ALTERNATIVE EM OFFERS DIVERSIFICATION IN CURRENT MARKET CONDITIONS

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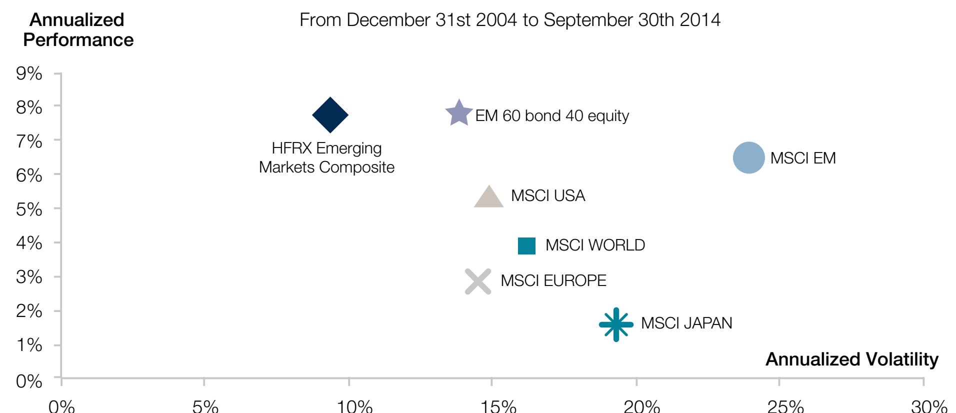
In this report, we discuss the attractiveness of Emerging Market equities based on valuation criteria. We also show that Alternative EM is a better option for diversification purposes, since it preserves the performance of EM while significantly reducing the volatility.

- Emerging Markets (EM) will soon represent 40% of world GDP. However, they barely represent 10% of global equity indices. Benchmarked portfolios are therefore structurally underweighted in EM equities compared to their size in the global economy. This gap appears unwarranted.
- The incomplete integration of EM into world markets and their relatively small equity market capitalisation creates potentially attractive investment opportunities. Nevertheless, EM equities have disappointed over the recent years, underperforming developed markets (DM) equities. Six years after the demise of Lehman Brothers, EM equities are trading at a 40% discount to DM equities.
- The case for Alternative EM as diversifiers: since correlations between EM and DM equity returns rose during the last decade, diversification benefits are a less compelling story for investing in EM through long-only vehicles. We nevertheless can show that actively managed strategies can still profit from EM diversification. Alternative EM funds have been able to preserve the outperformance of EM assets over the last decade while reducing the volatility.

The best of both worlds: Alternative EM capture higher EM performance with lower risk



* The EM Diversified portfolio is a 60%/ 40% allocation to EM bonds and EM equities respectively, based on the JPM EMBI Global and the MSCI EM. Past performance is not indicative of future returns. Source: Bloomberg, Lyxor AM.

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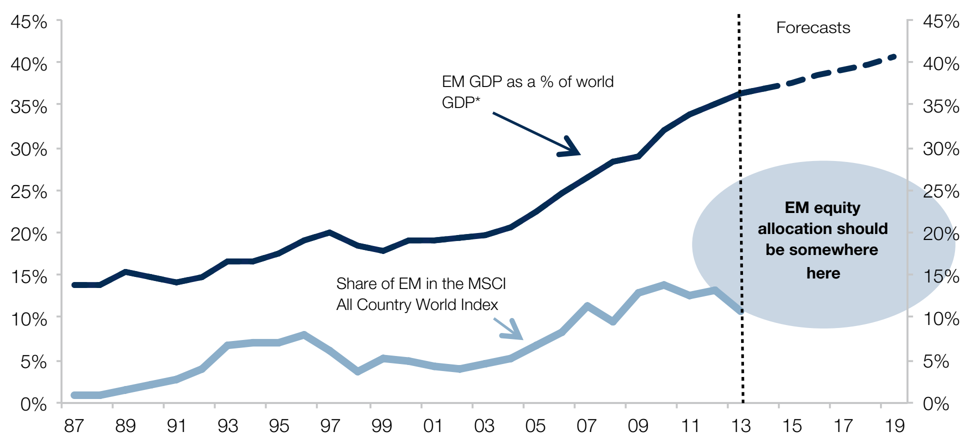
THE CASE FOR ADDING EM EQUITIES IN A GLOBAL PORTFOLIO

Benchmarked portfolios structurally underweight EM equities compared to the size of EM in the global economy. This gap appears largely unwarranted today.

