

Pioneers, Populace, and Perceptions in Emerging Markets

Acadian Asset Management

Charles Wang

“It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness...” ---Charles Dickens

Decades ago pioneers in the investment industry espoused the idea of international investing. For example, Gary Bergstrom from Acadian Asset Management wrote in *Journal of Portfolio Management* in 1975: “Securities of foreign companies tend to offer higher average returns than ours – but international diversification simultaneously lowers volatility of returns.”

Emerging markets had become the new frontier of global investing by the late ‘80s and had spectacular returns in the ensuing years, only to be followed by seven drought years starting with the Mexican peso crisis in 1994. According to Morgan Stanley Capital International (MSCI), emerging markets have lost 40% of their value from December 1994 to October 2001, while the S&P 500 index has gained 148% in the same period. Investors, disillusioned by this terrible experience, have deserted the emerging markets, most noticeably since the Asian financial crises. The current average emerging market weight in U.S. equity portfolios is only 2% versus its height of 5% in early 90s.

From the story of high growth, great market inefficiencies, and great diversification benefit to the tarnished image of rampant corruption, incompetent government officials, poor corporate governance, intellectual property right violations, and human rights abuses, why has there been such an about-face of perceptions about emerging markets? The pioneers may have looked too far into the future without fully considering the problems and challenges emerging markets have to face. Current investors, on the other hand, are too quick to judge and too preoccupied to understand the true situation of emerging markets. By following the rearview mirror, they have succumbed to happenstance and emotions instead of vision and wisdom. Like value investing in 1998 and 1999, the great wisdom is always non-conventional, uncomfortable, and even painful in the short term.

The failure of emerging markets in the past to live up to their expected potential has both its internal causes and external circumstances. The supposed role model of Japan with an export-driven economy and administrative industrialization proved to be inefficient and unsustainable in the long run, as Japan is still mired in recession and Asian economies have suffered crises and hardship since 1997. Lack of democracy and lack of transparency in the political and economic systems, poor fiscal and monetary policies, and poor corporate governance are some of the fundamental problems in those countries. Externally, the strong U.S. dollar and pegged currencies had greatly worsened the competitive positions of many developing economies before crises. The U.S. and IMF have not been helpful and have been wrong on several occasions in their prescriptions.

The inexperience of international banks and their irresponsible lending contributed directly to the worsening balance sheets of companies and countries in the developing world.

Like anyone in their adolescence, emerging markets have paid their tuition and have been learning from their mistakes. Two decades is only a short period in economic development and a fleeting moment in history. During this period emerging markets have come a long way in establishing sound fiscal and monetary policies, restructuring their economies, addressing corporate governance, and improving their economic fundamentals. For example, the foreign debt/GDP ratios and budget deficit/GDP ratios are lower for most emerging markets in 2000 than 1998 (charts 1 and 2). Russia, Korea, and China have seen many highly publicized scandals of embezzlements, transferring of wealth, and wrongful accounting in publicly traded companies, with subsequent precipitous drops in share prices. Under external pressure and the theory that better corporate governance helps stock prices, many corporations are addressing these issues seriously and embracing the concepts of transparency and fairness.

With the fundamental improvement, emerging equity markets are gradually recovering. Since December 1998, emerging markets have had a cumulative return of 4% according to MSCI, versus -8% for the U.S. and -17% for the developed world excluding the U.S. and Canada. In the year 1999 emerging markets had a spectacular return of 64%. Year to date emerging markets are doing far better than most developed countries.

Emerging markets are greatly under-appreciated by investors in the developed world. For example, more than one third of U.S. exports goes to developing countries, but we have far less understanding and interest in those countries than what we have in Western Europe and Japan. With the current state of international economic specialization, developing countries are short of capital, and developed countries are short of labor and are in ever increasing need for markets. However, our investments are not optimally allocated and reflect a high degree of “home bias”.

During this low tide of international money flow and emerging markets still feeling the effects of previous crises, emerging equity market valuations have been at or near their historical low (chart 3). With improving economic fundamentals and positive developments in reform and corporate governance, the neglect of emerging markets is one of the greatest investment anomalies today.

Jeffrey Garten, former Under Secretary of Commerce and the Dean of Yale School of Management, highlighted the vital importance of emerging markets (especially the big ten emerging markets as in his book *The Big Ten*) to the economic and strategic interests of the U.S. “All of the big emerging markets have varying degrees of these interlocking political and economic problems. How they are resolved is of crucial interest to the United States... Indeed, so significant is the Big Ten’s position in world trade that a sharp, generalized slowdown in the Big Ten could lead to a global recession.”

Of course nobody could have anticipated the September 11 terrorist attacks. With the global campaign on terrorism, many developing countries have become the focal point of U.S. foreign policy and national interests, with the awareness that we need to do much more to understand the four fifths of the world population living in developing countries and to help them build better economies and have better lives. This event may prove to be a watershed in our attitude towards those emerging markets with people still differing so much in values and social progress from us. In the long run this should bring those emerging markets to the forefront of our attention and many will attract renewed interest in emerging markets investing.

