Investing in Emerging Market equities – an Australian perspective

Presentation to PortfolioConstruction Conference

28 August 2008

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Agenda

A. Nature of emerging markets (Ems):

Why include them in your portfolio?

Geoff Warren - Director, Capital Markets Research

B. Implementation:

Getting the best out of your EM investment

Andrew Lill - Director, Investment Strategy

Part A: Nature of emerging markets

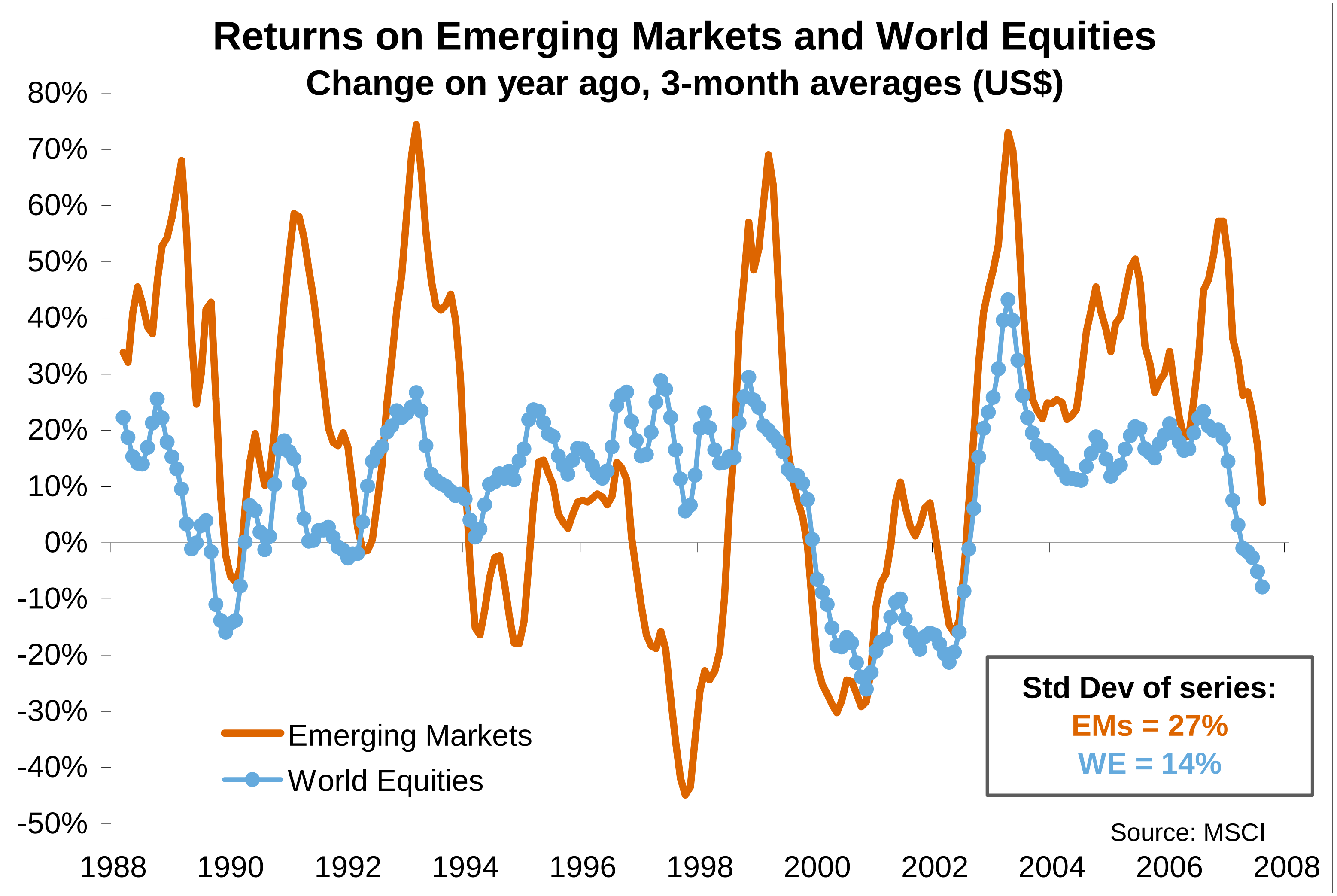
1. EMs are a high risk & potentially high expected return equity sub-class *(rather than as a diversifier)*

