Seeking Diversification Through Emerging Markets | July 2009

MSCI Barra RESEARCH INSIGHTS

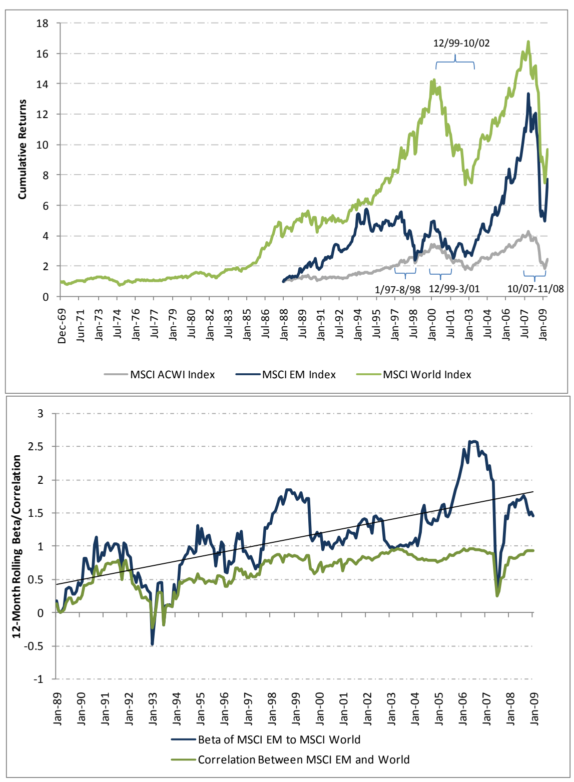
Introduction

The ongoing shakeout in global markets has had far-reaching consequences for equities across the world. For developed market investors seeking diversification through emerging markets at the aggregate level, the recent performance has been disappointing due to the dominance of overall negative market effects, which is consistent with what we have observed in past crises. The good news for developed market investors is that diversification possibilities did exist over the recent period for developed market investors willing to invest more granularly (for instance, in certain countries, regions, and styles), and able to at least partially hedge out market risk.

Seeking Diversification During the Recent Crisis

Both developed and emerging markets have been hit hard by the recent global crisis, with the latter squeezed by the global credit crunch and lower worldwide consumer demand for exports. Figure 1 shows the dramatic drop in the MSCI Emerging Markets (EM) Index in the last part of 2008, after a period of rapid gains in 2002-2007. Last year, both the MSCI World (reflecting developed markets) and MSCI EM Indices experienced their greatest annual loss since inception.

Figure 1: The MSCI World and MSCI EM Indices – Performance and Correlation



Past periods of market turmoil also witnessed drastic declines in emerging market stock price levels simultaneous with developed market crises. During the Internet tech collapse, for instance, the MSCI World and MSCI EM Indices plunged simultaneously. The high correlation between these indices during crises fits in with the overall rise in their correlations over the past two decades (Figure 2).

However, increasing betas have not completely spelled the death knell for diversification via emerging markets. We find substantial diversification possibilities for sub-groupings of emerging markets (i.e., those based on countries, regions, and styles) if investors were able to at least partially hedge out market risk.[1] In Figure 2, we first look at regions and countries. Figure 2 summarizes historical monthly correlations between the MSCI World Investable Market Index (IMI), which includes developed large, mid, and small caps, with regional MSCI Emerging Market Investable Market Indices.

Figure 2: Diversification for Developed Market Investors Has Been Limited at the Regional Level (Correlations with MSCI World, USD Returns)

	Historical (Jan 1997-Aug 2007)	Recent (Sept 2007-May 2009)
MSCI Emerging Markets IMI	0.78	0.95
MSCI EM Europe IMI	0.60	0.92
MSCI EM Asia IMI	0.66	0.93
MSCI EM Latin America IMI	0.74	0.91

Historically, emerging markets in Europe have provided the greatest amount of diversification for developed market investors. In the recent crisis, however, all regions experienced a prominent increase in correlations across the board.

Next we remove the aggregate Emerging Market component for each regional index in Figure 3 (by subtracting the return to the MSCI EM Index), and here the picture changes. MSCI EM Latin America IMI, in particular, has recently experienced negative correlation with the MSCI World Index net of the MSCI EM Index return.

Figure 3: But Diversification Has Been Available at the Regional Level Using Market Hedges (Correlations with MSCI World, USD Returns)

	Historical (Jan 1997-Aug 2007)	Recent (Sept 2007-May 2009)
MSCI EM Europe IMI	0.13	0.64
MSCI EM Asia IMI	-0.11	0.00
MSCI EM Latin America IMI	0.19	-0.10

Similarly, when we drill down to individual countries without removing the market return, we find some, albeit limited, opportunities for diversification using country indices. But again, more distinct opportunities show up when the market effect is removed. Countries including Korea, Malaysia, the Philippines, Israel, Morocco, and South Africa provided significant opportunities for diversification over the last 21 months (see Figure 5).

