

THE CHANGING FACE OF BENCHMARKING

EVALUATING EMERGING AND FRONTIER MARKETS

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Measuring Investment Success

Benchmarks are essential in shaping an investor's overall view of investment opportunities. In order to evaluate performance, investors are increasingly demanding benchmarks that accurately and fairly reflect the potential of the wider Emerging Market (EM) and Frontier Market (FM) universe.

A lack of real-time data, poor technological infrastructure and illiquidity in many Emerging and Frontier Markets has limited creating investable benchmarks in the past. More recently, however, significant strides have been made in terms of technology and legislative action that permit easier access to market data and allow more accurate benchmarking, spurring increased investment activity.

As both an art and a science, benchmarking has undergone a significant metamorphosis in just the past decade. Today, more providers are entering the EM and FM benchmarking arena, and existing players are extending their global coverage. Equally important, established providers such as MSCI, S&P and FTSE continue to re-evaluate and expand the benchmark universe, systematizing the quantitative and qualitative criteria that help determine how these markets are classified.

Some of these evaluation factors include:

- Level of economic development
- Perceived political risk
- Measurement of a market's depth, breadth and investment choices
- Assessment of operational efficiency and accessibility to domestic and global investors
- Qualification of the market and regulatory environment
- Efficiency of custody and settlement

MSCI, S&P and FTSE periodically review how these markets are classified and constantly evaluate the composition of their indices to reflect these changing dynamics.

CALCULATING EM AND FM RISK: THE AIG INVESTMENTS FIXED INCOME RATING SYSTEM

To identify key risks and opportunities in Emerging and Frontier Markets fixed income, AIG Investments evaluates countries using its own proprietary risk-rating framework that evaluates fundamental, valuation and technical drivers.

The process begins by taking a top-down, fundamental view of the global economy, focusing on growth, liquidity, relative value and risk appetite.

Next, a bottom-up credit analysis screens an initial investment universe of more than 50 countries for liquidity issues, as well as market access. This filter narrows the universe, and the subsequent analysis focuses on three key investment drivers:

Fundamentals:

- Domestic economy dynamics (including the ability to service debt, inflation outlook, balance of payments and economic activity indicators)
- Liquidity
- Solvency

Valuations:

- Absolute spread levels relative to the investment universe and its history
- Analysis of relative spreads

Technical:

- Risk appetite
- Momentum factors
- Fund flows and investor positioning
- Supply and demand

Permanent, "on-the-ground" AIG Investments research in locations around the world adds valuable information that further assists in the overall decision-making process. The final portfolio typically comprises fixed income securities from approximately 15 countries.

Frontier Benchmarking

In response to investors' newly whetted appetites for nascent opportunities, MSCI Barra has released a set of Frontier indices designed to track the performance of a wider range of equity markets that are now more available to global investors. Frontier Markets significantly expand the number of ground floor investment opportunities, as many are poised to become tomorrow's Emerging Markets.

The MSCI Frontier indices cover 19 countries, including Eastern and Central Europe, Africa, the Middle East and Asia, and aim to represent the broader opportunity set, while analyzing investability factors within each market.

S&P also rolled out its own version—the S&P Select Frontier Index. This investable subset of its S&P/IFCG Extended Frontier 150 Index addresses the increasingly sophisticated needs of investors interested in these still largely unexplored opportunities.

This particular index was launched as one of the premier investable benchmarks for the Frontier Markets arena and covers a broad range of Frontier equity markets across Emerging Europe, Asia, South America and the Middle East. It includes 30 of the largest and most liquid components of the broader S&P/IFCG Extended Frontier 150 benchmark.

The S&P Select Frontier Index has a total market capitalization of US \$46.9 billion, and individual components must have market capitalizations of at least US \$100 million.

African Business Research, an independent provider of business information and research on African economies, developed the Africa All-Share (ex-South Africa) Index as of 1999. This is a composite measure of the average performance of all stock exchanges in Africa, excluding South Africa, which covers all companies listed on African stock exchanges that conform to a minimum size and trading liquidity requirement.

Conclusion

As economies grow from Frontier to Emerging and then evolve into Developed Markets, it is vital that index providers keep abreast of timely events and review the components and contributors to the underlying benchmarks. This is essential to fully and accurately reflect the investment universe.

