do indeed continue to be greater in the emerging markets this means we would probably but not certainly earn higher returns. There are several ways we could still fail to do so: (1) if EM's PE ratios decline over time relative to the developed markets (due perhaps to perceptions of greater risks or higher interest rates), (2) if the rapid GDP growth rates in these countries fail to translate into similarly high growth rates in corporate earnings per share, or (3) if there is a large difference in dividend rates between the two groups of countries (unlikely).

have reduced their exposure to more expensive dollar-denominated debt, and they have built up large foreign-currency reserves that can easily finance their imports and serve to ward off speculative attacks on their currencies. So, relative to the past, many emerging-market countries have less of a need to borrow and, as a result, they are less dependent on foreign capital. This is a significant change because it gives them greater control over their own monetary policies.

The improvement in these countries' macro fundamentals will also benefit emerging-market companies. This is important because we invest in companies, not in the countries themselves. Corporate profitability for companies in these countries has indeed improved over the last several years and is now comparable to, if not better than, those of the developed world. Furthermore, there are reasons to believe these improvements in corporate profitability come from sustainable secular factors rather than cyclical factors that could fizzle as we enter the next phase of the business cycle. They include factors like improved management orientation towards profitability, decreased cost of capital (due to lesser investor risk perception as well as lower local interest rates) and a growing domestic middle class of consumers.

<u>Internal Development and Domestic Consumption</u> – Rapidly growing export industries, especially commodities production and manufacturing, have served the growth objectives of many emerging countries very well. But relying too much on such exports is not good for stability or independence. The upside leverage of exports during an economic recovery as mentioned above is matched by equally large downside leverage when the world economy is declining. Countries like China, India and Brazil have altered their intense focus on export industries and have begun rapidly developing their internal economies as well. In fact, during the current downturn China embarked on an internal stimulus program focused on local infrastructure development that is gigantic in comparison to the much debated U.S. fiscal stimulus program.

There has been much talk about emerging markets becoming economically delinked from the U.S. and other developed countries; i.e., of becoming increasingly able to grow and prosper of their own accord rather than depending so much on export demand from the developed countries. But when our financial crisis and accompanying deep recession hit last year, such soothsayers were shown to be premature at best. The emerging markets were hit hard by the recession, which quickly became worldwide. In fact, stock markets fell even more in the emerging markets than they did in the U.S., Europe and Japan. Not having a local housing bubble or mega financial institutions leveraged to the hilt proved <u>not</u> to be enough to inoculate these countries from the economic swoon. But consumer demand in these countries nevertheless <u>is</u> growing rapidly, and the largest of these countries do seem committed to continue feeding this growth. Even if the emerging markets have proved to not yet be meaningfully de-linked from the U.S., Europe and Japan, the growth of local infrastructure and consumer demand will only make them more hospitable and profitable environments for the local companies to operate.

<u>Financial and Economic Reforms</u> – Significant financial and economic reforms are taking place in many emerging market countries. As part of these financial reforms, such countries are deepening their local debt markets and lowering their reliance on foreign-currency debt, which can often be expensive to service and have onerous terms. This will give local companies easier access to capital, which will stimulate growth in the local economies. Capital projects are increasingly being financed by bonds denominated in local currencies, which was unheard of a decade ago.

Investment Returns in Emerging Markets: Historical and Prospective

Historical Returns - There is no question that emerging markets stocks have been on fire since the market low last spring. Since March 9, an index of emerging markets stocks[3] has gained 115%. In comparison, the S&P 500 has gained 68% since that time and the MSCI EAFE index of developed markets outside the U.S. has gained about 80%.

Taken in isolation, this is a little deceptive because most every asset class, region or economic sector that has outperformed since the market bottom had underperformed last year when the market was falling apart. Therefore I have compiled Table 3 which shows the returns by region in both 2009 and 2008, plus for the two years combined. It shows that emerging markets surely did fall more than EAFE or the U.S. in 2008, with a 53% loss versus 43% and 38% for the other two regions. But the comeback this year has more than made up for it, so that emerging markets have recovered all but 17% of 2008's crash, compared to 25% and 21% for EAFE and the U.S., respectively.