[1] Instruments required for hedging market risk may have incurred non-trivial costs, depending on the type used. In this simple example, a short position would have been taken in the MSCI EM Index, for instance through the use of an Exchange-Traded-Fund or futures contract. An alternative for situations in which these instruments may be hard to access or prohibitively costly is to substitute the short position in the MSCI EM Index with a beta-adjusted short-position in the MSCI World Index.

Figure 4: Some Diversification for Developed Market Investors Has Existed at the Country Level (Correlations with MSCI World, September 2007 – May 2009, USD Returns)[2]

Europe	Asia	Latin America	Middle East & Africa
Czech Rep. (0.88)	China (0.82)	Brazil (0.86)	Egypt (0.89)
Hungary (0.93)	India (0.87)	Chile (0.68)	Israel (0.77)
Poland (0.88)	Indonesia (0.87)	Colombia (0.88)	Morocco (0.37)
Russia (0.85)	Korea (0.87)	Mexico (0.92)	South Africa (0.92)
Turkey (0.82)	Malaysia (0.80)	Peru (0.76)	
	Philippines (0.74)		
	Taiwan (0.83)		
	Thailand (0.85)		

Figure 5: Diversification at the Country Level Has Been Available Using Market Hedges (Correlations with MSCI World, USD Returns)

Europe	Asia	Latin America	Middle East & Africa
Czech Rep. (0.13)	China (0.03)	Brazil (0.21)	Egypt (0.21)
Hungary (0.46)	India (0.63)	Chile (-0.55)	Israel (-0.68)
Poland (0.60)	Indonesia (0.24)	Colombia (-0.27)	Morocco (-0.83)
Russia (0.75)	Korea (-0.19)	Mexico (0.48)	South Africa (-0.23)
Turkey (-0.02)	Malaysia (-0.75)	Peru (0.10)	
	Philippines (-0.45)		
	Taiwan (0.39)		
	Thailand (0.40)		

We also look at style characteristics, such as size segments and value/growth indices during the recent period. For the Large Cap, Mid Cap, Small Cap, Value, and Growth versions of the MSCI Emerging Markets IMI, we observe the same high correlations as we did with the regional and country indices. However, if we instead look at the premium earned by these characteristics, by taking a long position in one index and a dollar-equivalent short position in another, the correlations are significantly lower. In Figure 6, we observe premiums to large cap stocks and value stocks that had correlations as low as -0.44 and -0.46. Figure 6 suggests that small-cap strategies in Asian emerging market countries and European emerging market Value strategies provided the most diversification during the observed period.

[2] Figure 4 includes correlations for four countries in the Middle East & Africa that are not included in Figure 3.

Figure 6: Diversification at the Country Level Has Been Available for Long-Short Style Groups (Correlations with MSCI World, September 2007 – May 2009, USD Returns)

	Large	Mid	Small	Growth	Value	Small Minus Large	Value Minus Growth
MSCI Emerging Markets IMI	0.95	0.95	0.93	0.93	0.96	0.36	0.00
MSCI EM Europe IMI	0.91	0.94	0.94	0.92	0.92	-0.03	-0.44
MSCI EM Asia IMI	0.93	0.92	0.91	0.91	0.94	-0.46	0.01
MSCI EM Latin America IMI	0.90	0.92	0.88	0.89	0.91	-0.23	0.13

In sum, although the market component has dominated most other effects during the recent crisis, simple combinations of long-short portfolios could have provided the diversification opportunities desired by investors. While our stylized examples assume full shorting of the MSCI EM Index, in reality there may have been shorting constraints that prevented investors from being able to fully hedge out market risk. Even partial hedges, however, would have reduced the correlations by a non-trivial amount, depending on the index in question.

Our discussion here segues into the broader issue of how to allocate assets in a risk-aware way. Institutional investors particularly concerned about correlations during crises may want to consider alternative approaches to asset allocation. For example, in the recent MSCI Barra Research Insight, Briand, Nielsen, and Stefek (2009) highlight the potential advantages of assessing portfolio allocation along risk premia dimensions instead of traditional asset classes. In a similar vein, our results suggest taking into account the commonalities among emerging market segments (particularly during crises) to better isolate any diversification opportunities. For instance, it may not be sufficient to hire five Emerging Market managers with broad global mandates, all benchmarked to the MSCI EM Index. Instead, smart manager selection might include choosing managers in different regions, countries, or segments (i.e., Value/Growth) benchmarked to universe-appropriate indexes. In times of market uncertainty, institutional investors may want to go one step further and hedge market risk, so that their performance is not dominated by the market component.

Conclusion

In times of crises, diversification opportunities can be limited due to overall markets effects. In the most recent crisis, correlations between stocks of varying cap size, value/growth characteristics, and across all regions and industries have been quite high, if not close to one. Investors seeking diversification opportunities would have benefited from being able to at least partially hedge out market exposure and invest more granularly in regions, countries, and style groupings. With respect to the asset allocation decision, the results suggested allocations to sub-groupings, rather than to emerging markets as a whole.

References

Briand, Remy, Frank Nielsen, and Dan Stefek (2009), “Risk Premia,” MSCI Barra Research Insight, January 2009.