Now more than ever, Frontier and Emerging Markets are proving increasingly attractive to global investors who understand their unrealized potential. Although these economies are still considered inefficient, expanded local and global coverage of these markets continues to build investor confidence in the future.

A BRIEF GLOSSARY

- Compared to Developed Markets, Emerging Markets (EM) and Frontier Markets (FM) are defined by a below-average Gross Domestic Product (GDP) per capita.
- Both Emerging and Frontier Markets are further limited by transparency issues that make regulatory initiatives and accountability either difficult or non-existent.
- Emerging and Frontier economies may suffer from political instability or widespread government intervention and regulation that restricts foreign investments or nullifies free markets through privatization.
- Geopolitical risks are often part of the equation, making developing infrastructure and providing basic services, including food, energy and health care, more challenging.

THE AIG GOVERNMENT BOND INDEX

For many years in Kenya, investors have relied on the short-term Treasury bill as the primary benchmark for fixed income securities. This has been problematic, as longer-term Kenyan government bonds now account for more than 70% of domestic debt and a significant portion of most fixed income portfolios.¹

This scenario created the need to benchmark fixed income portfolios with an appropriate index or composite that was more representative of the entire Kenyan fixed income market. As a result, the AIG Government Bond index was officially launched in April 2008 in Nairobi to serve as a yardstick for fixed income portfolios, as well as a tool to manage bond portfolio risk.

The AIG Government Bond Index closely follows the characteristics of the major world bond indices, with a few exceptions, such as the frequency of pricing. Since bond trading in the Kenyan market occurs less frequently, and bonds are not as liquid as they are in Developed Markets, the AIG Bond Index is priced on a weekly basis, compared to other markets that price daily.

Components of the Index include selected Kenya Government Fixed Rate Treasury Bonds with maturity greater than one year. The Index is market-capitalization weighted and is a total return index; all maturing coupons are re-invested. Rebalancing occurs on the last business day of each month.

It is anticipated that market players will use the Index to better manage and benchmark against their bond portfolios. Recently investor interest in the Kenyan bond market has increased dramatically, with bond turnover improving by over 100%.²

THE AIG 27 SHARE INDEX

The AIG 27 Share Index was officially launched in 2001 to facilitate examining Kenyan equity market returns and to act as a benchmark for evaluating these stocks against other equity performance.

This Index is also used by the industry to understand the factors that influence aggregate price movements. Similar to the major world indices, the AIG 27 Share Index is computed using an Arithmetic Mean and constitutes 27 stocks representing different sectors of the economy.

Additionally, the AIG 27 Share Index is a total return index, capturing both capital gains and dividends. It is market-capitalization weighted and is rebalanced every three months.

CLOSE-UP ON AFRICA

Often dubbed “The Final Frontier,” African markets represent the next chapter for alpha-seeking investors looking beyond the maturing Emerging Markets.

Significant development has occurred in Africa over the past decade or so, and there are now 23 bourses (stock markets) up from just eight in 1989. Recent additions include the *Bourse des Valeurs Mobilières de l’Afrique Centrale (BVMAC)* created in 2003, and based in Gabon; *Maputo Stock Exchange* (Mozambique) created in 1999; and the *Douala Stock Exchange* (Cameroon) created in 2001. The *Angola Stock Exchange and Derivatives (BVDA)* and *Rwanda Stock Exchange* are slated to open later in 2008.

Total market capitalization for African stock markets surged more than three-fold from US \$281,052 million to US \$951,187 million between 1997 and 2006.³

2007 proved to be a stellar year for both Frontier and Emerging Markets. According to the Africa All Share Index (ex- South Africa), African Markets were up 54% during that period in US dollar terms. Additionally, the MSCI Emerging Market Index was up 36.5%, compared to the MSCI World Index performance of just 9.6%, and the S&P/IFCF Frontier Markets composite of 24 countries’ markets posted a 45.6% total return, beating the S&P 500, which was up 3.8%.

Among specific Frontier Markets, Côte d’Ivoire’s market soared 122.7%, while the Malawi All Share Index rose by 111%. The Nigeria and Lusaka (Zambia) markets were both up by 91%, and the Mauritius SEMDEX was up by 79.6%.