2. Risk in EMs has multiple dimensions

3. A$ seems to have similar drivers

4. High return potential – both ‘beta’ and ‘alpha’ components

Risk dimension #1: Volatility



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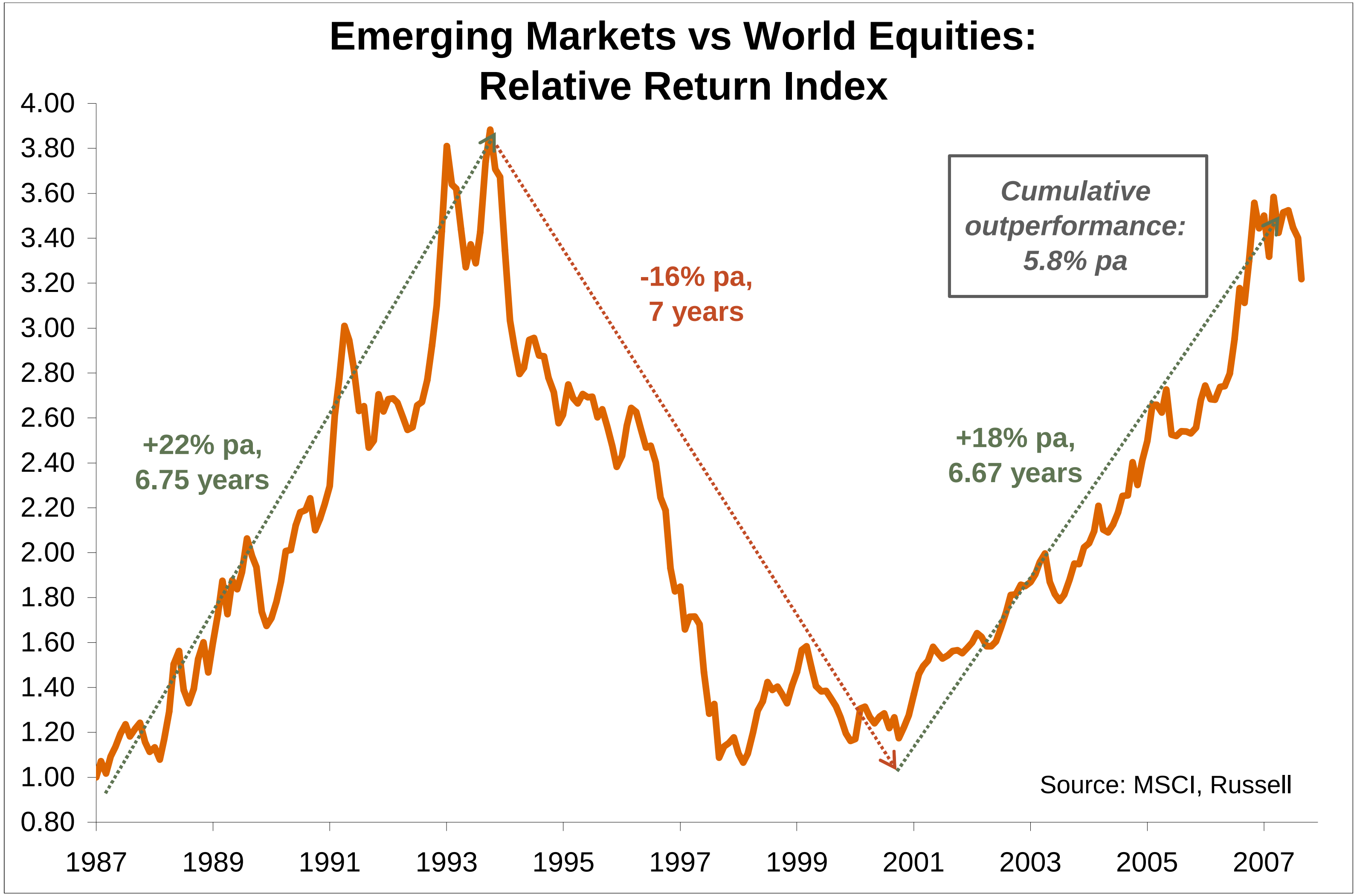
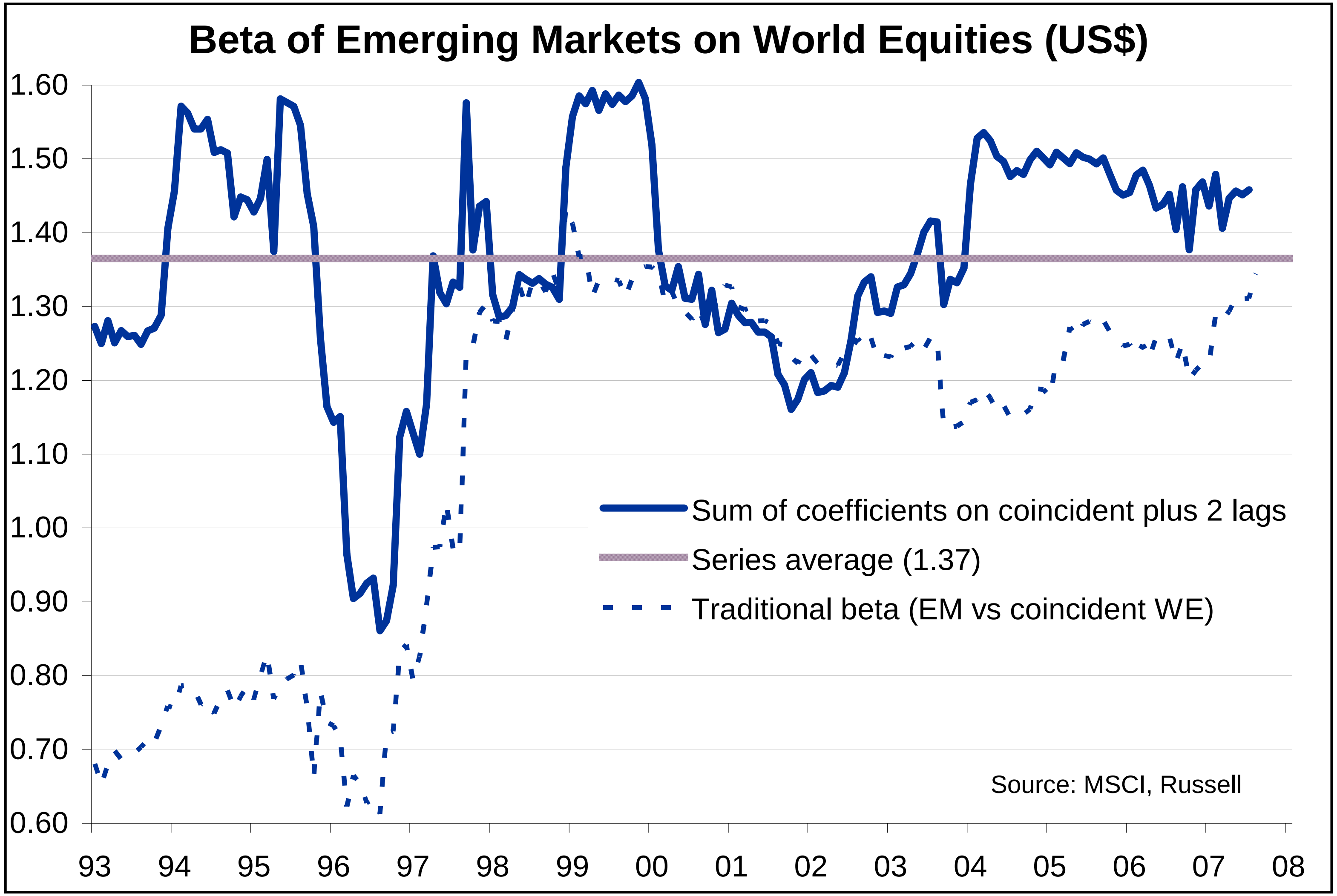
Risk dimension #2: Episodic performance