Are emerging markets coming of age? It is politically incorrect to be a prophet and financially dangerous to be a pioneer. Fortunately the earlier pioneers in emerging market investing have already started charting the treacherous waters and developing some techniques for successfully navigating them. There are some encouraging signs that emerging markets are getting more sophisticated and self-disciplined than before.

Remember the U.S. was the first emerging market when the Puritans settled in the new world. Their journey was rough and the first winter was brutal. The new country later on had major wars, first with its former colonial master and then within itself in a devastating civil war. The Great Depression and the lax regulatory environment in the financial industry in the U.S. in early 20th century provide parallels to what we have seen in emerging markets in recent years. Should we be more optimistic about emerging markets in view of how well the U.S. turned out despite all this? Is it possible for them to follow the U.S. path to prosperity and freedom?

Much still needs to be done in some emerging markets in addressing fundamental issues regarding democracy and free markets. Emerging markets vary a great deal in their political realities, their cultural and national identities, and their legal and economic institutions. Many people are still in poverty and lack the basic means for development.

Dangers always lurk somewhere in the world, be they political, economic, or financial. Great attention needs to be paid in understanding the complexities of emerging economies and distinguishing among different stages of development. From a purely investment perspective, with great skills and thorough research, it is possible to identify some early warning indicators of trouble and selectively invest only in high quality/high return countries and companies. For example, Acadian Emerging Market Fund (AEMGX) has managed a return of 9% versus the category average return of -3% for year 2001 and ranks number one among 209 diversified emerging market mutual funds, by avoiding some of the major problem areas that have developed in emerging markets, successfully identifying outperforming countries, and opportunistically exploiting market inefficiencies and short-term rallies.

With regard to asset allocation, it makes more sense investing in emerging market equities than emerging market bonds, in our view. The real vitality in emerging markets is in the private sector, with millions of aspiring entrepreneurs and a fast-growing middle class. Governments may well be snared in political deadlock, unchecked spending, and

corruption. Comparing between high-yield bonds with moral hazard and large default risk, and equities with much higher return potential and better-aligned interests, the answer is clear: Buy diversified emerging market equity funds. Doing so is safe, is a good cause, and is a good investment!

December, 2001
Hotel Del Coronado
San Diego



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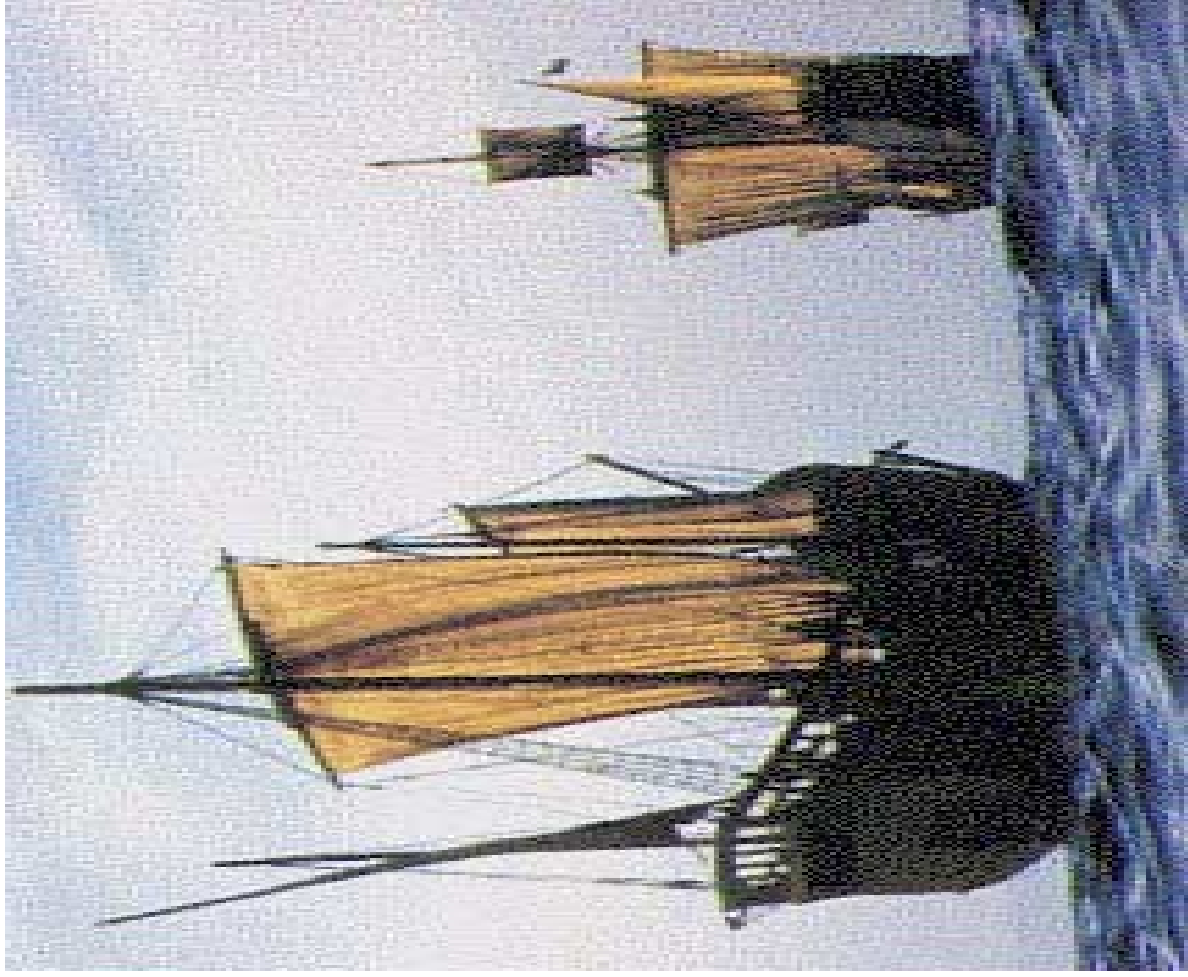
Charles H. Wang

