



## Perception versus Reality: Reassessing the Risks of Investing in Growth and Emerging Markets

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### GSAM Fundamental Equity Team

### Introduction

In 2011, Jim O'Neill, Chairman of Goldman Sachs Asset Management (GSAM), suggested that it is "time to redefine Emerging Markets", as the line between some "Emerging" and Developed Markets had become increasingly blurred. He introduced the concept of "Growth Markets" to distinguish eight non-Developed Market economies that have outgrown their "Emerging" label, as they are already meaningful contributors to global growth and could together drive almost 60% of the increase in global GDP over the next decade<sup>1</sup>. We expect that the Growth Markets – Brazil, Russia, India, China, South Korea, Mexico, Indonesia and Turkey – as well as the Emerging Markets, will reflect this economic growth in their market capitalisations and become increasingly important components of global equity portfolios. We therefore believe it is also time to reassess the risks of investing in the Growth and Emerging Markets. In this paper we seek to address what we believe are several persistent misperceptions.

We believe that the Growth and Emerging Markets...

- 1. ...offer high quality assets.** There have been significant improvements in sovereign debt levels, company fundamentals and corporate governance.
- 2. ...are home to rapidly growing domestic markets and globally competitive companies.** Domestic consumption in these countries is expanding and their companies are becoming increasingly competitive on a global scale.
- 3. ...have broadened and deepened.** Over the last decade, their equity markets have grown, diversified and become much more liquid.
- 4. ...warrant a dedicated portfolio allocation.** Investment in the Growth and Emerging Markets provides access to local companies directly benefitting from the rapid increase in domestic consumption, an opportunity which cannot be fully captured by developed market companies serving these regions.
- 5. ...offer attractively valued equity opportunities.** We believe that equity valuations in the Growth and Emerging Markets look compelling compared to their historical average, to Developed Market equities and to other asset classes.

<sup>1</sup> Source: GSAM, "It is Time to Re-define Emerging Markets," 31-Jan-11, IMF World Economic Outlook, Oct-11.

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### Growth and Emerging Markets offer high quality assets

Emerging Market investing has changed so much in the 30+ years since the term was first coined, that we no longer consider a number of these markets to be “emerging” anymore, given the size and importance of their economies. In addition, many have shown marked improvements in sovereign debt levels, company fundamentals and corporate governance.

### Sovereign debt levels are lower than in some developed market countries

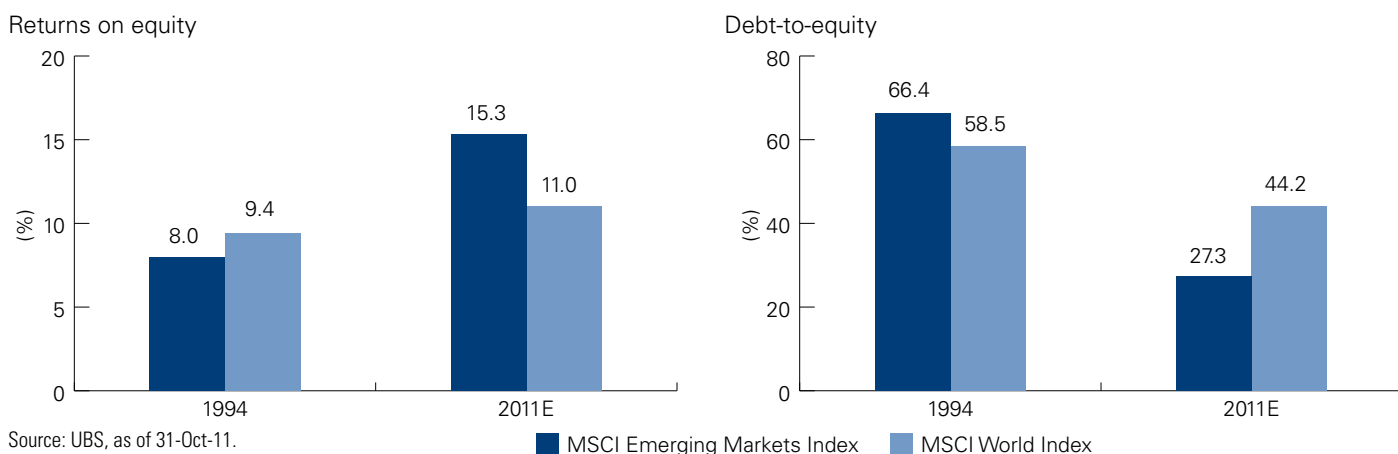
In the wake of the European crisis and the historic downgrade of US debt, Growth and Emerging Market sovereign balance sheets look more attractive than ever. Between 2000 and 2010, the debt to GDP ratio of the Growth Markets has come down to less than 40%. However, during the same period, the average for the G7 countries has increased from almost 80% to over 120%.<sup>2</sup> Interestingly, the Maastricht Treaty, which helped to lay the foundation for the euro, required countries’ gross general government debt to be less than 60% of GDP. It is ironic that today almost all of the Growth Markets yet almost none of the European Monetary Union (EMU) members would actually meet this key criteria<sup>3</sup>. It is therefore not so surprising that the spreads on credit default swaps (CDS), which are one measure of the risk of investing in a particular country, are lower for the majority of the Growth Markets than for some of the more troubled EMU countries.<sup>4</sup> Furthermore, since the 2008 financial crisis, CDS spreads have increased for G7 countries such as the US, UK, Japan and Germany more than for many Growth and Emerging Markets, where in some cases they have actually decreased.<sup>5</sup>

