

REVISITING OUR STRATEGIC RATIONALE FOR INVESTING IN EMERGING MARKETS

FEBRUARY 2014



EXECUTIVE SUMMARY

WHAT IS THE STRATEGIC INVESTMENT RATIONALE FOR INVESTING IN EMERGING MARKETS?

This paper reflects Mercer's strategic investment rationale for emerging markets investing in light of recent events and evaluates risks and potential actions for investors.

Mercer believes that the strategic rationale for investing in emerging markets can be summarized as follows:

- **Higher long-term economic growth rates than developed markets and generally more favorable demographic profiles**
- **Lower levels of government indebtedness, compared to most developed countries**
- **Higher secular productivity gains relative to developed countries**
- **Portfolio diversification: diversification from developed market equities and bonds.**
- **Attractive return potential on both equity and bond markets**

Economic and labor market/demographic advantages do not translate directly into superior investment returns versus developed country markets. Nevertheless it seems reasonable to expect faster, more vibrant economies, with a growing labor force and greater flexibility in their fiscal and monetary policies, to create a long term positive environment for emerging market investors.

RECENT MARKET DEVELOPMENTS

Continuing the poor performance witnessed in 2013 emerging markets weakened sharply and suddenly in the latter part of January 2014. In particular, the currencies of Argentina, Turkey, South Africa and Russia came under strong selling pressure. The specific trigger for this was on-going political concerns in Argentina, where central bank support for the peso was withdrawn, effectively devaluing the currency, and also growing concerns over the possible vulnerability of the Chinese economy to a domestic credit bubble. In the context of markets which are nervous about the implications of Fed tapering, along with political unease in Ukraine, Turkey and Thailand adding to concerns, the MSCI Emerging Market Equity Index fell 4% (in local currency terms) in three days, whilst the yield on the JP Morgan Local Currency Emerging Market Debt Index rose around 50bps to 7.25%. Emerging markets continued to trade nervously heading into the end of January 2014, when a number of countries took action: the Turkish Central Bank raised interest rates 450bps, India raised rates by 25bps, South Africa raised its key interest rate by 50bps and Russia's central bank intervened directly in currency markets to support the ruble.

In a wider context, this nervousness in emerging markets follows a period of turbulence that began in May 2013, when emerging markets suffered sharp falls triggered by initial comments by the US Federal Reserve hinting at a possible reduction ('tapering') in the scale of its quantitative easing policy. Whilst not part of our original thesis, emerging markets had been seen as a beneficiary of quantitative easing, since the policy increased investor flows towards 'growth' assets. The potential withdrawal of this liquidity left markets and investors questioning their investment thesis. In this period, much of the weakness in emerging markets had manifested itself via the currency markets.

The market began to focus on the current account position of certain countries, with a number moving into deficit territory. This resulting focus on currencies remains at the forefront of investors' minds.

DOES THE STRATEGIC CASE STILL HOLD IN THE LIGHT OF RECENT EVENTS?

Higher long-term economic growth rates? Emerging market economies can be expected to achieve higher levels of economic growth than developed markets for a number of reasons. This is driven by a greater potential for productivity gains (due to infrastructure improvements and labor market up-skilling), and typically younger populations, leading to growth in the overall work force. These factors are largely unaffected by recent events. However, emerging market growth is also positively influenced by other factors such as relatively low levels of government debt and flexibility in fiscal and monetary policy; these factors are more likely to be influenced by recent market developments. A clear example is Turkey's recent decision to raise interest rates sharply in order to protect its currency. All else being equal, such a move could have a negative influence on economic growth in the short-term, even if it achieves its main aim of defending the currency. We do not believe this would necessarily have a significant effect on Turkey's long-term growth potential.

