Viewpoint

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Expanding the Opportunity Set: Total EM Investing

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Bond and currency managers at Standish and equity managers at The Boston Company have combined forces to create a "total" emerging markets investing approach that seeks to identify the most attractive market segments across the entire public markets opportunity set.

STANDISH

THE BOSTON COMPANY
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Executive Summary

While the secular case for investing in emerging markets (EM) has been well articulated: higher expected growth rates, improving macroeconomic fundamentals, favorable demographics, and competitive cost structures, investors still grapple with the best way to achieve exposure to emerging markets. Investing in emerging market equities benchmarked against the MSCI EM Index has been one of the most popular approaches, though EM equities have traditionally exhibited high volatility. Over the past decade, U.S. dollar-denominated emerging market bonds have also secured a strategic allocation in the portfolios of many investors. More recently, there has been growing interest in investing in the local currency debt of emerging markets, as local fixed income markets have deepened. Emerging market currencies have been another way to gain exposure. Given this range of investment opportunities, bond and currency managers at Standish Mellon Asset Management LLC ("Standish") and equity managers at The Boston Company Asset Management, LLC ("The Boston Company") have combined forces to create a "total" emerging markets investing approach that seeks to identify the most attractive market segments across the entire public markets opportunity set. They believe that selectively combining country-specific exposures to EM bond, equity and currency markets might address volatility concerns with equity-only approaches and potentially enhance return opportunities. BNY Mellon Asset Management spoke with Alexander Kozhemiakin of Standish and Sean Fitzgibbon of The Boston Company about the potential benefits of this approach.

Question: What is the advantage of investing in a holistic, integrated emerging markets approach that seeks the best opportunities by country and asset class rather than just investing in separate EM equity, bond and currency strategies?

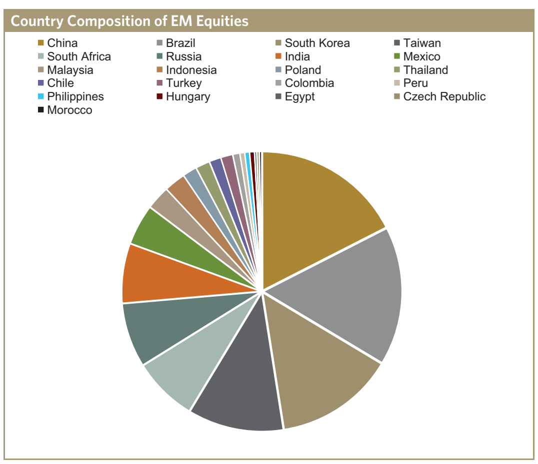
Alexander Kozhemiakin: We believe a total emerging markets approach is well suited to the distinctive risks and opportunities that are characteristic of emerging markets investing. In emerging markets, country-level risk is a dominant risk factor affecting the behavior of all asset classes, whether it's equities, bonds or currencies.

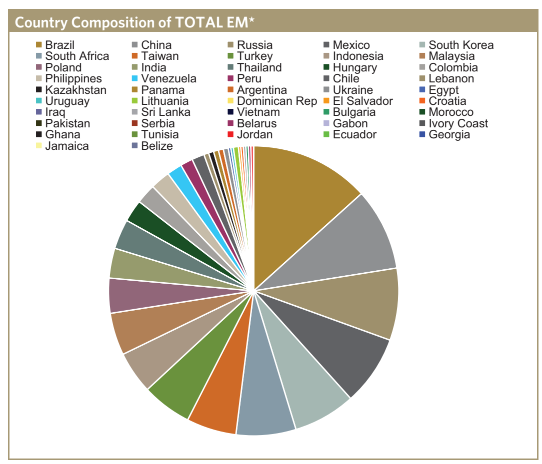
We believe one way of achieving that higher degree of country diversification is by expanding the traditional opportunity set; in other words, going beyond emerging market equities and looking at bonds and currencies.

Country-level risk is generally high in emerging markets. This is why, for example, most investors still classify South Korea as an emerging market country. It may already be relatively rich as measured by GDP per capita; its credit may be solidly investment grade; it may have fairly liquid markets; but it still suffers from a high level of geopolitical risk associated with North Korea. These country-level risks are not necessarily geopolitical. They may reflect high levels of regulatory, political, social, or macroeconomic uncertainty. As a result, we believe investors in emerging markets might be well served by diversifying these country-level risks as much as they can.

We believe one way of achieving that higher degree of country diversification is by expanding the traditional opportunity set; in other words, going beyond emerging market equities and looking at bonds and currencies. This is because the country universes of EM equities and fixed income only partially overlap. In fact, the intersection will only be around 50% (Exhibit 1). But rather than allocating a portion of a portfolio to emerging market equities and a portion to emerging market fixed income, we believe that an integrated approach provides a better way of mitigating the emerging market risk generally associated with equity-only portfolios.

