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Leaders in Structured Portfolio Management

THE TALE OF TWO MARKETS: A Brief Look at Crisis and Recovery in the Emerging Markets

Abstract

It was the best of times, it was the worst of times…Or was it the other way around? Throughout various booms and busts over the last sixteen years, Parametric has had a consistent record in managing assets in the emerging markets asset class. As we begin 2010, we take a quick look back over the shoulder to see what can be gleaned from the recent past. ▸▸

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2008 – THE BUST

However you want to label it, 2008 brought us one of the most significant financial meltdowns we have seen in decades. Due to a global credit crunch we were witness to a massive sell-off across all asset classes. As global institutions formerly thought too big to fail began to topple in the second half of 2008, we saw volatility spike and correlations converge across all asset classes. The emerging markets were in no way spared. During this time period, investors sought liquidity and, as a consequence, the biggest negative impact was observed in the largest and most liquid emerging market countries. The MSCI Emerging Markets Index posted the largest single-year drop in its 20+ year track record, wrapping up 2008 with a -53.33% return.

2009 – THE RECOVERY

The shellshock of the prior year hung over the first couple months of 2009. Then amid mixed results, the tidal shift of capital flows began to occur in mid-March. As the year progressed, we witnessed a run up in prices across most asset classes – some much greater than others. In the emerging markets, 2009 marked a period of sustained recovery. In the sharpest contrast possible, the MSCI Emerging Markets Index posted the largest single-year increase since inception, posting a 78.51% return. Investor dollars flowed primarily into the largest and most liquid markets, driving their relative values higher as compared to the smaller countries. During this time the frontier markets rose nicely, but for the most part did not fully experience the effects of this sustained recovery. Across the larger markets, Brazil led the way – the Bovespa Stock Index was up over 82% in local price return and, when one includes the currency effect from a US dollar basis, up over 120%.

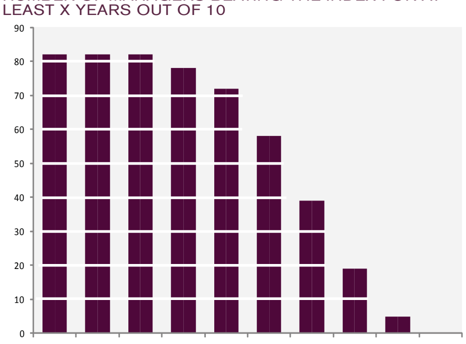
SO HOW DID TRADITIONAL ACTIVE MANAGERS FARE?

When reviewing the results of active managers throughout this tumultuous time period, some interesting things begin to come into focus. Of the 143 managers who reported returns to eVestment Alliance, one finds that only 63 managers outperformed the benchmark in 2008. During the following year, 74 managers experienced outperformance versus the Index. This punctuates that managing downside risk is a difficult endeavor.

An allocation to the emerging markets requires a long-term perspective. Powerful results surface when you take a step back and look at a longer time series. While many of the 84 market participants that have a 10 year track record have good 1, 2 and 5-year returns, only 5 managers have been able to beat the benchmark 9 out of 10 years. Consistency of outperformance over the long run is a rarity.

Exhibit 1:

NUMBER OF MANAGERS BEATING THE INDEX FOR AT LEAST X YEARS OUT OF 10



Source: eVestment Alliance 12/31/09

HOW DID PASSIVE INSTRUMENTS DO IN BOTH MARKET CYCLES?

It is no surprise that the passive indexes suffered in 2008 and expanded readily in 2009. However a couple of interesting things have occurred over the last two years as it applies to a passive approach in the emerging markets.