More generally, investors fear that market moves can have an adverse "vicious circle" impact on an emerging market economy, in that as portfolio flows reverse away from a country's bond and equity markets, this leads to a weaker currency. This pushes up inflation which causes the central bank to raise interest rates, potentially leading to lower growth. This is especially the case in what the market has termed the "fragile five" (South Africa, Indonesia, India, Turkey, and Brazil), due to their reliance on imported commodities. In our opinion, whilst we acknowledge that such a sequence of events is quite possible, we believe that the likelihood of such an outcome very much depends on a country's wider balance of payment flows and currency reserves. In particular, flows of foreign direct investment (FDI) into an emerging market economy are an important source of finance. Our view is that such capital flows (via FDI) are likely to continue, due to the productivity and demographic factors discussed above. It is also important to note that many emerging market countries have high levels of foreign exchange reserves, which gives them additional means of protecting their currencies in periods of weakness.

Generally better demographic profiles? Absenting conjecture on possible longer-term second order impacts (such as increased emigration if current events lead to recession), demographic profiles and the rise in work force growth are unaffected by recent events.

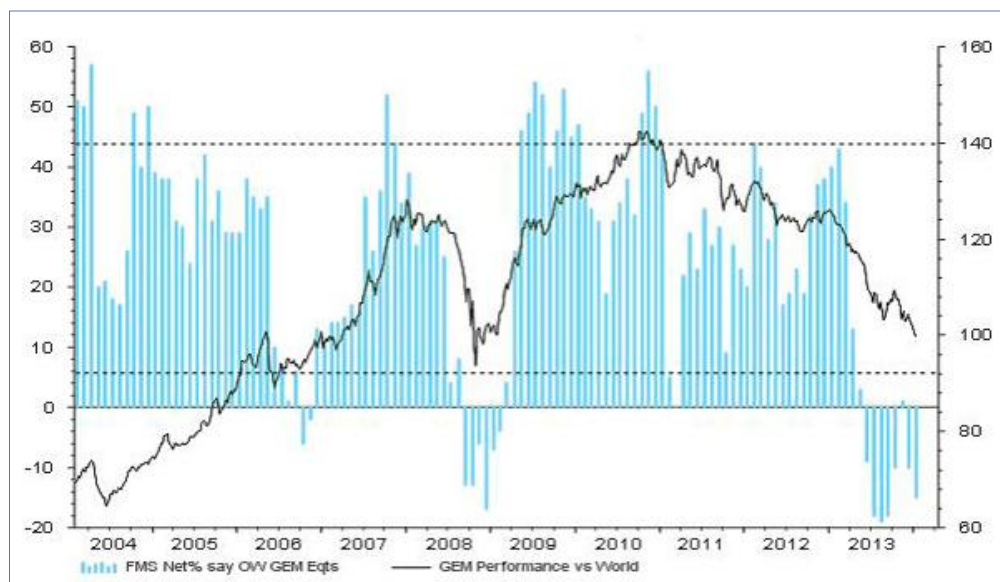
Lower levels of government indebtedness? The starting point of relatively low debt levels remains unchanged, but it is fair to say that currency weakness generally increases the debt servicing costs for emerging market economies (hard currency debt becomes more expensive, whilst local currency yields likely move higher). But the original point still stands – countries can more easily withstand the impact of such moves when initial debt levels are low rather than when debt levels are high.

Higher secular productivity gains relative to developed countries? Broadly speaking, the potential for productivity gains remains unaffected. It is possible to argue that certain funding inputs into productivity improvements (e.g. training budgets, infrastructure spend, etc.) are, at the margin, somewhat less likely during periods of market stress. However, we feel that such a case is too subjective to change our initial opinion that the potential for productivity gains remains intact.

Portfolio diversification? Arguably, the nature of emerging market investment has become much more "country specific" in the last 12 months or so, with market analysis increasingly distinguishing between categories of countries such as the "fragile five", the "edgy eight" and "debtor countries/creditor countries". Whilst emerging market investment has always had a country specific (and company specific) discipline, recent events highlighted the level of diversification inherent in emerging market portfolios. Emerging market benchmarks imply exposure to, and hence diversification across, a large number of countries and regions. However, one point to consider is that the most common EMD benchmark contains 40% in the "fragile five" countries. This factor does highlight our preference for an active management approach within emerging markets. Furthermore, correlations between emerging markets and developed markets have been low in recent times; this enhances the portfolio diversification potential of emerging market securities in client portfolios.

