Investing in Emerging Market Equities: How to achieve double alpha.

Over three years ago, Milltrust International, launched a 'double alpha' EM product and now finds itself amongst the best performers in the emerging markets equity asset class for its GEMS multi-manager portfolio.

There are two ways to make money when managing your investments in Emerging Markets equities, one, is by getting your stock selection right and, two, is by correctly managing your geographical exposure. If an investor is looking to maximize their returns in this asset class, they will need to exploit both of these sources of alpha. This is an incredible luxury that even developed market investors simply do not have as their investment universe tends to be more heavily influenced by bottom up factors.

There is so much disparity within the emerging markets universe which on the one hand further enhances the diversification and alpha-seeking potential within the asset class but on the other hand also questions the whole concept of the BRICS and GEMS buckets which are quickly becoming inappropriate. In fact, Goldman Sachs, who coined the term BRICS, recently closed down their BRICS strategy which has not gone unnoticed in the industry. The developing world has its commodity plays (Russia, Brazil), its high beta cyclical plays (Korea, Taiwan), its 'Chindia' play (China, India) as some investors call it which represents the urbanization theme, economic development and rising incomes. All of these investment buckets represent such vastly different market drivers that differentiating between them when investing is a no-brainer.

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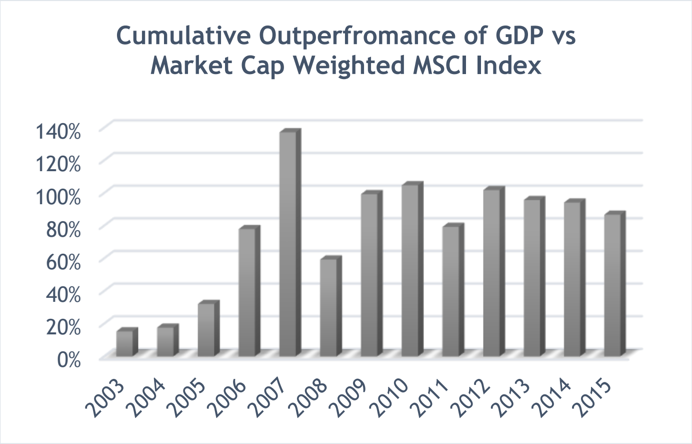
The bottom up approach to investing is certainly easier to grasp and less complicated as you are evaluating single businesses and the idea of appointing a locally-based manager with local knowledge makes sense. The top down, on the other hand, appears more complex given the number of moving parts; however, simple adjustments can already go a long way.

Most investors tend to default to a market-cap weighted approach when considering their top down allocation despite the well-known drawbacks of doing so. In the emerging markets the limitations of this approach are even more pronounced due to the significant divergence between the size of the market and the size of the economy. A large number of emerging markets still only represent less than 50% of their economy which is a reflection of the relative maturity (or immaturity) of each market and most importantly shows the future growth potential of that market. As an investor, you certainly want to be exposed to that future growth and definitely not constrained by unnecessary market-cap restrictions. These markets will also benefit as they open up, bringing with them a more diversified investor base and eventually lower volatility.

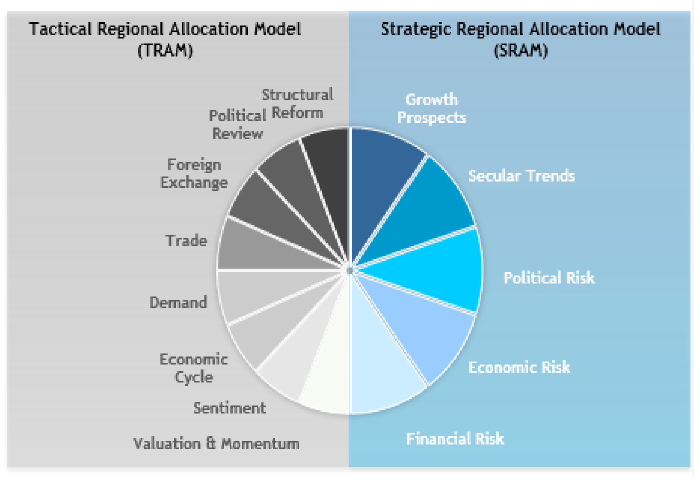
COUNTRY	MARKET CAP TO GDP
Hungary	17%
United Arab Emirates	18%
Egypt, Arab Rep.	22%
Poland	36%
Turkey	39%
Indonesia	43%
Russian Federation	43%
China	44%
Mexico	44%
Peru	50%
Saudi Arabia	51%
Brazil	51%
Qatar	67%
India	69%
Colombia	71%
Korea, Rep.	97%
Thailand	105%
Philippines	106%
Chile	118%
South Africa	154%
Malaysia	156%

In fact, over the last decade, if an investor had followed a GDP-weighted approach to their top down allocation they would have significantly outperformed a market-weighted approach. This is not surprising given a GDP weighting is more of an active bet on the country and currency factors which matter for stock market returns. This is just one example of using a top down factor, but it goes to show that even published GDP numbers can act as a better guide.



Besides growth, Milltrust extends its analysis to looking at demographic trends, political and financial risk, structural changes, as well as a country's sensitivity to global macro risks. The geographical allocation models are built using a quantitative framework and z-scoring system to identify which economies are the more favourable for investment given the current environment.

Milltrust Geogrpahical Allocation Models



How much does this top down' stuff matter? Well, our own analysis and portfolio performance has shown that approximately 40% of the alpha can be attributed to top down factors. This is consistent with other industry studies.

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The GEMS multi-manager portfolio is managed by the Milltrust Investment Solutions team led by Eric Anderson and Alex Kalis.