Risk dimension #3: High beta



Risk dimension #4: Cyclical tendencies

Sector Weightings: Emerging Markets vs World

MSCI Index as at Dec'07	Emerging Markets	World ex. Aust	Over(Under)
Materials and Processing	21%	9%	12%
Utilities	15%	9%	6%
Other Energy	8%	5%	3%
Integrated Oils	9%	7%	2%
Financial Services	21%	21%	0%
Autos and Transportation	3%	4%	-1%
Technology	8%	9%	-1%
Other	3%	4%	-1%
Producer Durables	4%	6%	-2%
Consumer Staples	3%	7%	-4%
Consumer Discret, Services	5%	10%	-5%
Health Care	2%	9%	-7%
	100%	100%	

Source: MSCI

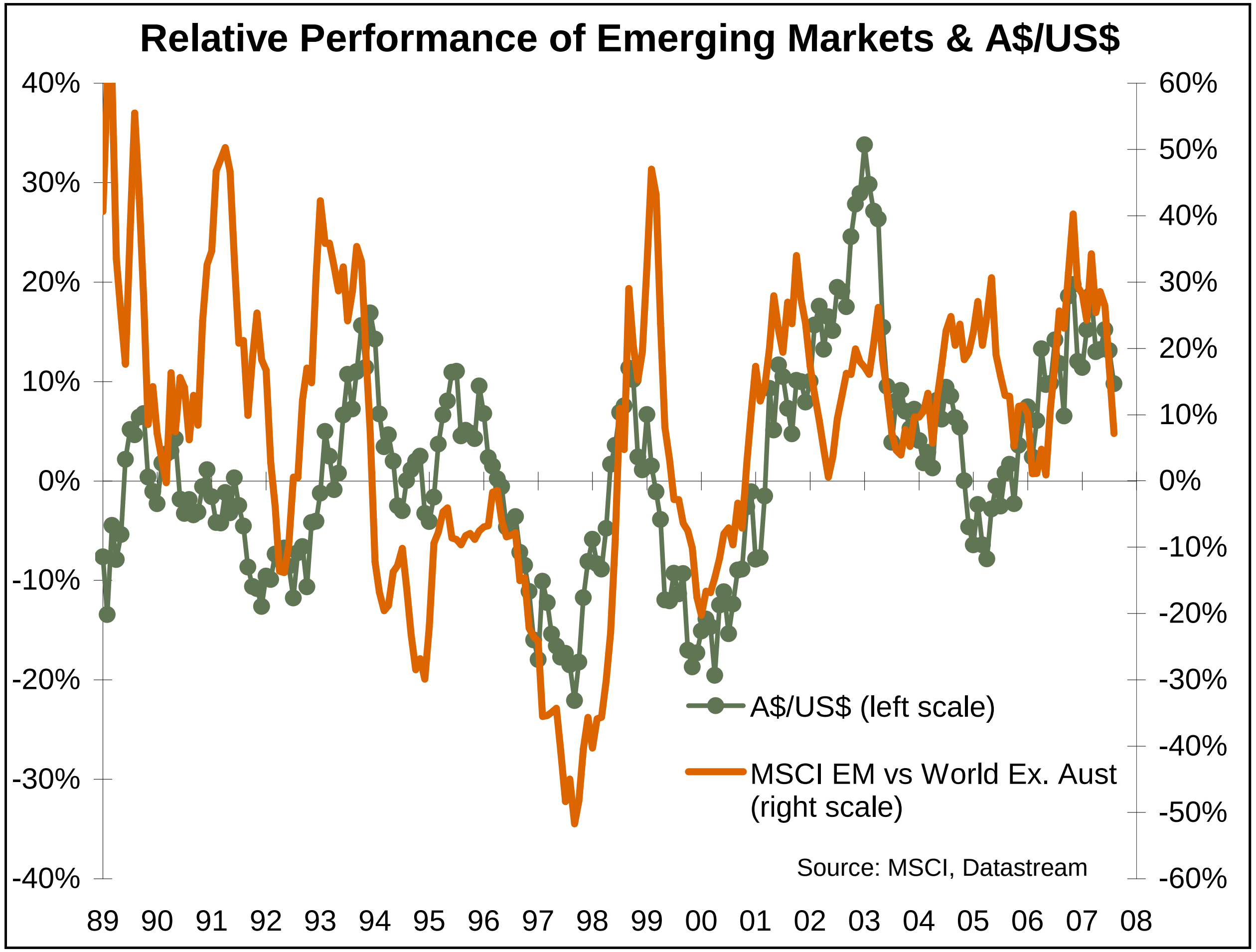
Risk dimensions #5 and #6: ‘Risk asset’ & A$ link

‘Risk assets’ tend to be sensitive to:

- Economy
- Liquidity conditions
- Investor risk aversion (or uncertainty)

Some notable examples:

- Small caps
- Credit
- Volatility trades (VIX)
- Emerging markets
- A$ and NZ$



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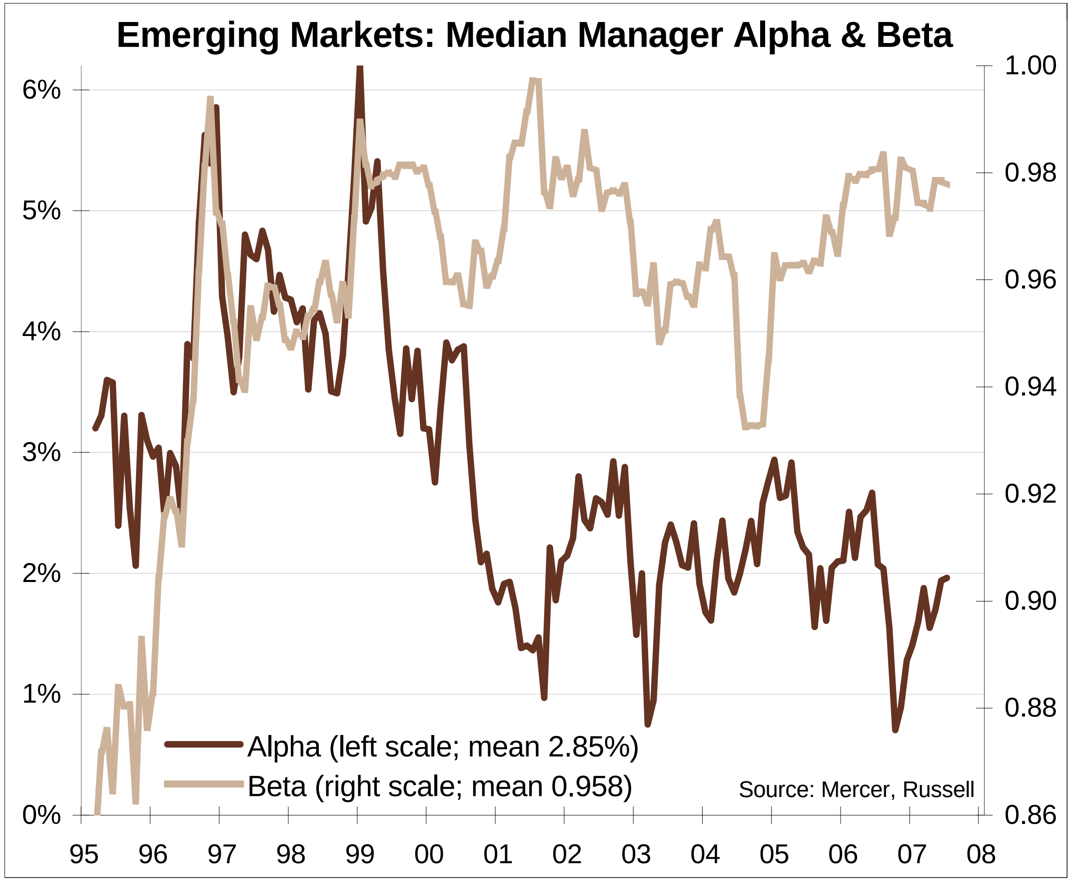
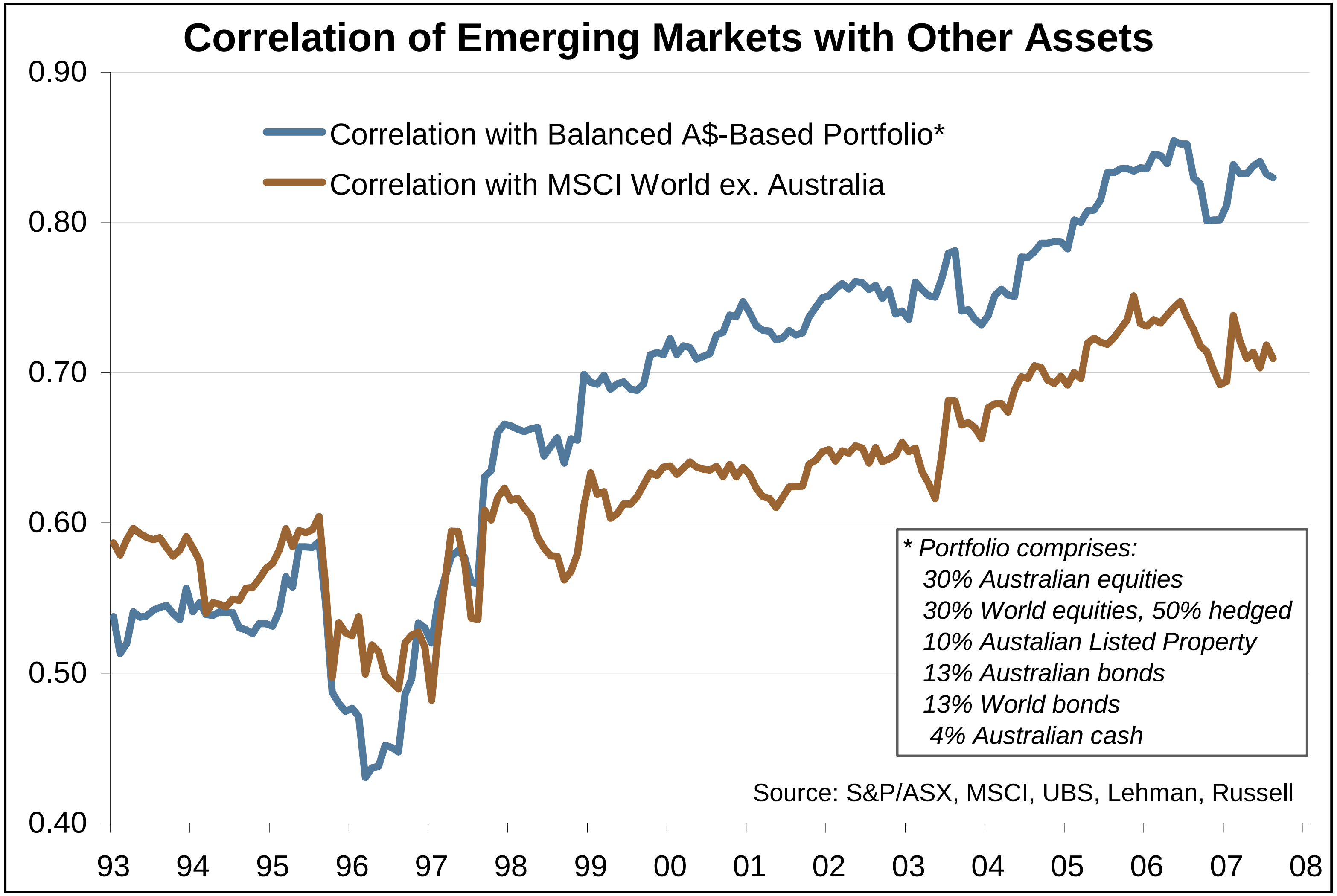
Return sources