Emerging Markets (EM) will soon represent 40% of world GDP. However, they barely represent 10% of global equity indices. Consequently, benchmarked portfolios structurally underweight EM equities compared to the size of EM in the global economy. There are some reasons for this, such as the higher volatility of EM equities, lower percentage of free float than in developed markets, higher transaction costs etc. Nevertheless, this gap appears largely unwarranted today.

The key question is therefore how much to invest in emerging markets. As stated in recent academic research, "a market capitalisation-based benchmark can be viewed as the lower bound on the asset allocation to emerging markets"[1].

How much to invest in emerging markets?



* We only consider the universe of countries comprised in the MSCI All Country World Index. Their share in the world GDP is calculated at market exchange rates. IMF forecasts as of October 2014. Source: Datastream, MSCI, IMF, Lyxor AM

GLOBAL EQUITY INDICES HAVE A LOW SHARE OF EM

Share in indices	MSCI All Country (Market Weight)	MSCI All Country (GDP Weight)
Developed	89%	63%
Emerging	11%	37%

The MSCI All Country World Index comprises 46 countries, of which 23 are classified as developed markets and 23 are classified as emerging markets. Source: MSCI, Lyxor AM

The MSCI GDP weighted index has outperformed the market weighted index over the long run

Total return indices in USD, rebased. The MSCI ACWI comprises 46 countries, of which 23 are classified as EM. Past performance is not indicative of future returns. Source: Datastream, MSCI, Lyxor AM

1 Bekaert G. and C. R. Harvey (2014), "Emerging Equities in a Globalizing World", available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2344817

THREE REASONS WHY THIS IS THE RIGHT MOMENT TO REASSESS EM

The incomplete integration of EM into world markets creates potentially attractive investment opportunities.

Coupled with their relatively small equity market capitalisation, it is commonly agreed that the incomplete integration of EM into world markets creates potentially attractive investment opportunities[2]. However, EM equities have disappointed over the recent years by underperforming DM equities in the relief rally seen in the US in the wake of the global financial crisis in 2008. Six years after the demise of Lehman Brothers, EM equities are now trading at a substantial discount to developed equities. Expressed in terms of relative price to books, EM equities currently show a 40% discount to developed market equities.

EM equities currently show a 40% discount to developed equities.

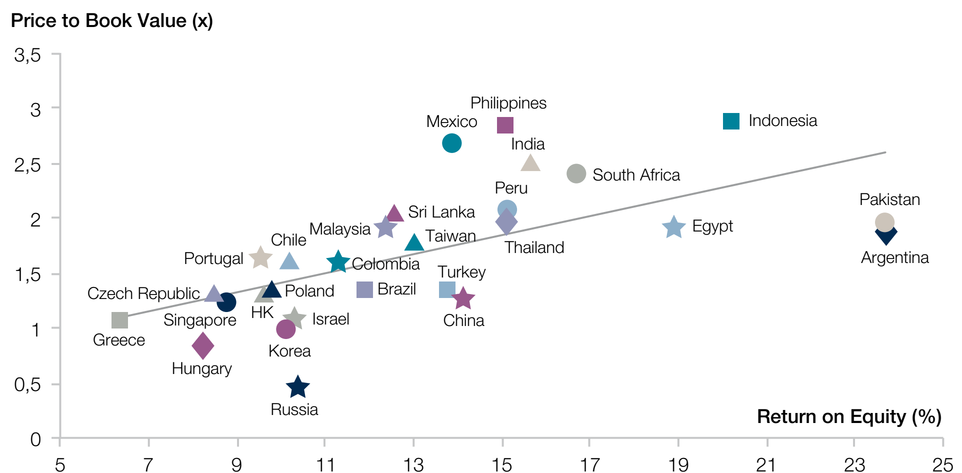
#1: EM equities are cheap compared to developed equities

The undervaluation of EM equities has returned to levels last seen in 2004

Relative price to book ratio of the MSCI EM (1.6x) and the MSCI World (2.2x). Data as of end-September 2014. Source: Bloomberg, MSCI, Lyxor AM.

