BNY MELLON
ASSET MANAGEMENT

A Case for Emerging Small Cap

By

Carolyn M. Kedersha, CFA, CPA
Managing Director
Senior Portfolio Manager

Introduction

The staggering growth of emerging market economies has led to a new dynamic in global consumerism. Increasing wealth and modernization across these markets is creating a new global middle class, which will likely become tomorrow's most important consumer base. Favorable long-term demographics, low product-penetration levels, and greater purchasing power all point to current and future growth in domestic demand. While emerging market equities are able to capture much of this economic expansion, traditional indices have a bias toward the natural resources sector and global exporters. In order to access this new middle class, investors must look beyond the more popular emerging market indices or global multinational corporations and consider smaller, more domestic-driven companies. Emerging markets small cap equity provides another option for investors looking to capitalize on the promising trends derived from a new consumer population.

The Boston Company
Asset Management, LLC

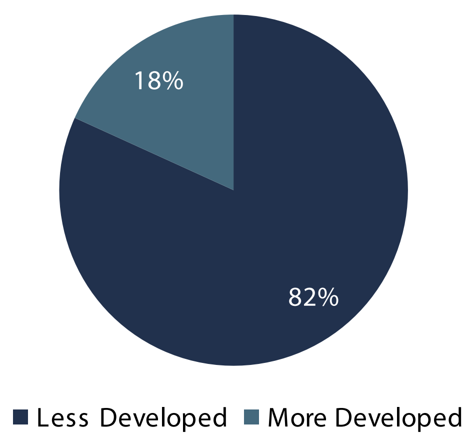
November 2009

Demographics support long term secular growth

Large industrialized markets do not fully reflect the long-term potential of global demand. Emerging markets are at the forefront of worldwide growth, with over 80% of the world's population advancing towards income parity with the developed world. This unprecedented phenomenon provides fertile ground to tap current and future consumer demand. (Please see Exhibits 1, 2 and 3.)

Exhibit 1

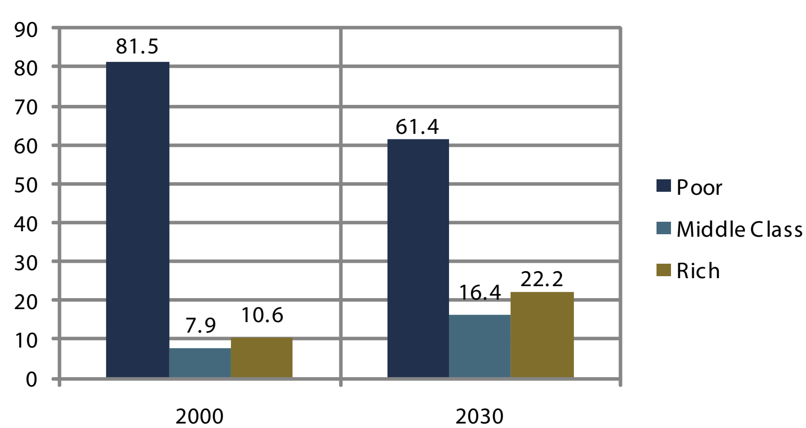
Percentage of Global Population (2008)



Source: US Census Bureau.

Exhibit 2

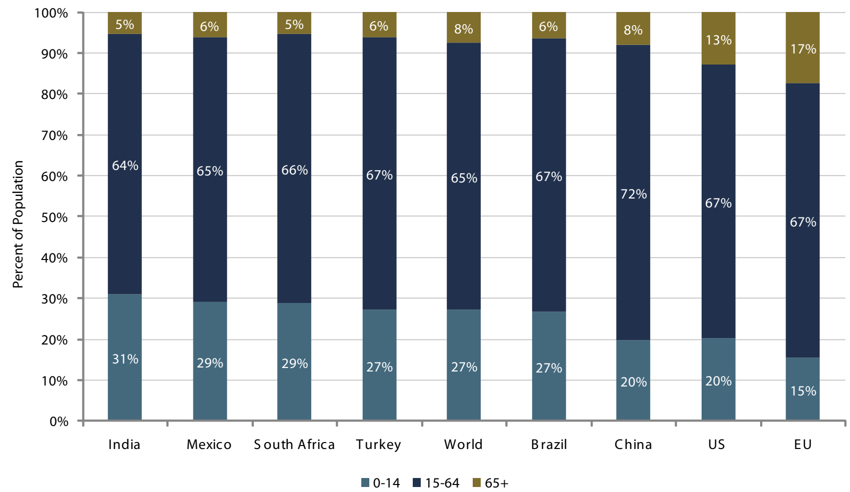
Composition of Global Population (%)