Table 3 - Investment Returns by Region & Country

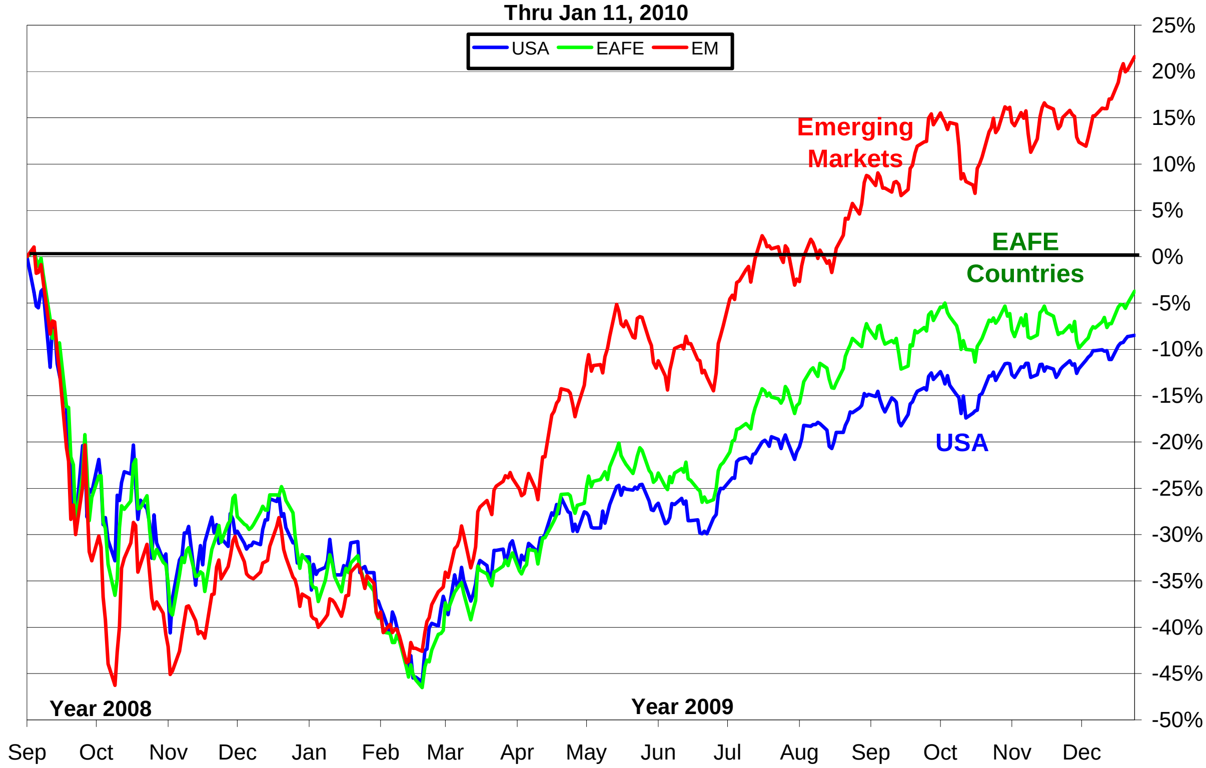
				Annualized Rates		
MSCI Index*	**Year 2009**	**Year 2008**	**Cumulative 2008 & 09**	**Past 2 Yrs 2008-09**	**Past 5 Yrs 2005-09**	**Past 10 Yrs 2000-09**
Emerging Markets	78.5	(53.3)	(16.7)	(8.7)	15.5	10.1
EAFE	31.8	(43.4)	(25.4)	(13.6)	3.5	1.2
USA	26.3	(37.6)	(21.2)	(11.2)	0.0	(1.8)
World	30.0	(40.7)	(22.9)	(12.2)	2.0	(0.2)
Sub-Indexes						
Europe	35.8	(46.4)	(27.2)	(14.7)	3.9	2.0
Japan	6.3	(29.2)	(24.8)	(13.3)	(0.8)	(3.7)
Pacific excl Japan	72.8	(50.5)	(14.5)	(7.5)	10.9	8.4
Canada	56.2	(45.5)	(14.9)	(7.7)	10.8	8.6

* All data herein from www.mscibarra.com, and are based on MSCI indexes, using net returns in U.S. dollars.