Countries with geopolitical issues show a significant discount compared to other countries: Russia (though its valuation has structurally been low), Turkey, Egypt, Pakistan, Argentina etc.

Bottom fishing in EM equities: some countries are cheaper than others



Relative price to book ratio of the MSCI EM (1.6x) and the MSCI World (2.2x). Data as of end-September 2014. Source: Bloomberg, MSCI, Lyxor AM.

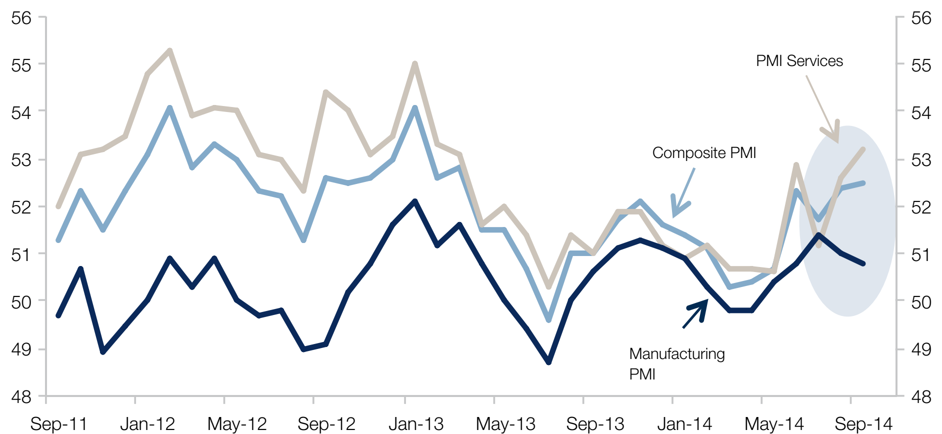
2 IMF (2014), "How Do Changes in the Investor Base and Financial Deepening Affect Emerging Market Economies?" in Global Financial Stability Report, April. Bekaert G., C R. Harvey, C. T. Lundblad, and S. Siegel (2011), "What Segments Equity Markets?" Review of Financial Studies, Vol. 24, No. 12, pp. 3847–90.

PMI indices indicate that economic activity in EM bottomed out at the end of Q1 14.

#2: Economic growth in EM has bottomed out

Growth concerns in EM have eased since the end of the first quarter, as shown by the chart below. PMI indices have bottomed out recently and the strength of the services sector (non tradables) versus the manufacturing sector (tradables) signals that domestic conditions are faring better than external conditions. Since the PMI indices have started to rebound, the MSCI EM has outperformed the MSCI World. The MSCI EM (total return) is up 3.1% versus 2.9% for the MSCI World (total return) since March 2014.

PMI indices indicate that economic activity in EM bottomed out at the end of Q1 14

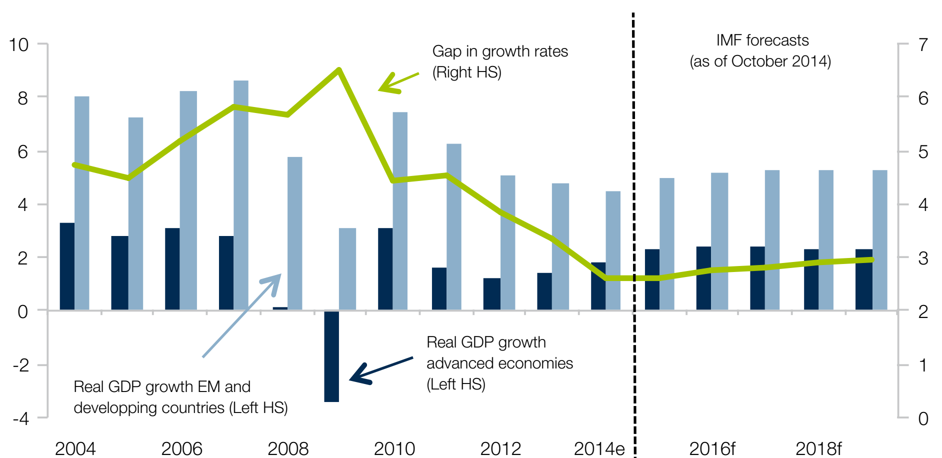


HSBC Emerging Markets PMI. Source: Bloomberg, HSBC, Lyxor AM.

