Investing in Emerging Markets: Local Opportunities and Risks

Conrad Saldanha
Portfolio Manager
Emerging Market Equities

In general, investors look to emerging markets for above-average growth potential—both at the country level, where gross domestic product (GDP) growth is widely expected to exceed that of the developed world, and at the corporate level, where earnings have outpaced those in mature markets. This growth has been driven by both global and domestic factors—emerging companies have improved their global competiveness, and are well positioned to benefit from an increasingly affluent local population. In this paper, we assert that the most compelling growth opportunity for investors is found at the local level, where companies with a strong domestic position in emerging markets will benefit from a growing consumer base and rising disposable income. In focusing on this local market segment, we believe that a bottom-up investment approach supported by rigorous analysis can unlock compelling opportunities beyond those represented in benchmark indices, and is important to mitigating risk.

DRIVERS OF GROWTH IN EMERGING MARKETS

In the years following the Asian and Russian financial crises of the late 1990s, emerging economies have experienced superior GDP growth—and their prospective growth is expected to exceed that of developed economies for years to come. Secular domestic trends account for an increasingly significant and, we would argue, more sustainable component of GDP growth.

THE EMERGING MIDDLE CLASS

Local consumption rates have accelerated in emerging markets, as more and more households have entered the middle class—a dynamic that is impacting growth across various sectors.

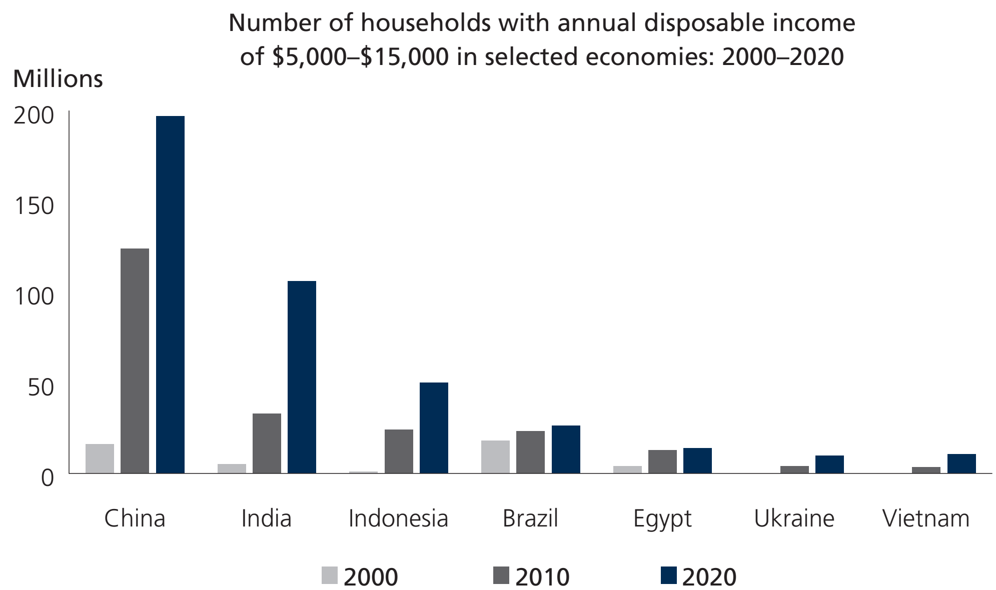
Local consumption rates have accelerated in emerging markets, as more and more households have entered the middle class—a dynamic that is impacting growth across various sectors. Consumer products companies are the obvious beneficiaries, as an increase in disposable income allows for a higher standard of living. Infrastructure is another example, as ongoing urbanization drives the need for more road, railway, building and power infrastructure. As an indicator, in 2009, total motor vehicle sales for Brazil, India and China combined surpassed those of the U.S., the European Union and Japan.[1] In combination with increased manufacturing and construction activity, this has increased demand for energy and raw materials. Agriculture is another beneficiary as diets have broadened to include more animal proteins, driving significant demand for grain as feed.

Figure 1 gives a sense of the dramatic rise of the emerging middle class, measured by the growth in the number of households with disposable income of $5,000–$15,000. This segment of the population in emerging economies, including China, India and Brazil, more than doubled between 2000 and 2010, and is expected to continue to rise.

[1] Source: J.P. Morgan. As of December 31, 2010.

Since 2007, the percentage of total global consumption coming from emerging nations has surpassed that of the U.S.,[2] making the emerging middle class an important driver of both local and global GDP growth (Figure 2).