The improved debt levels and financial conditions in Growth and Emerging Market countries are also important because they allow the governments more policy flexibility to attempt to manage growth, inflation or asset bubbles. The value of this is particularly pronounced right now, as most countries in the developed world struggle with the conflicting economic goals of stimulating growth while cutting spending to reduce debt.

### Improved company fundamentals and corporate governance

Company fundamentals in the Growth and Emerging Markets, including improved corporate governance standards, further support our view that these are high quality assets. As illustrated in *Exhibit 1a*, since 1994, the return on equity (ROE), a measure of a company’s profitability, for Growth and Emerging Market companies has risen from 8.0% to 15.3%, surpassing that of Developed Market companies which increased from 9.4% to 11.0%.<sup>6</sup> Furthermore, this has not been achieved through greater financial leverage, but instead through improvements in operating efficiency and profitability. Indeed, as shown in *Exhibit 1b*, over the same period, debt-to-equity ratios of companies in the Growth and Emerging Markets have decreased by almost 40% and are now lower than those in Developed Markets.

**Exhibits 1a and 1b – Growth and Emerging Market companies earn higher returns on equity than developed market companies yet have lower debt-to-equity ratios<sup>6</sup>**



Source: UBS, as of 31-Oct-11.

<sup>2</sup> Source: IMF, JP Morgan Emerging Markets Debt and Fiscal Indicators, as of Apr-11. Debt levels for 2010 and 2011 are forecasts by JP Morgan as of Nov-10.

<sup>3</sup> Source: GSAM, IMF and Eurostat, estimates for 2011.

<sup>4</sup> Source: Bloomberg, as of 2-Sep-11.

<sup>5</sup> Source: Bloomberg, GSAM as of 28-Oct-11.

<sup>6</sup> Source: UBS, as of 31-Oct-11.

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Corporate governance practices have also improved as the Growth and Emerging Markets increasingly transition to International Financial Reporting Standards (IFRS). More than 80% of companies now report at least semi-annually.<sup>7</sup> In some countries, such as Brazil, a significant transformation in the equity market has had a revolutionary impact on corporate governance and minority shareholder rights. In 2001, the Brazilian stock exchange created a new listing segment, called the Novo Mercado, for companies that voluntarily commit themselves to additional corporate governance and transparency practises. Companies listing on the Novo Mercado are required to have: 100% of capital stock in common (voting) shares; a minimum free float of 25% of capital; a board of directors comprised of at least 20% independent directors; and a number of other measures that improve quarterly reporting and disclosures.<sup>8</sup> Over the last five years, the majority of companies that have issued shares in Brazil have done so on the Novo Mercado, significantly improving shareholders' rights and enhancing the quality of information that companies provide.