Another perspective is illustrated in Figure 1 which shows the time paths of the three indices starting with the infamous weekend of September 19 (when Lehman, AIG and Merrill Lynch all went under) up to today (January 11). Again we see that emerging markets fell even more than their developed counterparts, but have since easily more than made up for it.

[3] This return figure actually refers to the iShares Emerging Markets Index ETF, ticker EEM as reported by Morningstar.com. This ETF is designed to track MSCI Emerging Markets Index that has been discussed earlier in this paper, although there is always some tracking error.

Figure 1 - Returns By Region Since Sept 19, 2008



The past five and ten year returns by region and selected countries are also shown in the right hand side of Table 3. Over these longer periods the outperformance of emerging markets is considerably more dramatic than over the past two years. This is clearly illustrated in Figure 2.

Finally Figure 3 shows the time paths of the three indices over the past seven years since the end of year 2002, which marked the end of the dot-com market collapse. The story is much the same here. But more than the other exhibits this figure tells a cautionary tale. It illustrates how volatile emerging markets stocks have been, absolutely and in comparison to developed markets. To put some numbers behind the picture, Table 5 show the standard deviations of returns (another name for volatility) over the past 3, 5 and 10 years for the three market indices. Although emerging markets are less volatile than they used to be, they are still clearly more so than developed markets stocks. Though volatility can be scary, Figure 3 also shows the beneficial effect of long holding periods. The worst drawdown of emerging markets stock prices, occurring in 2008 and early 2009, would still have left the investor with a 100% percent gain relative to their 2003 starting point, whereas the S&P 500 investor could have experienced a small loss relative to the same starting point[4]. And, as we have seen, even starting at the beginning of the recent financial crisis, the emerging markets stocks have since more than made up for their precipitous fall.

[4] More precisely, the emerging markets index at its 2009 trough remained 99% higher than at the beginning of 2003, while the MSCI USA index reach a low of 7.6% below its starting point. The graph is based on monthly data over the seven year period. If we observed daily data, we would likely see greater highs and lows.