Source: World Bank

Exhibit 3

Population Distribution by Age

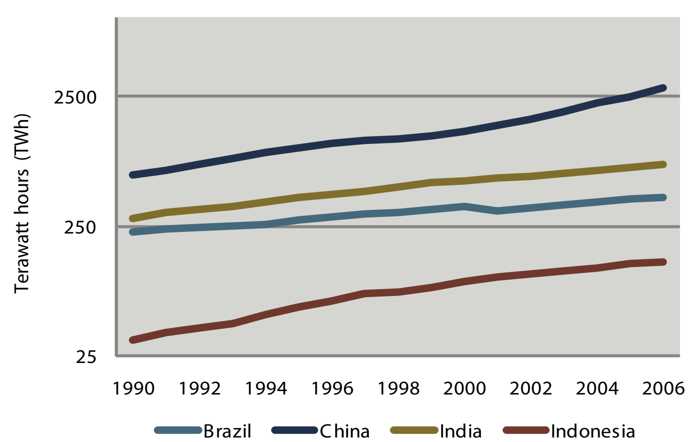


Source: CIA World Factbook

Several emerging economies have been investing in capital at a higher rate than many industrialized nations. While the investment rate (the rate of gross capital formation as a percent of GDP) of developed OECD member nations has remained somewhat stagnant for the past decade, those of China, India, and other developing economies have been trending upward and many have already exceeded the rates of the OECD members. This high rate of capital investment has begun to expedite modernization, from increased electricity generation to greater telephone access. These countries are likely to see a commensurate rise in key elements of a developed economy: a solid middle class and consumer-driven expansion. (Please see Exhibits 4 and 5.)

Exhibit 4

Electricty Generation



Electricity generation growth is particularly high in China and India, with both countries expected to out-produce some of the largest developed economies by 2015. (India is expected to out-produce Japan, and China to out-produce the US.)

Source: OECD Factbook 2009

No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.

Exhibit 5

China: Lifestyle Indicators

	2005	2006	2007	2008	2009
Consumer expenditure on food (US$ million)	300,842	347,723	409,841	522,871	552,607
Internet users ('000)	111,847	138,982	212,581	298,000	375,253
New registrations of passenger cars ('000)	3,971	5,176	5,451	5,699	
Consumer electronics (RMB million)	188,535	202,470	213,832	238,159	
Dog and cat food (RMB million)	1,797	2,007	2,223	2,452	2,687
Cosmetics and toiletries (RMB million)	75,323	82,762	90,125	97,573	105,097
Soft drinks (RMB million)	160,051	175,642	189,904	205,032	215,352

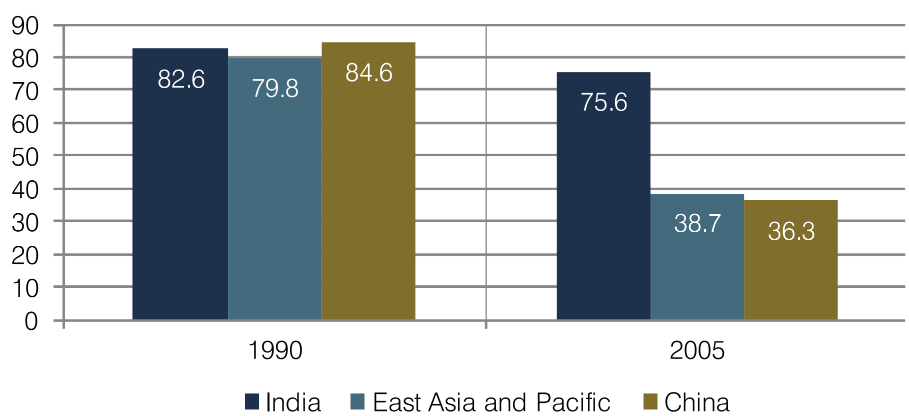
Source: World Income Distribution, Who Buys What, World Consumer Spending, World Consumer Lifestyles Databook.

In fact, many companies around the world are already generating a sizeable proportion of organic revenue growth from emerging markets. From auto companies to agricultural exporters, the world sees emerging markets as essential to future growth and success.

