Emerging Markets Views

By Altaf Kassam, Managing Director and Head of EMEAI Applied Research, MSCI

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> "When we launched the MSCI Emerging Markets Index in 1988, there were just 10 countries with just over fifty billion dollars in market cap. Today it consists of 21 countries and close to four trillion dollars in market cap."

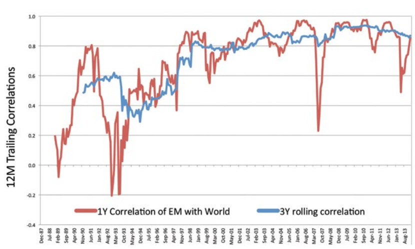
As the leading provider of Emerging Markets indexes for the past 25 years, how does MSCI view the Emerging Markets as a region?

An important point to note is that what attracts people to the Emerging Markets is that they are dynamic – and that's exactly our approach to creating an index for the region.

When we launched the MSCI Emerging Markets Index in 1988, there were just 10 countries with just over fifty billion dollars in market cap. Today it consists of 21 countries and close to four trillion dollars in market cap. Malaysia started out as almost a third of the index, now its weight is just under 4%.

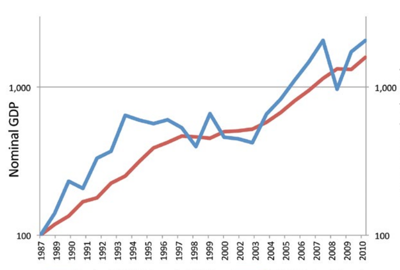
We can't predict what's going to happen in the Emerging Markets – what we aim to do is to keep the index as dynamic as possible so that it reflects the Emerging Markets opportunity set.

Today, Emerging Markets correlation with the Developed Markets is, for some people, surprisingly high. For many years, people saw the Emerging Markets as an uncorrelated source of growth in their equity portfolio – completely different from their Developed Markets equity allocation. But following the Asian crisis in 97/98, we have seen the Developed and Emerging Markets moving much more closely together.



The Emerging Markets still outpace the Developed Markets in terms of economic growth and that should continue to translate into higher equity returns, but there is no longer this uncorrelated source of growth. As a result we're seeing many clients looking at the Emerging and Developed Markets as one equity universe – what we call MSCI ACWI – rather than thinking of them as separate animals.

And of course the emergence of China is a big trend. MSCI is currently consulting with clients on the potential inclusion of China A-shares in the MSCI Emerging Markets Index. If China A were eventually to be included at its full market capitalization, the weight of China could be as high as 27% – but there's a long way to go before that happens.



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What about the recent outflows and underperformance in the Emerging Markets?

People realize that we have had a few years of loose credit and easy money – and a lot of that flowed into the Emerging Markets so they had got somewhat inflated, so I think last year was a reaction to that. I recently had a great conversation with a large asset owner client who said that he felt that the trade-off between continuing to be tactically underweight in the Emerging Markets was now being outweighed by the danger of missing out on the long term performance. He's starting to think about allocating back to the Emerging Markets and we're seeing a lot of that from institutional investors. Unlike previous Emerging Markets dips people are starting to see past the bumps in the road, such as recent developments in Russia and Ukraine, and are buying into the long term growth story.

Is a broad Emerging Markets investment approach still valid?

It very much depends on the investor's investment beliefs – and at MSCI we leave it up to investors to decide where to invest – we just offer them a sophisticated toolkit to help them make those investment decisions. Today, investors seeking equity exposure to the Emerging Markets employ a broad range of mandate configurations. In our paper **"Built to Last – Two Decades of Wisdom on Emerging Markets Allocations"**, we defined four basic approaches to investing in the Emerging Markets:

Approach	Description	MSCI Index
Integrated	Views the Emerging Markets as an integrated part of the global equity opportunity set	MSCI ACWI, MSCI ACWI IMI, MSCI ACWI + FM
Dedicated	Carves the Emerging Markets out as a dedicated segment, completely different to the Developed Markets.	MSCI Emerging Markets, MSCI Emerging Markets IMI
Picking the Winners	Focuses on a specific subset of the countries within the Emerging Markets which are believed to have a better growth trajectory	MSCI EM Beyond BRIC, MSCI EM Country Indexes
Pushing the Boundaries	Argues that because of its high correlation with the Developed Markets, the Emerging Markets no longer offer the kind of growth previously expected so investors should look further afield	MSCI Emerging + Frontier Markets Index, MSCI Frontier Markets Index

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How can MSCI help institutional investors tap into these new ways of looking at the Emerging Markets?