Acadian Asset Management

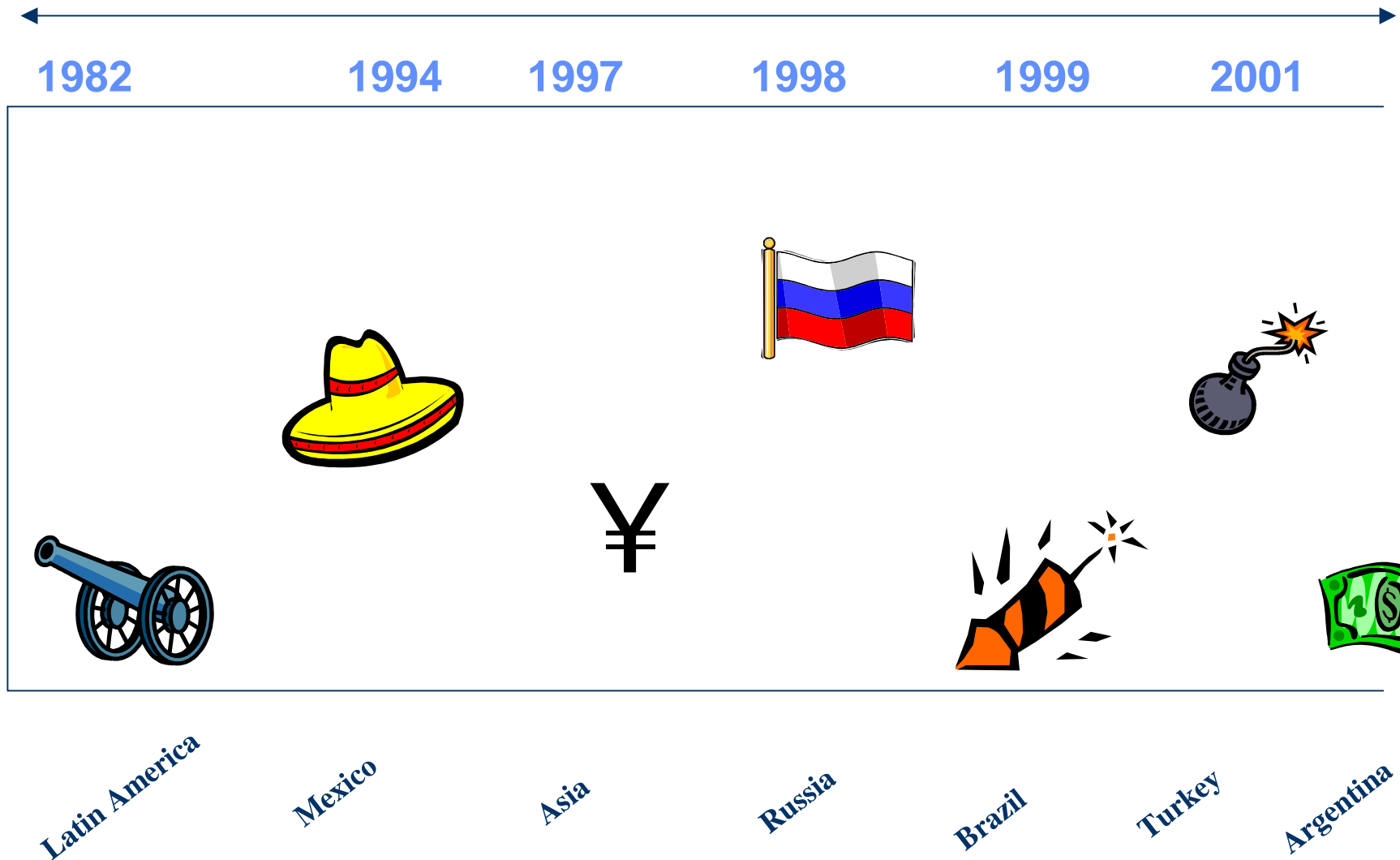
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December 2001

