

Emerging Markets

January 2010

Emerging markets currently account for around 80 percent of the world's population and produce over 40 percent of the world's GDP (in purchasing power parity terms).

Emerging markets entered and exited the global financial crisis in much better shape than many of the developed economies of the world.

We believe that global growth will be driven over the long term by emerging markets.

A long-term growth story

The economic growth experienced by emerging markets is not purely a cyclical phenomenon, but we believe a reflection of a structural long-term growth trend. There have been sustained improvements in key metrics such as:

Higher GDP growth

Emerging markets have been growing at a higher rate than developed countries, and are expected to be a key driver of future global growth.

Rising per capita income

Per capita income in emerging markets has steadily increased and is expected to rise further. In addition, domestic consumption levels continue to improve, shifting the emphasis of sustainable growth from exports.

Favourable demographics

Emerging market countries have demographic profiles which support economic growth (around half the population of emerging markets are below 25 years of age). Younger populations and higher birth rates are likely to lead to strong aggregate demand going forward.

Exchange rates

Many emerging governments maintain artificially low foreign exchange rates, lending continued support to exports and foreign investment.

Developing trends

The economic development has driven change within these countries and provided a range of investment opportunities. We highlight some of the main trends:

Increased consumer demand

As income per capita in emerging countries continues to rise, growth is being driven by rising domestic consumption. A number of asset classes are positively correlated with GDP growth.

Development of infrastructure

As emerging economies grow, spending on infrastructure will continue to increase, as the need to develop logistics (e.g. transportation, warehouses, electricity) to sustain growth rises.

Foreign investment

Foreign investment in emerging countries has been increasing, as investors seek to take advantage of the rapidly growing economies. According to a 2009 survey by UCTAD (United Nations Organisation), India and China ranked third and first, respectively, as the most preferred foreign direct-investment locations.

Benefits of an allocation

A long-term strategic allocation to emerging markets can improve a pension scheme's overall risk-adjusted returns, the degree to which will be dependent upon the scheme's overall risk and return objectives and portfolio allocation.

Return premium

Investors allocating to emerging markets expect to receive a return premium over developed market investment. This premium is driven by the economic growth potential and perceived relative riskiness of emerging markets compared to developed markets.

Diversification

As emerging markets have historically had imperfect correlation with developed markets, an allocation will provide diversification benefits, further improving the return/risk profile of a pension scheme's portfolio.

Whilst there are a range of different investment options for clients wishing to have exposure to emerging markets, listed equities provide ease of implementation and liquidity versus private equity or property funds (for example).

We believe that emerging markets provide attractive investment opportunities through a return premium over developed markets, together with diversification benefits.

Investment risks

When investing in emerging markets, a number of risk factors should be taken into consideration. However, we believe that many of these risks have reduced somewhat over the last 10 years as the level of overall economic development has improved.

Political instability remains a key risk in many emerging countries.

Lower than expected growth can affect investor confidence and lead to simultaneous extraction of capital across markets.

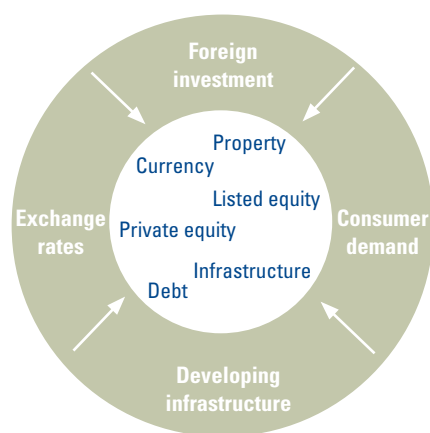
Governance/transparency risk remains, as regulatory bodies in emerging markets need to develop further.

Timing risk arises due to inherent volatility in emerging markets.

Manager selection risk – given the high dispersion of returns amongst managers, accessing skilled managers is vital.

Accessing the emerging markets growth trend

There are several routes available to investors wishing to access emerging markets; each have their own unique investment characteristics whilst providing exposure to the emerging markets.



Private equity/Infrastructure

Emerging markets are increasingly a target for private equity capital, as investors are attracted by high returns and a growing pool of opportunities.

Most emerging market deals are growth capital investments with little or no leverage. Political and economic risk is also seen as decreasing, thus fuelling this capital migration.

Asia and Eastern Europe are no strangers to private equity, but there is also growing interest in Africa, Latin America, and the Middle East.

Accessed through: Fund of funds or a direct fund.

Currency

Emerging market currencies are presently at an artificially depressed level, which is maintained through government intervention. This is not a sustainable long-term scenario, and we believe that emerging market currencies will appreciate to reflect the improving economic realities in the respective countries.

Accessed through: Specialist manager or currency overlay.

Property

Property returns are closely linked to GDP growth.

As emerging countries develop and a greater percentage of the population moves to the city, driving urbanisation, there will be a greater demand for residential as well as commercial property.

Accessed through: Fund of funds, direct fund, listed property securities.

Emerging market debt

Emerging market debt is issued by an emerging sovereign or company based in an emerging market country, and is a relatively easy and liquid route to gain exposure to emerging markets.

The debt can be issued in 'hard currency', e.g. US Dollar, or local currency which will offer an extra return potential from currency appreciation. The credit quality will usually be below investment grade, offering higher returns than developed market debt.

Accessed through: Specialist manager.

Listed equities

Listed equities are the most straightforward route for investors to access the long-term growth trend in developing economies through direct investment in stocks.

Listed equities in emerging markets are expected to provide a return premium over developed equity markets. An allocation to emerging market equities can also improve the overall risk/return profile of an existing equity portfolio through diversification.

Accessed through: Specialist manager or passive exposure.

Building up an allocation

We believe that post the financial crisis, emerging markets overall are in much better shape economically to provide the right environment to sustain long-term growth. In addition, emerging markets tend to be under-represented within pensions schemes' portfolios.

Given the strong rally across many risky assets since the start of the year, our advice is that clients should invest in stages to mitigate any timing risk.

KPMG Investment Advisory Research View

- We believe there is a strong case for a strategic allocation to emerging markets, driven by their long-term economic growth prospects.
- Specifically, we believe that a long-term strategic allocation will enhance the risk-adjusted returns achieved on a pension scheme's overall portfolio.
- Following the outcome of the financial crisis, which highlighted the weakness in developed economies, we believe that emerging markets are in a much better position going forward to sustain strong growth.
- An allocation to emerging markets can be accessed through a number of different routes, dependent upon a scheme's circumstances.
- Investing in listed emerging market equity can be one of the most straightforward routes to implementation, providing liquidity, and is the least governance-intensive approach for first time allocators to emerging markets versus other investments.
- KPMG Investment Advisory has prepared a thorough paper on accessing emerging markets through the listed equity route, and would be happy to provide this and discuss the opportunities with you.

Contact us

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