## Growth and Emerging Markets are home to rapidly growing domestic markets and globally competitive companies

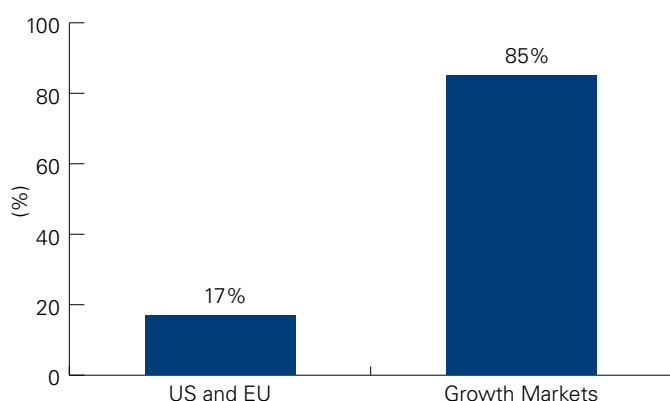
### Increasing domestic consumption driven by an expanding middle class

One of the major drivers of growth in the Growth and Emerging Markets is domestic consumption, fuelled by rapidly expanding middle classes with increasing disposable incomes. Over the last five years, private consumption in the eight Growth Markets has increased by 85% and now represents almost a quarter of private consumption globally. By contrast, as illustrated in *Exhibit 2a*, private consumption in the US and EU has risen by only 17% over the same period.<sup>9</sup> By the end of this decade, it is possible that the BRIC consumer will be almost as large as the US consumer, in terms of aggregate real consumption, and could exceed it by 2022. Chinese consumption alone could challenge the US in the first half of the next decade if China succeeds in raising its consumption-to-GDP ratio over the next few years.<sup>10</sup>

This trend has also been reflected in the equity markets, as illustrated in *Exhibit 2b*. Over the last five years, the Consumer sectors have grown from 13% of market capitalisation in the Growth Markets to more than 17% today.<sup>11</sup> As a result, the equity markets are becoming increasingly representative of the underlying growth drivers of these economies.

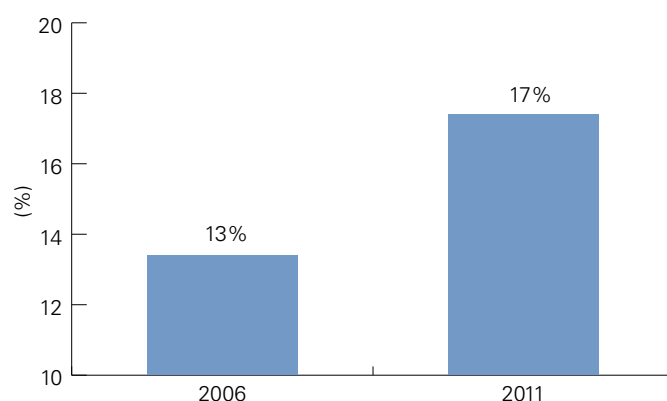
### Exhibits 2a and 2b – Consumption is growing rapidly in the Growth and Emerging Markets and is becoming an increasingly important part of the equity market

Growth in private consumption from 2006 to 2011



Source: FactSet, MSCI, as of 30-Nov-11

Consumer sector as percentage of Growth Markets equity market capitalisation



<sup>7</sup> Source: FactSet, MSCI, as of 30-Nov-11, based on MSCI Emerging Markets Index.

<sup>8</sup> Source: BM&FBovespa, as of Dec-11.

<sup>9</sup> Source: Haver Analytics, national databases, as of Dec-11.

<sup>10</sup> Source: GSAM, "The Rise of the BRICS and N-11 Consumer," 3-Dec-10.

<sup>11</sup> Source: FactSet, MSCI, as of 30-Nov-11.