Exhibit 1 – Country Universes of EM Equities and Fixed Income
As of February 28, 2011





* **See Exhibit 2 for description of Total EM.**

Source: Standish using data from MSCI, JP Morgan as of February 28, 2011.

We believe the combined approach might be an attractive option for investors contemplating an increase in exposure to emerging markets but who are concerned about the high volatility and concentration of traditional emerging markets equity products.

For example, an EM equities manager may overweight Russia at the same time that a separate fixed income manager overweights Russia. If there is an event risk in Russia that affects both bonds and equities, the separate overweights will not mitigate the country risk associated with Russia. For example, in our approach, we look at all the countries individually and attempt to select what we consider to be the best equity and fixed income exposures, seeking to avoid any excessive country concentration.

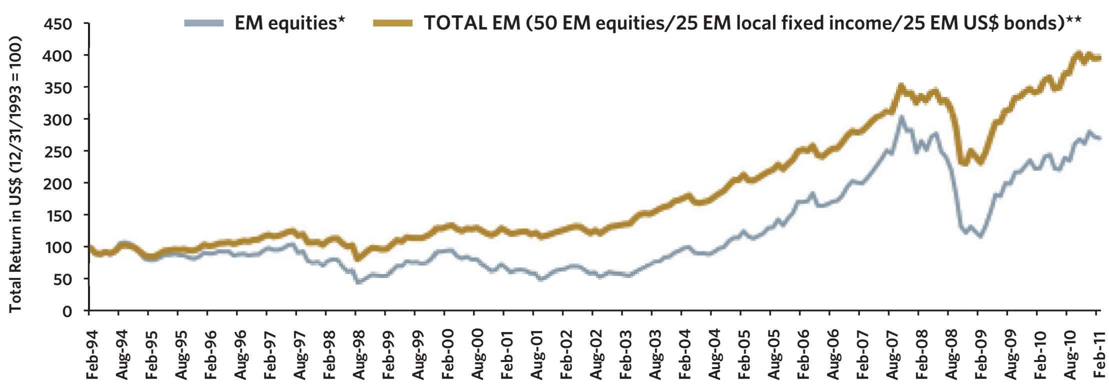
Sean Fitzgibbon: To further illustrate, our combined approach is integrated in that we assess investment opportunities in each emerging market country by asset class, as opposed to simply deciding on the overall asset allocation split for the entire portfolio and then managing equity and fixed income sleeves separately.

Question: How does this holistic combined approach help mitigate some of the common risks associated with emerging market investing?

Alexander Kozhemiakin: We believe the combined approach might be an attractive option for investors contemplating an increase in exposure to emerging markets but who are concerned about the high volatility and concentration of traditional emerging markets equity products. In particular, we believe the fixed income exposure of the strategy may dampen the volatility associated with exclusive exposure to emerging market equities. Historical data have shown that including an exposure to EM fixed income (25% EM local bonds, 25% EM U.S. dollar bonds) would have enhanced the returns of an emerging markets portfolio over the last 17 years, which is the longest period for which the data are available, spanning up and down phases of the market cycle (Exhibit 2).

Exhibit 2 – EM Equity Performance vs EM Equity and Fixed Income Performance

Historical Returns as of February 28, 2011



* MSCI EM, please see disclosures.

** Total EM = 50% MSCI EM/25% GBI-EM Global Diversified/25% EMBI Global; please see disclosures for index definitions.

Source: Standish using data from Bloomberg as of February 28, 2011. Past performance is no guarantee of future results. Investors cannot invest directly in any index.

Question: What are the kinds of capabilities required to manage this kind of integrated approach?

Sean Fitzgibbon: You really need to have thorough analytic expertise across emerging market equities, fixed income and currencies. For example, we believe managers should use an integrated investment process that takes advantage of the insights of EM investment professionals with expertise in equities, currency and fixed income.

By contrast, we believe a more traditional fund-of-funds approach (allocating between separate EM equity and fixed income sleeves) does not address these questions aimed at identifying the most attractive opportunities on a country-by-country basis.

Alexander Kozhemiakin: That's right. Together, we believe this integrated investment process should include a global macro outlook and views of individual countries. For each emerging market that the strategy invests in, we believe you should ask four questions. First, is there value in equities? For us, we look at the P/E ratio and free cash flow yields, returns on capital, growth prospects and competitive dynamics. Second, is there value in the currency forward? This requires understanding the balance of payments situation, the central bank's priorities, the country's monetary policy, level of sovereign risk, the overall global market and market technicals. Third, one should look at whether there is value in the currency-hedged bond. Here we look at inflation expectations, policy rate forecasts, sovereign risk as well as the global environment and, again, market technicals. Finally, one should ask whether spreads on U.S. dollar-denominated bonds compensate for the unexpected losses, uncertainty and potential illiquidity. Here, too, we do a thorough assessment of sovereign risk, taking a close look at external and internal balances, liquidity, and structural variables such as political and institutional risk.

