



# Emerging Markets Value: The Prospects Remain Bright

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## Introduction

The MSCI Emerging Markets Index surged to dizzying heights in October 2007, ending the month with a five-year annualized return of 35% in US dollars. The bull market traced its roots to a solid and sustained period of earnings growth and profit-margin improvement. Valuations eventually expanded, with China and India trading above 20x P/E, and the Index, as a whole, priced at a premium to US and developed market equities. Commentators pushed the theory of Emerging Markets decoupling, which suggested that the likes of India, China and Brazil could continue their brisk growth prospects despite a possible recession in the US and developed markets.

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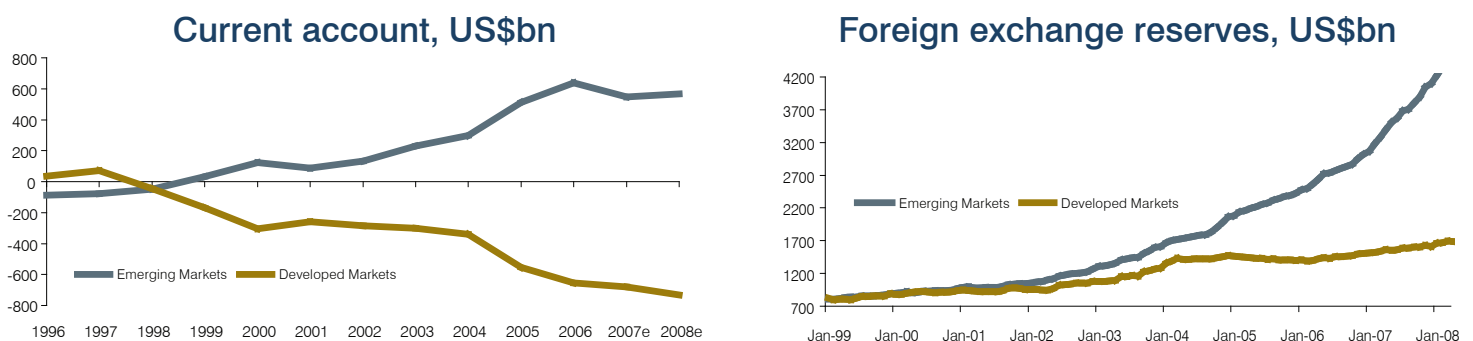
But as of mid-October 2008, the MSCI EM Index has plummeted by 57%, in line with the worst of the 1997-98 “Asian Crisis” which was marked by Russian and Asian economic crises and a series of currency devaluations and sovereign debt defaults. The theory of decoupling has been silenced for the time being as Emerging Markets equities continue to react to the devastating global financial crisis that began in the US in the summer of 2007.

While headlines remain bleak and investors continue to reduce their appetite for risk, it is important to step back to remind ourselves that the long-term secular drivers of Emerging Markets’ growth prospects are as strong as they were a year ago! And although earnings and margins are likely to come under pressure for a period of time, we believe this trend reflects a normal cyclical decline instead of a secular change. In fact, current valuations are as low as they’ve been since the inception of the MSCI EM Index, which we believe has created opportunities to buy quality companies with compelling growth prospects at rock-bottom prices.

## The Secular Argument for EM Equities

The Emerging Markets asset class is bigger and stronger than a decade ago. It offers significantly more growth potential as emerging economies ascend to developed market GDP per capita levels. In fact, Emerging Markets have matured to 11% of global equity market cap from 4% in 1998 and just 1% 20 years ago. The improved strength of the asset class is revealed in Exhibit 1, which illustrates the enviable position of being a net creditor to the developed market regions today.

