

REMAPPING THE WORLD OF OPPORTUNITY

EMERGING AND FRONTIER MARKETS

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WHY EMERGING MARKETS—AND WHY NOW?

In the next 40 years, 78% of the world’s investment returns and global GDP are expected to be generated by Emerging and Frontier Markets, despite their below-average GDP per capita and relative political instability.¹ That statistic isn’t surprising, given these combined markets already have a population of 5.7 billion people and a GDP of over US \$18 trillion.

A combination of accelerating economic growth and numerous privatizations—as well as lower correlations compared to more developed economies—have increased the attractiveness of Emerging and Frontier Markets for investors seeking both alpha and diversification.

Additionally, liquidity has greatly increased in both arenas, so that investors can now realistically consider these markets as part of an overall portfolio. Restrictions on foreign investments are also relaxing, further contributing to returns that may outpace Developed Markets globally.

Reflecting their considerable potential, Emerging economies are now well-tracked by indices such as MSCI Barra, Standard & Poor’s Emerging Market Indices, and *Euromoney* Institutional ISI Emerging Markets. As a result, investors enjoy far greater access to reliable analysis and proven decision-making tools.

Today, the Emerging and Frontier Markets landscape is one that offers a world of opportunity to investors. Yet, as little as 20 years ago Emerging Markets and Frontier Markets represented only a small portion of the investable universe.

Those who diversified into these markets over the past two decades reaped the rewards of a far broader range of investment choices. Today, Emerging and Frontier Markets continue their rapid upward trajectory and expansion, mirroring the lightning-fast pace of global change.

As a result, any expanded definition needs to keep pace with both short- and long-term geopolitical and economic developments. Additionally, it can no longer be assumed that a nation will remain an Emerging or Frontier market for decades, as was so often the case in the past.

A Steadily Improving Environment

Many cyclical and structural changes have occurred in Emerging and Frontier Markets, including greater economic alignment with Developed Market economies and the fact that Emerging

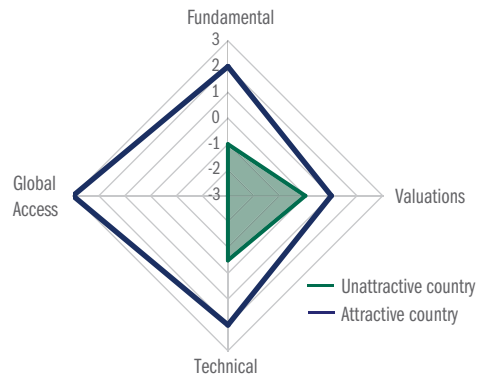
EXHIBIT 1

How the World Stacks Up: Developed, Emerging and Frontier Markets

DEVELOPED MARKETS		EMERGING MARKETS		FRONTIER MARKETS	
NORTH AMERICA	Norway	LATIN AMERICA	Poland	CENTRAL & EASTERN EUROPE & CIS	MIDDLE EAST
Canada	Portugal	Argentina	Russia	Bulgaria	Lebanon
United States	Spain	Brazil	South Africa	Croatia	Bahrain
	Sweden	Chile	Turkey	Estonia	Kuwait
EUROPE	Switzerland	Colombia	EMERGING ASIA	Kazakhstan	Oman
Austria	United Kingdom	Mexico	China	Romania	Qatar
Belgium		Peru	India	Slovenia	United Arab Emirates
Denmark	PACIFIC		Indonesia	Ukraine	Saudi Arabia*
Finland	Australia	EUROPE MIDDLE EAST & AFRICA	Korea	AFRICA	ASIA
France	Hong Kong	Czech Republic	Malaysia	Kenya	Sri Lanka
Germany	Japan	Egypt	Pakistan	Mauritius	Vietnam
Greece	New Zealand	Hungary	Philippines	Nigeria	
Ireland	Singapore	Israel	Taiwan	Tunisia	
Italy		Jordan	Thailand		
Netherlands		Morocco			

Source: MSCI Barra, March 2008.

*Saudi Arabia is currently not included in the MSCI Frontier Markets Index, but is part of the MSCI GCC Countries Index.