FIGURE 1: DISPOSABLE INCOME IN SELECTED COUNTRIES



Source: Euromonitor International from national statistics. Note: Data for 2010 and 2020 are forecasts.
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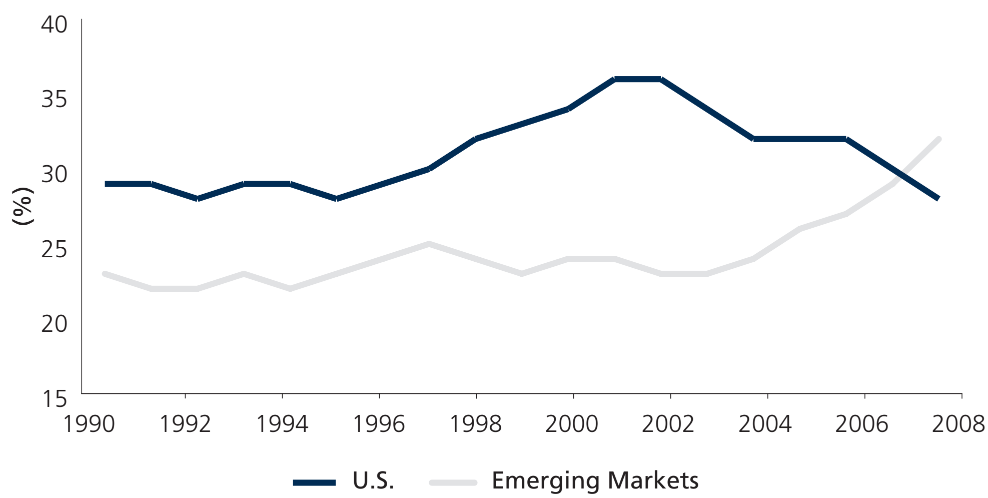
FIGURE 2: EMERGING MARKETS VERSUS U.S. CONSUMPTION AS A PERCENTAGE OF GLOBAL CONSUMPTION



Source: J.P. Morgan.
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[2] J.P. Morgan.

Locally driven emerging market companies are expected to enjoy superior growth rates, while trading at a slight premium in terms of price/earnings ratio. In our opinion they represent an attractive investment opportunity.

IMPACTS ON THE MARKET: LOCAL VERSUS GLOBAL COMPANIES

Our research sought to identify how the share prices of companies serving this growing consumer segment have performed in recent years and what returns might look like going forward.

To do this, we separated emerging market companies into two categories—those whose end markets are primarily global and those who target local needs. In terms of sectors, globally oriented businesses tend to characterize the Energy, Information Technology, Materials and Health Care sectors. These firms represent approximately 40% of total market cap of the MSCI Emerging Markets (EM) Index. Companies with a greater local customer base include those within sectors such as Consumer Discretionary, Consumer Staples, Financials, Industrials, Telecommunications and Utilities, as well as Health Care firms with a local focus. Locally driven companies make up approximately 60% of the market cap of the index.

A comparison of the two groups of businesses reveals some interesting characteristics. As Figure 3 shows, the average market capitalization of local companies is smaller than that of globally focused emerging market companies or their developed market peers. Locally driven emerging market companies are expected to enjoy superior growth rates, while trading at a slight premium in terms of price/earnings ratio. In our opinion they represent an attractive investment opportunity.

FIGURE 3: SUPERIOR GROWTH, SIMILAR VALUATIONS

Characteristics of Local vs. Global Companies (As of 12/31/10)

	MSCI Emerging Markets Index		MSCI World Index	
	Local Sectors	Global Sectors	Local Sectors	Global Sectors
Weighted Avg. Mkt Cap	27,791	46,523	52,998	85,073
P/E (FY1)	14.8	13.4	14.0	13.9
Est. 3–5Yr EPS Growth	18.5	17.3	13.8	14.5

Sources: Neuberger Berman, MSCI and FactSet.

"Global Sectors" for the MSCI World Index includes companies within Energy, Health Care, Information Technology, and Materials sectors, while "Local Sectors" includes companies within Industrials, Consumer Discretionary, Consumer Staples, Financials, Telecommunication Services and Utilities sectors. "Global Sectors" for the MSCI Emerging Markets Index includes companies within Energy, Information Technology, and Materials sectors, while "Local Sectors" includes companies within Industrials, Consumer Discretionary, Consumer Staples, Financials, Telecommunication Services and Utilities sectors. Health Care is categorized as a Local Sector for the MSCI Emerging Markets Index since June 1, 2010, due to Israel's upgrade to developed market status by MSCI. Indexes are unmanaged and are not available for direct investment. Returns include the reinvestment of all dividends and distributions. Investing entails risks, including possible loss of principal. Past performance is no guarantee of future results.