Contact Information

clientservice@mscibarra.com

Americas

Americas	1.888.588.4567 (toll free)
Atlanta	+ 1.404.551.3212
Boston	+ 1.617.532.0920
Chicago	+ 1.312.675.0545
Montreal	+ 1.514.847.7506
New York	+ 1.212.804.3901
San Francisco	+ 1.415.576.2323
Sao Paulo	+ 55.11.3706.1360
Stamford	+1.203.325.5630
Toronto	+ 1.416.628.1007

Europe, Middle East & Africa

Amsterdam	+ 31.20.462.1382
Cape Town	+ 27.21.673.0100
Frankfurt	+ 49.69.133.859.00
Geneva	+ 41.22.817.9777
London	+ 44.20.7618.2222
Madrid	+ 34.91.700.7275
Milan	+ 39.02.5849.0415
Paris	0800.91.59.17 (toll free)
Zurich	+ 41.44.220.9300

Asia Pacific

China Netcom	10800.852.1032 (toll free)
China Telecom	10800.152.1032 (toll free)
Hong Kong	+ 852.2844.9333
Singapore	+ 65.6834.6777
Sydney	+ 61.2.9033.9333
Tokyo	+ 81.3.5226.8222

www.mscibarra.com

Notice and Disclaimer

- This document and all of the information contained in it, including without limitation all text, data, graphs, charts (collectively, the "Information") is the property of MSCI Inc. ("MSCI"), Barra, Inc. ("Barra"), or their affiliates (including without limitation Financial Engineering Associates, Inc.) (alone or with one or more of them, "MSCI Barra"), or their direct or indirect suppliers or any third party involved in the making or compiling of the Information (collectively, the "MSCI Barra Parties"), as applicable, and is provided for informational purposes only. The Information may not be reproduced or redisseminated in whole or in part without prior written permission from MSCI or Barra, as applicable.
- The Information may not be used to verify or correct other data, to create indices, risk models or analytics, or in connection with issuing, offering, sponsoring, managing or marketing any securities, portfolios, financial products or other investment vehicles based on, linked to, tracking or otherwise derived from any MSCI or Barra product or data.
- Historical data and analysis should not be taken as an indication or guarantee of any future performance, analysis, forecast or prediction.
- None of the Information constitutes an offer to sell (or a solicitation of an offer to buy), or a promotion or recommendation of, any security, financial product or other investment vehicle or any trading strategy, and none of the MSCI Barra Parties endorses, approves or otherwise expresses any opinion regarding any issuer, securities, financial products or instruments or trading strategies. None of the Information, MSCI Barra indices, models or other products or services is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such.
- The user of the Information assumes the entire risk of any use it may make or permit to be made of the Information.
- NONE OF THE MSCI BARRA PARTIES MAKES ANY EXPRESS OR IMPLIED WARRANTIES OR REPRESENTATIONS WITH RESPECT TO THE INFORMATION (OR THE RESULTS TO BE OBTAINED BY THE USE THEREOF), AND TO THE MAXIMUM EXTENT PERMITTED BY LAW, MSCI AND BARRA, EACH ON THEIR BEHALF AND ON THE BEHALF OF EACH MSCI BARRA PARTY, HEREBY EXPRESSLY DISCLAIMS ALL IMPLIED WARRANTIES (INCLUDING, WITHOUT LIMITATION, ANY IMPLIED WARRANTIES OF ORIGINALITY, ACCURACY, TIMELINESS, NON-INFRINGEMENT, COMPLETENESS, MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE) WITH RESPECT TO ANY OF THE INFORMATION.
- Without limiting any of the foregoing and to the maximum extent permitted by law, in no event shall any of the MSCI Barra Parties have any liability regarding any of the Information for any direct, indirect, special, punitive, consequential (including lost profits) or any other damages even if notified of the possibility of such damages. The foregoing shall not exclude or limit any liability that may not by applicable law be excluded or limited, including without limitation (as applicable), any liability for death or personal injury to the extent that such injury results from the negligence or wilful default of itself, its servants, agents or sub-contractors.
- Any use of or access to products, services or information of MSCI or Barra or their subsidiaries requires a license from MSCI or Barra, or their subsidiaries, as applicable. MSCI, Barra, MSCI Barra, EAFE, Aegis, Cosmos, BarraOne, and all other MSCI and Barra product names are the trademarks, registered trademarks, or service marks of MSCI, Barra or their affiliates, in the United States and other jurisdictions. The Global Industry Classification Standard (GICS) was developed by and is the exclusive property of MSCI and Standard & Poor's. "Global Industry Classification Standard (GICS)" is a service mark of MSCI and Standard & Poor's.

About MSCI Barra

MSCI Barra is a leading provider of investment decision support tools to investment institutions worldwide. MSCI Barra products include indices and portfolio risk and performance analytics for use in managing equity, fixed income and multi-asset class portfolios.

The company's flagship products are the MSCI International Equity Indices, which include over 120,000 indices calculated daily across more than 70 countries, and the Barra risk models and portfolio analytics, which cover 56 equity and 46 fixed income markets. MSCI Barra is headquartered in New York, with research and commercial offices around the world.