1. Risk compensation
   - Equity beta
   - Illiquidity
   - Currency link enhances trade-off in A$

2. Returns from active strategies (*'alpha'*)
   - Relatively inefficient markets
   - Country selection
   - Active returns have been attractive at near 200bps (typical mgt fee ~120bps)

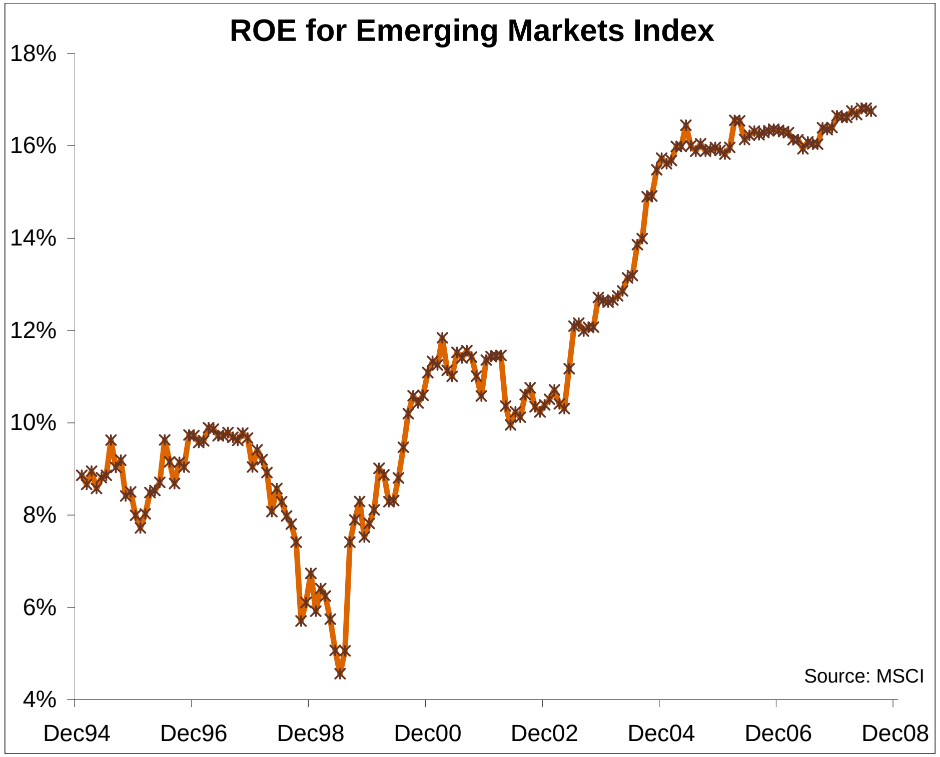


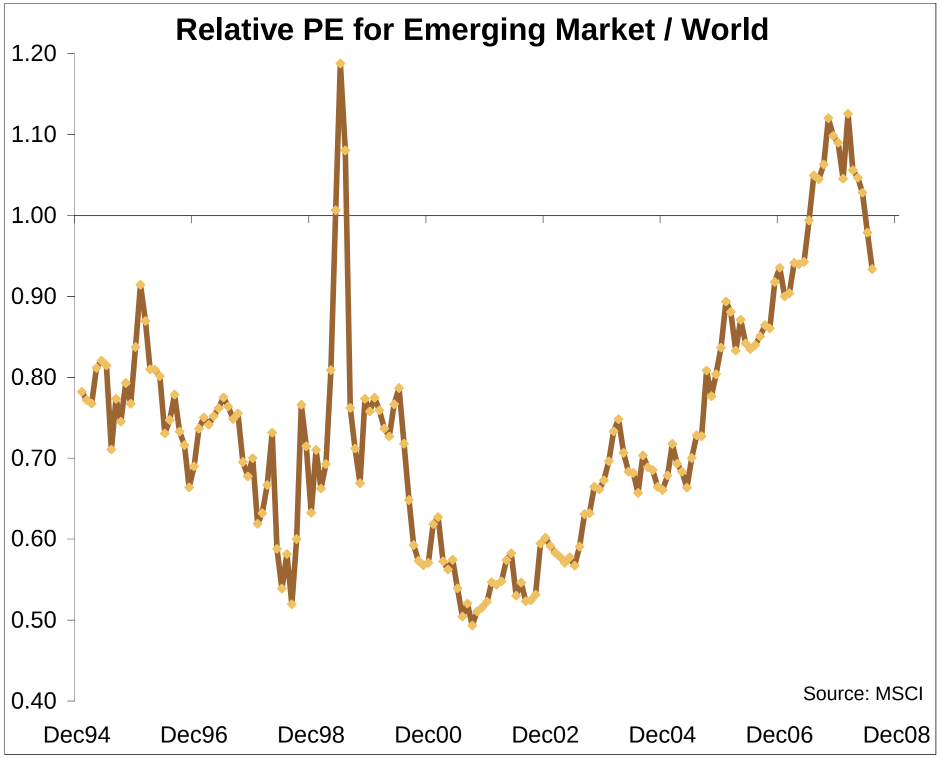
Limited diversification benefits



Current outlook: Some considerations

- Economic prospects, ‘decoupling’, etc
- Impact from structural reforms
- Valuations





Why include EMs in your portfolio?