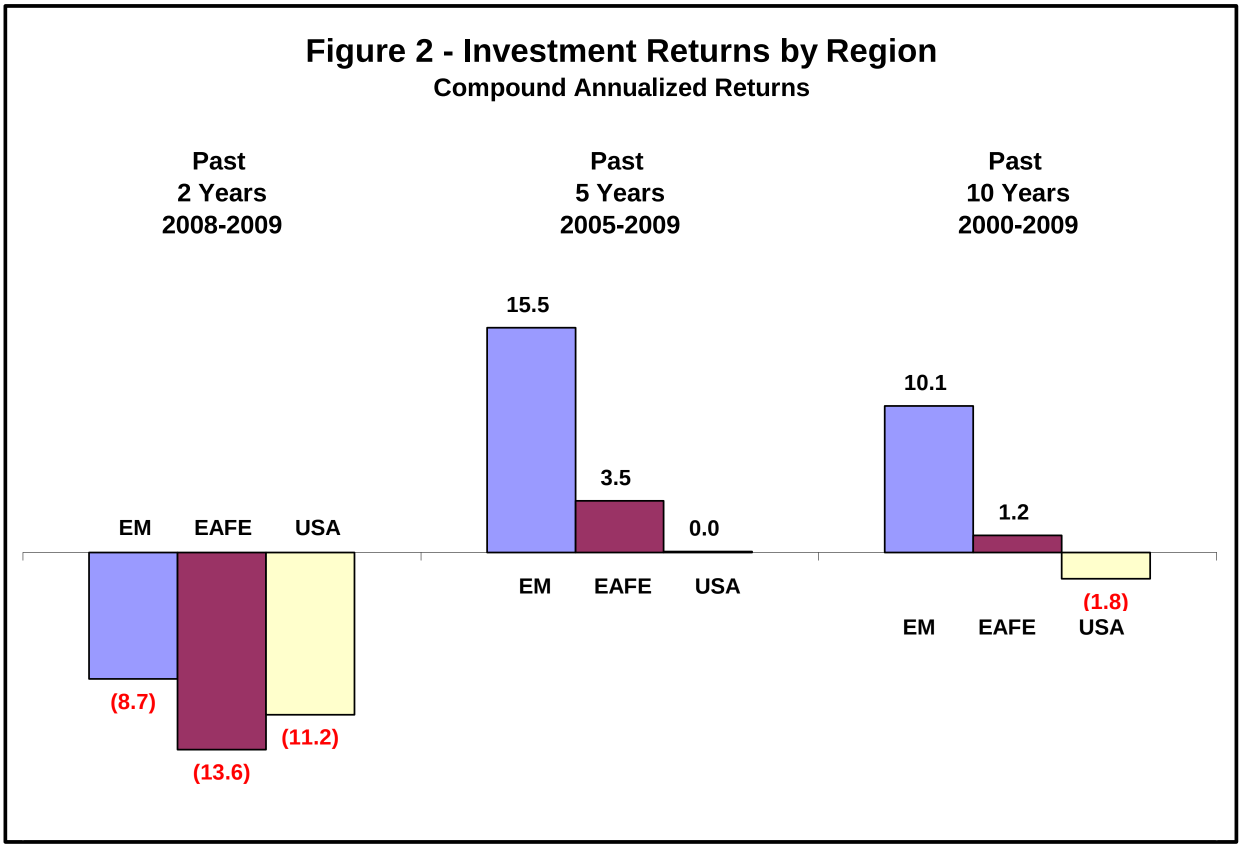


Figure 2 - Investment Returns by Region

Figure 3 - Returns by Region for Past 7 Years
2003 - 2009

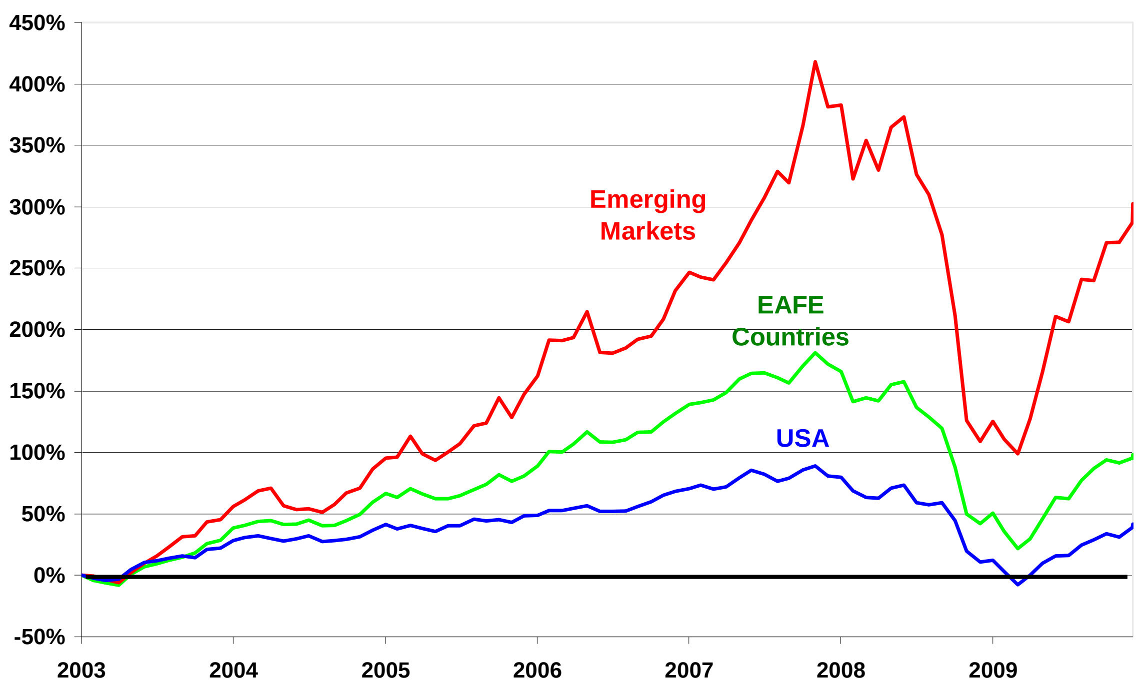


Table 5 - Volatility of Equity Prices by Region

	Standard Deviation of Returns*		
Region	**3 Years**	**5 Years**	**10 Years**
USA - Russell 1000	20%	16%	16%
MSCI EAFE	24%	20%	18%
MSCI Emerging Mkts	33%	28%	25%

* Source: Morningstar Principia, Dec. 31, 2009 edition.