The demographics of these regions point to long-term consumption growth. Over the 15 years between 1990 and 2005, the poverty rates of developing countries (by developing country standards) dropped by 18.4%. (For an individual country and region breakdown, please see Exhibit 6.) At some point, emerging markets will be on par with the world's consumption powerhouses. China's middle class rose from 65.5 million in 2005 to 80 million in 2007, and Euromonitor estimates that number could rise to as much as 700 million by 2020. In addition, economic reform has created a surprisingly upwardly mobile middle class in India, a country with better age support than China. By 2025, India will surpass Germany as the world's fifth largest consumer market with a middle class surpassing half a billion people, ten times higher than today's figure. At the same time, average household income is also expected to triple.

Exhibit 6

Percentage of Population "Poor" by Developing Country Standards



Source: World Bank

In Latin America, Brazil has recovered from a sluggish period of high inflation and falling household income to show remarkably stable economic growth accompanied by the emergence of a strong middle class. A populist president has provided support for low earners, and Brazil's consumer market should rise exponentially over the next decade on an absolute basis, far outpacing its neighbors'. These trends will likely continue well into the future. World Bank forecasts suggest that the global middle and upper classes will have doubled in population between 2000 and 2030.

Access to Emerging Markets through Multinationals Falls Short

Since the demographics and economic trends suggest promising future growth in emerging markets, how can investors capitalize on this opportunity? Mainstream and conventional wisdom would propose a higher investment in multinational corporations; however, this is not a direct route to the benefits of a rising global middle class.

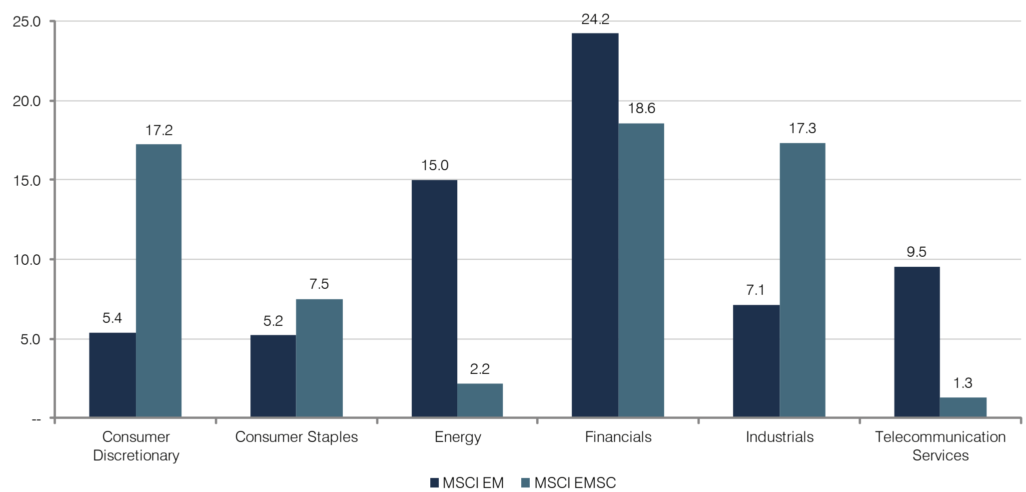
Although multinational corporations have an extensive worldwide presence, their penetration in emerging markets does not fully capture the consumption trends in these countries. For example, Procter & Gamble, one of the world's largest consumer staples companies, derived only 30% of their fiscal 2008 sales from developing markets. Local companies are often more sensitive to culture, consumer tastes, and shopping behavior. They often compete admirably with more well known global competitors. The formation of a new middle class within these markets will boost demand for food, clothing, education, and other basic goods and services. We believe the most effective way to participate in this burgeoning opportunity is through a diversified portfolio, which includes a portion of emerging markets small cap equity.

Emerging Markets Small Cap versus Traditional Emerging Markets

The MSCI Emerging Markets Small Cap Index serves as a complement to the MSCI Emerging Markets Index in several ways. First of all, MSCI EMSC provides additional exposure to the Asia/Pacific region, which coincides with positive demographic and higher GDP growth trends in areas such as India and China. EMSC is also geared toward consumption growth through its heavier concentration in demand-driven sectors such as consumer discretionary, consumer staples, and industrials. (Please see Exhibits 7, 8 and 9.)