By contrast, we believe a more traditional fund-of-funds approach (allocating between separate EM equity and fixed income sleeves) does not address these questions aimed at identifying the most attractive opportunities on a country-by-country basis.

Question: What are the specific kinds of supporting risk management tools required?

Sean Fitzgibbon: As both The Boston Company and Standish have been transacting in emerging markets for many years, we have developed proprietary risk models that help us assess the equity, currency and debt risk of the countries we're considering. At The Boston Company, our own fundamental analysis is complemented by our proprietary models that rank countries and sectors.

As the emerging markets universe expands and local capital markets deepen there, we believe this kind of integrated approach might help investors better manage to diversity their risk exposures and potentially capture better risk-adjusted returns.

Alexander Kozhemiakin: At Standish, we also use proprietary currency and sovereign risk models. For example, in our sovereign risk model, for each emerging market in which we invest, we formulate rolling 12-month forecasts of several dozen economic, financial, and political variables. Using these forecasts, our model generates a risk score that reflects the cumulative probability of default. We have continuously sought to refine and improve this proprietary model for more than a decade. Ultimately, however, we are fundamental analysts. Our proprietary models enhance and impose discipline on our fundamental analysis but never override it. We pride ourselves on intimately knowing the emerging market countries we invest in. In many cases, we speak their languages and visit them frequently. We truly have a global reach. In addition to our central team in Boston, Standish's emerging market resources also include analysts based in London (for East European coverage) and Singapore (for Asian markets).

Sean Fitzgibbon: We think the fact that we use an integrated platform for controlling risk (based, in part, on the Barclays Capital Point platform[1]) also distinguishes this approach from more common fund-of-funds approaches. We incorporate the expertise and complementary perspectives of investment professionals at Standish and TBCAM with experience in emerging markets equities, U.S. dollar-denominated bonds, local interest rates, and currencies. For each asset class, security selection is based on an established investment process.

Alexander Kozhemiakin: As the emerging markets universe expands and local capital markets deepen there, we believe this kind of integrated approach might help investors better manage to diversify their risk exposures and potentially capture better risk-adjusted returns than a single asset class approach.

1 The Barclays Capital Point platform is a risk modelling platform widely used in the financial services industry, which includes a wide array of advanced portfolio analytics tools including a global risk model and optimizer, hybrid performance attribution, scenario analysis, and market exposure reporting. Security coverage includes fixed income and equities as well as derivatives.

Alexander Kozhemiakin

Alexander is Managing Director of Emerging Market Strategies and Senior Portfolio Manager responsible for managing all emerging market debt portfolios. He joined Standish from Putnam Investments, where he was Senior Vice President and Portfolio Manager for emerging market debt. Prior to that, he was Emerging Market Sovereign Analyst at Citibank in New York. Alexander received an Honors Diploma from Moscow State Institute for International Relations. He has a PhD in International Relations from the University of Illinois and was a post-doctoral fellow at Harvard University. He holds the CFA® designation and has 14 years of investment experience. Alexander's research on emerging market debt and other areas of fixed income has been published in the leading finance journals, including The Journal of Portfolio Management, The Journal of Fixed Income, and The Journal of Investing.

Sean Fitzgibbon

Sean is the Team Leader for The Boston Company's Global Core Equity Team and Lead Portfolio Manager for the Emerging Markets Core, U.S. Large Cap Core, and Multi-Alpha Market Neutral Equity strategies and Portfolio Manager on the U.S. Large Cap Core 130/30 and Global Core Equity strategies. Sean joined The Boston Company in 2003 and has been working on the U.S. Large Cap Core Team since 1994, previously at our affiliate Standish Mellon Asset Management. While at Standish, Sean served as Vice President, leading the Large Core Equity Team and guiding portfolio strategy and stock selection. Previous equity coverage responsibilities have included health care, consumer discretionary, consumer staples and utilities at The Boston Company and health care, financials and consumer durables while at Standish. He has 19 years of experience in the industry. Sean received a BS in Economics from Northeastern University and an MBA from Babson College. He holds the CFA® designation and is a member of the Boston Security Analysts Society and the CFA Institute.

Index Definitions

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 **JP Morgan Government Bond Index-Emerging Markets (GBI-EM)** indices are comprehensive emerging market debt benchmarks that track local currency bonds issued by Emerging Market governments. The index was launched in June 2005 and is the first comprehensive global local Emerging Markets index.

JP Morgan EMBI Global is an *investable* benchmark that includes only those countries that are directly accessible by most of the international investor base. The GBI-EM GLOBAL excludes countries with explicit capital controls, but does not factor in regulatory/tax hurdles in assessing eligibility. Specifically, it includes all GBI-EM countries, as well as the Brazil NTN-F, LTN, and the Colombia local TES tasa fija bond. Classified as the most investable of all three indices, the GBI-EM GLOBAL is effectively the GBI-EM Broad excluding China and India.

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