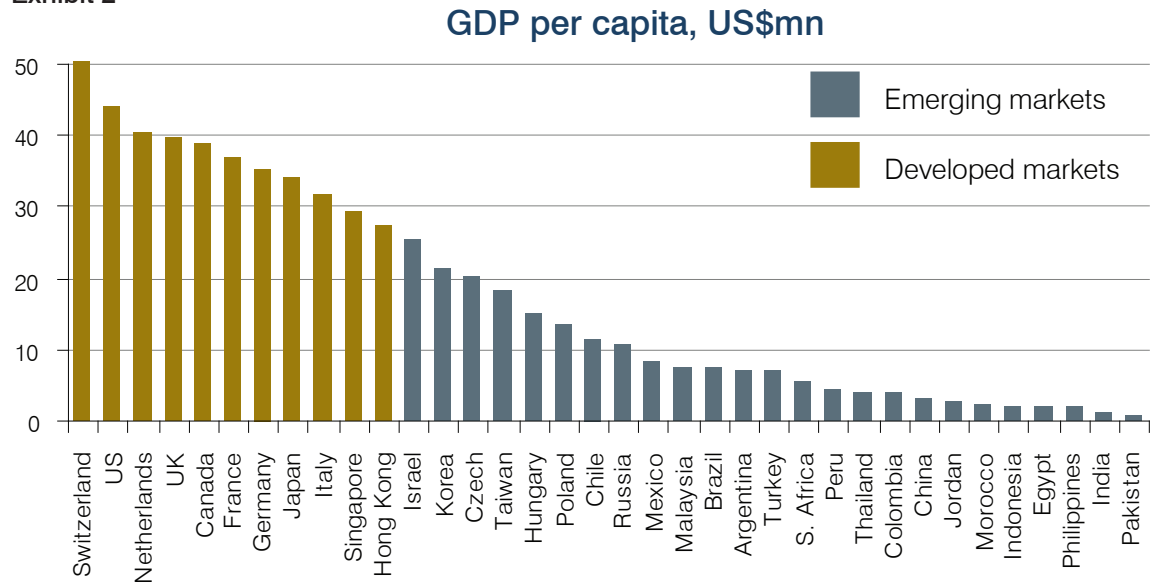
Exhibit 1



Source: IMF, Merrill Lynch calculations

Since the constituent emerging economies are starting from a far lower base than developed economies (as evidenced in Exhibit 2), the continued trends of industrialization, modernization, and growth of the middle-class consumer should eventually translate to higher and more efficient levels of GDP per capita.

Exhibit 2

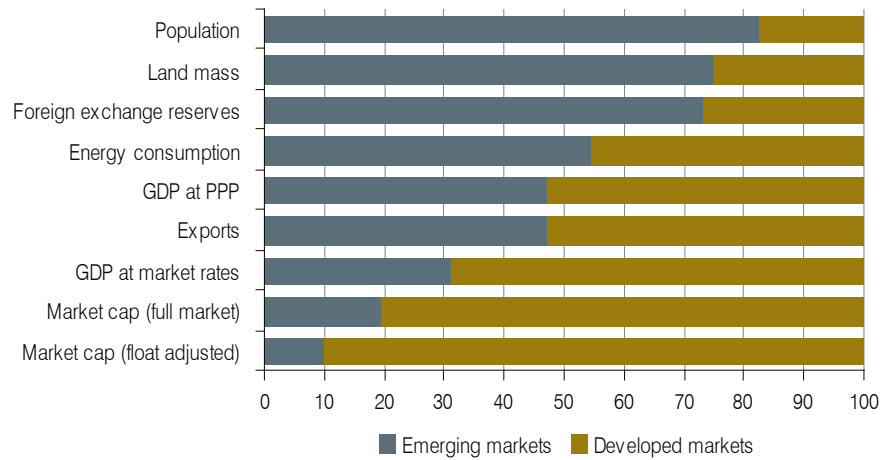


Source: EIU, Merrill Lynch, as of 2008E

There are two additional secular factors to consider: first, the asset class is undercapitalized versus the developed markets; and second, Emerging Markets are arguably at the cusp of a credit-growth cycle as opposed to mopping up the credit bust in developed market economies. Exhibit 3 illustrates the likelihood that Emerging Markets would capture more of the global equity market capitalization over time, as the region boasts 80% of the world population, 75% of the land mass and 50% of GDP, but only 11% of market cap. Exhibit 4 highlights the low, relative penetration of financial products such as home mortgages and credit cards, which is a compelling factor when paired with the burgeoning middle class consumer demographic.