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### Low cost producers to branded global competitors

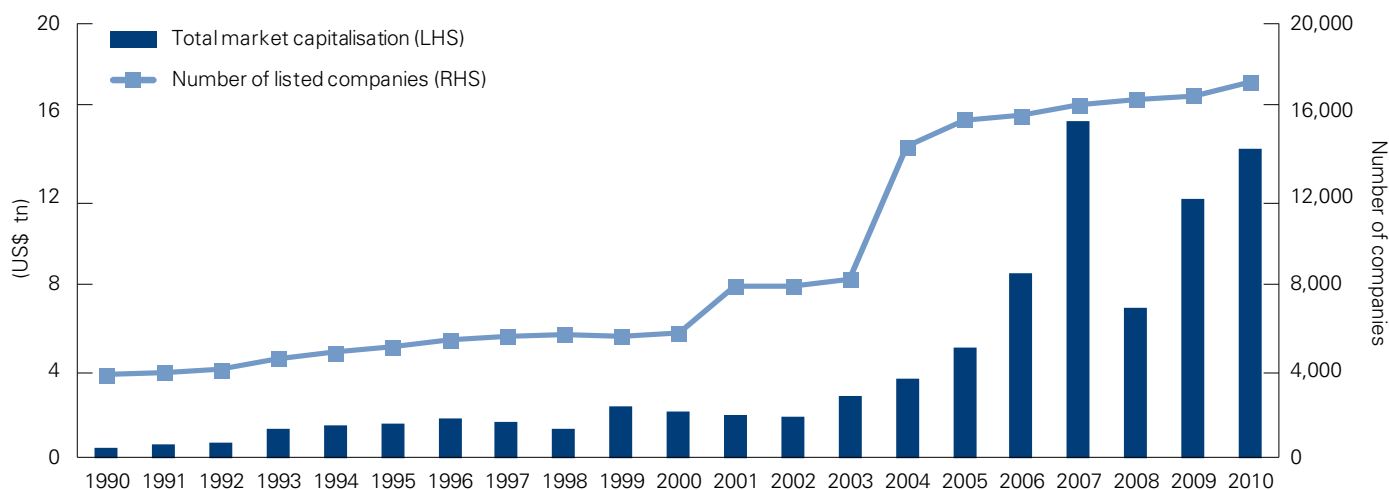
A common misperception is that the Growth and Emerging Markets are simply exporters of raw materials and lower margin products. This is not the case. For example, commodity exports, which are often thought to be a significant driver of Brazil's economy, account for less than 5% of GDP.<sup>12</sup> Similarly, having long been stereotyped as an exporter of cheap manufactured goods, China is now shifting its focus to higher margin products. In 2011, the proportion of US and European low-end light manufacturing imports coming from China began to fall, while China's share of their higher margin information technology (IT) electronics imports continued to rise.<sup>13</sup>

Even more exciting is the evolution of many Growth and Emerging Market companies from low cost suppliers to branded competitors. Many of these companies are becoming more competitive as they benefit from expanding domestic markets, increased spending on research and development (R&D), government support and international acquisitions.<sup>14</sup> Korea, for example, is home to several technology companies that have progressed from being producers of low cost alternatives to leading global brands. Of the seven largest wireless infrastructure companies, the only two to gain market share between 2002 and 2010 were both Chinese, and they did so at the expense of their Developed Market competitors.

### Growth and Emerging Markets have broadened and deepened

Whilst the Growth and Emerging Market economies have been growing rapidly, their equity markets have been expanding and diversifying. As illustrated in *Exhibit 3*, over the last decade alone, the number of companies listed in the Growth and Emerging Markets has tripled, from less than 6,000 companies in 2000 to more than 17,000 by 2010.<sup>15</sup> This has coincided with total equity market capitalisation rising almost seven-fold, from just over US\$2 trillion in 2000 to more than US\$14 trillion in 2010.<sup>16</sup> Looking forward, we expect these trends to continue. We believe the Growth and Emerging Markets, which comprised 31% of the world's equity market capitalisation in 2010, could grow to 55% by 2030, through continued economic growth and capital market deepening.<sup>17</sup>

**Exhibit 3 – Market capitalisation and the number of listed companies have both increased significantly over the last decade**



Source: LHS – World Federation of Exchanges, as of Dec-11, based on total number of listed companies (domestic and foreign); RHS – World Bank, as of Dec-11, based on market cap of listed companies in current US\$.

<sup>12</sup> Source: Bloomberg, SECEX, MDIC, as of Dec-10.

<sup>13</sup> Source: UBS Investment Research, "So Who Gets China's Market Share Now?", 2-Sep-11. Light manufacturing refers to toys, clothing, sporting goods, furniture and footwear.