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STRESS-TESTING OUR THEORY: PERFORMANCE DURING PERIODS OF VOLATILITY

As longer-term investors, we wanted to understand how the two categories of emerging market companies performed over an extended period and how they performed in different market environments. We analyzed returns of both local and global companies within the MSCI EM Index to determine how each performed during the recent global financial crisis (May-October 2008) and how they performed in the subsequent recovery, as measured from the March 2009 market low through calendar year-end 2010. What we found, as Figure 4 demonstrates, was that domestically oriented firms significantly

Although smaller cap companies are often assumed to entail higher risks, we found that companies with a market capitalization below $10 billion held up similarly to their larger peers in the downturn, but outperformed significantly in the recovery.

outperformed during the downturn—at lower levels of volatility than their global peers—but participated comparably in the ensuing market rebound.

Although smaller cap companies are often assumed to entail higher risks, we found that companies with a market capitalization below $10 billion held up similarly to their larger peers in the downturn, but outperformed significantly in the recovery. Volatility of returns for the smaller caps was comparable to that of the larger local firms both on the way down and on the way up.

Over the five year period ending December 2010, local firms generated a total return of 93% while global firms appreciated only 77%, and were less volatile (standard deviation of 27.5% for local firms vs. 30.4% for the global companies). The stand-out performers were the smaller cap local firms, which appreciated almost 120% over the period with a standard deviation of only 28.2%.[3]

FIGURE 4: PERFORMANCE IN VOLATILE MARKETS

Total Return Analysis—MSCI Emerging Markets Index

	Economic/Financial Crisis (05/20/2008 – 10/27/2008)		Economic/Financial Recovery (03/02/2009 – 12/31/2010)		5 Year Period (12/31/2005 – 12/31/2010)	
	Return	Standard Deviation	Return	Standard Deviation	Return	Standard Deviation
Local Sector: Market Cap Breakdown	**-58.3**	**38.4**	**153.5**	**21.4**	**93.3**	**27.5**
> $10.0 Billion	-58.0	38.2	125.4	21.3	68.0	26.5
$0 – $10.0 Billion	-58.1	39.6	174.4	21.5	119.6	28.2
Global Sector: Market Cap Breakdown	**-67.2**	**39.1**	**155.2**	**24.8**	**77.4**	**30.4**
> $10.0 Billion	-68.0	40.0	137.8	24.0	65.5	29.9
$0 – $10.0 Billion	-64.1	38.7	194.9	24.4	109.7	30.9
Total	**-62.7**	**37.7**	**154.1**	**22.6**	**85.51**	**28.19**

Sources: Neuberger Berman, MSCI and FactSet. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. Past performance is no guarantee of future results.

"Global Sectors" for the MSCI Emerging Markets Index includes companies within Energy, Information Technology, and Materials sectors, while "Local Sectors" includes companies within Industrials, Consumer Discretionary, Consumer Staples, Financials, Telecommunication Services and Utilities sectors. Health Care is categorized as a Local Sector for the MSCI Emerging Markets Index since June 1, 2010 due to Israel's upgrade to developed market status by MSCI. Indexes are unmanaged and are not available for direct investment. Returns include the reinvestment of all dividends and distributions.

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We believe investors seeking to capitalize on the impact of growing local incomes and consumption rates should consider expanding their horizons beyond the index.

CAPITALIZING ON LOCAL GROWTH

Companies geared to local growth in emerging markets constitute approximately 60% of the MSCI EM Index, which is itself made up of only 802 companies. As a result, we believe investors seeking to capitalize on the impact of growing local incomes and consumption rates should consider expanding their horizons beyond the index.

A broader set of emerging market firms is available within the FactSet emerging markets universe—which includes 7,204 companies.[4] As Figure 5 shows, the MSCI EM Index provides a fair representation of larger capitalization companies—both local and global. However, if we extend the opportunity set to mid-cap and smaller firms, we find many more companies available for investment—in particular among those driven by local factors. Including companies below $10 billion in market cap yields more than 10x as many locally driven firms to consider versus the index alone (4,556 vs. 427).