Exhibit 3

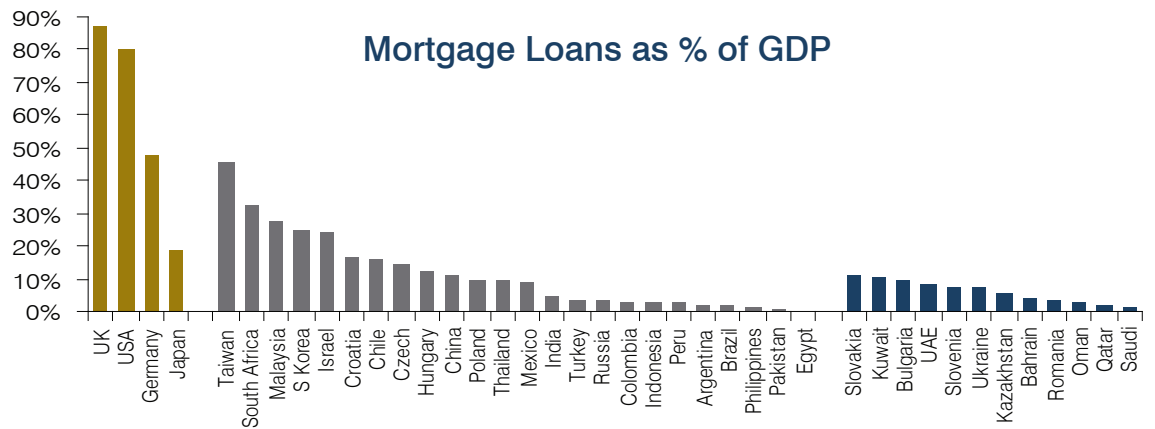
### Emerging economies as % of total world



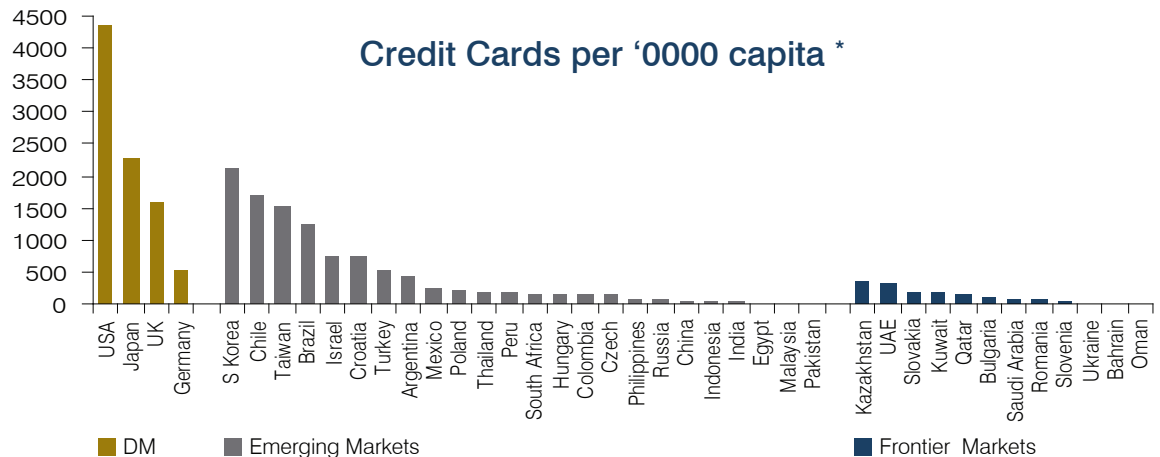
Source: Merrill Lynch, BP, CIA World Factbook, Factset, IMF World Economic Outlook, Thomson DataStream, Bloomberg. Market data as of September 2008, rest as of 2007.

Exhibit 4

### Mortgage Loans as % of GDP



### Credit Cards per '0000 capita \*



\* Denotes the number of credit cards per 10,000 people.  
Source: Merrill Lynch calculations, Central Bank data, data as of 2007.

## The Market Capitulates – A Return to TBC’s Relative Value Approach

We believe the long-term trends in Emerging Markets remain bright, and that the current bear market is cyclical in nature. The pullback has created what we believe will likely be a very attractive entry point for long-term investors who are interested in the asset class. We believe the valuation opportunity across many of the countries and sectors is as attractive as we’ve seen since we launched the portfolio in 1996. As an example, Exhibit 5 depicts just how low the global equity markets have fallen as a result of the sell-off, with the MSCI EM Index trailing 12-month valuations now trading at their widest discount relative to history, while offering significantly greater growth potential than developed markets.