In terms of portfolio positioning, the recent Bank of America Merrill Lynch Global Fund Manager survey also revealed that fund managers are already underweight emerging market equities, with net exposures significantly lower than the long-term average. Thus there is “capacity” for portfolios to diversify and allocate more capital to emerging market assets. The bars in the chart show the net percentage of survey respondents who are overweight emerging market equities. The current reading is -15%, meaning that there are more managers underweight the asset class than managers who are overweight the asset class. The line in the chart shows the relative performance of EM equities versus DM equities.

ASSET ALLOCATION: GLOBAL EMERGING MARKET EQUITIES



Source: BAML Global Fund Manager Survey (January 2014)

Attractive return potential? Yes, we believe so. In 2013 the MSCI World index (in USD terms) rose 27.4%, whilst the MSCI Emerging Market index (in USD terms) fell 2.3%. On this metric alone we believe relative valuations look attractive. Although some areas in emerging markets equity have become expensive, such as the consumer staples and healthcare sectors, it is important to note that they comprise a relatively small portion of the overall market. In contrast, the more cyclical areas of emerging markets such as energy, materials and financials, which account for approximately 50% of the broader opportunity set, are trading well below their long-term average valuations. However, this is mainly due to the large weights in the high risk markets of Russia, Brazil and China. In valuation terms, price-to-book ratios for the MSCI emerging markets energy, materials and financials sectors are trading substantially below their long-term averages. In addition, the 12 month forward price/earnings ratio of the MSCI World index has risen to a post crisis high of 14.9, whereas the ratio on the MSCI Emerging Markets index is down to 10.1. This valuation difference is at its highest since June 2005. We believe that although there are short term risks to our expectations, current valuations from an absolute, and maybe more importantly, from a relative perspective make emerging market equities a strong investment opportunity over the longer term.

Meanwhile, local currency emerging market bonds offer a yield in the region of 7.25%. In addition the yield spread between JPMorgan’s Government Bond index and their Emerging Market Global Diversified index at the end of January stood at 525bps. The only time it traded at this level over the last 10 years was very briefly at the height of the financial crisis in 2008. We feel that this is an attractive level of valuation, given the credit quality of emerging market sovereign issuers (70% of the index is rated investment grade). It should also be noted that the improving outlook for the global economy provides a positive backdrop for emerging market debt, notwithstanding the market’s more immediate focus on the importance of Chinese growth prospects for emerging market economies.

WHAT ARE THE RISKS?