As an index provider we aim to provide our clients with indexes that reflect the way that they want to invest. A recent example is the launch of the MSCI EM Beyond BRIC Index – clients came to us saying that they felt that the BRIC countries were no longer the engines of growth that they had been within the global economy and that they wanted a way to play that theme via an index. So we took our market-leading MSCI Emerging Markets Index, excluded Brazil, Russia India and China, and added some capping to ensure certain countries were not dominating the index. Within two months of its introduction, State Street Global Advisors launched ETFs based on the index in Europe and the US.

Another interesting way that we are helping clients tap into this region – particularly those who may not be able to invest directly into the Emerging Markets – is via our economic exposure indexes. To construct these indexes we look at companies based on their revenue exposure to different countries – for example the MSCI World with EM Exposure Index targets 300 companies with the highest revenue exposure to Emerging Markets countries in the parent index, the MSCI World Index.

As the market matures and investors in the Emerging Markets are becoming more sophisticated they are starting to look at things like factors – we've already had client interest in an ETF on the MSCI Emerging Markets Quality Mix Index – which is one of our newly launched multi-factor indexes. We've also seen a lot of interest in ESG within the Emerging Markets. I think that what's happening now is that the toolkit that we've developed that was previously used for the Developed Markets is now starting to be applied to the Emerging Markets, given that liquidity and capacity are improving.

It's not just on the index side that MSCI can help – just this month we launched the Barra Emerging Markets Model, designed to identify unique sources of risk and return in over 80 countries.

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When creating a new index, what are the criteria that you look at to ensure that the index remains as representative of the opportunity set as possible – particularly in the Emerging Markets where liquidity and capacity may still be an issue?

MSCI applies a number of quantitative and qualitative measures. Regarding quantitative measures, we take into consideration the liquidity and size of a company. Markets have to remain liquid and they need to have enough companies of sufficient size to be considered as an Emerging Market. Morocco is a good recent example – due to a decreasing number of companies of sufficient size it was reclassified from our Emerging Markets universe to our Frontier Markets universe. A similar situation happened to Greece, which was moved from Developed Markets to Emerging Markets.

For qualitative measures we look at things like market accessibility, governance and freedom of capital. We can take Korea as an example – it remains in our Emerging Markets universe because we consider that, especially in terms of capital flows and foreign exchange convertibility, it doesn't offer international investors the opportunities they could find in the Developed Markets.

Another example is China. The Chinese authorities have started lifting some of the capital mobility restrictions on investment allocation that used to be in place. We think that's an important precursor for the full lifting of those controls – so we have started a consultation on a proposal to add China A-shares to the MSCI Emerging Markets Index. We try to be dynamic in our approach to creating indexes but that doesn't mean just adding or taking away countries – it means staying on top of developments within all the countries in the region. Every June, MSCI publishes the results of its Global Market Accessibility Review which goes through in detail the issues facing all the different countries in our universe.

MSCI Market Classification Framework Criteria – Emerging Markets

Criteria	Emerging Markets
A Economic Development	
A1 Sustainability of Economic Development	No requirement
B Size and Liquidity Requirements	
B1 Number of companies meeting the Standard Index criteria:	3
• Company size (full market cap)*	USD 1032 mm
• Security size (float market cap)*	USD 516 mm
• Security liquidity	15% ATVR
C Market Accessibility Criteria	
C1 Openness of foreign ownership	Significant
C2 Ease of capital inflows/outflows	Significant
C3 Efficiency of the operational framework	Good and tested
C4 Stability of the institutional framework	Modest

*Minimum in use for the May 2013 Semi-Annual Index Review, updated on a semi-annual basis

Does MSCI believe that Frontier Markets are the "new" Emerging Markets?

It depends what you are looking for. When investors started investing in the Emerging Markets they were looking for sources of uncorrelated growth to the Developed Markets. Today however, as I mentioned earlier, they are generally highly correlated on the whole to the Developed Markets. Given that the Frontier Markets have lower correlation to the Developed Markets you could say that they are the new Emerging Markets, but you have to take into account the different risks that they represent. MSCI has both Emerging and Frontier Markets indexes and also indexes which blend the two, perhaps giving you the flavour of investing in the Emerging Markets 25 years ago. Ultimately at MSCI we leave it up to investors to decide where to invest, we just offer them the tools they need to help them make better informed investment decisions.

For more information on MSCI products for the Emerging Markets, visit **www.msci.com**

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