Prospective Returns – As we all know by now, historical returns cannot be counted on to foretell future returns. Future return expectations should be based on one's best assumptions about fundamentals like future economic growth, business conditions, changes in valuation multiples and political and regulatory environments. All things considered, I believe the odds are favorable that emerging markets stocks will outperform developed markets stocks over the next 3 to 5 years or more, although no one can be sure. Table 4 shows the most recent forecasts of long term prospective returns by two investment organizations in which I have great confidence, JP Morgan Asset Management and Litman Gregory. The JP Morgan estimates are for a 10 to 15 year time horizon, Litman Gregory's are for the next five years. Both are stated in nominal dollar terms, with JP Morgan having built in a 3.25% average inflation assumption, and Litman Gregory 3.0%. Actually, Litman Gregory publishes four forecasts for four different economic scenarios. The values shown here are for their Scenario 1, "Sub-Par Recovery", which is the one they consider the most likely of the four. Also these figures represent compound returns, which are lower numbers than if they had quoted simple arithmetic averages[5].

Table 4 - Future Return Estimates

Asset Class	**J.P. Morgan**	**Litman Gregory**
U.S. Bonds	4.5	4.7
U.S. Stocks	7.5	6.8
EAFE Stocks	7.75*	6.8
Emerging Markets	9.5	9.6

* Presumes 7.00% returns in local currencies, 7.75% in US dollars.

JPMorgan estimates from "J.P. Morgan Asset Management Long-Term Capital Market Return Assumptions", Nov 30, 2009. Figures are expected 10 - 15 year annualized compound returns. Inflation assumption of 3.25% is built in.

Litman Gregory estimates from Advisor Intelligence website, "Asset Class Returns as of November 17, 2009". Figures shown are from Scenario 1: Sub-Par Recovery (most likely). LG's Scenario 1 inflation assumption of 3% has been added to their published real return estimates by me to convert to nominal figures.

Both organizations estimate future returns for emerging market stocks to be around 9 ½% per year, which is from two to nearly three percentage points higher than they have estimated for

[5] Compound returns are the same as geometric average returns. These are less than the arithmetic averages (obtained by adding up each period's returns and dividing by the number of periods), with the difference being greater the more volatile the series of period by period returns. Therefore, if we published arithmetic return estimates, the differences between emerging markets estimated returns and the other asset class's would be even larger.

developed markets stocks. This may not sound like an enormous difference, but once you remove inflation and taxes, and compound what is left for a number of years, the effect on ultimate wealth is impressive. For example, using the Litman Gregory estimates and assuming an average of 25% paid in taxes each year on capital gains and dividends, after 10 years, an initial $1,000 invested in U.S. or EAFE stocks would grow to $1,224 after taxes and inflation (i.e., in 2010 dollars), while the same $1,000 invested in emerging market stocks would grow to $1,491. The emerging markets' investment earnings of $491 would be 120% greater than the $224 in the developed market investment.

At the risk of being redundant, I remind the readers that this is only an illustration based on someone else's highly uncertain forecasts. No one can be sure if emerging market stocks will outperform, even in the long run, or in fact if they will even produce positive returns.

Our Allocation to Emerging Markets Investments

For our investment portfolios at MAM, I am going to be increasing our target allocations for emerging markets stocks again in the next cycle of portfolio reviews. Aside from buying individual stocks from emerging markets, which I do not plan on doing as a rule, there are two ways we can invest in emerging markets stocks: (1) via international stock funds in which the fund managers have discretion to buy emerging market stocks if they so choose[6], or (2) via dedicated emerging market funds. I had used dedicated emerging markets funds off and on in small amounts over the years I have been in this business, but up until last fall, I had for several years relied only on the first method: letting our international fund managers use their discretion to dabble or not dabble in such markets. However, this method will never lead to a very large proportion of total stocks in emerging markets. The percentage of stocks that the discretionary fund managers we currently use have historically allocated to emerging markets has ranged from 0% up to 20%, with the higher end of that range only rarely visited. Currently, our international funds have allocated between 4% and 17% of assets to emerging markets. When you consider that we have about 25% to 30% of equities in international funds, this would translate to only between 1% and 5% of total portfolio equities being in emerging markets.