The narrowing of the gap between EM and DM growth has already taken place.

Emerging markets have been in the headlines recently regarding their growth deceleration and their exposure to the fall in commodity prices (see link). However, we would emphasise that growth deceleration is not a particular feature of EM, but rather a generalised aspect of the world economy today. As shown by the chart below, the gap between EM and DM growth is no longer narrowing.

Growth deceleration in EM: much ado about nothing in relative terms



Source: IMF, Lyxor AM.

The current sharp decline in commodity prices is expected to have a moderate overall impact on EM. Asia and EM Europe (except for Russia and CIS countries) are expected to benefit from it.

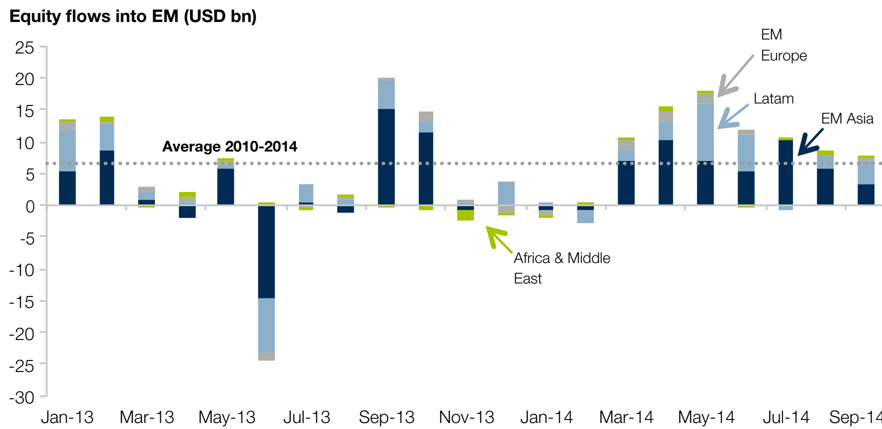
Much has also been said concerning the impact of falling commodity prices on EM. In this regard, the IMF calculated the impact of a 30% decline in metals prices and a 10% decline in energy prices a few months ago[3]. The main conclusion here was that the impact was heterogeneous across and within regions. Asia is expected to benefit the most from steep falls in commodity prices due to the fact that it is a significant net importer of commodities. EM Europe would also benefit (except for Russia and CIS countries). At the same time, the Middle East, Latin America and Africa are expected to be more negatively impacted. The overall impact on EM would be somewhat neutral.

#3: EM equities have seen renewed investor interest since the end of Q1 14

After several years of paltry and irregular flows into EM equities, investors have flocked back into them since the end of Q1 14. A regional split of equity flows shows that EM Asia and Latin America traditionally receive the bulk of these flows. At the same time, EM Europe and Africa & Middle East remain somewhat off EM investor radars due to the lack of market depth.

Since the end of Q1 14, equity flows to EM have been above their average over the past four years.

Since growth conditions in EM have bottomed out, equity flows have resumed



Non-resident portfolio flows. The IIF Portfolio Flows Tracker is a monthly measure of equity flows to 30 EM. Based on monthly data published by national central banks. The most recent period is based on estimates, whether from data published by national exchanges and central banks or by regressing portfolio equity flows on a number of predictor variables. Source: IIF, Lyxor AM.

3 IMF (2013), "Commodity Market Review", for World Economic Outlook (October).

INVESTING IN EM THROUGH ALTERNATIVE MANAGERS

The correlations between EM and DM equity returns rose over the last decade. Diversification benefits are thus a less compelling story for investing in emerging markets through long-only vehicles.

The benefits of adding EM in a portfolio for the purpose of diversification has been a largely discussed topic over the last decade[4]. However, the correlation of equity market returns between EM and DM has increased substantially since EM embarked on a process of liberalisation of their capital accounts in the 90s. Diversification benefits are therefore a less compelling story for investing in EM. For example, the BIS recently indicated that "there is a higher degree of concentration in the use of benchmarks by asset managers investing in EM assets [and] these factors can [...] raise the potential for one-sided markets in EM[5]."