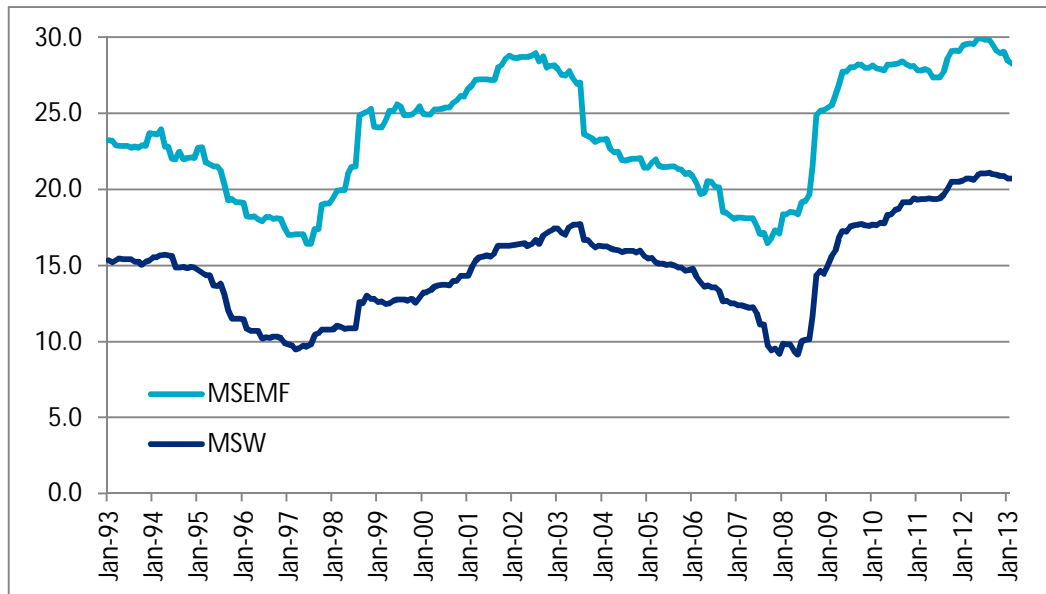
As with all growth assets, there are a number of risks and uncertainties associated with emerging market investment. Idiosyncratic country risk will likely have a far higher bearing on market direction than it has in the past few years. Furthermore, the policy uncertainties which exist at a global level, such as changes in US monetary policy, may result in continued volatility in emerging market assets for some time, and investors need to be aware of these factors.

Growth prospects for emerging market economies in the short to medium term will be heavily influenced by the wider global economy.

- China is of extreme significance for many emerging markets, forming a large part of the equity index and being a major source of demand for emerging market exports. As China continues its attempt to transition from investment led to more balanced growth, concerns have grown over the rapid pace of debt expansion. Indeed Chinese bank credit has increased from 100% of GDP to nearly 140% of GDP since the financial crisis. Many commentators have pointed out that this is leading to a potential credit bubble and this risk will have to be monitored carefully. However, we do not see a catalyst for a crisis as China does not need foreign capital inflows, and the government has the capacity to recapitalize banks and support local governments if needed. Nevertheless, reducing debt growth will put downward pressure on economic growth over the short-term.
- There is a heavy election calendar in emerging markets in 2014, including the so-called “fragile five”, which will undoubtedly contribute to volatility. Most of the recent movements in debt markets have focused on these five countries as their economies have experienced a widening of their trade deficit. These countries have found it harder to attract capital inflows, which have led to significant currency depreciation and interest rate increases. However, broadly speaking, current account deficits are smaller today than in the lead up to the crisis in 1997/98 and levels of external debt are lower. Additionally, many countries have amassed large currency reserves, which should act as a buffer in the event of a panic. Therefore, although it remains a major risk, a widespread crisis appears unlikely.
- Rising US bond yields (and eventually interest rates as well) are likely to represent a headwind for some emerging economies and markets over the next few years. However, if the pace of US rate increases is as moderate as we expect, this should relieve some pressure.
- Rising wage costs in most emerging economies relative to developed economies have made emerging markets less competitive, while their higher share of world trade makes further gains more difficult. As a result, it is important that emerging market economies seek to improve their competitiveness through structural reforms.
- Additionally, in deficit countries, rising inflation, due to higher import prices, have put central banks in a difficult position. Soft growth requires lower interest rates while higher inflation requires higher interest rates. Central banks of deficit countries have generally responded by raising interest rates, while hoping that recently depreciated domestic currencies would remain relatively weak and boost exports. There have been some signs of a pick-up in export growth in some countries, although consumption remains soft. We expect the on-going pick-up in the developed world to lead to stronger emerging market export growth.
- On a trade-weighted basis the US dollar advanced 4.5% in 2013. This was another contributing factor that led to declines in emerging market currencies, especially those that are commodity sensitive. If this trend continues it could place further pressure on commodity sensitive currencies and impact inflation expectations. Although the risk remains, a lot of this news appears to be discounted in the price.

Recent volatility does serve to highlight the risks of investing in emerging market assets. The chart below highlights how volatile emerging market equities have been in comparison to their developed peers, and we have no reason to believe that this relationship is likely to change meaningfully in the short to medium term.