The First Emerging Market in the World



A Chronology of Market Crises



Lessons from Past Crises:

Internal

- **Wrong role model of Japan:**
 - **Export-driven economy**
 - **Administrative industrialization**
- **Lax fiscal policy and disregard of economic efficiency**
- **Poor corporate governance and neglect of minority shareholders' interests**

Lessons from Past Crises:

External

- **Ignorance about and insensitivity to emerging countries**
- **Unfavorable world economic order and industrial specialization**
- **Unrealistic expectations**
 - **The fallacy of being pioneers**
 - **Backward looking of populace**

A World Full of Uncertainties

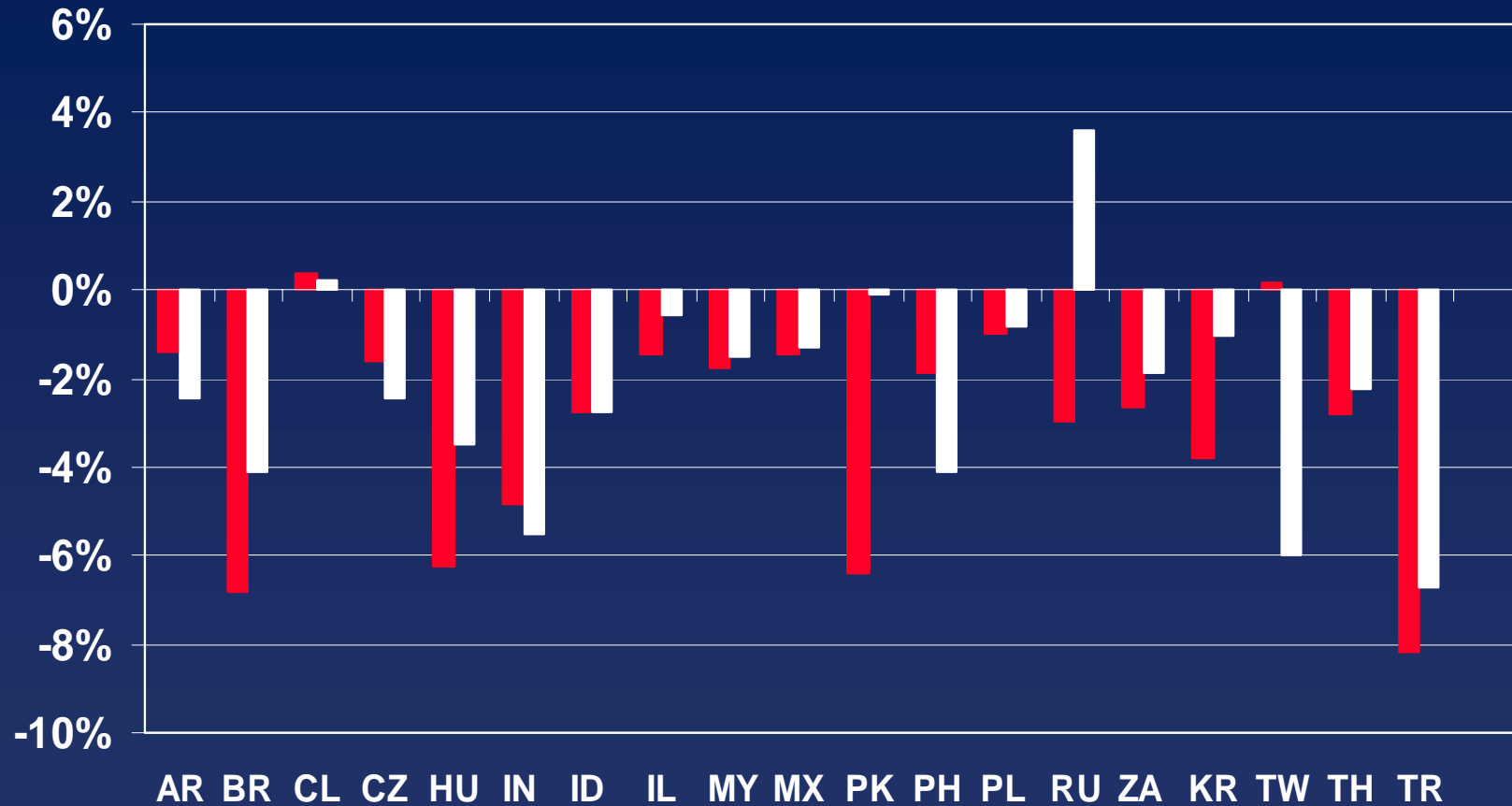
MSCI EMF Cumulative Returns
1985 - October 2001