<sup>14</sup> Source: Goldman Sachs Global Economics, Commodities and Strategy Research, "China: The opportunity and the competitive threat", 4-May-11.

<sup>15</sup> Source: World Federation of Exchanges, as of Dec-11, based on total number of listed companies (domestic and foreign).

<sup>16</sup> Source: World Bank, as of Dec-11, based on market cap of listed companies in current US\$.

<sup>17</sup> Source: Goldman Sachs Global Economics, Commodities and Strategy Research, "Global Economics Paper No: 204 – EM Equity in Two Decades: A Changing Landscape", 8-Sep-10.

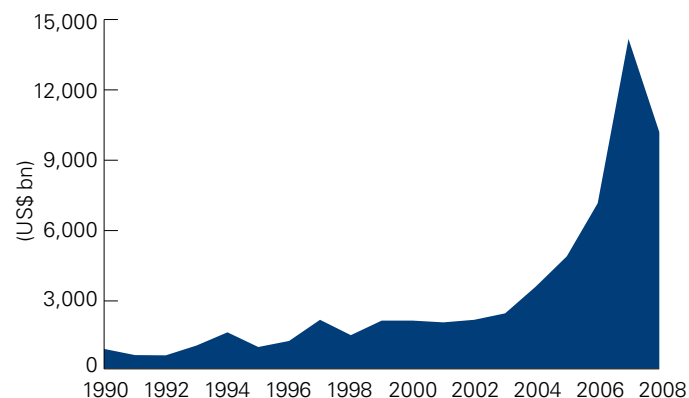
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In addition to there being a greater number of companies from which investors can choose, entire new industries have been born, improving the diversification on offer. The increased investability of these markets is also reflected in trading volumes and costs. As illustrated in *Exhibits 4a and 4b*, the total volume of Growth and Emerging Market share trading grew from around US\$2 trillion in 2000 to more than US\$10 trillion by 2008.<sup>18</sup> This increased volume has driven down trading costs, with the average transaction cost in Growth and Emerging Markets declining 34% between 2003 and 2010.<sup>19</sup>

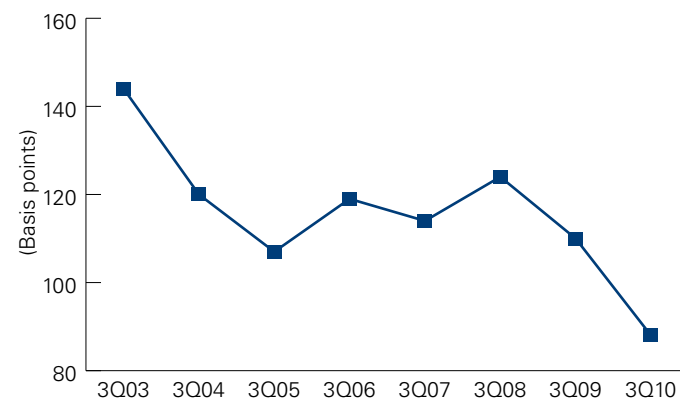
**Exhibits 4a and 4b – Trading volumes have increased and transaction costs decreased**

Value of share trading in Growth and Emerging Markets



Source: World Federation of Exchanges, as of Dec-08, based on total share trading (domestic and foreign), including electronic order book and negotiated deals. Equivalent data unavailable from 2009 onwards.

Average transaction cost in Growth and Emerging Markets



Source: ITG, as of Dec-11, based on the average transaction costs in 3Q03 and 1Q11.

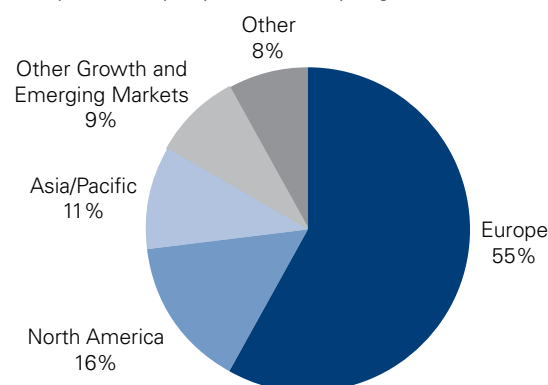
Broader and deeper equity markets have also increased the importance of stock selection. A decade ago, when these regions were often subject to boom and bust cycles, investing was largely driven by macroeconomic factors and dominated by risk appetite and capital flows. Today, Growth and Emerging Markets are increasingly influenced by individual stock performance. Macroeconomic factors remain important, as they are for all countries, because they influence policy and regulatory actions. However, we believe successful investing in the Growth and Emerging Markets now also depends on picking the right stocks, within the context of a dynamic policy or regulatory environment.

