



ARE EMERGING MARKETS IN A BUBBLE? Similarities to the tech bubble in the late '90s...

At the height of the US tech bubble in the late '90s, an incredible market narrowness unfolded that made it very difficult for active management strategies to outperform unless risk was eschewed in favor of a concentrated portfolio of very similar stocks. The characteristics of those stocks bear a striking resemblance to those that are driving the MSCI EM index ever higher today. That is, they were large cap and expensive.

In the late '90s, the US stocks were the largest in the S&P 500 and were surrounded by "buzz", speculation, and momentum. Expectations became so high and so uniformly positive that much of the rest of the market became overlooked and ignored. In fact, at the market peak in 1999, the top 10 contributors to the S&P 500's return were mega cap securities with an average one-year forward P/E of 75.0x versus 31.0x for the broader index. As you can see below, these 10 stocks accounted for nearly two thirds of the S&P 500's 21% return in 1999. And the majority operated in the technology sector. However, when the tech bubble burst in 2000, the technology-oriented stocks listed here severely underperformed the S&P 500, which declined -9.11%.

S&P 500 Index

Company Name	1999 Return	Contribution to return	Cum % cont to return	2000 Return
Microsoft Corp	68.40	2.39	12.22	-62.80
Cisco Systems, Inc	130.80	1.91	22.00	-28.60
GE Co.	53.50	1.75	30.94	-7.10
Wal-Mart Stores	70.40	1.26	37.40	-23.10
Oracle Corp	289.80	1.16	43.36	3.70
Sun Microsystems	261.80	0.87	47.81	-28.00
Nortel Networks	196.80	0.85	52.14	-36.50
Citigroup	70.10	0.84	56.46	22.30
Qualcomm Inc.	351.60	0.79	60.50	-53.30
Intel Corp	39.10	0.77	64.45	-69.30

Source: Factset, The Boston Company Asset Management

Emerging markets have been in a bull market since 2003. The asset class has delivered five years of consecutive double digit returns (annualized 36%). This is the longest winning streak since the inception of the MSCI EM index in 1988. While recent studies observed that strong earnings have driven much of this return, we contend that many companies are earning record profits driven by record sales growth and profitability which are unsustainable. We believe that outsized profits and margins inevitably attract increased competition and capacity growth over time, which can augment the downside potential for companies if combined with a slowing economy. These time tested truths in market cycles are now being ignored, creating a bubble in certain segments of emerging markets. While bubbles can be great on the way up, there is invariably a hangover after the ride is over, with the downside potentially severe once the tide turns.

Since 2005, there has been a persistent trend of large cap companies (stocks over \$10bn in market cap) outperforming most of the MSCI EM Index. Elevated liquidity created by extended monetary easing has fueled gains in emerging markets, especially those stocks that are relatively easy to trade. This has contributed to a significant valuation (Price/Earnings, Price/Book) premium for larger stocks in the index, regardless of fundamentals or long-term growth prospects. During the first half of 2007, the liquidity premium trade had begun to moderate, implying broader participation in market returns. The reversal was short lived, however. Since mid-August when the Federal Reserve Board responded to the credit crisis by lowering the discount rate and cutting the Fed Funds rate by 50 basis points, there has been a euphoric response from investors who flocked back to emerging markets. But not just any Emerging equities - the most dramatic price movement has been in the biggest and most expensive securities in the index. The liquidity trade had returned. In September alone, just 2% of the companies in MSCI EM (or 15 of the 842 stocks in the index, representing nearly 20% of the market cap) have contributed 40% of the return!

MSCI EM Index

September 2007

Company Name	Average Weight	Total Return	Contribution To Return	Cum % cont To Return
Companhia Vale do Rio Doce	2.68	37.00	0.91	8.24
China Mobile Ltd.	2.69	21.59	0.56	13.31
Petroleo Brasileiro S/A	2.73	20.84	0.56	18.37
POSCO	1.57	20.21	0.31	21.19
PetroChina Co.	0.94	32.21	0.28	23.76
CNOOC Ltd.	0.67	39.28	0.24	25.96
Gazprom OAO	3.21	6.26	0.21	27.87
Reliance Industries Ltd.	1.05	20.20	0.21	29.76
China Life Insurance Co.	1.12	19.02	0.20	31.61
China Shenhua Energy Co.	0.52	38.67	0.18	33.29
Ping An Insurance	0.51	33.16	0.16	34.75
Lukoil Holdings	1.16	11.51	0.13	35.96
Banco Bradesco S/A	0.78	16.72	0.13	37.14
ICICI Bank Ltd.	0.57	23.28	0.13	38.29
Impala Platinum Holdings Ltd.	0.53	21.64	0.11	39.29
Relative Valuation		2007E P/E	P/B	
TBC EM		12.4x	1.7x	
MSCI EM Index		15.7x	2.8x	
Top 15 EM (listed above)		20.0x	4.5x	

Source: Factset, Morgan Stanley Research

This group of securities has a weighted average P/E and P/B of 20.0x and 4.5x, which represents a 33% and 60% premium to the MSCI EM index respectively. Versus our TBC Emerging Markets Value portfolio, that premium is an astounding 61% and 165% respectively. While we have modest exposure to the group, the majority do not meet our value criteria. Merrill Lynch has recently published a study that concludes that only 33% of EM stocks have outperformed the MSCI EM index during the current rally which began on August 16, 2007. This breadth in the market is the narrowest it's been in seven years, and well below the normal 50% threshold – a typical attribute in equity bubbles. Logically, one can conclude that global and emerging market growth does not depend on a select group of stocks. There are a wide range of companies that contribute immensely to economic expansion in the developing world. Yet, many of these stocks have been completely overlooked by investors intent on gaining exposure quickly and easily. For example, while the

BRIC countries (Brazil, Russia, India, China) have produced strong economic growth recently, so too have countries such as the Philippines, Malaysia and Taiwan. We don't see how the BRIC financial companies can justify the extreme valuation premium (depicted in the table below) they currently enjoy over their Philippine, Malaysian and Taiwanese peers. As a result, we are overweight the latter, and underweight BRIC financials.

Relative Valuation	2007E P/E	P/B
MSCI BRIC Financials	27.1x	4.5x
MSCI Philippine, Malaysian, Taiwanese Financials	16.6x	1.8x
BRIC valuation premium	63%	250%

Source: Factset

We sense that parts of the Emerging Markets asset class are now in a bubble, much like the tech bubble eight years ago. And while it hurts in the near term to employ a relative value strategy, we are convinced that our stocks are the “best ideas for tomorrow”. The index's weakest performers, many of which we own as we adhere to our philosophy and process of targeting value opportunities that are out of favor yet offer solid business prospects, will be the main source of alpha in the future. We continue to run a broadly diversified portfolio of securities with attractive value characteristics and remain confident that the value in our portfolio will prevail and produce exceptional risk adjusted returns when the sentiment for today's high fliers wanes.

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