



asset allocation
masterclass

[Asset Allocation Masterclass 2010]

The evolution of risk in emerging markets

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CONFERENCE

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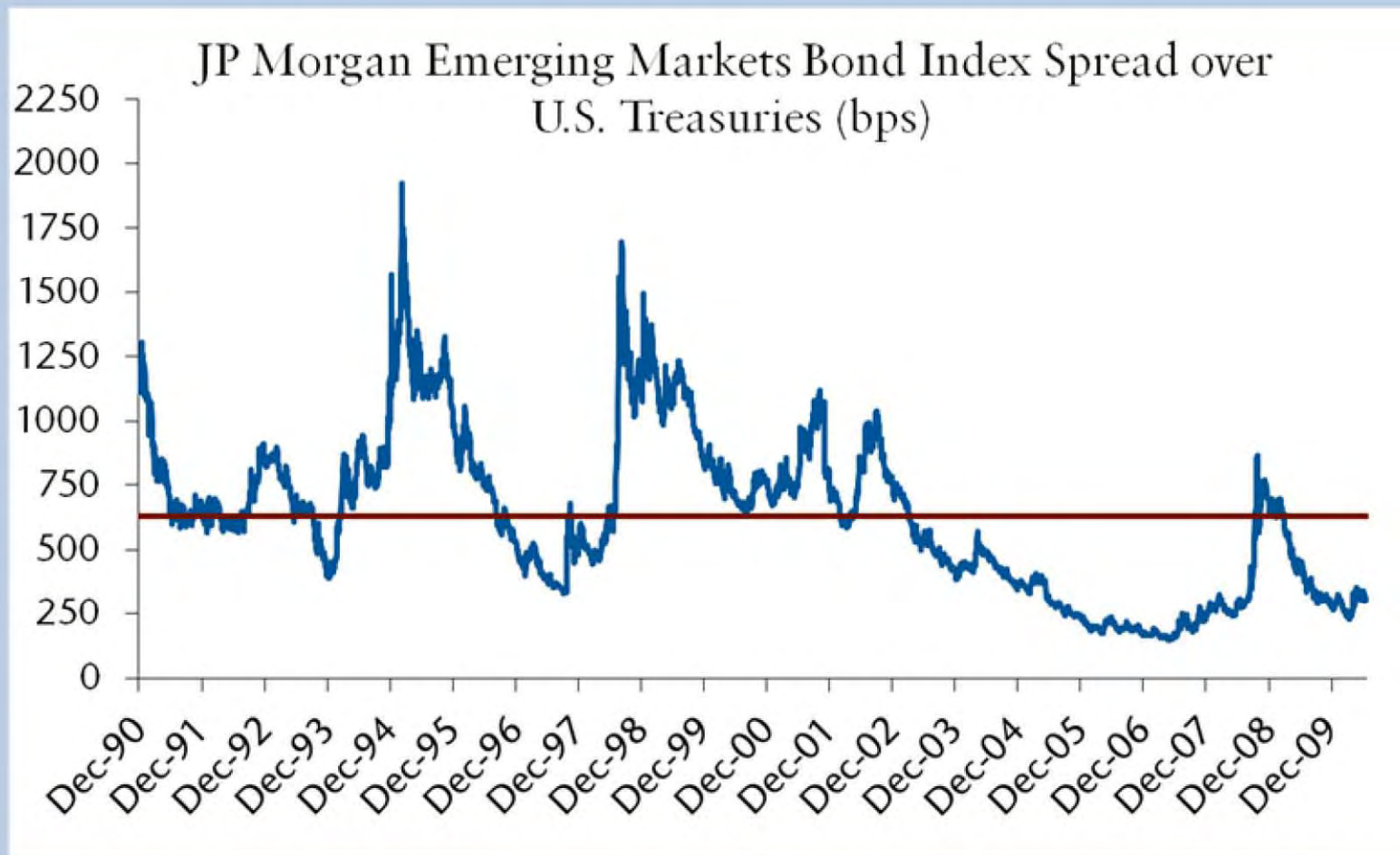
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Evolution of Emerging Markets Risks

- Country risk
 - Economic risk
 - Policy risk
 - Political risk
 - Foreign exchange risk
- Sector risk
- Industry risk
- Stock specific risk
- Style risk
- All of the above are risk factors, but also return factors.

- Risk controls should be designed to preserve the alpha generated by the investment process
- Minimize or eliminate unintended risks (region, country, sector, FX, beta)
- Take only the risks that you understand and are compensated for
- Risk exposure is a function of portfolio positioning *and* market volatility: the higher the volatility, the higher the risk exposure.
- Style risk became a key factor in 2008-2009 crisis

Country Risk – Dominant Factor in the 90s



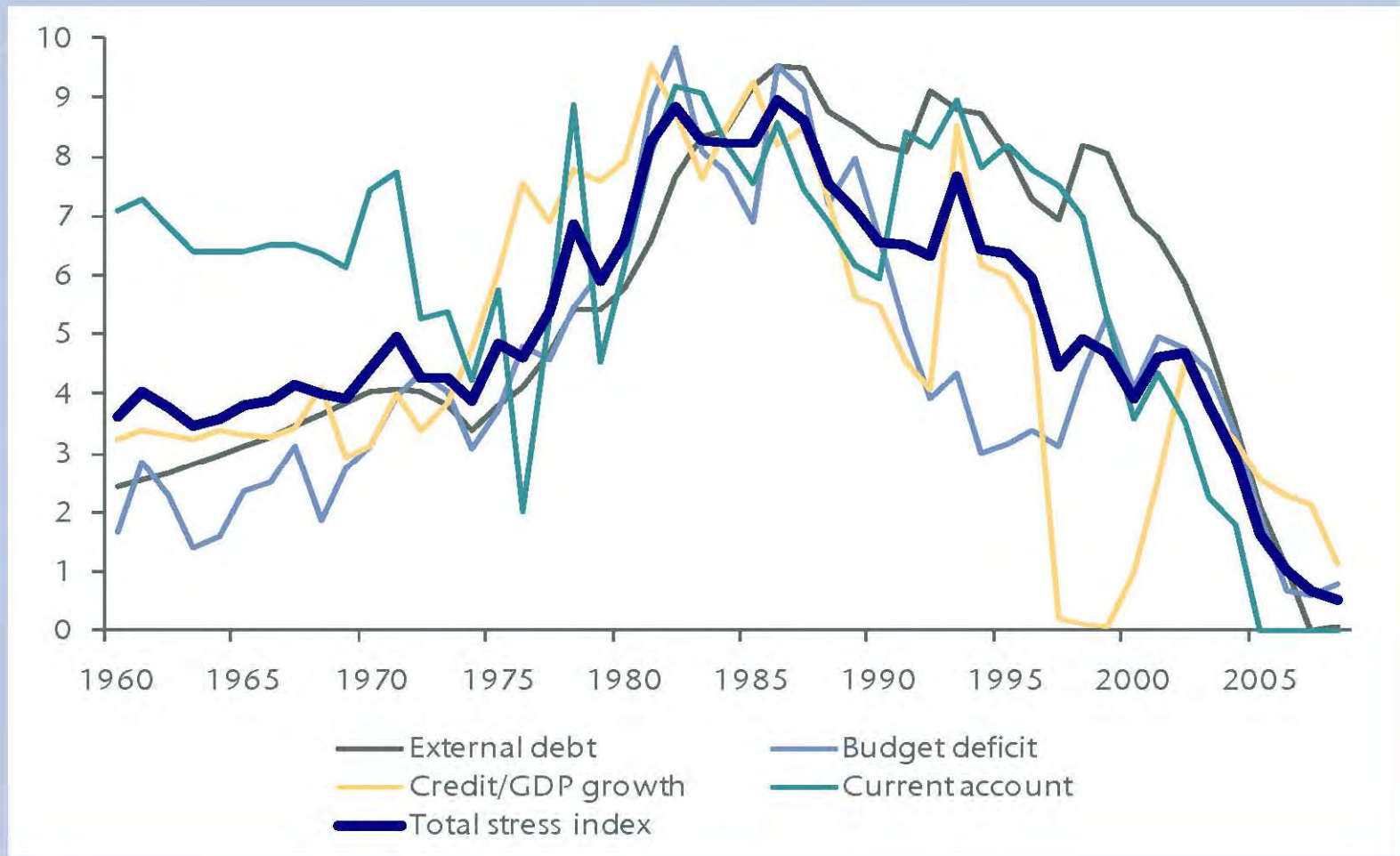
Risk premia in emerging markets have shifted down since the turn of the decade