Exhibit 5

	Trailing P/E Multiple					Trailing P/Book Multiple				
	World	US	Europe	Japan	EM *	World	US	Europe	Japan	EM *
<b>Current (10/21/08)</b>	11.3x	13.9x	8.6x	11.9x	8.0x	1.6x	1.9x	1.4x	1.1x	1.4x
<b>5 Year Average</b>	19.8x	21.2x	16.4x	16.4x	14.2x	2.4x	2.9x	2.2x	1.7x	2.0x
<b>10 Year Average</b>	22.6x	22.7x	18.9x	23.3x	16.2x	2.8x	3.5x	2.6x	1.8x	1.9x
<b>30 Year Average</b>	18.5x	17.0x	15.3x	33.1x	16.3x	2.2x	2.5x	1.9x	2.3x	1.8x
<b>Current Premium (Discount) to:</b>										
<b>5 Year Average</b>	-43%	-34%	-48%	-28%	-44%	-36%	-36%	-38%	-37%	-32%
<b>10 Year Average</b>	-50%	-39%	-55%	-49%	-51%	-44%	-47%	-47%	-41%	-27%
<b>30 Year Average</b>	-39%	-18%	-44%	-64%	-51%	-28%	-24%	-26%	-53%	-26%

\*Source: Morgan Stanley, MSCI

The 17-person investment team for the TBCAM Emerging Markets Value Equity strategy implements a disciplined, relative-value approach that has yielded attractive absolute and relative performance throughout a variety of market cycles over the long term. Our team’s process is value-oriented, fundamentally driven and risk aware. We believe that over a full market cycle (generally between three and five years), stocks valued lower than the market on a price/earnings and price/book value basis will typically outperform the broader market. This philosophy rings especially true when stocks with these valuation characteristics also demonstrate strong fundamentals and improving business momentum.

No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.

## Conclusion

The tail-end of the most recent bull market that ended in October 2007 was distinguished by strong price momentum and complex financial engineering that was bolstered by unsustainably high levels of cheap credit. The subsequent meltdown in global financial markets has been astounding, and although markets will eventually stabilize, it is unlikely that they will revert to the excessive factors of momentum and leverage. The more plausible scenario may be an environment where companies are judged on their underlying fundamentals and business model, in addition to their ability to finance their business opportunities with internally-generated cash flow and a high degree of credit quality. In other words, does a company offer attractive valuation based on a more normal level of earnings potential?

We believe such an environment would play to the strengths of the TBC Emerging Markets Value strategy. Our team believes that the portfolio is attractively positioned, not only to protect in a prolonged bear market, but to take advantage of the oversold opportunities in the current market environment.

We recognize that investors are naturally worried about the outlook for Emerging Markets equities. An understandable response is to want to reduce exposure to the asset class and instead seek a safe haven. However, Emerging Markets equities have traditionally provided investors with exposure to dynamic growth opportunities and diversification benefits, while delivering strong, yet admittedly volatile returns over time. Although we are cautious about the present market dynamics, we remain optimistic about the performance of the asset class over the long run. The current bear market is a stark, yet compelling reminder that investors should seek an Emerging Markets manager that not only provides alpha in most positive return environments, but also protects and preserves those outsized gains during the inevitable downturns.

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## Author Biographies

### **William J. Adams**

#### **Vice President**

Bill is a Portfolio Strategist and a member of the investment team for The Boston Company's Non-US Value Equity investment disciplines.

Prior to joining The Boston Company, Bill was an Associate for Deutsche Bank, where he was responsible for European equity research sales. Before Deutsche Bank, he was a Senior Account Officer at Putnam Investments, where he managed 401(k) relationships, and a Senior Account Administrator at State Street Research and Management Company.

Bill graduated with a BA in Political Science from Boston College. He received an MBA in Finance from the University of Maryland.

### **Andrea M. Clark, CFA**

#### **Vice President**

Andrea is a Portfolio Strategist and an Equity Research Analyst on The Boston Company's Non-US Value Equity investment team.

Prior to joining The Boston Company, Andrea was a Vice President with Standish Mellon Asset Management, where she was responsible for equity product management, development and positioning. Previous to that, Andrea was a Vice President of Institutional Product Management at Pioneer Investment Management, Inc. During her career, Andrea also worked for Putnam Investments in several business groups including Portfolio Analysis and Marketing.

Andrea received a BS and an MBA from Suffolk University. Andrea holds the Chartered Financial Analyst designation and is a member of the CFA Institute and the Boston Security Analysts Society.

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