Argument	Judgment	Comment
1a. Return premium 1b. Correlation with A$	Strong Strong	Compensation for 'global' risk Risk reduction mechanism for A$-based investors
2. Alpha capture	Strong	A) ~2%-3% median manager B) Low correlation vs other alpha
3. Diversification	Weak	Correlation is relatively high
4. Current outlook	Debatable	Cyclical? Structural? Value?

Part B: Implementation

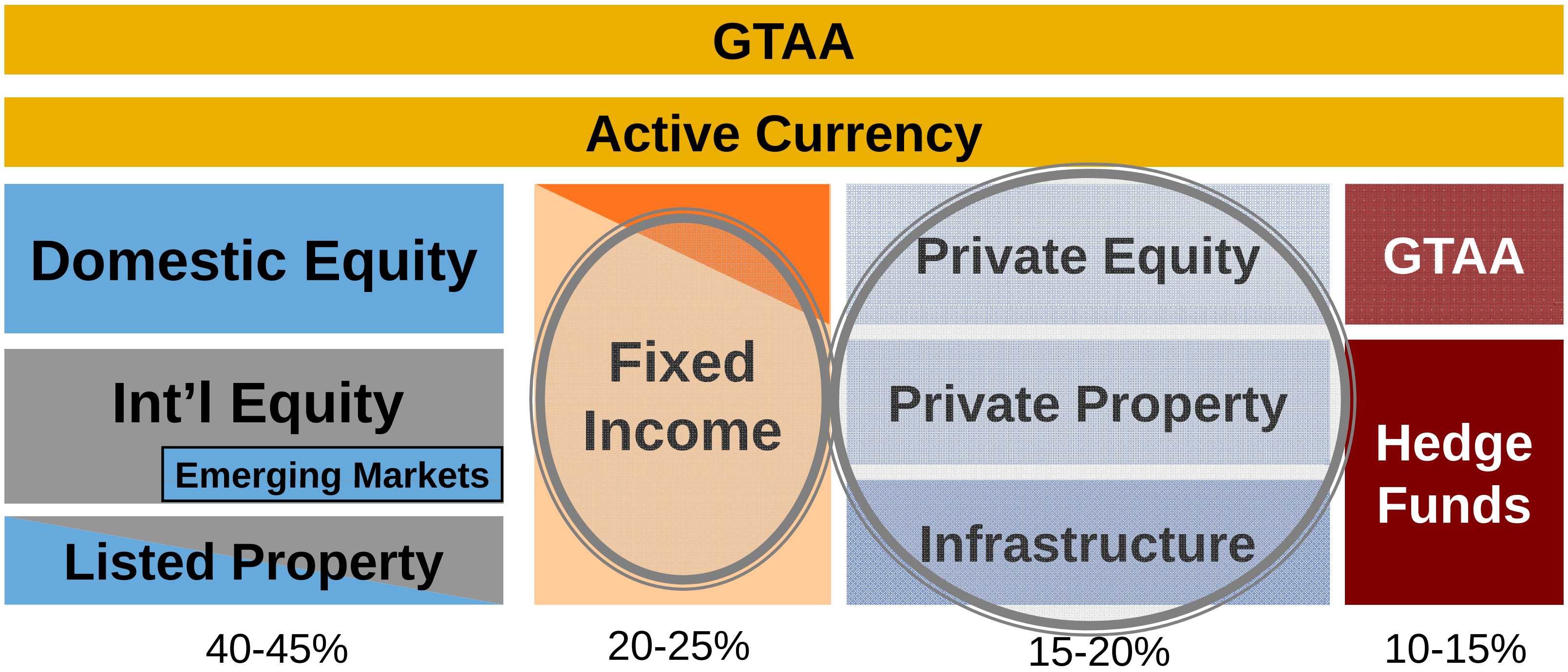
Issues:

1. **Setting the EM allocation**

2. **Structuring manager mandates**

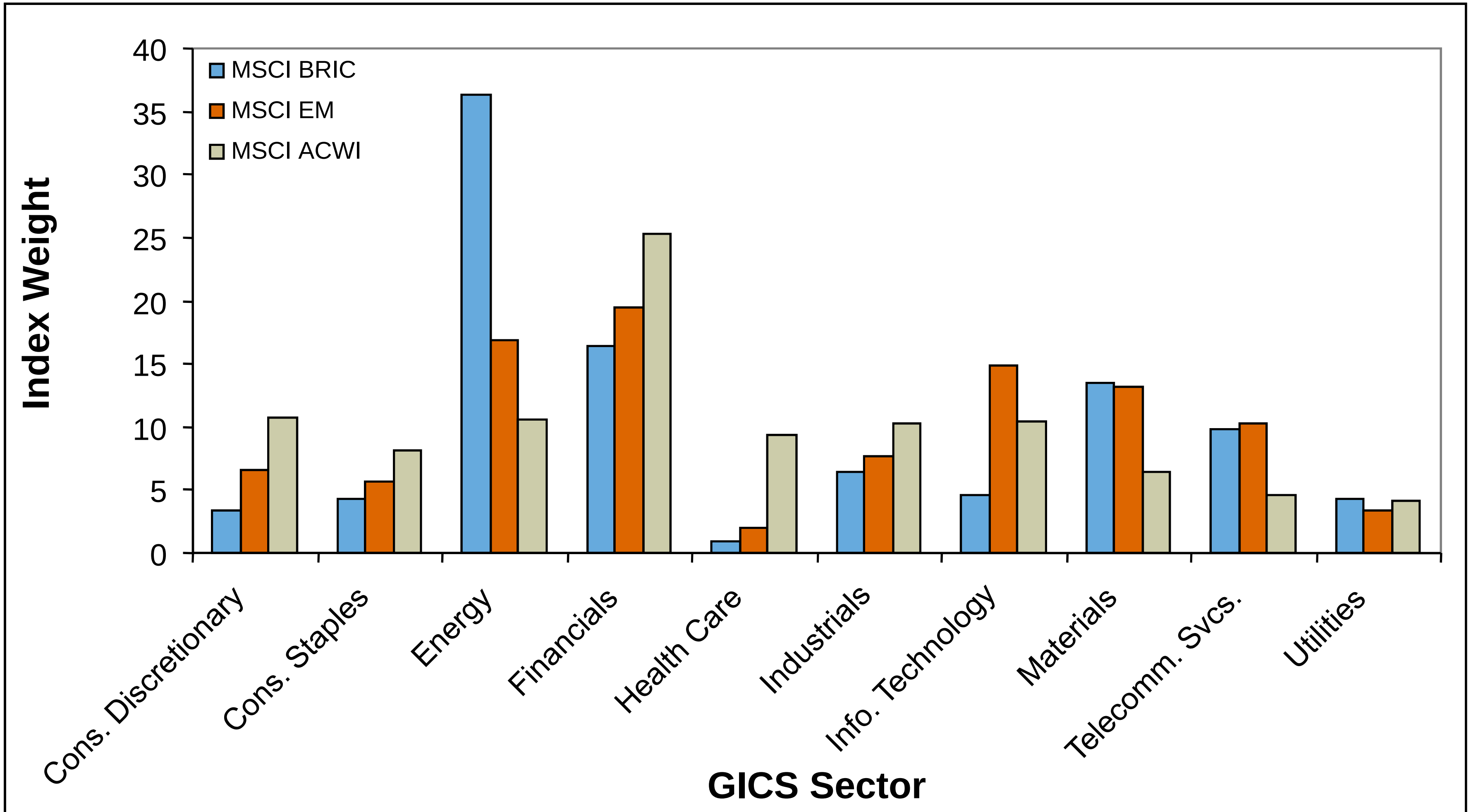
Q & A

Russell's model for thinking about portfolios



- MSCI benchmark includes only about 830 (or 5%) of the 15,000+ stocks listed on emerging markets stock exchanges
- Earnings of emerging market companies make up over 12% of world's total earnings

BRIC – a four country straight jacket



Note: MSCI ACWI refers to All Countries World Index

Exposure to a broad range of emerging markets…

Country Exposure			
Country	**Weight (%)**	**Country**	**Weight (%)**
Argentina	0.3	Malaysia	2.8
Brazil	14.5	Mexico	4.4
Chile	0.6	Pakistan	0.5
China	8.8	Peru	0.9
Colombia	0.3	Philippines	0.6
Czech Republic	0.7	Poland	0.7
Egypt	2.5	Russia	9.5
Hungary	0.4	South Africa	7.3
India	7.6	Taiwan	8.9
Indonesia	2.3	Thailand	2.3
Israel	2.9	Turkey	3.8
Korea	13.2	Others	3.9

* Russell's Emerging Markets Fund (Dec'07)

Implementation options

- Global manager with discretion to time entry/exit
  - Up to 15% of portfolio appropriate
  - Recent examples – mutton dressed as lamb
- Specialist manager(s)
  - Location of head office – fees
  - Asia ex. bias
- Multi-manager funds
- Don’t forget the new frontier!

Some key take aways

- **Approach emerging markets as a high risk equity investment that offers high returns *(rather than as a diversifier)***

- **Hold cap-weighted exposure in core portfolio, plus consider additional satellite investments for:**
  - **Times when the outlook is positive**
  - **More exotic exposures, e.g. frontier markets**

- **Implement using skilled, specialist managers**

Important Information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Let's start thinking about…

This session was:

1. awful
2. mediocre
3. good
4. excellent

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