Source: JP Morgan

Emerging Markets -Total Stress Index
(1960-2008, index level)

High Stress

Low Stress

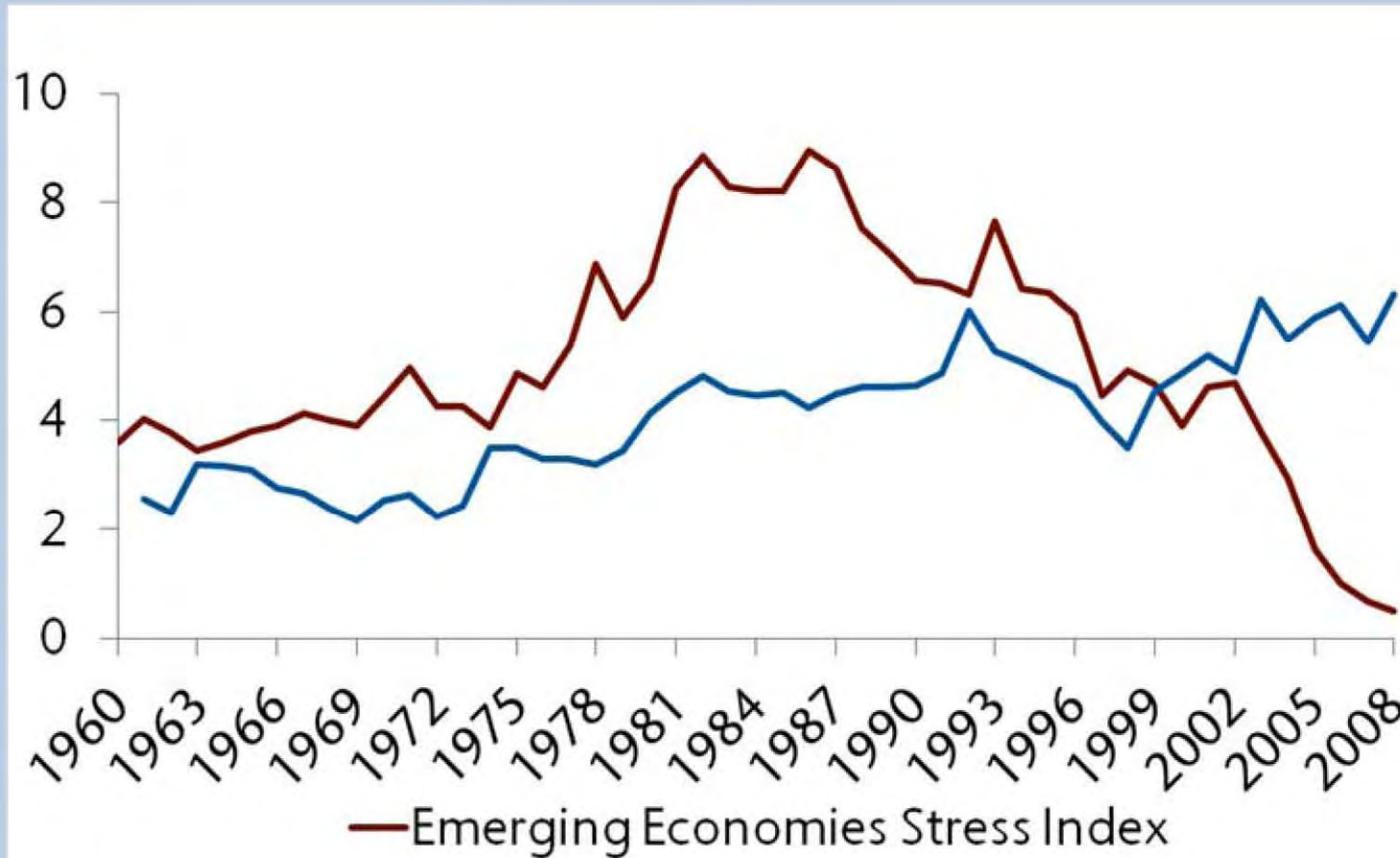


Source: UBS

Diverging Trends

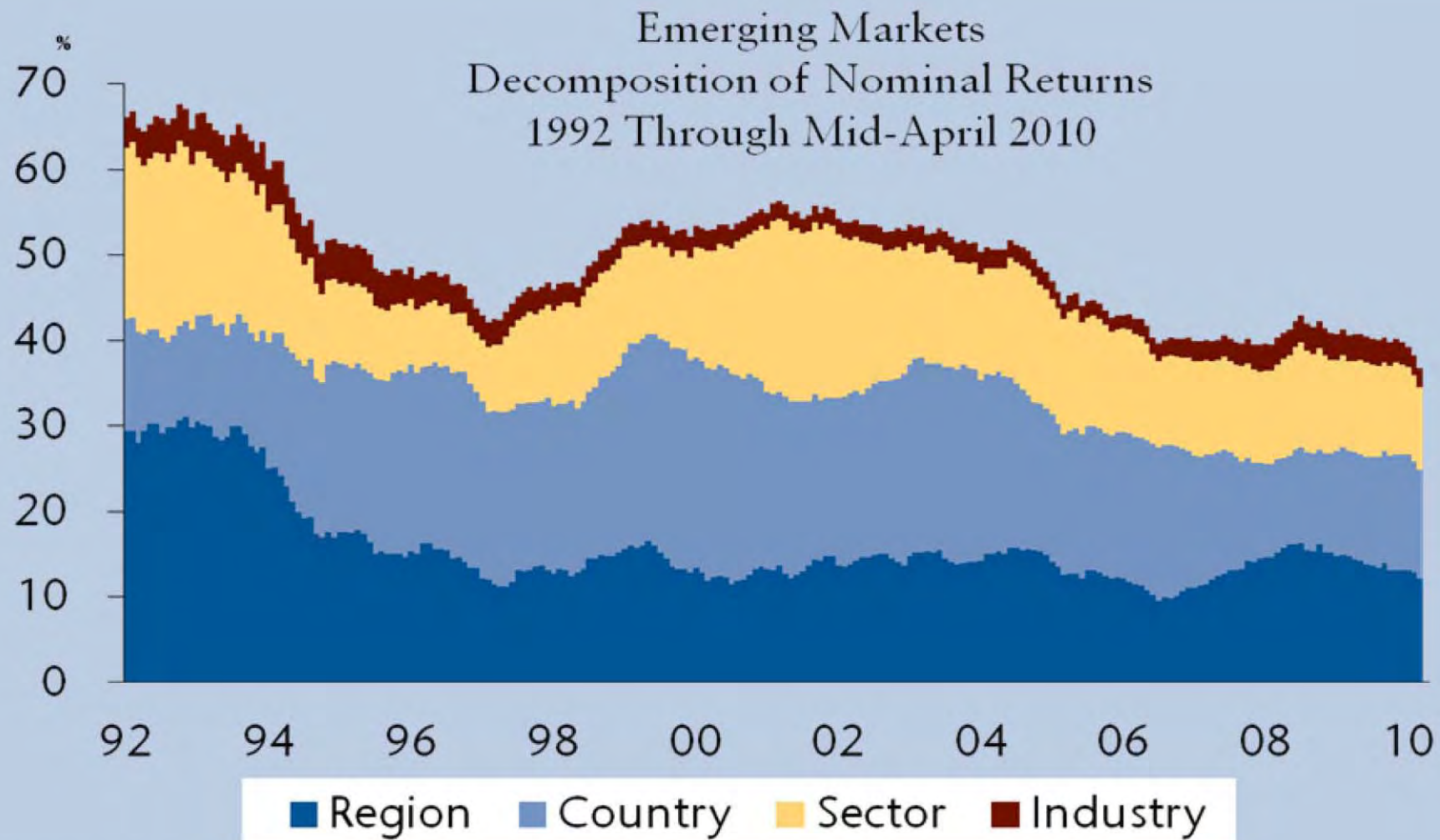
Emerging vs. Developed Market Total Stress Index
(1960-2008)