Exhibit 7

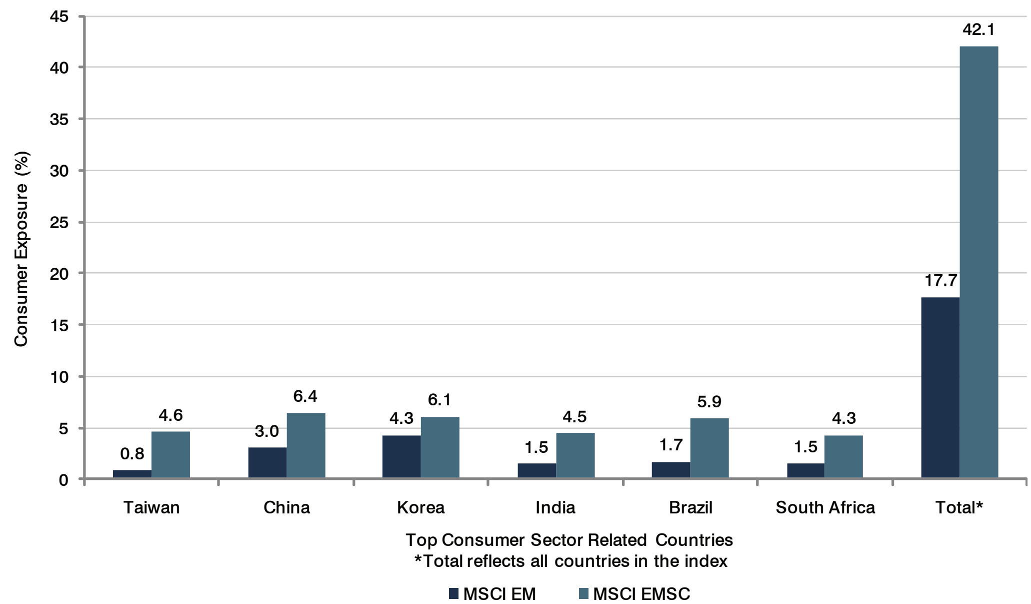
Select Sector Exposure August 31, 2009



Source: FactSet

Exhibit 8

Consumer Exposure: Consumer Discretionary + Consumer Stables + Industrials August 31, 2009

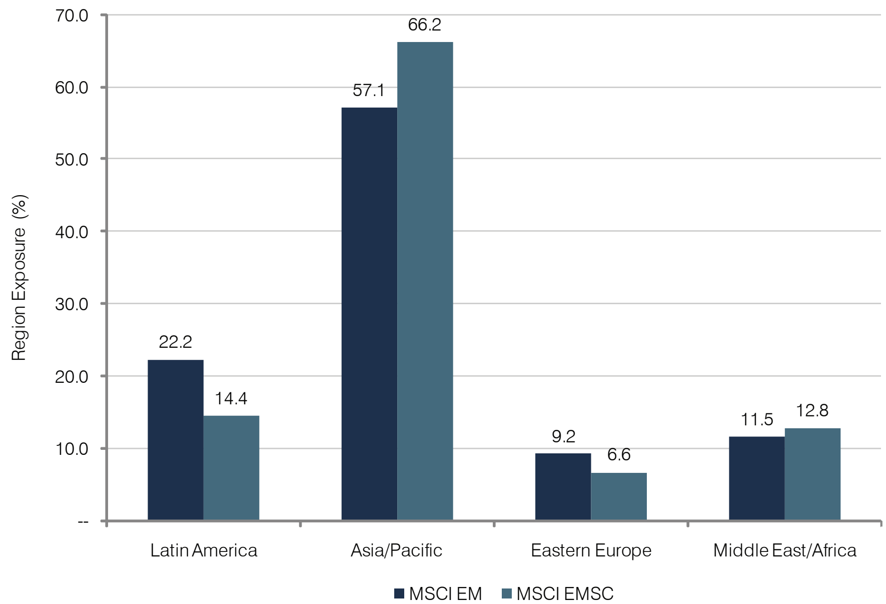


Source: FactSet

No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.

Exhibit 9

Regional Exposure, August 31, 2009



China (15.6%), India (11.2%) and Brazil (8.3%), along with Taiwan (18.9%), constitute 54% of the EMSC benchmark. Korea 14.1% and Russia a surprising 0.9% due to its economy's strong focus on energy and other natural resources.