[3] Neuberger Berman, MSCI and FactSet. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. Past performance is no guarantee of future results.

[4] The FactSet universe consists of the same countries that are represented in the MSCI Emerging Markets Index.

It is important to note that not all local opportunities are comparably attractive. In particular it is important to understand the level of state ownership in listed companies in emerging markets.

FIGURE 5: OPPORTUNITY SET FOR LOCAL EXPOSURE

Market Capitalization Breakdown (%)				
	MSCI Emerging Markets Index		FactSet Universe*	
	Market Cap Weight (%)	Number of Companies	Market Cap Weight (%)	Number of Companies
Market Cap Breakdown: > $10bn	**65.43**	**201**	**46.84**	**236**
Local Sectors	33.83	127	26.72	150
Global Sectors	31.60	74	20.12	86
			3x	
Market Cap Breakdown: $1bn – $10bn	**34.42**	**592**	**39.99**	**1,659**
Local Sectors	23.96	424	28.96	1,198
Global Sectors	10.46	168	11.03	461
			1,000x	
Market Cap Breakdown: < $1bn	**0.15**	**9**	**13.17**	**5,309**
Local Sectors	0.06	3	8.68	3,358
Global Sectors	0.10	6	4.49	1,951
Total	**100**	**802**	**100**	**7,204**
Local Sectors	57.84	554	64.36	4,706
Global Sectors	42.16	248	35.64	2,498

Sources: Neuberger Berman, MSCI and FactSet. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. Past performance is no guarantee of future results.

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VARIATION IN LOCAL OPPORTUNITIES

By country, stock markets such as Indonesia, China, India and Brazil have fairly large domestic sectors, representing 77%, 76%, 53% and 50%, respectively, of local benchmark market capitalization.[5] With the exception of China—where consumption represents less than 40% of GDP, vs. 60%–70% in many other markets—private consumption is the key driver of growth in each of these economies.

It is important to note that not all local opportunities are comparably attractive. In particular it is important to understand the level of state ownership in listed companies in emerging markets. In China, for example, approximately 85% of the benchmark is represented by state-owned businesses, most notably in local sectors like Financials and Telecommunications. By contrast, in India, companies controlled by the government comprise less than 15% of the index.[6] This is important in terms of performance outlook, as governments have not had a strong track record in deploying capital to enhance returns.

When we look at the relationship between valuation and returns, we see a clear demonstration of this effect. In Figure 6, we plot profitability (as represented by Return on Equity) versus valuation (as measured by Price/Earnings to Growth, or the "PEG ratio") for select emerging market countries. Over the last five years, companies in China and Russia—where state ownership of listed companies is high—had significantly lower returns than those in Brazil, India and Indonesia, where state participation is less. This explains the market's willingness to pay a higher valuation multiple for higher returns.

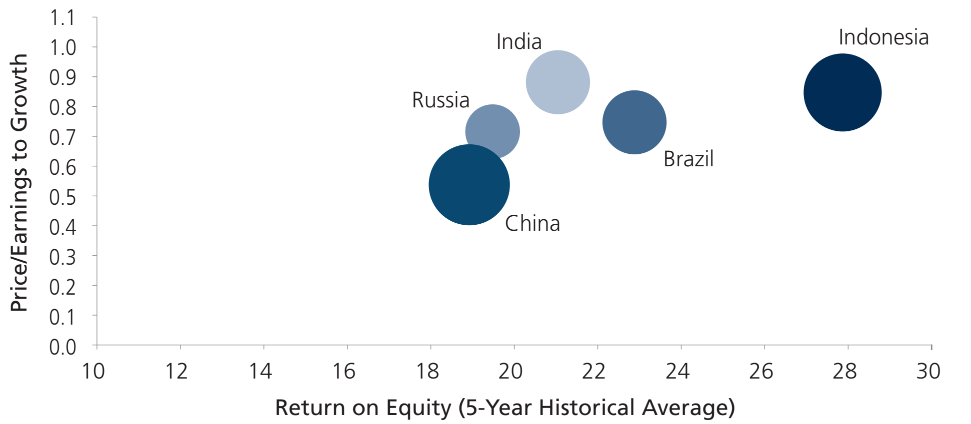
[5] Source: MSCI, World Bank. As of December 31, 2010.

[6] Sources: Neuberger Berman, MSCI and FactSet. As of December 31, 2010.