High Stress



Source: UBS

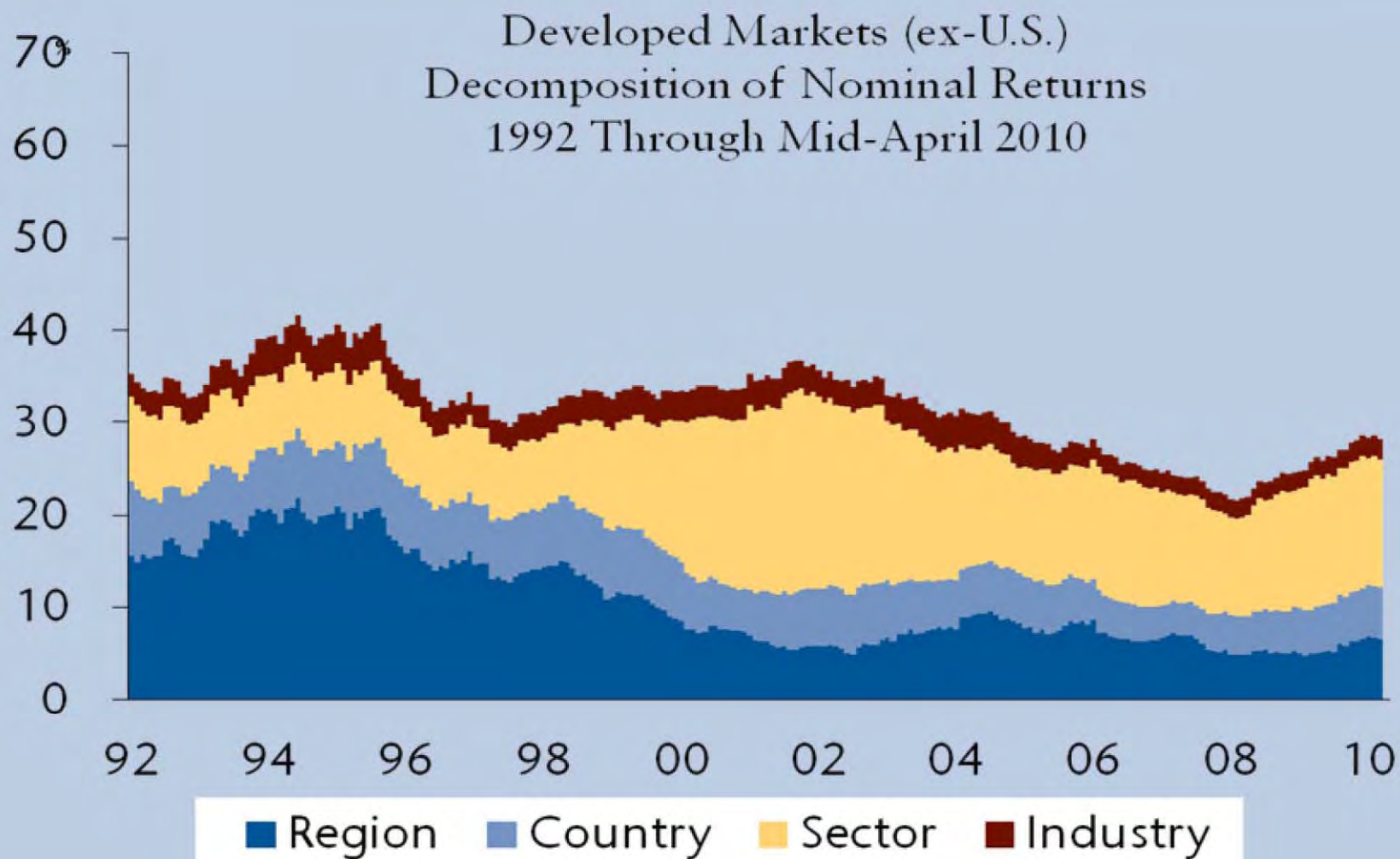
Emerging Markets – Returns Decomposition



Source: Empirical Research Partners Analysis

Computed using capitalization-weighted monthly USD returns to various factors. Data smoothed on a trailing two-year basis.

Developed Markets – Returns Decomposition



Source: Empirical Research Partners Analysis

Computed using capitalization-weighted monthly hedged USD returns to various factors. Data smoothed on a trailing two-year basis.

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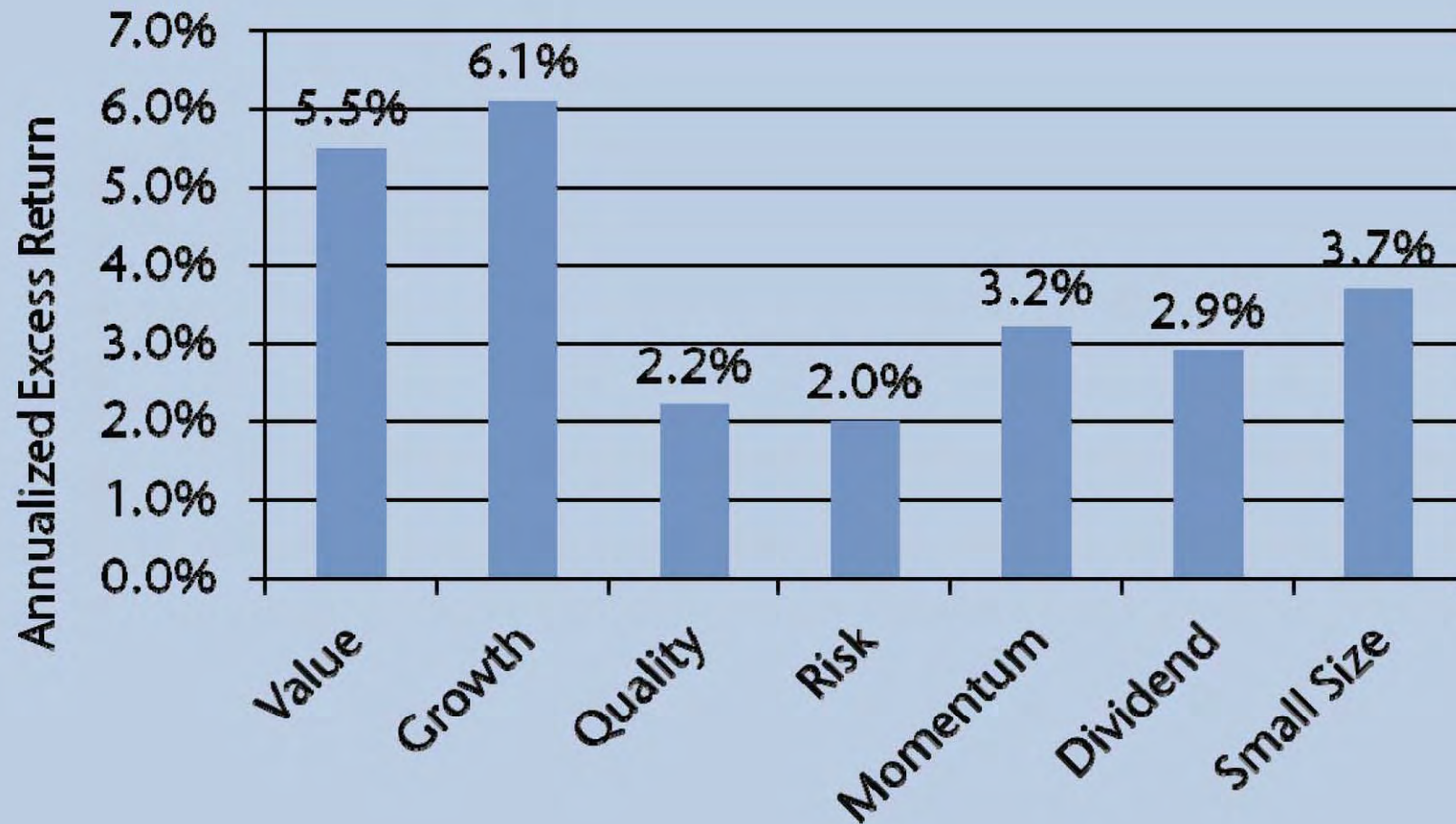
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Managing Style Risk in Emerging Markets

What is Style?