**Growth and Emerging Markets warrant a dedicated portfolio allocation**

Over the last decade, exports from the Developed Markets to the Growth and Emerging Markets have grown, both in absolute terms and as a percentage of their total exports, and many Developed Market companies now derive a portion of their sales in these regions.<sup>20</sup> However, the vast majority of their revenues and profits are still derived from Developed Markets.

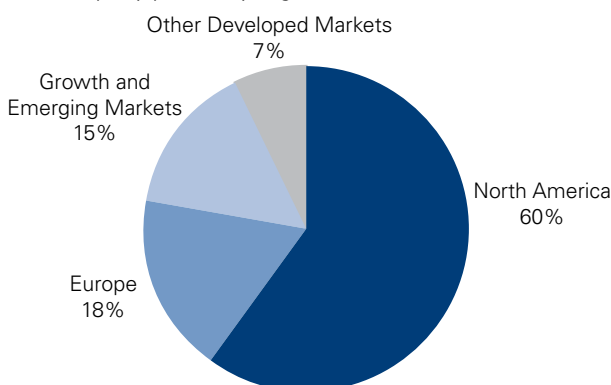
**Exhibits 5a and 5b – Developed Market corporate revenues and profits are still largely derived from Developed Markets**

European company revenues by region



Source: UBS Investment Research, "European Equity Strategy – Outlook 2012", as of 14-Nov-11, based on companies in the FTSEurofirst 300 Index.

US company profits by region



Source: Bank of America Merrill Lynch, as of 11-Sep-11, based on companies in the S&P 500 Index.

<sup>18</sup> Source: World Federation of Exchanges, as of Dec-08, based on total share trading (domestic and foreign), including electronic order book and negotiated deals. Equivalent data unavailable from 2009 onwards.

<sup>19</sup> Source: ITG, as of Dec-11, based on the average transaction costs in 3Q03 and 1Q11.

<sup>20</sup> Source: GSAM, Haver Economics, Datastream, WorldScope.

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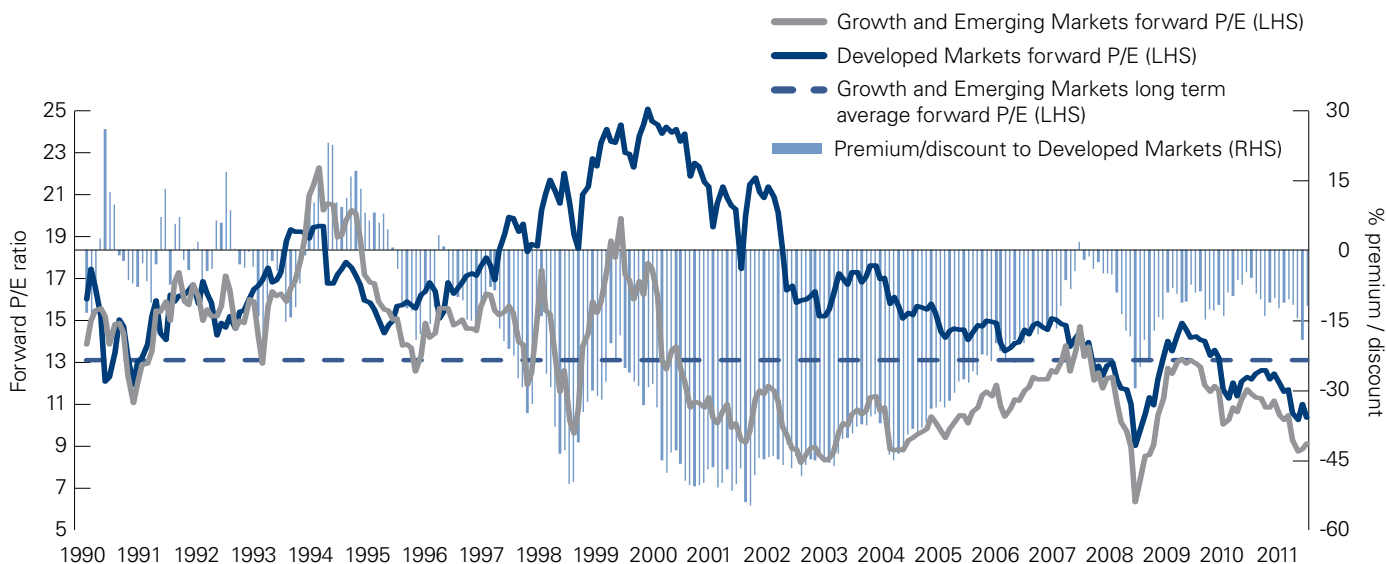
A dedicated Growth and Emerging Markets equity allocation can give investors direct exposure to the themes that are playing out at the local level, such as the emergence of a middle class with new discretionary spending power and the resulting growth in domestic consumption. We believe some of the most exciting investment opportunities are in local companies that are direct beneficiaries of these trends. For example, companies that sell household appliances, manufacture motorcycles or provide education services benefit from the growing trend of people moving from rural to urban areas and having discretionary income to spend on goods for their homes, means of transportation, and education to improve their job prospects and earnings potential.

