

Emerging markets – Making the most of the opportunity that can't be ignored

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The emerging markets opportunity

Over the next 20–30 years, nominal GDP growth in emerging markets (EM) countries is expected to reach 9–13%, compared with 5–7% in developed markets. Assuming corporate profits are a constant share of GDP, this higher growth may translate into higher stock market returns – growth that can help fund Western pension plans (Exhibit 1).

In fact, most pension funds already have an allocation to developing markets, through the North American companies that they own. For example, Proctor & Gamble saw very strong profit growth from China last year. Nevertheless, there are so many attractively valued emerging market companies that we are obliged to treat them as a separate category.

How have pension plans approached emerging markets?

Many plan sponsors have recognized the opportunity. Recent survey findings indicate that 17% of plans have explicit emerging market allocation, a number that has increased steadily over time. While the average asset allocation to EM is only 3.3%, that is bound to increase.

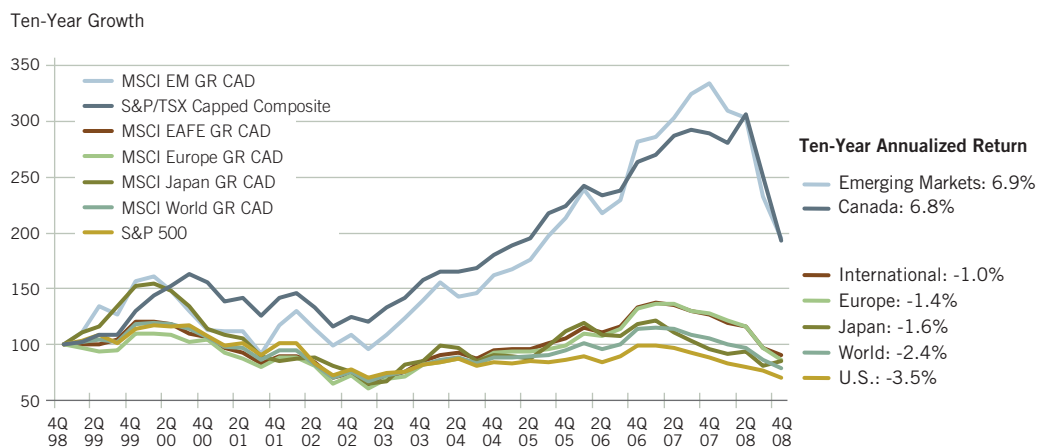
Of the plans who say they are increasing their EM exposure, 27% are hiring

specialist managers, while 5% are adding the ACWI to their benchmark. However, almost half of plans have asked their managers to allocate tactically – the “free lunch” approach. This allows the manager to simply take advantage of high EM growth, without being measured against a benchmark.¹

Where's the risk?

The biggest risk specific to EM investing is the country allocation. Political stability, regulation and the supremacy of the law can be particularly problematic in these countries, and even the most astute stock picker can have his or her portfolio derailed by, for example, an uprising or a decision to nationalize a resource company. As investors, we need to appreciate

Exhibit 1 – Emerging markets offer higher return and growth



	GDP Growth (%)	Dividend Yield (%)	Inflation (%)	Growth (%)	Real Growth (%)*
Developed Markets	2–3	3–4	2–3	7–10	5–7
Emerging Markets	6–8	3–5	5–7	14–20	9–13

Source: Fidelity Investments Canada ULC. Emerging Markets = MSCI EM Index, Canada = S&P/TSX Capped Composite Index, International = MSCI EAFE Index, Europe = MSCI Europe Index, Japan = MSCI Japan Index, World = MSCI World Index, U.S. = S&P 500 Index. * Based on projected growth. Actual results may differ.

¹ Source: Pyramis Global Advisors 2008 Canadian DB plan sponsor research

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that a country's politics will always trump any other need – economic development, wealth creation, well-being – and that this is particularly true in emerging markets.

Consider the example of Yukos, the Russian oil company. The politicians decided they were going to throw the CEO in jail and bankrupt the shareholders, and they did, with just the stroke of a pen.

The second-most important issue is promoter risk: what is the quality of the company management? Are they long-term players, or are they using equity investors as a short-term financing tool?

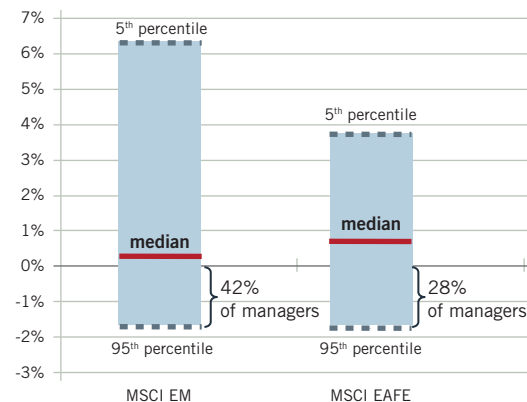
In EM, manager risk is also significant

As the chart in Exhibit 2 indicates, in EM the difference between success and failure is much higher. Approaches that may pass muster in developed markets can prove unsuccessful in EM. Having a single point of view or relying on a few key people to make overall projections can lead to major errors. Some managers make the mistake of judging companies in the same sector by the same rules, regardless of where they are located. A quantitative approach is particularly prone to failure in emerging markets, where reliable data can be hard to come by.

To increase your manager's ability to succeed, you need to be clear in your instructions. Recognize that EM are a legitimate opportunity by making an active strategic asset allocation and including them in your plan benchmark. Make sure your manager is clear that you want that allocation fully invested. You want to see

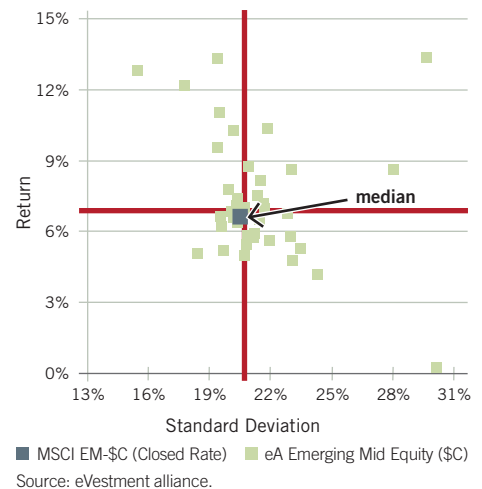
Exhibit 2 – Manager risk is evident in emerging markets

Five-Year Excess Returns Ending December 31, 2008



Source: eVestment alliance.

Five Year Returns Ending December 31, 2008



Source: eVestment alliance.

returns coming from stock selection, not from betting for or against the benchmark. And ask questions about a manager's decision to underweight certain stocks. You want to be sure managers are basing their decisions on knowledge, not ignorance.

How to recognize a good emerging markets manager

In order to succeed, an EM manager needs to have access to global research and focus on stock picking to find opportunities, rather than relying on set measures that have worked in other markets. At the same time, the manager must understand the importance of country risk and negative bets.

Pyramis recognizes that emerging markets can be intimidating. But with the right manager and a proper understanding of the risks, we believe they can become an important tool in helping pension plans meet their future responsibilities. We are continuing to expand our global research capabilities and our product solutions to help plan sponsors benefit from the EM opportunity. To learn more, visit Pyramis.ca or speak with your Fidelity Canada sales representative.