Source: AIG Investments

Markets have greatly improved balancing their external accounts, thanks to strong trade surpluses and successful debt-buyback programs.

As a result, Emerging Markets have quickly climbed the steps towards Developed Markets status, meeting many of the conditions needed to “emerge” onto the global scene with sizeable participation in global growth, trade, income and investment. This significantly expanded investable universe stands to benefit investors with a greater number of opportunities all along the risk/reward scale.

Perhaps the most influential factor in shaping Emerging Markets over the past several decades has been the transition from volatile political systems to more stable, democratically organized governments.

At the same time, many of these economies became more open and receptive to globalization, modernized their countries with new public works and telecommunications systems, and overhauled industrial plants to increase production capabilities.

“It is predicted that by 2045, the four BRIC economies will become larger than the G6.”

In one notable, high-profile example of how Emerging Markets are changing the global landscape, it is predicted that by 2045 the four BRIC economies (Brazil, Russia, India and China) will become larger than the G6 (U.S., Japan, France, Italy, Germany and the United Kingdom).²

These rapidly growing Emerging Market countries generated 15% of the world’s total GDP by the end of 2007. The BRIC economies are expected to continue exercising considerable

more influence globally, potentially altering the dynamics of the world stage and the course of global policies. In fact by 2050, three of the largest four economies are expected to be in Asia.²

Changing Definitions

In considering such fundamentally different nations as China, India, South Africa, Kazakhstan and Korea, a “one-size-fits-all” definition of Emerging Markets appears limited, at best. Although plagued with unrest in the past, these Emerging Markets are now characterized by relative political and economic stability based on factors that range from improved GDP and currency management to increased corporate governance and legal accountability.

Although the official definition of Emerging Markets is based on Gross Domestic Product (GDP), the smaller subset of approximately 100 Frontier Markets is further limited by stagnant economic development policies, high geopolitical risk and fewer market opportunities. These nations may also be hampered by high birth and death rates that impact the human capital resources available for economic development.

Additionally, many of these Frontier countries, especially those in Sub-Saharan Africa and Southeast Asia, are current or past recipients of Bretton Woods (IMF and World Bank) development aid in the form of loans. Financing these debts combined with devalued currencies, domestic instabilities and high inflation have saddled many Frontier Market economies with a high deficit-to-revenue ratio.

In Uganda, for instance, 40% of the nation’s budget is donor-funded, although the country has made notable strides in the past 15 years by addressing its social, economic and political issues.³ Yet the biggest boom may still be ahead: Uganda has recently discovered large deposits of oil and natural gas in various regions throughout the country.

Furthermore, improved domestic policies in other Frontier Markets, such as Vietnam, Bulgaria and Nigeria, may also serve as a catalyst for moving these “on the brink” countries from the Frontier into the Emerging category.

We believe that the most accurate picture of an Emerging or Frontier Market should not rely exclusively on any one definition and should also consider the ever-changing balance of qualitative and quantitative factors, as well as economic volatility.

Investing in Frontier Markets

Many Frontier economies, such as Zambia, Nigeria and Ghana, put this balance in sharp perspective. They lack well-developed capital markets, so access to their local markets is difficult, and trading investment opportunities are clearly riskier

There can be no assurance that these projections will be achieved.

propositions. Additionally, the controls and taxes charged to gain access to local markets make investing in some of these countries cost-prohibitive.

For example, Ghana only allows foreign investors to invest in government debt securities with a term longer than three years, and Zambia has a high 18% effective withholding tax. Nigeria requires that money invested stays in the country for at least one year.³

Additionally, investing only in public markets in these and other countries can be extremely limiting, as this approach does not access all areas of growth.

Investment strategies through alternative investment vehicles, such as hedge funds, private equity and real estate, have proven to be an important mechanism for gaining greater access to Emerging and Frontier markets. These alternative investment strategies can source deals at different levels of a company's growth. Additionally, they allow taking an active role in a company's development, including serving on their boards and shaping key decisions.