Changes After Crises

- **Sounder fiscal policies and a focus on efficiency instead of growth**
- **More open societies, more transparency, better corporate governance**
- **Structural reform and development of domestic market: so far more rhetoric than substance**
- **More sophisticated monetary policies and flexible exchange rates**
- **More responsive IMF and better understanding of emerging markets in the developed world**

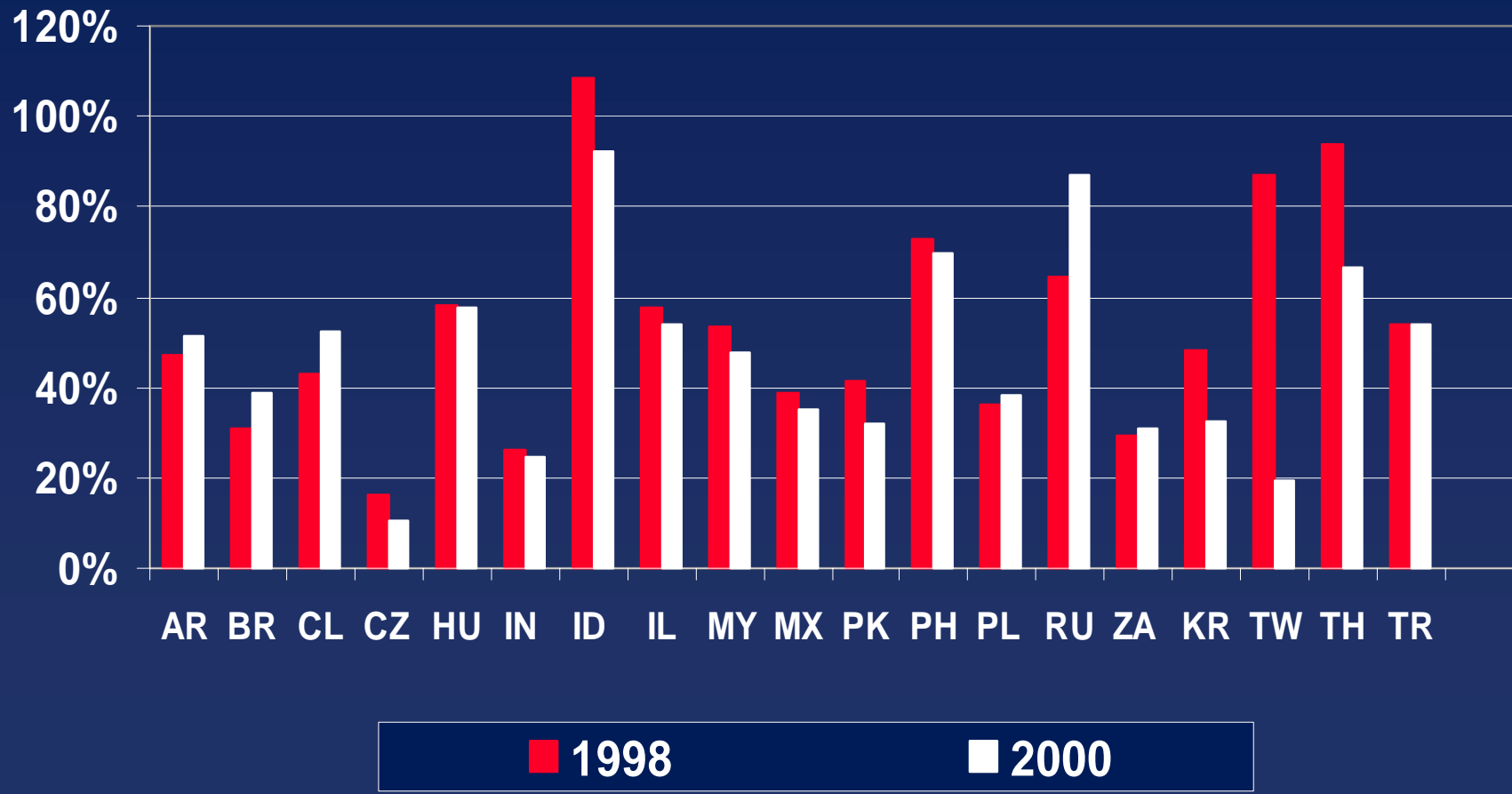
Budget Balance - GDP Ratio



■ 1998

■ 2000

Foreign Debt - GDP Ratio



