

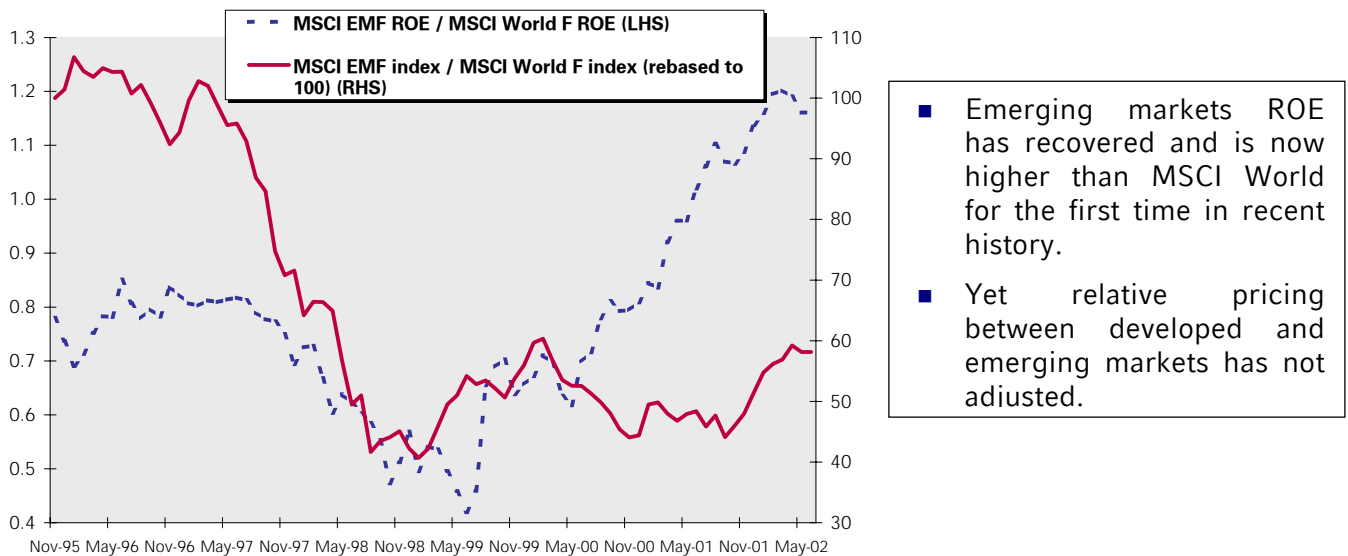
The Rediscovery of Emerging Markets

Emerging markets have weathered the latest tempest on financial markets quite well as attractive valuations relative to developed markets have proved something of a defence. Although the MSCI World Index plunged a substantial 12.9% in \$A terms in the first 22 days of this financial year, emerging markets have stayed fairly flat, dropping only 1.0%.

After a number of years in the wilderness, emerging markets are reappearing on the radar screens of international investors. There has been a substantial pickup in search activity for emerging markets, particularly in the United States. Over the first half of 2002 searches in emerging markets totalled US\$3.0 billion, almost 1.5 times the amount over the whole of 2001.

During the TMT bubble, emerging markets were seen merely as an alternative to investing in developed markets, but with higher risk. However, with the S&P 500 Index down over 19% in the last financial year and the S&P IFCI Emerging markets index up almost 4% in \$US, the diversification advantages from investing in emerging markets are becoming apparent once again. But diversification is not the only reason for the renewed interest.

Valuations are clearly attractive. Emerging market equities are cheap, both relative to their own history, and relative to developed markets, notwithstanding recent movements. On either a Price/Book or a P/E basis, emerging markets are at around a 40% discount to valuations in developed markets, and over a 50% discount to US valuations. Similarly, return on equity calculations for emerging companies are currently 20% higher than those for developed and rising, c.f. the chart below.



- Emerging markets ROE has recovered and is now higher than MSCI World for the first time in recent history.
- Yet relative pricing between developed and emerging markets has not adjusted.

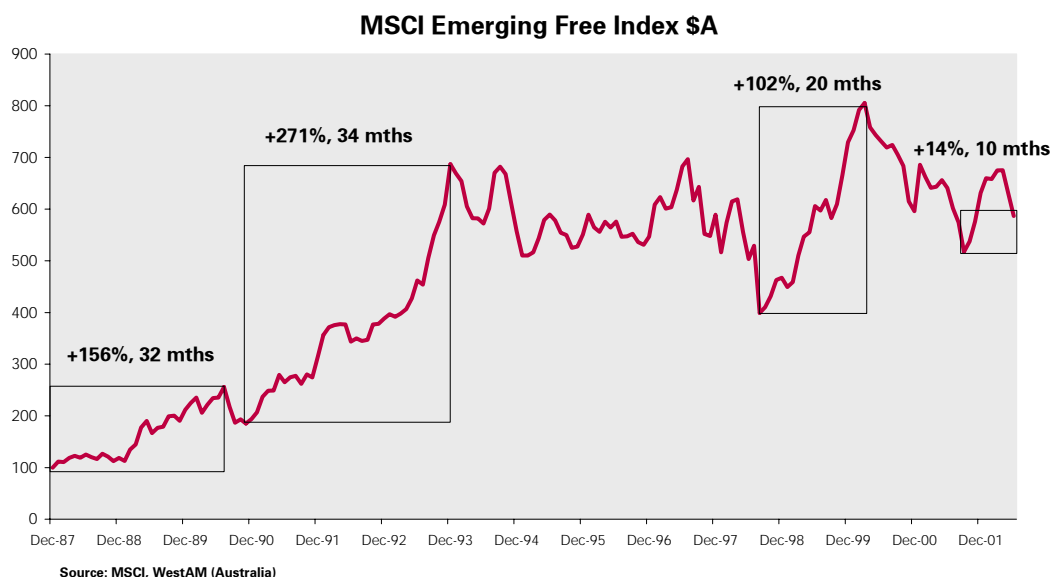
Source: WestAM, CSFB

Growth prospects for emerging markets remain favourable. Despite the recent sharp downward valuation of developed country equities, the outlook is for continued recovery in world activity. Emerging market economies are expected to grow at faster rates than developed market economies. Over the last 30 years emerging market economies have grown on average 1.1% pa faster than developed economies. However, according to Consensus Economics, over the next five years this gap is expected to widen to 2% pa.

Emerging equity markets have historically been a strong early cycle performer, with a high correlation between the OECD leading indicator of economic activity and emerging market equity returns. It is normally during the first 18 to 24 months of the upturn that emerging equities perform strongest.

Although searches in emerging markets are gathering pace, international investor weightings in emerging markets are still low. Anecdotal evidence continues to suggest US investors in particular are underweight emerging markets, compared to benchmarks such as the MSCI ACWI Free Index which has a current weighting of 3.9% in emerging markets.

Investing in emerging markets can reap investors substantial rewards. The following chart shows the performance of the MSCI Free Index unhedged in \$A over the period from December 1987 when the index was first created to June 2002. Over this fourteen and a half year period, there have been three complete bull runs, each delivering more than 100% over an average 2½-year time frame. In comparison, the current phase, where emerging markets have outpaced developed ones, which started at the end of September 2001, seems to be well in its infancy.



Since 11 September 2001, emerging markets have been the best performing asset class. Over the 10 months post September 2001 to June 2002, emerging markets have returned 14% in \$A terms. This is in sharp contrast to the S&P500 Index which returned -17% in \$A over the same time period and better than our local market which returned 8%.

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