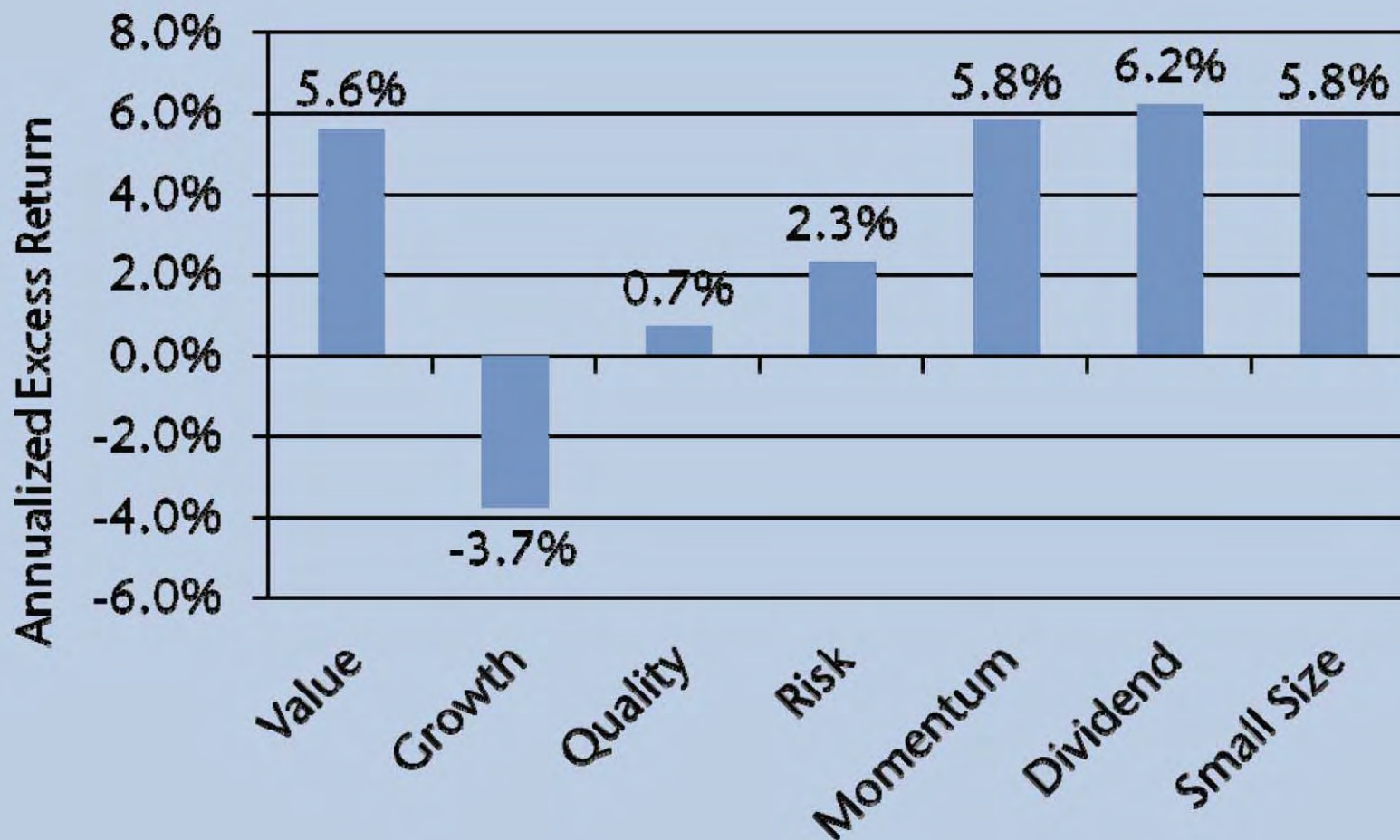
Style	Reason	Definition
Value	Outperforms in down-markets, on average	PE (forecast) PB (trailing) P/FCF (trailing)
Growth	Outperforms in up-markets, on average	EPS Revisions, 2-year EPS Growth Forecast, 7-year EPS Growth
Quality	Outperforms in down-markets, on average	Quality Rank, Stability of ROE
Risk	Has mixed performance in upturns, on average	Beta, Price Volatility
Momentum	Outperforms in trending markets (but underperforms near cycle turning points), on average	12-month Trend Price
Dividend	Underperforms in upturns, on average	Reported Div Yield, Div Growth, Div Revisions
Small Size	Outperforms in up-markets, on average	Low Mcap (free), high Average Daily Turnover/MCap

Global Emerging Markets Style Relative Performance Since 1994



Performance is based on monthly-rebalanced 25-stock GEM Quantessential Style portfolios

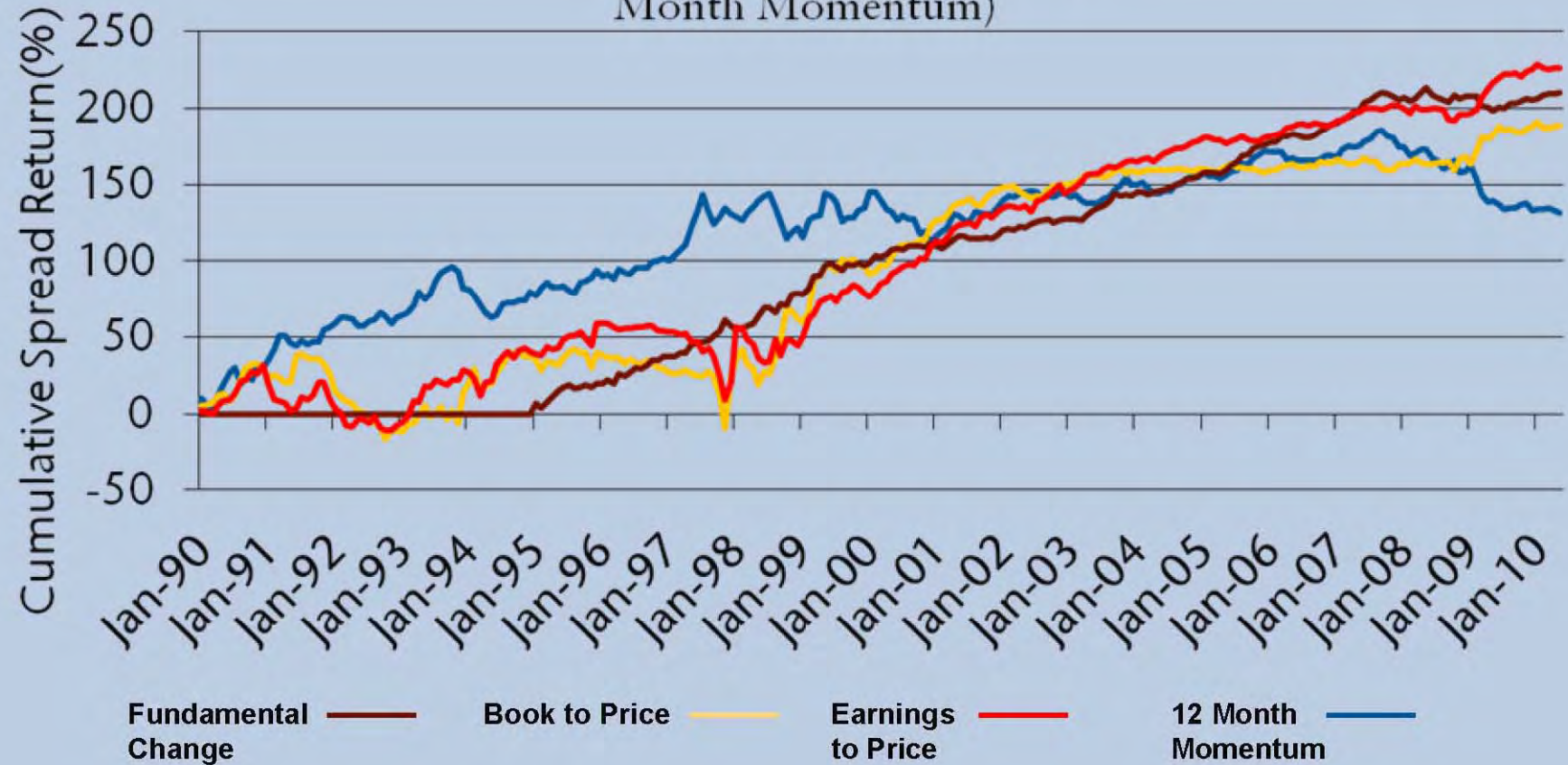
Global Emerging Markets Style Relative Performance: YTD