I began committing to dedicated emerging markets funds in a systematic way in November, 2008 when I set the target at 5% of equities (which is in addition to any emerging market stocks held by our discretionary international funds). I increased this target across the board (i.e., for all MAM clients) just last September, up to 9% of equities. <u>Now in the upcoming cycle I am planning to raise the target for dedicated emerging market funds all the way up to 14%</u>[7]. (This sentence is actually the whole reason for writing this paper.) Most or all of the increase in emerging market stocks will come out of international developed market stocks. So our total holdings of international stocks, be they from emerging or developed markets, will be maintained at about 30% of equities, as it has been for some time.

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[6] Most of our domestic stock fund managers also buy some international stocks, and some of these can be emerging markets stocks at their discretion. But this generally only amounts to a very small percentage.

[7] I do reserve the discretion to increase or decrease this by a percentage point or two when I actually get to making the trades. All targets mentioned in this paragraph are for *dedicated* emerging markets funds, and are *in addition* to any emerging markets stocks our other discretionary fund managers may choose to hold. As mentioned, this extra slice of emerging markets stocks is likely to be relatively small.

I anticipate that this may elicit questions like, "Is 14% a lot?", or the related questions, "Why so much?" or "Why so little?" There is no correct answer to the question of how big is big for our emerging markets target[8]. It depends on our perspective.

From the view of the typical U.S. investor our new target is considerably higher than average. But this doesn't bother me because it is intentional. I agree with the statement below by Mohamed El-Erian. El-Erian is currently one of the best known and most respected personalities in the professional investment world. He has split the past thirty years about half and half between the International Monetary Fund and PIMCO, where he is currently the co-CEO along with Bill Gross. A few years ago he took time off to run the gigantic endowment fund of Harvard University, where he became famous in the industry for his creative and profitable investment policies. Recently he published an investment book[9] that is highly renowned in investment circles.

In a recent interview by Fortune magazine[10], when asked "What are the most important things that individual investors need to do differently?" El Arian says:

> "The average (U.S.) investor is too U.S. centric. There is a reason for that; the behavioral finance people will tell you that we like the familiar, so we tend to invest in names we know, that give us comfort. The problem is you don't want to be too U.S. centric in a globalizing world where the center of gravity is shifting. So the first thing for the average investor to recognize is that the asset allocation of tomorrow should be much more global than the asset allocation of yesterday."

Though not noted in the passage above, it is mostly the emerging market countries he is talking about when he recommends that investors adopt a more global asset allocation. In fact, later in the article he presents a recommended model portfolio in which emerging markets occupy 24% of his overall equity allocation.

Another frame of reference is to consider the entire world's stock market. Because emerging markets had always been much less developed financially than the rest of the world, until recently their share of the world-wide stock market capitalization was very small relative to their economic output and infinitesimal relative to their population. But as discussed herein, locally-based companies and markets in these countries have been growing at rapid rates in recent years. <u>Currently 13% of worldwide stock market capitalization is comprised by the countries in the MSCI Emerging Markets group</u>. So from a world investor's view of their place in the world's markets, our new target of 14% for emerging markets[11] is only marginally above their worldwide market weight.

It is important to understand that my target allocation for emerging markets stocks is expressed as a <u>percentage of equities</u> in one's consolidated portfolio. This target need not vary by investor

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[8] There are numerous software tools designed to "optimize" one's portfolio in terms of the academic Capital Asset Pricing Model. You input the expected returns and correlation coefficients for the various asset classes, and the model purports to tell you how much of each to hold in order to maximize returns for a given level of risk, or to minimize risk for a given level of expected return. In my opinion, these tools are pretty much worthless. You can reverse engineer them to give you just about any answer you want. In my view, a common use of such models is to promote a veneer of science and precision to those who don't understand modeling and/or the level of uncertainty and non-permanence that exists in the data need to drive the models.

[9] The book is <u>When Markets Collide: Investment Strategies for the Age of Global Economic Change</u>. Among other honors it won the Financial Times (of London) business book of the year award.

[10] Fortune, December 21, 2009, pp 17-22.