Institutional investors in the developed world, however, continue to hold meaningful home biases in their portfolios and, as a result, remain significantly under-exposed to Growth and Emerging Markets. The average investor's dedicated allocation to Growth and Emerging Market equities is between 5% and 10%<sup>21</sup> yet these countries represent 14% of global equity market capitalisation-weighted benchmarks.<sup>22</sup> Furthermore, we believe this still drastically underplays their economic importance. On a GDP-weighted basis – which we would argue is more forward-looking and a better reflection of economic reality – Growth and Emerging Markets comprise 32% of the global equity universe.<sup>23</sup>

### Growth and Emerging Markets offer attractively valued equity opportunities

We believe Growth and Emerging Market equity valuations look attractive compared to their historical averages, to Developed Market equities and to other asset classes, especially in light of the many structural improvements we have already discussed. While individual markets vary, on average Growth and Emerging Markets are trading at a forward price-to-earnings (P/E) ratio of 8.6X, a 20% discount to their 10-year average and a 15% discount to Developed Markets.<sup>24</sup> In addition, the equity risk premium for Growth and Emerging Markets, which measures how much investors expect to be compensated for taking on additional risk relative to 10-year US Treasuries, is at an elevated level. Despite significantly stronger fundamentals and a downgrade of US sovereign debt, it is currently at its second-highest level since 1995 and approaching its 2008 peak. As illustrated in *Exhibit 6b*, peaks in the Growth and Emerging Markets equity risk premium have historically coincided with troughs in their equity prices and been followed by a sharp rebound.<sup>25</sup>

**Exhibit 6a – Growth and Emerging Market equity valuations look attractive relative to history and to Developed Markets<sup>29</sup>**



Source: GSAM, IBES, Datastream, as of 1-Dec-11.

<sup>21</sup> Source: InterSec Research and Morningstar, as of 31-Dec-10.

<sup>22</sup> Source: MSCI, FactSet, as of 31-Aug-11. Based on the MSCI All Country World Index (ACWI).

<sup>23</sup> Source: MSCI, FactSet, as of 31-Aug-11. Based on the MSCI All Country World (ACWI) GDP Weighted Index.

<sup>24</sup> Source: Morgan Stanley, Asia/GEMs Strategy Weekly Market Monitor, as of 28-Nov-11.

