



2009 YEAR END NOTE

*Emerging Markets*

Emerging markets are maturing and the investment community is taking notice. During the last decade, several emerging markets actually emerged, generally becoming more stable, attractive places for investment. Despite the Latin American defaults early in the decade and the sharp declines caused by the credit crunch, emerging markets earned higher returns than any other major equity asset class. Earning these returns required a long term commitment and a willingness to accept additional volatility. Table 1 below shows how investors were well rewarded.

TABLE 1: ANNUALIZED PERFORMANCE TO 12/31/09

	S&P 500 Index	MSCI EM Index	MSCI EAFE Index
3 year	-5.61	5.42	-5.57
5 year	0.42	15.88	4.02
10 year	-0.95	10.11	1.58

Source: Bloomberg, MSCI Barra

Institutional investors are making increasingly larger allocations to the asset class. They also appear to be taking a greater interest in factors such as value/growth distinctions and market capitalization. Managers are now being hired and combined based on these considerations, a common practice when allocating to developed markets, but only desirable (or even possible) with larger allocations to the asset class.

Last year provides a stark example of divergent sources of return in what is normally a relatively homogenous asset class. Small capitalization stocks outperformed the benchmark by 3,500 basis points. Prior to 2009, the largest outperformance was 480 basis points in 2002. The magnitude of this outperformance is unprecedented. Korea was the only major market where larger stocks outperformed smaller ones (by 750 basis points).

What is more surprising is that some major countries where overall market returns lagged the index had among the best performing small cap stocks. China is the most notable. While the Chinese country index underperformed the broad emerging markets index, Chinese small caps outperformed the small cap stock index. The same occurred in Taiwan, Israel and the Philippines.

Table 2 below highlights some of the discrepancies between larger and smaller caps in emerging markets as a whole and also within certain countries.

TABLE 2: MSCI INDICES PERFORMANCE FOR 2009

	MSCI Standard Index	MSCI Small Cap Index
Emerging Markets	79.02	114.32
Brazil	128.62	249.96
China	62.63	150.56
India	102.81	125.95
Korea	72.06	64.53
Russia	104.91	245.30
Taiwan	80.25	132.24
Turkey	98.49	176.97

Source: MSCI Barra, Indices in USD % Change

The pronounced small capitalization effect in emerging markets holds both promise and frustration for emerging markets investors. Frustration may occur as many of these opportunities take place in stocks often removed from consideration due to liquidity concerns. It is highly unlikely that the eye-popping returns achieved by unmanaged indices were truly available. This frustration is likely to be most palpable to investors who focus on American Depositary Receipts (ADRs), which typically represent only the largest and most liquid shares.

Of the largest 50 stocks in emerging markets at the beginning of 2009, more than half (27) underperformed the index, many of them by a significant amount. The major Chinese energy companies all had relatively poor performance, and China Mobile, the largest stock on the Shanghai exchange, had its price decline. Major phone companies in Mexico and Korea also were in the red during the year.

This information provides a roadmap for 2010. Value still exists in emerging markets, even

after last year's 79% increase. It is located in some of the largest, most liquid and easily accessible companies in the market. As the global economy continues to recover, emerging markets are not only among the prime beneficiaries, they are the primary cause. Larger and more liquid markets appear poised for greater success as these stocks are where investors are likely to focus with increased allocations to the asset class. ♦

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PAGE 2

### DEFINITIONS:

The MSCI Emerging Markets (EM) Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of June 2009 the MSCI Emerging Markets Index consisted of the following 22 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. As of June 2007 the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

S&P 500 is widely regarded as the best single gauge of the US equities market, this world-renowned index includes 500 leading companies in leading industries of the US economy. S&P 500 is a core component of the US indices that could be used as building blocks for portfolio construction. It is also the US component of S&P Global 1200.

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