MSCI EMERGING MARKETS AND MSCI WORLD INDEX



Source: Mercer MPA

WHAT ACTIONS SHOULD INVESTORS CONSIDER?

We believe that investors' growth portfolios should have a broad and diversified exposure to different asset classes, covering both developed and emerging markets. We also believe that investors should assess their strategic asset allocation in the context of their longer-term return and risk objectives, without being unduly swayed by shorter-term market volatility.

Equities

For equity portfolios, a natural reference point for sizing the emerging markets allocation is its market capitalization, which currently stands at around 11% of the global equity universe. For investors who are significantly underweight the market cap exposure, we recommend that those with the risk tolerance to withstand the volatility associated with emerging markets consider increasing their allocation towards the market cap weight. While our medium to long-term view remains positive, given the potential short-term risks to emerging markets discussed above, we would suggest phasing such an increase in allocation over the next 6–12 months in order to mitigate timing risk.

Investors with significant underweight to market cap exposure and risk tolerance to withstand the volatility should consider increasing their allocation towards the market cap weight.

Where the current allocation to emerging markets is at or around the market cap weight, we would suggest that the appropriateness of any action will depend on investor specifics:

- For investors with a low to moderate risk tolerance, who intend to reduce equity risk over the next 5–10 years, it may be appropriate to retain the current position. Rebalancing the emerging markets allocation should be considered if it has fallen materially below the target level.

- Investors with a higher risk tolerance and a relatively long time horizon might consider increasing their emerging markets allocation to reflect the favorable medium-term outlook and the fact that recent performance has left emerging markets at attractive valuation levels (both in absolute and relative terms). A phased approach could be adopted, using any short-term underperformance as an opportunity to increase exposure. We continue to suggest that an allocation to emerging markets of around 20% could be accommodated within an equity portfolio that is balanced in terms of risk by an allocation to low-volatility equities, and diversified into smaller companies (around a core invested in developed markets).

Fixed Income

We are of the view that local currency emerging market debt plays a valuable role in growth portfolios, particularly since the prevailing yield on emerging market debt is broadly in line with what many investors would consider to be a reasonable long-term rate of return for growth assets. This being so, an allocation to emerging market debt will likely improve portfolio diversification by broadening the range of return drivers away from equities. We view the recent increase in yields and currency weakness as an opportunity for investment in this asset class. However, we do note the risks mentioned above could well lead to more pain in the short term.

We continue to favor local currency debt over hard currencies on the grounds of better issuer quality, higher yield, and the potential for currency appreciation over the long term. However, we recognize that hard currency debt can also be attractive in its own right, and its lower volatility characteristic may appeal to some investors. This also means that blended products (with both hard and local currency) may also have an increasingly significant role to play.

We would recommend investors who have yet to allocate capital to emerging market debt should consider this asset class as part of their growth portfolio. Given the current volatility and potential for further currency declines in the near term it might be wise to adopt a phased approach.

For those clients currently invested in the asset class we would advise clients remain invested. The short term economic prospects have weakened, but this should be kept in perspective; growth remains healthy in absolute terms, even as some economies struggle with imbalances.

Current yields look attractive from both an absolute and relative basis and further weakness could lead to opportunities to add to existing positions.

Investors should stay invested and consider emerging market debt as part of their growth portfolio.

CONCLUSION

Emerging markets are a volatile asset class by their very nature, and we have had significant negative years before, such as 1994 and 1998. In both cases markets ultimately recovered and subsequently provided strong returns, and we believe that the current situation will prove to be the same. As touched on in this paper, there is a diverse range of risks and challenges facing emerging market economies in the current environment, and active management is essential for portfolios so they can be appropriately constructed to reflect the manner in which different countries address these challenges. The silver lining is that the current upheavals could provide the impetus for reforms to boost long term growth potential, which are often hard to make when times are good.



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