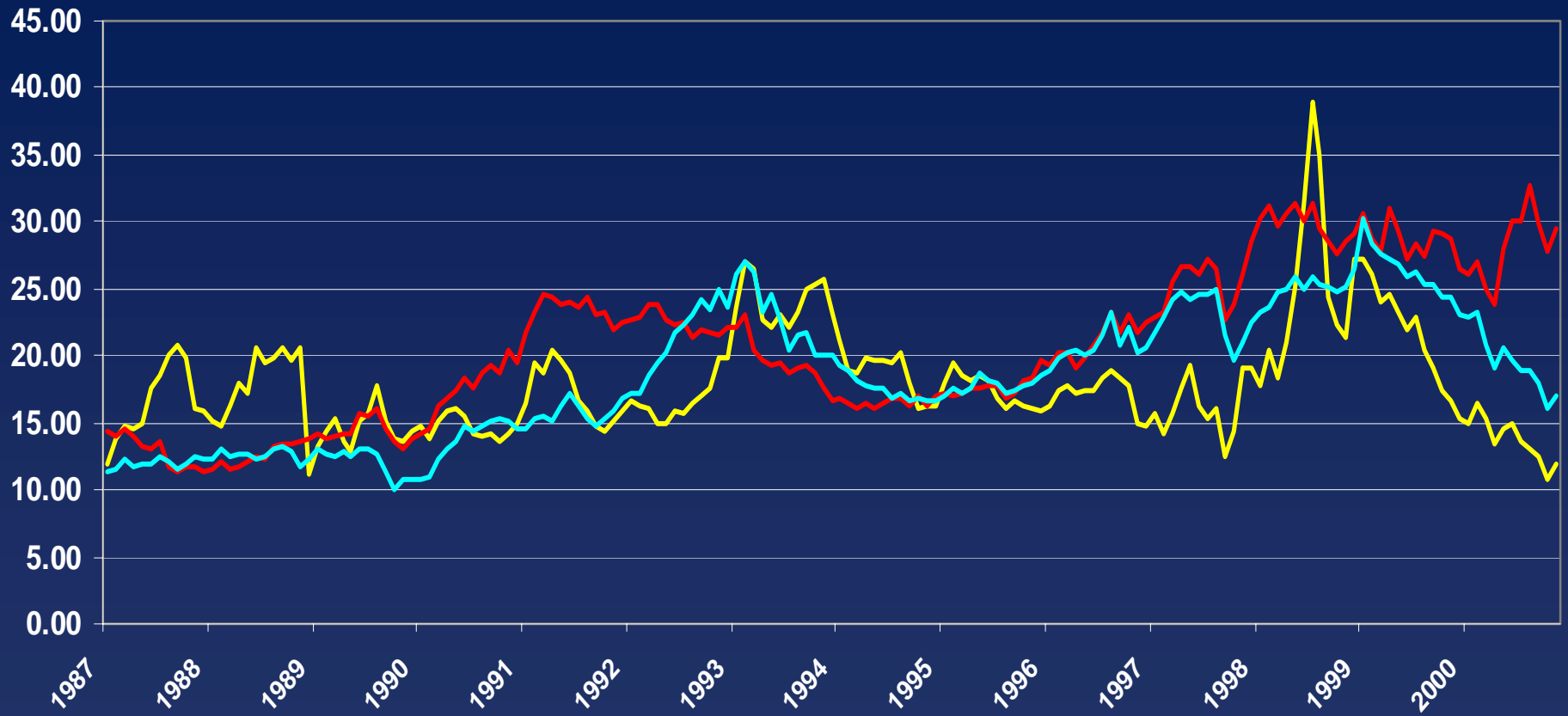
Corporate Governance

- **Shleifer: corporate governance matters, democracy and culture matters**
- **It is in emerging markets' best interests to have better corporate governance**
- **Countries are making progress: Russia, China, Korea, etc.**

The Current State of Emerging Equity Markets

- **Low valuations**
- **Weakening U.S. dollar and more flexible exchange rates**
- **Far less leveraged markets**
- **A U.S. recovery sometime next year**
- **Renewed growth in the future**
- **Increasing risk appetite**