Currently, Central Asia, Eastern Europe and Sub-Saharan Africa are being "discovered" by many private equity and real estate investors as prime regions for alternatives, because these illiquid markets are attractive to those comfortable with a higher level of risk and a longer-term investment perspective. Investors can now capture these "ground floor" opportunities whether they are competing for oil companies in Kazakhstan or commercial real estate properties in India.

While it may seem daunting to invest in Africa or Central Asia, the local experience and presence of an asset manager can often make a significant difference in terms of contacts, knowledge and experience in trading illiquid assets.

Potential Risks and Pitfalls

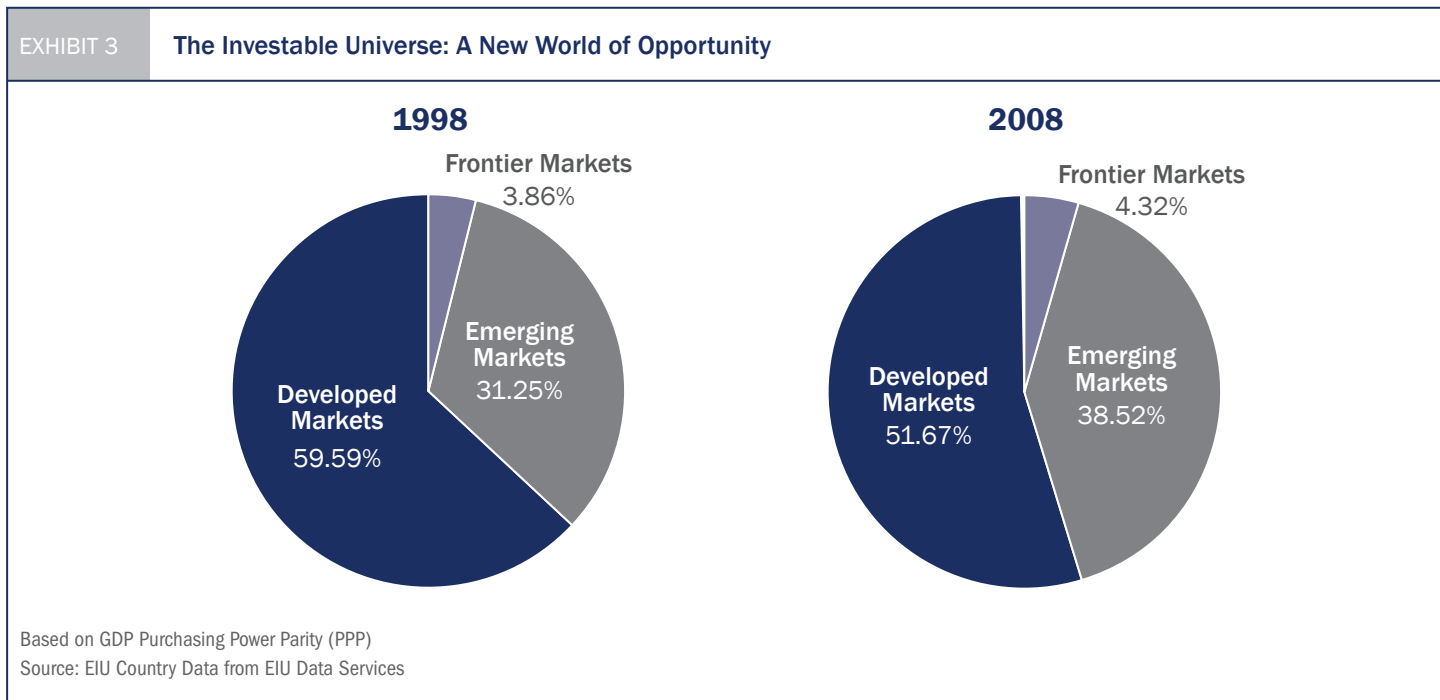
Certainly, investing in Emerging Markets and Frontier Markets poses a number risks. It is worth noting that protectionist policies, trade barriers, export bans and rising import taxes in the Developed World may jeopardize both the future development and the growth of Emerging and Frontier Markets.

Additionally, the current rapid expansion of Emerging Markets is outpacing domestic production capabilities in meeting rising demand, which could create new obstacles on the horizon.