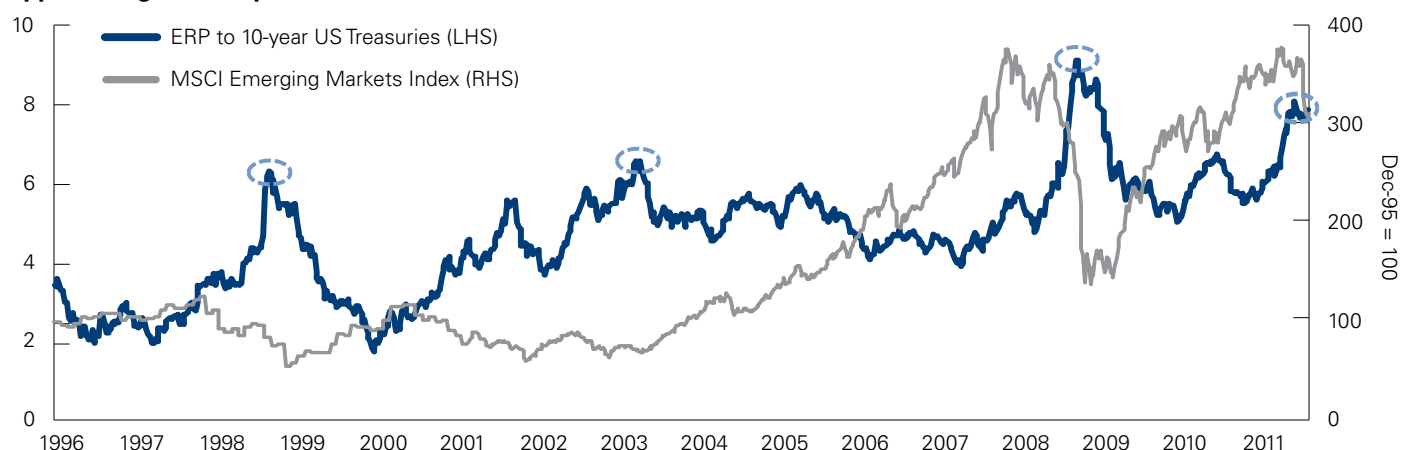
<sup>25</sup> Source: GSAM, Datastream as of 2-Dec-11.

<sup>26</sup> Source: GSAM, IBES, Datastream, as of 1-Dec-11.

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### Exhibit 6b – The equity risk premium for Growth and Emerging Markets is at its second-highest level since 1995 and approaching its 2008 peak



Source: GSAM, Datastream as of 2-Dec-11.

### How we invest in the Growth and Emerging Markets

Over the last decade, as the Growth and Emerging Markets have evolved, so have we. We believe a local presence is critical to fully capture the alpha generation opportunities available. As a result, GSAM's Growth and Emerging Markets equity team has grown from 11 investors based in London and Singapore in 2003 to 31 investors today based in eight offices around the world: Beijing, Hong Kong, London, Mumbai, São Paulo, Seoul, Shanghai and Singapore.<sup>27</sup> This gives us the twin benefit of having local insights as well as a global perspective.

As fundamental equity investors, we seek to generate the majority of our excess returns through stock selection, leveraging the resources and insights of our locally based investment teams. Our on-the-ground presence enables us to gain a deeper understanding of local companies, particularly those that are small and less well known by foreign investors. It also allows us to have more frequent access to management teams and more timely access to local news flow and capital markets. These advantages enable us to identify compelling alpha generation opportunities in small- and mid-capitalisation stocks as well as some that are not included in the benchmark, to differentiate our portfolios. We offer a broad suite of Growth and Emerging Market equity portfolios – including global, regional, thematic and country-specific – to help investors access this vast opportunity.

### Conclusion

We expect the next decade to be an exciting one for the Growth and Emerging Markets as they will drive a significant portion of global economic growth. We believe this will be accompanied by continued capital market deepening, making them ever more important to investors and offering the potential for attractive equity returns. We therefore believe it is also time to reassess the risks of investing in these countries and give some common misperceptions a reality check.

In summary, we believe that the Growth and Emerging Markets:

1. Offer high quality assets.
2. Are home to rapidly growing domestic markets and globally competitive companies.
3. Have broadened and deepened.
4. Warrant a dedicated portfolio allocation.
5. Offer attractively valued equity opportunities.

Not only is it time to re-define Emerging Markets, it is time for investors to reassess the risks and capitalise on what we believe is one of the greatest investment opportunities of the coming decade.

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