[11] Again, 14% is the target for dedicated emerging markets funds. Our total holdings of emerging markets stocks will be a little higher than this if we add in the amounts held by some of our other discretionary fund managers.

type in my way of managing portfolios (i.e., where they fall on the aggressiveness versus safety scale), because it is the overall fraction in equities that varies by that dimension. So, for example, if the emerging market target is set to 10% of equities, the fraction of overall portfolio assets in emerging markets will automatically vary by investor type. It would be 5% for a portfolio with a 50% equity target or 8% for a portfolio with an 80% equities target. So when I say I intend to allocate 14% of equities to dedicated emerging market stock funds, I mean to do this for all MAM clients, from the most aggressive down to the most conservative.

Our Investment Approach for Accessing Emerging Market Stocks

When I first began allocating to emerging market stocks the November before last, I used an index fund from Vanguard that attempts to passively track the MSCI Emerging Markets Index as closely as possible[12]. I chose to use an index fund because I was unable to convince myself that any of the active managers I considered were worthy of our investments, or at least not worthy enough to justify their higher fees. This could certainly change in the future, and I continue to evaluate several active managers.

In September, when I increased our allocation to emerging markets to 9%, I also made a change in the type of fund we are using to access emerging markets. I did not go to a pure active fund, but decided to go with a fundamental indexing fund[13]. There is an ongoing debate in the investment community about whether fundamental indexing is a form of passive investing, or active investing, or something in between. It doesn't really much matter, but I go with the latter. I would call it a quasi-passive quantitative investing methodology.

Fundamental indexing is an investment approach developed in 2005 by Rob Arnott and his colleagues at Research Affiliates, LLC. It attempts to index the entire market, or large slices of it (like small cap U.S. companies), but it uses a different methodology than traditional market cap based weighting to determine how much of each company to hold[14]. Instead of a company's market cap, which is directly proportional to the price the market assigns to a company on any given day, fundamental indexing set the weights based on a company's "economic footprint" in the economy. There are many ways to define such an economic footprint or "fundamental" weight. The exact method chosen is not all that important, except in that it cannot be affected by the market price of the company. In Arnott's version of fundamental indexing, a company's weight in the portfolio is based on equal weighted consideration of the company's total cash flow, sales, book value and dividends paid. The basic idea of this approach is to avoid holding too much of companies whose prices are stretched beyond reason by bubbles or other irrational investor exuberance, or too little when investors over-react to current company or industry problems. Had fundamental indexing been in existence during the dot-com boom, it would have avoided holding nearly as much over-priced tech stocks as did market-cap based indexing. More recently, when financial sector stocks collapsed during last fall's financial crisis, fundamental indexing funds bravely rebalanced back into that sector. When stocks, and especially financial stocks, came roaring back starting last March, fundamental index funds outperformed traditional market cap based indexing funds by a mile.

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[12] This is the Vanguard Emerging Markets Stock ETF, symbol VWO. Its expense ratio is only 0.27%. Actively managed emerging market stocks that I have considered have OER's between 1% and 2%. The fundamental indexing fund we are now using has an OER of 0.61%.

[13] The fund we have been using is the Schwab Fundamental Emerging Markets fund (SFENX). There is also an ETF offered by PowerShares that attempts to track the same index, PowerShares FTSE RAFI Emerging Markets (PXH).

[14] I wrote a paper for MAM clients about Fundamental Indexing in 2006. It is simply titled "Fundamental Indexing and can be found on the MAM website, www.marshalla.com .

We at MAM had been using fundamental indexing funds as a component of our equity strategy since 2006 in the U.S., and to a more limited extent in developed markets overseas. Since last September, it has become the sole means by which we are accessing emerging markets stocks. This will continue to be the case as I further increase our emerging markets stocks targets in the current review phase (although this could certainly change in the future).

Comparisons of returns of fundamental indexing versus traditional market cap indexing have been thoroughly back tested over the past seven decades. They have been compared in different countries, for different sizes of companies, and in all kinds of different economic and market conditions. Fundamental indexing has been found to have had advantages over traditional indexing in virtually all of these cases except in the market cycles when growth beats value.