We believe that locally oriented firms offer more attractive appreciation potential, with their focused exposure to growth in consumer and corporate spending and, especially outside the MSCI EM Index, local firms tend to be more inefficiently priced.

FIGURE 6: INVESTORS PAY MORE FOR HIGHER GROWTH

Price/Earnings to Growth vs. Return on Equity (5-Year Historical Average)



Sources: Neuberger Berman, MSCI and FactSet. As of December 31, 2010. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. Past performance is no guarantee of future results.

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MANAGING RISK WITHIN A WIDER INVESTMENT UNIVERSE

Global and local emerging market firms each have distinct pros and cons. In the case of global firms, on the positive side, we see more diversified revenue streams, by both product and geography, and greater access to capital markets. In addition to the general risks of foreign and emerging markets investing (*see note on Foreign and Emerging Market Risk at the end of this material*), potential negatives include more challenged growth, especially among larger market-cap companies, and significant government ownership, with many examples in one global sector, Energy, as well as two local sectors, Financials and Telecommunication Services.

We believe that locally oriented firms offer more attractive appreciation potential, given their focused exposure to growth in consumer and corporate spending. Especially outside the MSCI EM Index, local firms tend to be more inefficiently priced. However, other risks include liquidity issues, family or entrepreneurial control, transparency and auditor quality concerns.

Even as many investors extend their focus—and their risk—into the larger emerging market universe, we believe there are ways that some of these risks can be mitigated. In our view, careful bottom-up due diligence and adequate diversification are key. As we evaluate candidate companies, we emphasize cash flow and scrutinize both balance sheets and corporate governance. We are also mindful of who the majority shareholders are and where their interests may lie, the skill of the management team and board of directors, and the reputation of the auditors. Our approach hinges on the efforts of an experienced analyst team that travels extensively, meeting not only with company managements, but also with each company's suppliers, customers and competitors for a holistic view of both the business and the industry.

We view the current market—where nearer-term inflation and political worries have caused a selloff in emerging markets—as having created an even greater long-term opportunity for investors considering domestic companies.

THE CASE FOR LOCAL COMPANIES

With local consumption driving significant and ongoing growth across emerging markets, we believe locally based firms offer a compelling risk/reward profile. Furthermore, while these companies are subject to the general risks of small-capitalization stocks and foreign and emerging markets investing, our research shows that these companies have demonstrated less volatility than their global peers. We view the current market—where nearer-term inflation and political worries have caused a selloff in emerging markets—as having created an even greater long-term opportunity for investors considering domestic companies.

While accessing well-positioned local firms may require reaching beyond the benchmark, we believe attractive potential benefits exist for investors who are willing and able to conduct the required research. In our view, this is the opportunity to identify firms with profitability, growth and valuation that is not fully appreciated by the market.

CONCLUSION

Over the past ten years, emerging market stocks have significantly outperformed equities in the U.S. and international developed markets and have garnered significant investor attention as a result. With valuations now more consistent with those in the developed world, we feel it is important for investors to identify those firms with the ability to outgrow and out earn their peers at managed levels of risk. Local firms across the market cap spectrum are the primary beneficiaries of the secular opportunity in emerging markets offered by economic growth, higher incomes and an expanding middle class. We feel that identifying those firms that are well positioned, regardless of size, and combining the resulting ideas into a portfolio that manages risk, should be an important component of emerging market investing in the years ahead.

NOTE ON FOREIGN AND EMERGING MARKET RISK

Foreign/Emerging market securities involved additional risks including exposure to less developed or less efficient trading markets; social, political or economic instability; fluctuations in foreign currencies; nationalization or expropriation of assets; settlement, custodial or other operational risks; and less stringent auditing and legal standards. Investing in emerging market countries involves risks in addition to those generally associated with investing in developed foreign countries. Securities of issuers in emerging market countries may be more volatile and less liquid than securities of issuers in foreign countries with more developed economies or markets.

NOTE ON SMALL-CAP RISK

Small-capitalization stocks are typically more vulnerable to financial and market risks and uncertainties than large-capitalization stocks. They may trade less frequently and in lower volume than large-capitalization stocks and thus may be more volatile and be less liquid. Consequently, investments in small-capitalization stocks may not be appropriate or suitable for all investors.

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The **MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of May 27, 2010 the MSCI Emerging Markets Index consisted of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

The **MSCI World Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. As of May 27, 2010 the **MSCI World Index** consisted of the following 24 developed market country indices: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

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605 Third Avenue
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