Performance is based on monthly-rebalanced 25-stock GEM Quantessential Style portfolios

Factor Performance 1990-2010

Factor Cumulative Spreads Returns – Top Decile Minus Universe
(Fundamental Change, Book to Price, Earnings to Price and 12
Month Momentum)

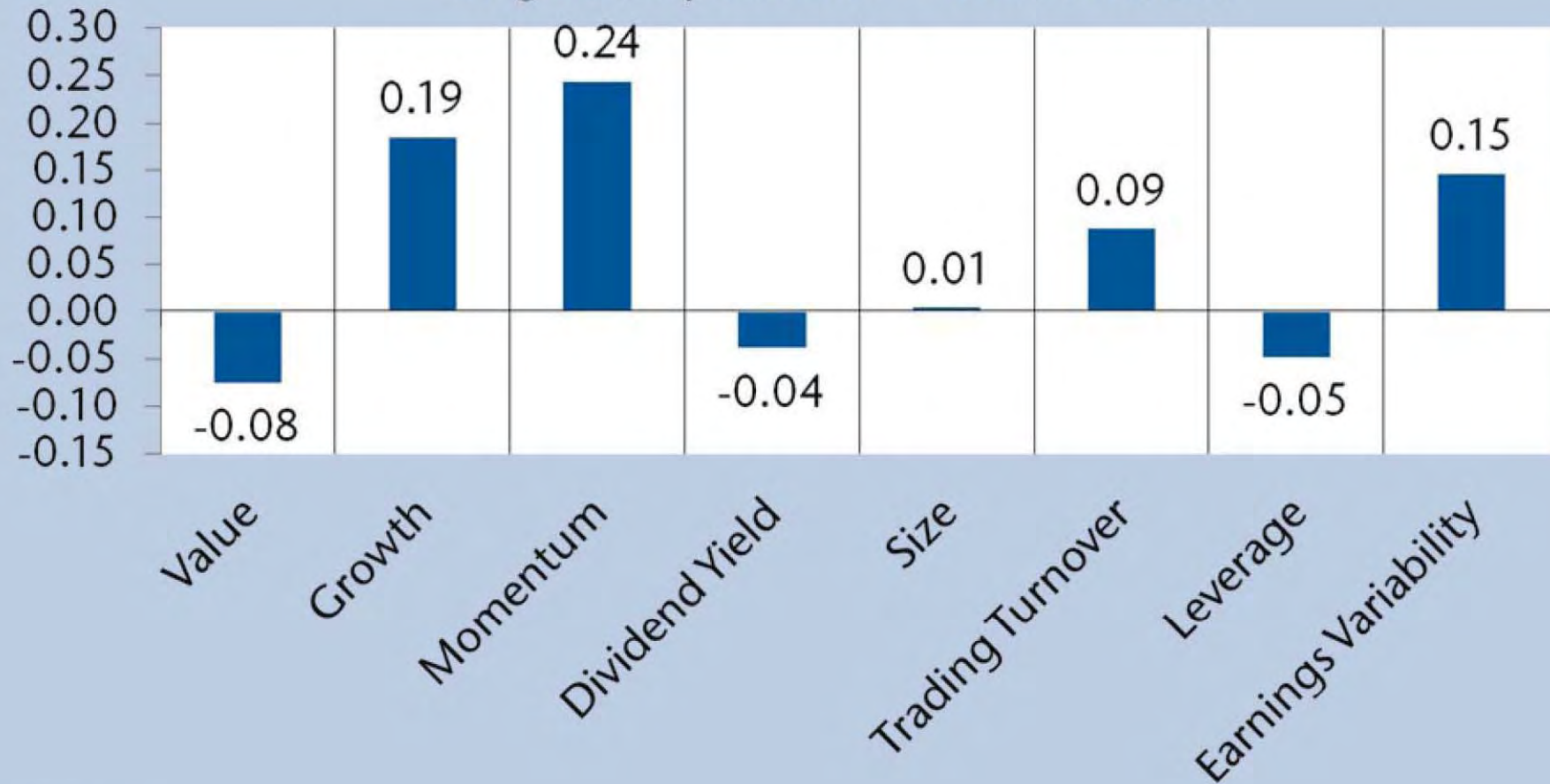


Source: Principal Global Investors

Measuring Style Tilts

APT Risk Factors Profile

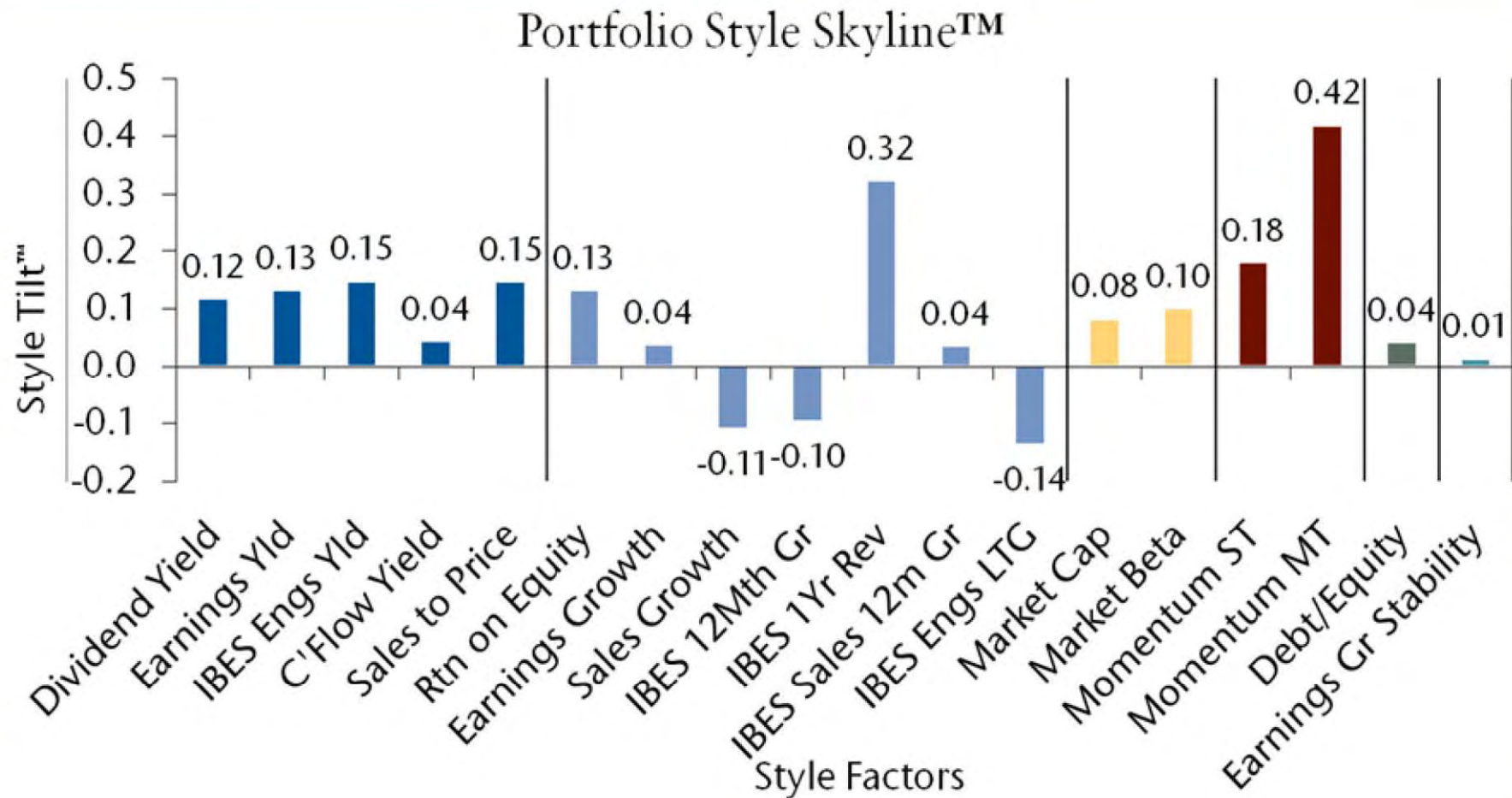
Weighted Style Scores - Active Portfolio



Source: APT Inc.