Many times researchers find that some investing approach *would have* worked in the past, but once it is actually implemented, the effect disappears. This has not been the case for fundamental indexing. In fact it has worked every bit as well as might have been hoped since accessible investment funds were introduced in 2005. Table 6 compares the returns of fundamental indexing versus market cap indexing for the past two, three and five years[15] for the U.S., EAFE countries and the emerging markets. It shows that fundamental indexing has outperformed in each time period and in each region. In fact, the effect in emerging markets is shown to be roughly as strong as or stronger than in the developed markets, depending on the time period.

Table 6 - Fundamental Indexing Versus Market Cap Weighting Returns

Region	Index or Fund	Past 2 Years 2008 - 2009	Past 3 Years thru 10/31/09	Past 5 Years thru 10/31/09
United States		All returns are annualized.		
Fundamental	FTSE RAFI 1000	(7.7)	(5.6)	2.4
Market Cap	Russell 1000	(10.5)	(6.8)	0.7
Difference		2.8	1.3	1.7
Foreign Developed				
Fundamental	FTSE RAFI Developed ex U.S.	(10.1)	(1.3)	8.5
Market Cap	MSCI EAFE	(13.2)	(4.7)	5.6
Difference		3.1	3.5	2.9
Emerging Markets*				
Fundamental	FTSE RAFI Emerging Mkts or PXH	(4.4)	12.6	22.8
Market Cap	MSCI Emerging Markets or EEM	(7.1)	6.7	17.2
Difference		2.7	5.9	5.7

* Emerging Markets returns for 2008 to 2009 based on ETF returns (PXH & EEM) due to lack of availability of FTSE RAFI index returns for 2009.

Also, I think it is quite significant that fundamental indexing has beaten market cap indexing over these particular time periods. The strongest and most common criticism leveled at the fundamental indexing approach is that it is just another value approach. It has long been known

[15] Actually, the three and five year periods are only thru October 31, 2009 due to unavailability of the FTSE RAFI indexes thru year end.

that value stocks outperform growth stocks over long time periods, and the value tilt in fundamental indexing is claimed by some of its critics to be the main reason for its relative good performance. Even proponents of fundamental indexing acknowledge that it is likely to lag market cap based indices in market cycles when growth is beating value, though (they would assert) by less than would a pure traditional value index. But based on the widely used Russell indices, growth stocks have actually beaten value stocks in each of the past two, three and five year periods. But these are just the periods wherein fundamental indexing is shown in the table to have beaten the market cap indices. Fundamental indexing doing better than the traditional indices during periods when growth is outperforming is very likely to be an exception to the rule and not something we should count on going forward. Nonetheless, having such an exceptional period now, during these troubled times for equity investors, is something I gladly accept and which only bolsters my confidence in this investing approach.

Summary and Wrap-Up

In the next decade I believe it will be impossible to find asset classes or investment styles that produce returns anywhere near the magnitudes investors got used to in the 80's and 90's. Large company U.S. stocks enjoyed compound returns averaging a phenomenal 17.9% per year over those two decades. But now in the first decade of this century we have experienced two major market crashes, and U.S. stocks actually lost money over a ten year period, returning -0.8% per year[16] from 2000 through 2009. Given where the economy is now, even shooting for double digit returns over the next decade would seem like quite a stretch. But we need not confine ourselves to domestic markets, as there are fast growing regions outside the U.S. that have at least the potential to approach a double digit return. In our investment portfolios I have been building up our exposure to emerging markets stocks for over a year now, and with this paper I am announcing my highest new target ever for dedicated emerging markets funds, at 14% of equities.

Emerging markets are no sure thing. Even if their anticipated rapid economic growth materializes, that is no guarantee that investors will profit commensurately. But I think the risk-return tradeoff for emerging markets is increasingly attractive. The downside risks are not much greater than for developed market stocks, while the upside possibilities are decidedly better. We are never sure of the future with any investments, which is why I would never put all (or too many) of our eggs in any one basket. But given my deliberative, diversified approach to investing, I'm now adding what seems to me like a pretty big basket for this asset class.

Sincerely,

Bob Marshalla
Your Financial Advisor

[16] Computing the returns for all three decades combined, I was amazed to see that despite having negative returns for the pas ten years, the compound annual return for the full 30 year period since 1980 was still a robust 11.0% per year.