The case for Alternative EM as diversifiers

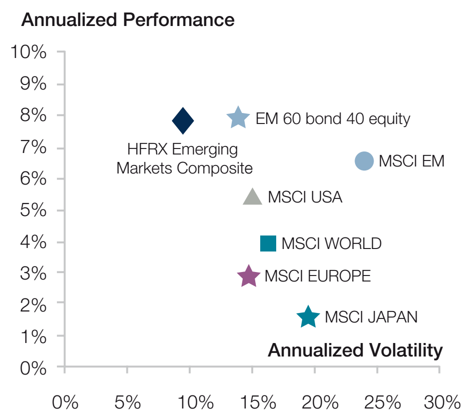
Nevertheless, actively managed strategies can still profit from EM diversification. Alternative EM funds have been able to preserve the outperformance of EM assets over the last decade while reducing the volatility. The HFRX EM Composite hedge fund index has outperformed the MSCI EM, posting an annualised return of 7.8% (vs. 6.5%) with lower volatility.

Since the HFRX EM Composite reflects a combination of equity, fixed income, currency and commodities, the comparison with the MSCI EM is not straightforward. As a result, we built a diversified long-only EM portfolio and have seen that alternative EM is still more efficient. However, much of the performance of EM was recorded in the first half of the last decade. As a result, we focused on the period between 2008 and 2014, when EM underperformed. We found that alternative EM still outperformed on a risk-adjusted basis.

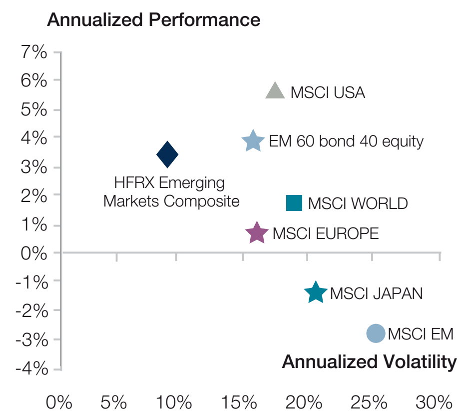
Actively managed strategies can still profit from the benefits of EM diversification. EM alternative managers have been able to preserve the higher performance of EM over the last decade while significantly reducing the volatility.

The best of both worlds: Alternative EM captures higher performance with lower risk

From December 31st 2004 to Sep 30th 2014



From May 30th 2008 to Sep 30th 2014



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4 See Li K., A. Sarkar and Z. Wang (2003), "Diversification Benefits of Emerging Markets Subject to Portfolio Constraints", *Journal of Empirical Finance Vol. 10, No. 1-2, pp. 57-80.* Caruso M., B. Silli and R. Umlauft (2005), "The Benefits of Emerging markets Diversification in Practice: Institutional vs. Private Investors", Universitat Pompeu Fabra.

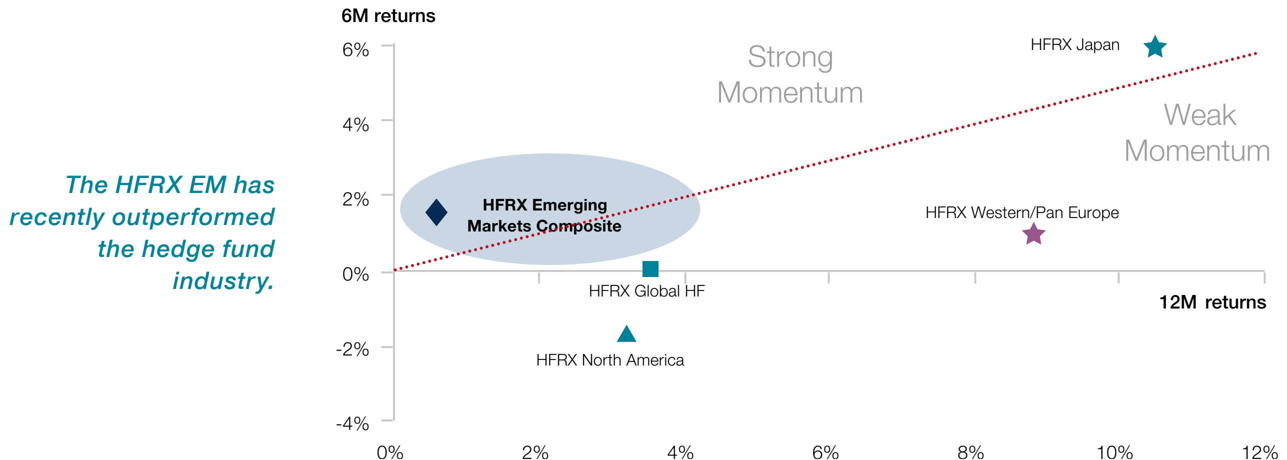
5 See BIS (2014), "Asset Managers in Emerging Market Economies", in *BIS Quarterly Review*, (September).