Measuring Style Tilts

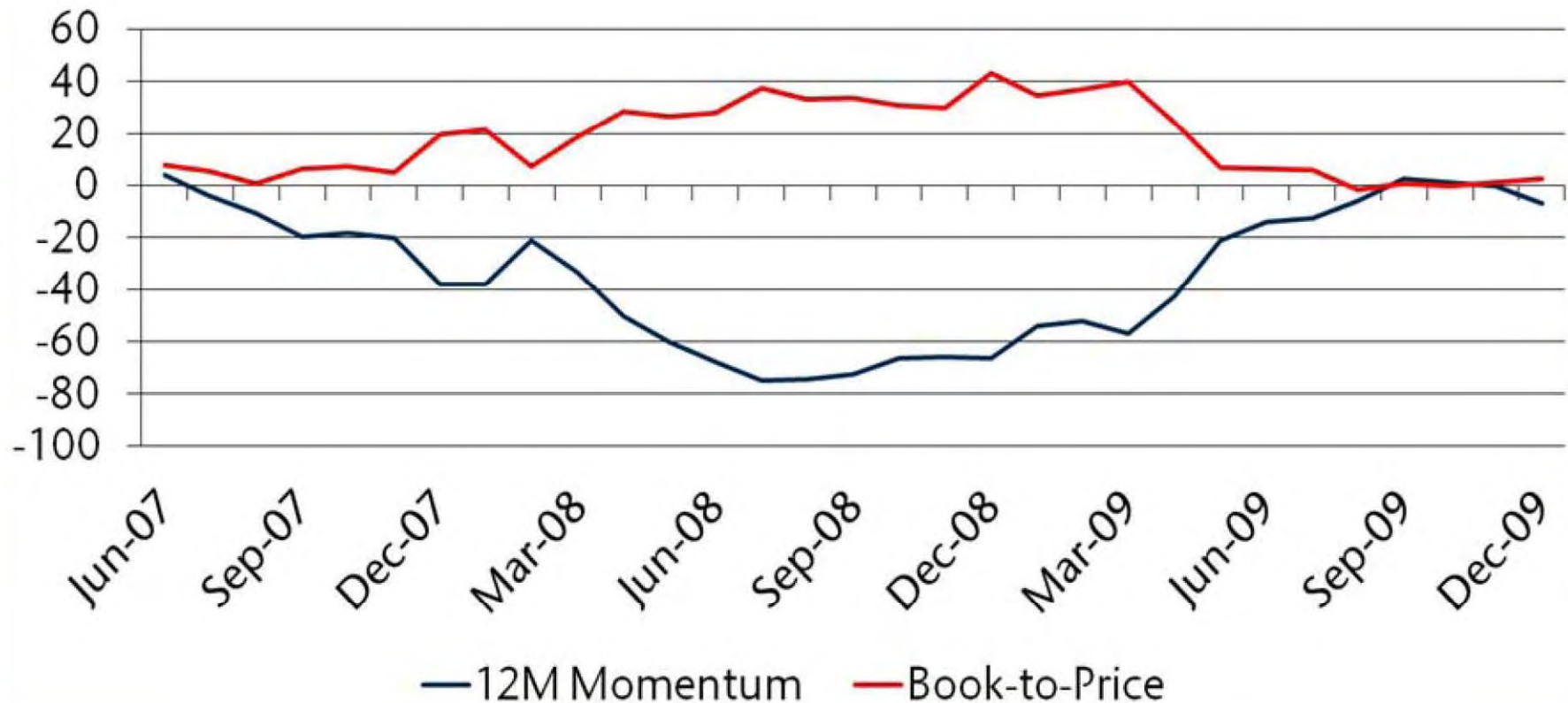
Style Research Risk Factors Profile



Source: Style Research

When is Your Style at Risk?

One Year Trailing Spread Return D1-D10 (%)



A style becomes risky when it is overbought by the market

Source: Principal Global Investors
As of July 2010

When is Your Style at Risk?