Source: FactSet

Unlike in the MSCI EM Index, there is noticeably less exposure in MSCI EMSC to the commodities complex and export-driven companies. In fact, of the top thirty stocks in the MSCI EM Index by weight, there are no companies within the Consumer Discretionary or Consumer Staples sectors. At the same time, over one-third of the top 30 companies in the MSCI EMSC Index are composed of Consumer Discretionary or Consumer Staples stocks. (Please see Exhibit 10 for a comparison of the top 20 stocks in each index.) Furthermore, the opportunity set in the MSCI EMSC universe, which is composed of over 1,700 securities, is far greater than MSCI EM, which consists of less than half of the former, with 744 securities. In addition, many large cap emerging market bellwethers that populate the MSCI EM Index are more efficiently priced than smaller cap issues. Thus, the potential to deliver alpha through stock selection is somewhat greater in emerging markets small cap.

Exhibit 10

MSCI Emerging Markets - Top 20 Stocks by Weight September 30, 2009

Security Name	Sector	Country	Weight
Petrobras Petroleo Brasileiro	Energy	Brazil	3.9
Samsung Electronics	Information Technology	Korea	2.6
Cia Vale do Rio Doce	Materials	Brazil	2.6
China Mobile	Telecommunication Services	Hong Kong	2.0
Gazprom	Energy	Russia	1.9
Taiwan Semiconductor Manufacturing	Information Technology	Taiwan	1.7
Teva Pharmaceutical Industries	Health Care	Israel	1.5
Itau Unibanco Banco Multiplo	Financials	Brazil	1.4
America Movil	Telecommunication Services	Mexico	1.4
China Construction Bank	Financials	China	1.2
Industrial & Commercial Bank of China	Financials	China	1.2
China Life Insurance	Financials	China	1.1
Hon Hai Precision Industry	Information Technology	Taiwan	1.1
Banco Bradesco	Financials	Brazil	1.0
Reliance Industries	Materials	India	1.0
Bank of China	Financials	China	1.0
POSCO	Materials	Korea	0.9
Lukoil Holdings	Energy	Russia	0.9
CNOOC	Energy	Hong Kong	0.8
PetroChina	Energy	China	0.8
			30.0

MSCI Emerging Markets Small Cap - Top 20 Stocks by Weight September 30, 2009

Security Name	Sector	Country	Weight
Lojas Renner	Consumer Discretionary	Brazil	0.5
Gafisa	Consumer Discretionary	Brazil	0.4
BR Malls Participacoes	Financials	Brazil	0.4
PDG Realty	Consumer Discretionary	Brazil	0.4
Spar Group	Consumer Staples	South Africa	0.4
Barloworld	Industrials	South Africa	0.4
Diagnosticos da America	Health Care	Brazil	0.3
Empresas ICA	Industrials	Mexico	0.3
Tongaat-Hulett	Consumer Staples	South Africa	0.3
LLX Logistica	Industrials	Brazil	0.3
Poly (Hong Kong) Investments	Industrials	Hong Kong	0.3
Corporacion Geo	Consumer Discretionary	Mexico	0.3
Sun International	Consumer Discretionary	South Africa	0.3
Duratex	Industrials	Brazil	0.3
Central European Media	Consumer Discretionary	Bermuda	0.3
Nampak	Materials	South Africa	0.3
Seoul Semiconductor	Information Technology	Korea	0.3
Adcock Ingram	Health Care	South Africa	0.3
Punj Lloyd	Industrials	India	0.3
Multiplan Empreendimentos	Financials	Brazil	0.3
			6.7