According to Emerging Portfolio Fund Research (EPFR) Global, which tracks fund flows and allocations globally, net inflows into African regional equity funds alone totaled US \$650 million in 2007; up from about \$100 million in 2006.

As for the region’s fixed-income prospects, China alone is promising up to \$8.5 billion of investment through sovereign wealth funds in the Democratic Republic of the Congo, in exchange for a share of its mineral assets. Additionally, China has signed a \$1.6 billion private equity deal to develop an oil field in Angola that will tap into estimated reserves of 4.5 billion barrels.

A Rich Source of Uncorrelated Performance

African markets enjoy low correlation to the U.S. markets, and although political turbulence in countries like Kenya and Zimbabwe are clearly a reality, the majority of the continent’s nations have made significant progress towards political stability and freedom.

Additionally, investments in Africa provide valuable diversification benefits. When the United States struggled with credit and liquidity during the subprime crisis, for example, the African markets continued to rise due to global demand for resources.

Exhibit 1 - African Correlations Versus the U.S. S&P 500

From 1/31/03 to 2/14/08

Frequency of Returns:	Weekly	Monthly
Russell 2000	88.9%	86.2%
South Africa Jalsh Index	58.1%	53.2%
MSCI South Africa	53.7%	56.4%
Egypt Hermes	22.5%	13.9%
MSCI Morocco	8.7%	8.7%
Nigeria Stock Exchange	-4.5%	0.7%
The AIG 27 Share Index	0.3%	0.9%

Currently, certain Frontier Markets in Africa and other regions of the globe appear poised for the same exponential growth witnessed in Emerging Markets over the last decade.

However, such countries need to be selected carefully. Local presence and deep knowledge of these markets offer investors a decisive advantage, and asset managers that offer these capabilities are able to locate exceptional companies with the best management, structuring the most potentially rewarding transactions.

Sources

1 Kenyan Government Bond Database, AIG Investments, 2008

2 Kenyan Government Bond Database, AIG Investments, 2008

3 http://goliath.ecnext.com/coms2/gi_0199-7349118/New-African-frontier-markets-tempt.html

Jonathan Stichbury (Africa) joined AIG Investments in 2000 and is responsible for directing all listed equity and public debt investments throughout Sub-Saharan Africa. He chairs the local Investment Committee and coordinates investment strategy. Mr. Stichbury joined AIG Investments after four years with Old Mutual Asset Managers where he initially worked as a portfolio manager but was latterly CEO of Old Mutual's operations in Kenya and Botswana. Prior to that he worked for Martin Currie Investment Management Ltd. in Scotland for five years as an investment analyst and portfolio manager. He graduated from the Royal Military Academy Sandhurst in 1984 and subsequently received a Post-Graduate Diploma in Investment Analysis from the University of Stirling in Scotland. He was made an associate member of the UK Society of Investment Professionals in 1994 and is a founder council member of the Fund Managers Association of East Africa.

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Marc Kasher (U.S.) joined AIG Capital Partners in 1997 as a Vice President. Over his career, Mr. Kasher has been responsible for several successful private equity investments in oil exploration & production, information technology, and telecommunications in the former Soviet Union. Mr. Kasher currently sits on the Investment Committee of the AIG Russia Century Fund and the AIG Global Sports and Entertainment Fund. He is also responsible for AIG GEM Viaduct Fund's investment in Sindicatum Carbon Capital, a leading developer of carbon credits. Prior to joining AIG, Mr. Kasher worked as a consultant for the United States Agency for International Development (USAID) in Russia, Ukraine, Uzbekistan and Kyrgyzstan. Mr. Kasher holds a BA in Soviet studies from Tufts University and an MBA from the Georgetown School of Business.

Vincent Ntalami (Africa) began his career as an Investment Analyst with AIG Investments in August 2004. He currently focuses on research for Equities, Fixed Income and offshore assets. In 2006, his scope of responsibilities expanded to portfolio management responsibilities, and in 2007, he became an Investment Manager, co-managing the AIUO Sub-Saharan product. Mr. Ntalami holds a BSc. in Actuarial Science from the University of Nairobi, Kenya; a BSc. in Computer Science from the University of Sunderland, UK; and will complete his MSc. in Financial Economics from the University of London in 2008. He also holds a Graduate Diploma in Information Systems from the Institute for the Management of Information Systems (IMIS), UK.

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