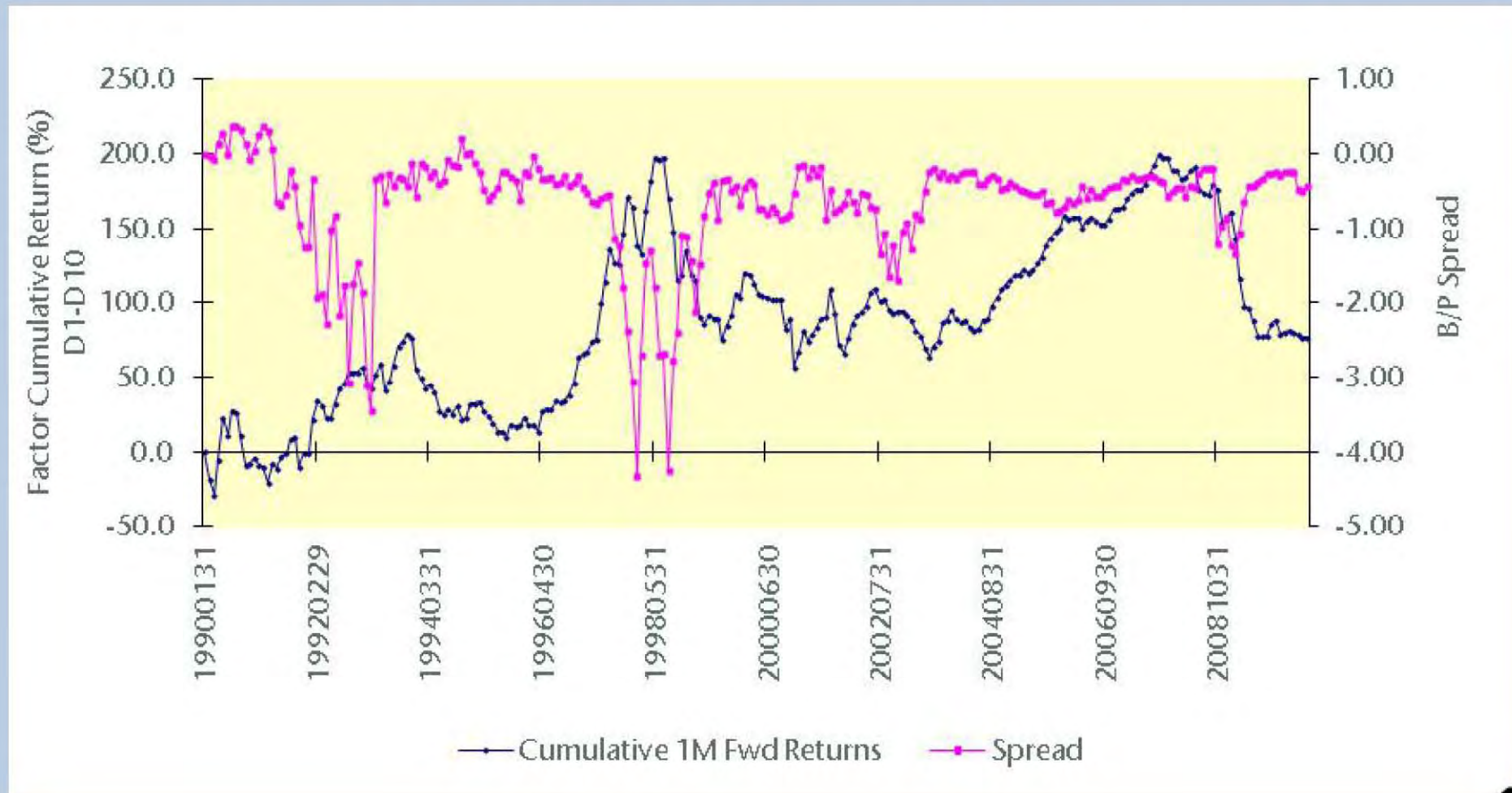
1-Year Momentum

Factor	1YMom					
Benchmark	MSCI EM (Emerging Markets)					
Predictions	1 Month	3 Month	6 Month	12 Month		
Excess Return	2.42	6.30	9.61	5.17		
Volatility	3.14	8.05	12.77	12.01		
Characteristic Spreads	%ile (100=Exp)	Last	Max	Median	Min	
B_to_P	43%	-0.42	0.37	-0.46	-4.31	Neutral
E_to_P	37%	-0.01	0.06	-0.02	-0.27	Neutral
S_to_P	30%	-0.30	0.70	-0.59	-5.27	Cheap
CF_to_P	17%	-0.03	0.07	-0.08	-1.06	Cheap
FCF_to_P	29%	0.02	0.10	0.00	-0.23	Cheap
Holt_%Chg	22%	-8.76	116.55	-27.22	-270.29	Cheap
Holt_Value	27%	5.00	53.00	12.75	-36.50	Cheap
C_to_P	75%	-0.17	0.11	-0.10	-1.21	Expensive
E_to_P_3Yr_Avg	21%	0.02	0.09	0.00	-0.29	Cheap
Div_Yield	54%	0.51	11.52	0.63	-52.84	Neutral
EBIT_to_EV	44%	0.02	2.44	0.01	-0.22	Neutral

Using valuation factors to measure riskiness of a style factor

When is Your Style at Risk?

1 Year Momentum – Cumulative Spread Return Top Minus Bottom Decile

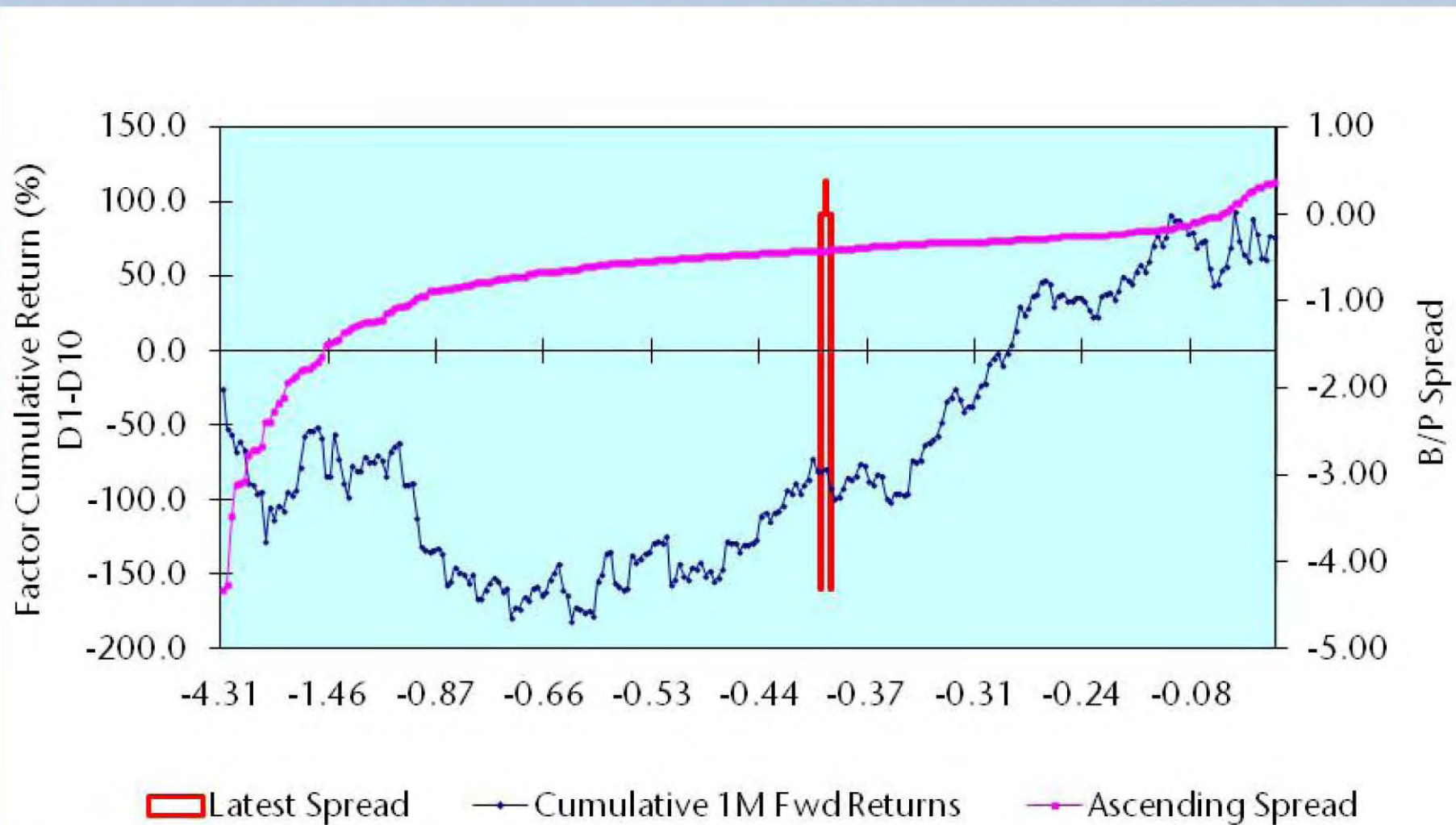


Based on universe of MSCI Emerging Markets Index

Source: Principal Global Investors
As of July 2010

When is Your Style at Risk?

1 Year Momentum – Cumulative Spread Return Top Minus Bottom Decile vs. Book to Price Spread



Source: Principal Global Investors
As of July 2010

When is Your Style at Risk?