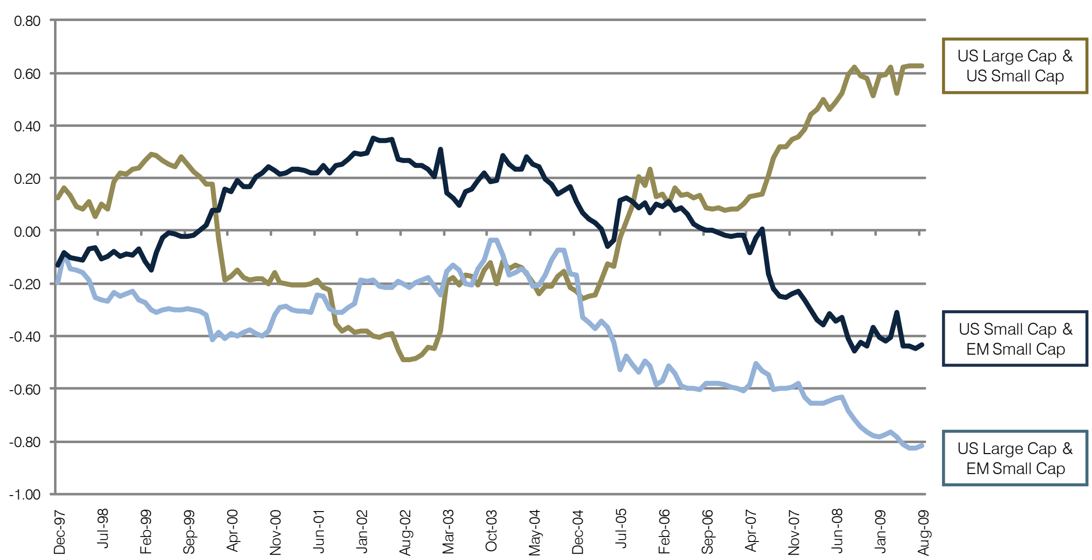
Source: FactSet

Diversification Benefits

Correlation analysis suggests that an investor who seeks to diversify US large cap exposure would benefit from investing in the emerging markets small cap asset class. Over the past few years, US Large Cap returns and US Small Cap returns have become more correlated. Conversely, the correlation between the excess returns of the MSCI EMSC Index and Russell 1000, as well as the MSCI EMSC Index and Russell 2000, have considerably weakened. As a result, the diversification benefits of emerging markets small cap may exceed those of US small cap in portfolios with a sizeable domestic allocation. (Please see Exhibit 11.)

Exhibit 11

Correlation of Excess Returns (against S&P/Citigroup Global BMI Index)



Source: Zephyr

Clearly geographic and currency exposure has a major influence on performance correlation. However, sector variation could also be causing this shift in asset class correlation. The following table (Exhibit 12) illustrates the difference between the Russell 1000 sector allocation when compared to both the Russell 2000 and MSCI EMSC. There is a much greater difference in the MSCI EMSC sector construction when measured against the Russell 1000.

Exhibit 12

Absolute Variation of Sector Weights, September 30, 2009

	Russell 1000 vs. Russell 2000	Russell 1000 vs. MSCI EMSC	MSCI EM vs. MSCI EMSC
Consumer Discretionary	3.9	7.6	12.2
Consumer Staples	7.4	3.2	2.3
Energy	6.4	9.6	13.4
Financials	4.5	3.0	6.1
Health Care	1.4	7.9	2.9
Industrials	5.4	7.1	10.8
Information Technology	0.9	3.4	1.3
Materials	0.5	9.2	1.1
Telecommunication Services	1.9	1.9	8.2
Utilities	0.7	0.9	0.5
Total Variation	32.9	53.9	58.7

Source: FactSet

Conclusion

With a burgeoning middle class, pent up consumer demand, and young population, emerging markets appear unmatched in their prospective return on investment. In our view, smaller local companies provide more focused exposure to structural developments in the emerging market consumer. However, the market segment is inefficient and prone to periods of volatility that require an active, stock-selection-based investment strategy. We believe this approach will navigate the ever-changing investment landscape and capture the promise of emerging markets' greater role as a global consumer.

Author Biography

Carolyn M. Kedersha, CFA, CPA

Managing Director

Carolyn serves as a Senior Portfolio Manager on The Boston Company's Non-US Value Equity Team where she conducts research on Latin American and emerging markets small cap companies.

Prior to joining The Boston Company, Carolyn worked for Kelso Management (an affiliate of Fidelity International). Previously, she was a consultant to the Center for International Financial Analysis and Research and spent several years as an Auditor with Price Waterhouse & Co.

Carolyn received a BA in Accounting from George Washington University and an MBA with a concentration in Finance from Rutgers University. She holds the Chartered Financial Analyst designation and is a Certified Public Accountant.

BNY Mellon Asset Management

The Alcentra Group
Ankura Capital Pty Limited
Blackfriars Asset Management Limited
BNY Mellon ARX
BNY Mellon Beta Management
BNY Mellon Cash Investment Strategies
The Boston Company Asset Management, LLC
The Dreyfus Corporation
EACM Advisors LLC
Hamon Investment Group
Mellon Capital Management Corporation
The Newton Group
Pareto Investment Management Limited
Standish Mellon Asset Management Company LLC
Urdang Capital Management, Inc.
Urdang Securities Management, Inc.
Walter Scott & Partners Limited
WestLB Mellon Asset Management

BNY MELLON
ASSET MANAGEMENT