The case for Alternative EM as performers

Alternative EM had a difficult time in 2013 and during the first half of 2014. However, the HFRX Emerging Markets Composite has rebounded recently (+2% over the last three months; +1.5% last six months) after a somewhat weak relative performance over the last 12 months (+0.6%). Momentum is therefore getting stronger, especially compared to developed HFRX indices.

The HFRX EM has recently outperformed the hedge fund industry.

EM alternative managers have shown strong momentum recently

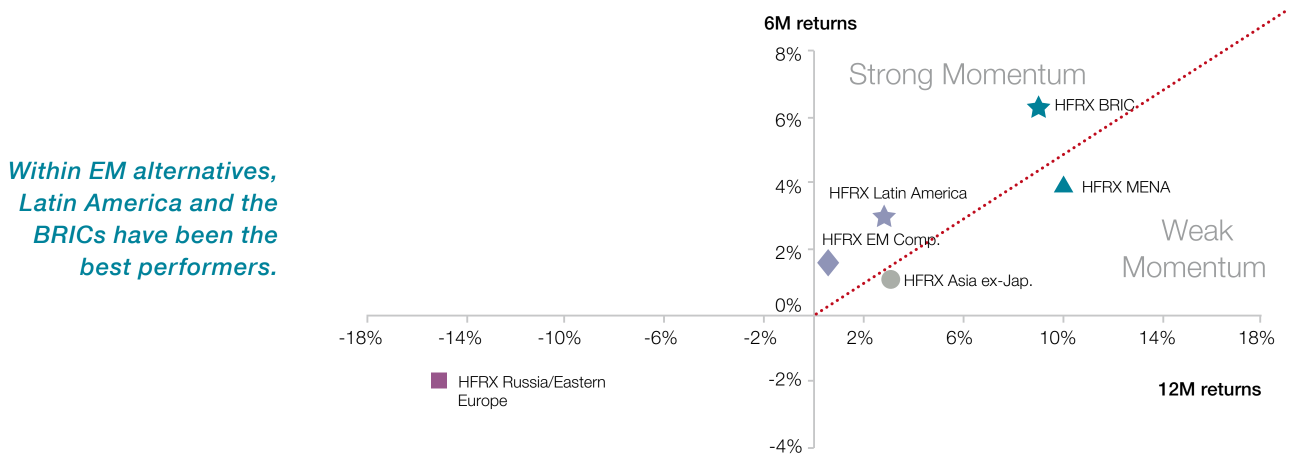


Past performance is not indicative of future returns. Data as of September 30 2014. Source: Bloomberg, HFR, Lyxor AM.

From a regional perspective, Latin America and the BRICs have been the best performers. The HFRX BRIC has delivered a solid performance both on a 12-month and a 3-month basis. At the same time, the HFRX Russia / Eastern Europe is underperforming, mainly related to the geopolitical issues surrounding Russia and this country's exposure to negative trends in commodity prices.

Within EM alternatives, Latin America and the BRICs have been the best performers.

Within EM alternatives, Latin America and the BRICs have been the best performers



Past performances is not indicative of future results. HFRX Indexes. Data as of August 31 2014. Source: Bloomberg, HFR, Lyxor AM. HSBC Emerging Markets PMI. Source: Bloomberg, HFR, Lyxor AM.

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