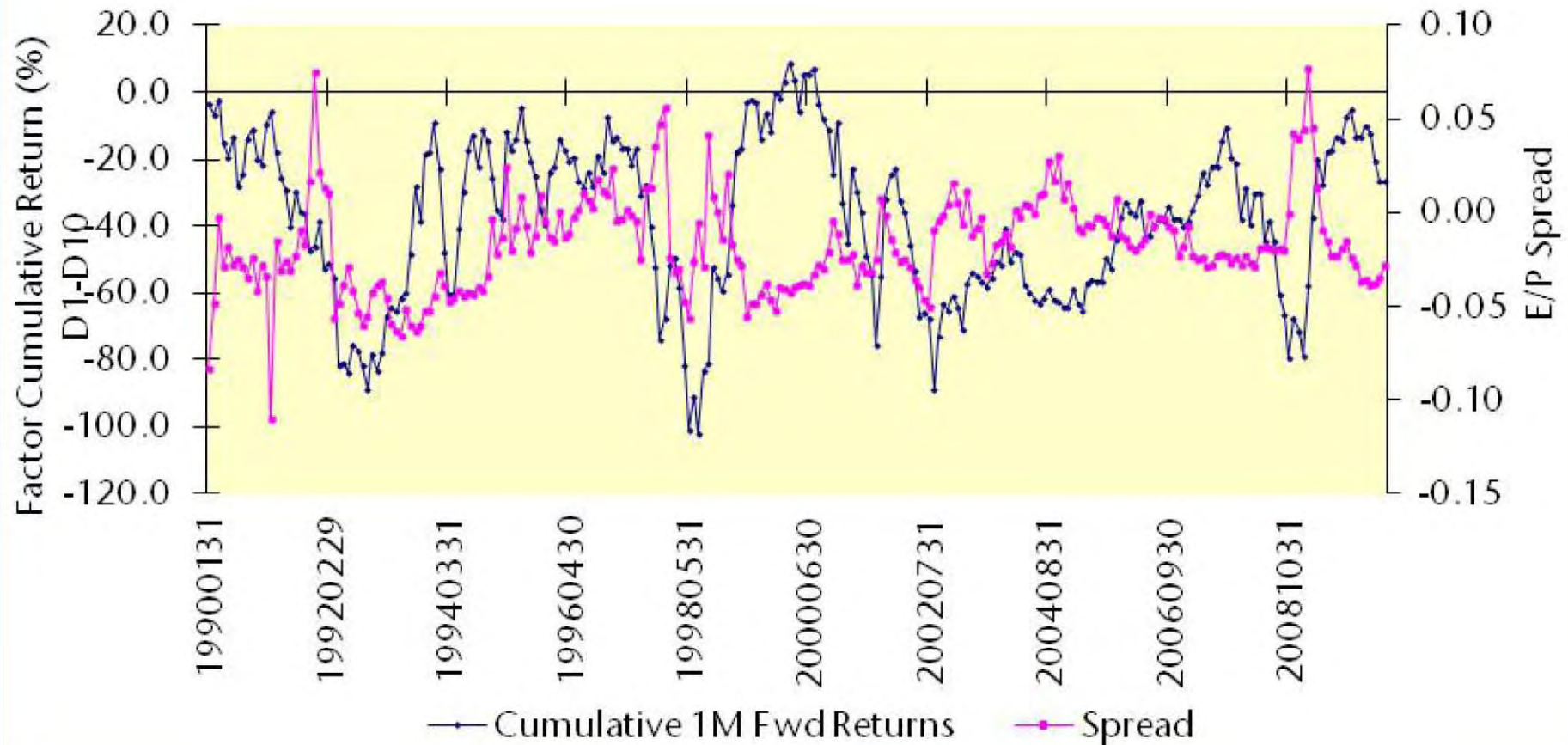
6 Month Volatility

Factor	6MVol					
Benchmark	MSCI EM (Emerging Markets)					
Predictions	1 Month	3 Month	6 Month	12 Month		
Excess Return	-2.18	-3.34	-2.71	-1.87		
Volatility	2.88	7.86	8.88	9.64		
Characteristic	%ile					
Spreads	(100=Exp)	Last	Max	Median	Min	
B_to_P	52%	0.06	2.04	0.08	-0.63	Neutral
E_to_P	67%	-0.03	0.08	-0.02	-0.11	Expensive
S_to_P	48%	0.23	2.85	0.22	-0.64	Neutral
CF_to_P	78%	-0.03	0.53	0.00	-0.22	Expensive
FCF_to_P	71%	-0.02	0.18	-0.01	-0.14	Expensive
Holt_%Chg	12%	3.44	46.48	-14.65	-109.00	Cheap
Holt_Value	18%	-1.00	60.00	6.00	-54.50	Cheap
C_to_P	38%	0.03	0.57	0.02	-0.15	Neutral
E_to_P_3Yr_Avg	25%	0.01	0.29	-0.01	-0.38	Cheap
Div_Yield	69%	-2.09	6.78	-1.57	-8.47	Expensive
EBIT_to_EV	69%	-0.02	0.36	0.00	-0.27	Expensive

Using valuation factors to measure riskiness of a style factor

When is Your Style at Risk?

6 Month Volatility – Cumulative Spread Return Top Minus Bottom Decile

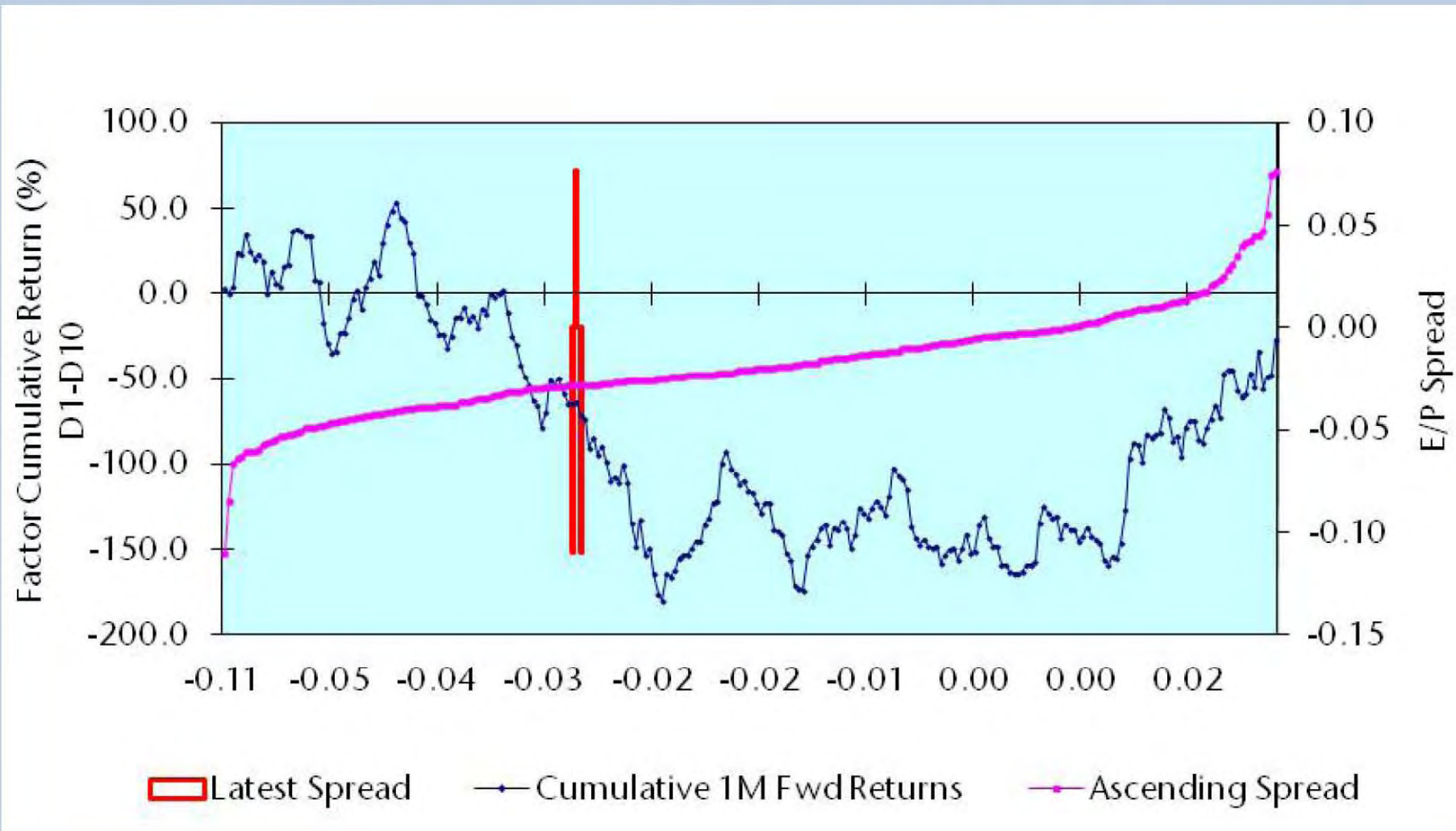


Based on universe of MSCI Emerging Markets Index

Source: Principal Global Investors
As of July 2010

When is Your Style at Risk?

6 Month Volatility – Cumulative Spread Return Top Minus Bottom Decile vs. Earnings to Price Spread



Source: Principal Global Investors
As of July 2010

- Return and risk are linked. Alpha turns into risk and vice versa, depending on market conditions and relative valuations.
- Country risk has diminished in significance in the emerging markets universe, but is still more important than sector risk. In the developed markets, sector risk dominates, but country risk is on the rise.
- Stock selection is currently dominating returns in the emerging markets universe. We believe managing stock specific risks starts with the stock selection process.
- Managing and minimizing unintended risks, such as region, country, sector, industry and currency improves the likelihood of preserving the excess return generated through stock selection.
- Style risk relates to the biases built into the investment process. Understanding and managing style risk is complex, but necessary part of the risk management process.

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