The Current State of Emerging Equity Markets

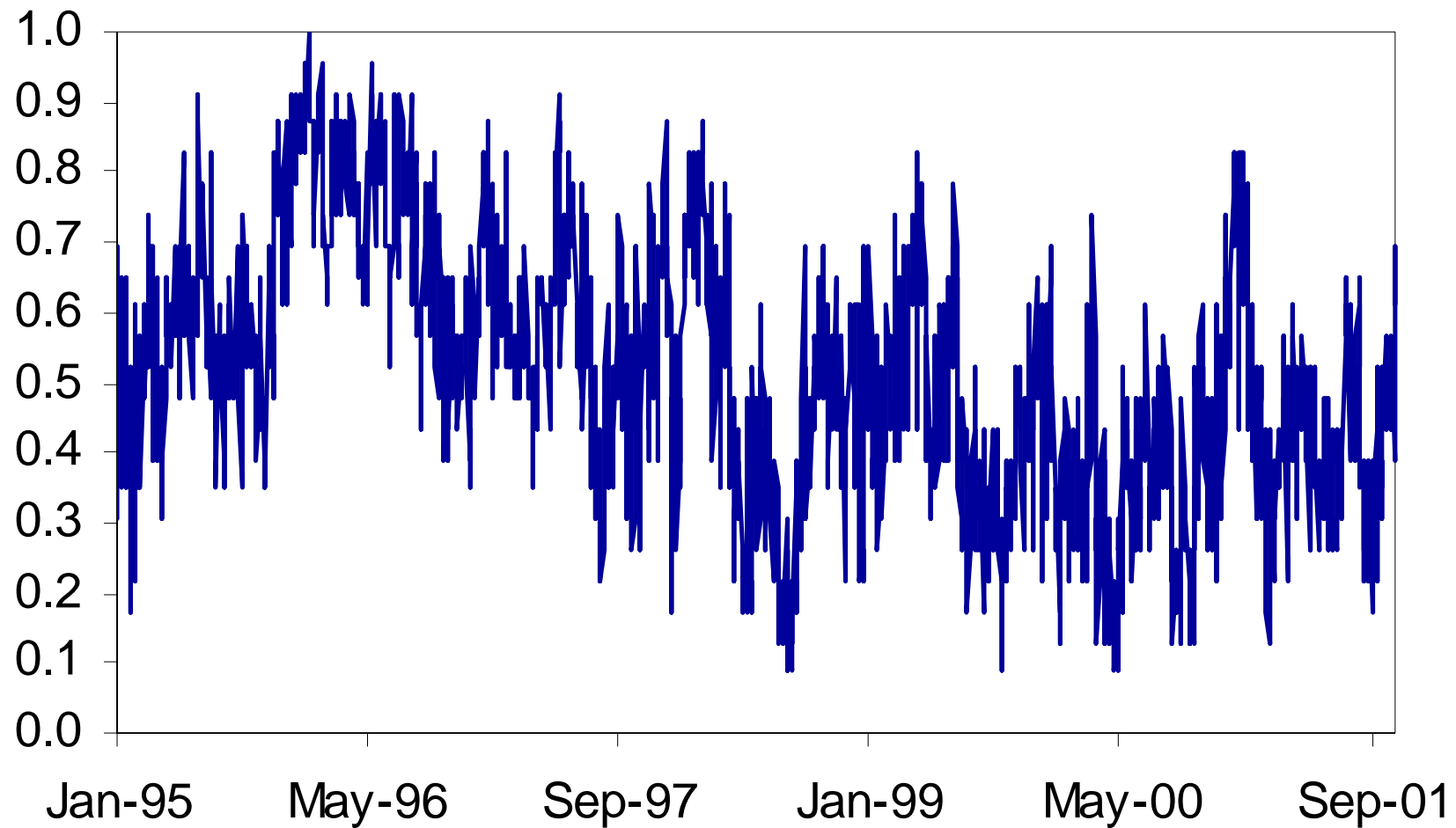


— MSCI EMERGING MARKETS PE

— MSCI USA PE

— MSCI EUROPE PE

Proportion of Emerging Market Countries Receiving Cross-Border Inflows



Early Warning Signals for Future Crises

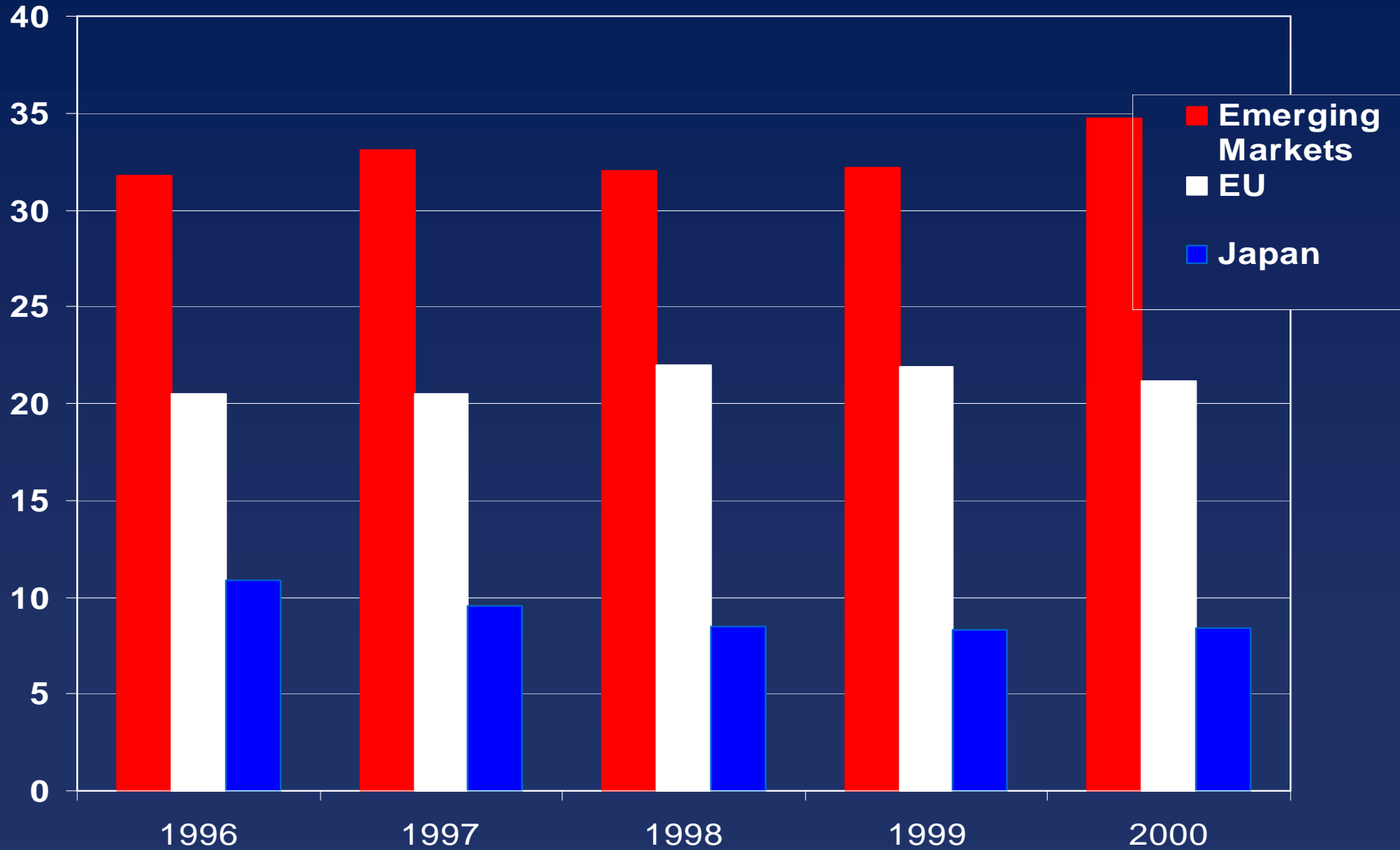
- **Budget deficit and public debt**
- **Current account deficit and foreign debt**
- **Short-term borrowing**
- **Real effective exchange rates**
- **Soundness of banking system**