The risks of power cuts (as seen in South Africa or Brazil) or food shortages (as seen recently in the Philippines, Thailand and Mexico) occur when the local economy grows faster than the necessary support for infrastructure. Such troubling signs indicate these economies may have reached their peak output capacity.

Given the fast pace of growth of domestic demand, new investments will be required to expand these countries' industrial capabilities and meet the increased consumption demands of a flourishing middle class.

In just one example of this trend, the number of inhabitants living in rural China represents 60% of the country's total population, but the level of urbanization is still low. As the agricultural sector becomes more reliant on technology, the reduced agricultural labor force may be increasingly forced to migrate to larger cities in order to find jobs. As a result, China's cities will have to be prepared to develop increased infrastructure, such as, roads, electricity, water and sewage lines, to accommodate this population influx from rural areas.³



The Impact of Poverty

Although economic growth represents a positive force for many, it is not always synonymous with creating a more equitable society for its poorest citizens.

According to Xavier Sala-i-Martin, a Columbia University economist renowned for his work on world economic growth, global income inequality narrowed significantly between 1980 and 1998. As a result, the one-dollar-a-day poverty ratio fell from 20% to just 5% in 39 countries ranging from Latin America to Africa, including the Baltics and former USSR republics.⁴

However, Sala-i-Martin also notes that unless entire regions grow considerably in the near future, global income disparities are certain to widen. This is because most income inequalities throughout the world are explained by differences in per-capita income between countries, as opposed to the per-capita differences within countries.

The gulf between the very wealthy and the abjectly poor will continue to be an issue of concern as it shapes long-term prospects for Emerging and Frontier Markets.

Conclusion

Emerging and Frontier Markets can potentially provide investors with higher returns and greater diversification than Developed Markets, and an expanded definition of this investable universe can help capture this wider range of opportunities while they are still available.

It is appropriate for long-term investors to consider Emerging and Frontier Markets, because without them investors would be “putting all their eggs” in one basket and increasing the risk that a downward trend in Developed Markets would generate steep portfolio declines.

However, successful due diligence is essential and requires asking the right questions and analyzing the opportunities from multiple perspectives. This necessitates in-depth knowledge of how the country and its systems operate on every level. Local expertise and insight are invaluable in understanding the complex, opaque systems that often characterize these rapidly changing markets.

A “fly-in, fly-out” investment approach does not serve foreign investment interests, as no two countries are the same, and investment strategies are generally best built from the ground up. A firm must truly be a part of the immediate “eco-system” in order to understand the business landscape and the psyche of the culture, as well as its full investment potential.

Diversification does not insure against market loss. There can be no assurance these projections will be achieved. Past performance is not indicative of future results.

A CLOSER LOOK AT CENTRAL ASIA

Despite its recent impressive GDP growth of 10%, Central Asia clearly remains a Frontier Market. The absence of transparency, accountability, currency stability and the lack of regulatory bodies are keeping this region a Frontier Market for the time being.

For example, Almaty, the former capital of Kazakhstan, is a city devoid of any regulated, stable, savings and banking institutions. Existing banks within Kazakhstan are unregulated by any government agencies; thus, their mistrust and lack of use by the general population.

In general, Kazakh investors fear that the unregulated environment of the banking system will not protect them from capital loss in the event of a bank run, and they also believe they are not being fairly compensated for inflation risks and currency devaluation.

A similar scenario occurred in the past during the collapse of the Soviet Union, and then again in Russia in 1998. As a result, retail banking is small in Kazakhstan, with only 15 million depositors, and most Kazakh banks obtain financing from external sources, such as international banks and financial institutions. Furthermore, the stock market is nearly non-existent, with very few shares and limited liquidity.

However, in what may be an increasing trend, a portion of Kazakhstan’s population has benefited from increased demand and the rise in price of raw materials and resources, such as oil. These affluent investors are willing to buy real estate in Almaty for \$7,000 to \$10,000 a square meter—a disparity in wealth between upper and lower classes that is often seen in many Frontier and Emerging Markets.

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