**Why Has the U.S.
Been So Successful???**

The U.S. Relationship with Emerging Markets

- **Source of growth and a curb on inflation**
- **Breeding ground of misery, conflicts and terrorism**

Percentage of U.S. Exports



The War on Terrorism and Its Implications

- **A renewed focus on emerging countries**
 - **Political progress**
 - **Economic development**
 - **History and culture**
- **More help from the West**
 - **A new Marshall Plan?**

Emerging Markets Equity Strategies

- **Country research: close monitoring of fundamental risk and market uncertainties**
- **Monetary and fiscal policies**
- **World trade and business cycle**
- **A focus on ROE, enterprise value and other valuation criteria**
- **Company quality, earnings quality and earnings growth**

Emerging Markets are Attractively Valued (October 2001)

	<i>U.S. Stocks (S&P 500)</i>	<i>World World (MSCI)</i>	<i>Int'l Large Cap (EAFE)</i>	<i>Emerging Markets (EMF)</i>	<i>Emerging Markets Portfolio (Acadian)</i>
<i>Price/Earnings</i>	27.6	23.7	19.7	11.4	8.3
<i>Price/Book</i>	3.1	2.4	2.0	1.1	1.0
<i>Price/Cash Earnings</i>	12.4	10.5	8.7	6.1	4.8
<i>Yield</i>	1.5%	1.9%	2.3%	2.9%	3.7%

Performance

Emerging Markets Equity Strategy - Composite Performance
(Net Total Returns in U.S. Dollars - After Transaction Costs, Before Management Fees)

Time Period	Emerging Markets Equity Strategy	S&P / IFC Investable Index	Acadian Value-Added vs. S&P / IFCI
1994	(6.5) %	(12.6) %	6.1 %
1995	(5.1)	(8.6)	3.5
1996	10.7	8.8	1.9
1997	(12.2)	(15.0)	2.8
1998	(22.4)	(22.4)	0.0
1999	65.2	66.4	(1.2)
2000	(25.1)	(32.1)	7.0
2001 through October	(10.9)	(16.4)	5.5
Since-Inception Annualized Return	(3.8)	(7.5)	3.7
Since-Inception Annualized Standard Deviation	25.6	24.5	7.0
Information Ratio			0.5

Key Success Factors

- **Country selection and stock valuation framework that exploits inefficiencies**
- **Major underweighting in crisis-bound countries and markets**
- **Quantitative discipline combined with fundamental insights**
- **Rigorous risk-controlled portfolio construction process**
- **Superior execution and focus on minimizing transaction costs**

Conclusions (I)

- **In U.S., Europe and Japan, economic growth rates and high equity returns are likely**
- **In emerging markets, you probably won't see high growth rates either ...**
- **But you will see**
 - **Fewer crises than before**
 - **Better managed companies than before**
 - **Potentially strong returns from low valuations currently**
 - **Decreasing risk premium**
 - **Increasing growth rates in the future**

Conclusions (II)

- **Buy emerging markets funds now!**
 - It is “safe” to do so
 - It is a good social cause
 - It is a good investment
- **Buy diversified funds with discipline and risk control**