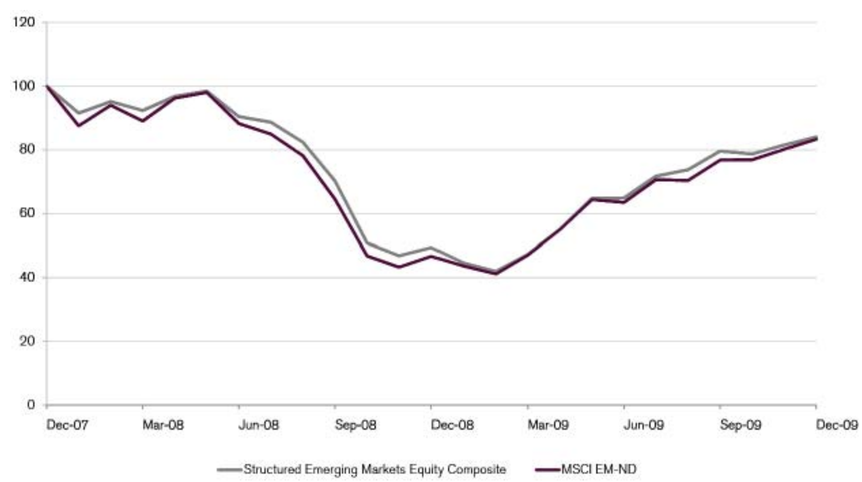
First, we have seen concentration build-up again in some of the largest countries in the Index. As of the end of 2009, the top four countries (China, Brazil, South Korea and Taiwan) account for nearly 60% of the Index. Furthermore, the top eight countries (China, Brazil, South Korea, Taiwan, India, South Africa, Russia and Mexico) comprise almost 85% of the Index.

Secondly, not all passive investment vehicles provide the same exposure or the Index like returns one might anticipate. For example in 2009, there have been implementation issues for some passive investment vehicles. One of the largest ETF's in the marketplace actually underperformed the Index by more than 9.5%. All passive approaches are not equal.

HOW DID OUR STRUCTURED EMERGING MARKETS STRATEGY RESPOND IN BOTH ENVIRONMENTS?

Despite the extreme downward move of 2008 and the reversal in 2009 the strategy performed as expected in both market cycles. Over the course of this unprecedented two-year period (12/31/07-12/31/09), the strategy composite experienced returns in line with the benchmark. Along the way the strategy had times of outperformance and underperformance, as one would expect during these extreme market events.

Exhibit 2:
STRUCTURED EMERGING MARKETS VS MSCI EMERGING MARKETS NET OF DIVS



Source: Bloomberg, Eaton Vance

2008

During much of 2008 the strategy outperformed the Index. As markets began to reel during the second part of the year, the emerging markets experienced heightened levels of volatility. It was during the highest points of volatility that the strategy outperformed significantly. Our structural underweights to the largest countries and overweights to the smaller countries provided a benefit to relative performance, since capital outflows were concentrated in the largest emerging market countries.

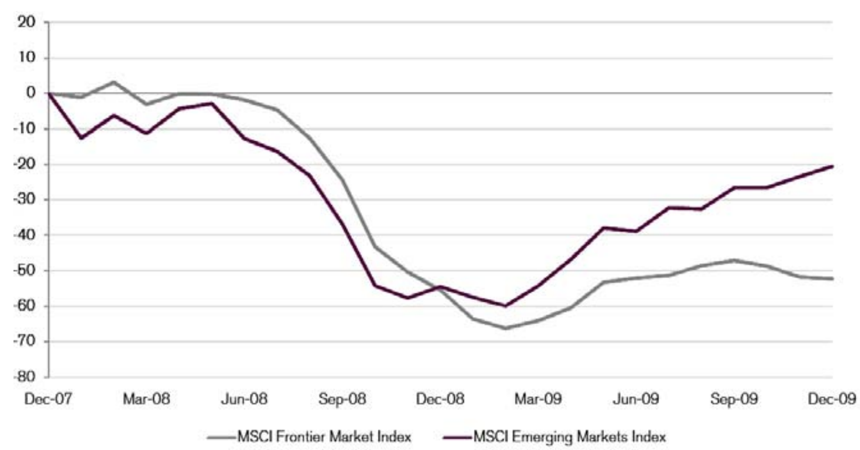
2009

The main driver of relative performance in 2009 was the structural exposure to the frontier markets. While the frontier markets posted positive returns for the year, their outstanding performance could not keep pace with the explosion of the more developed emerging markets (up 78%). The very same structural underweights to the largest countries and overweights to the smaller countries which provided outstanding downside protection in 2008 dampened performance during this tremendous updraft.

Further examination of how differently the MSCI Frontier Markets Index behaved as compared to the MSCI Emerging Markets Index reveals much about the nature of these returns during 2008 and 2009. Throughout the course of 2008 the Frontier Markets handily outperformed the Emerging Markets on a relative basis until the final few trading days of the calendar year. Once that inflection point occurred, the Emerging Markets advanced well above the Frontier Markets throughout the course of 2009.

Exhibit 3:

RETURNS OF MSCI FRONTIER MARKET INDEX VS MSCI EMERGING MARKETS INDEX



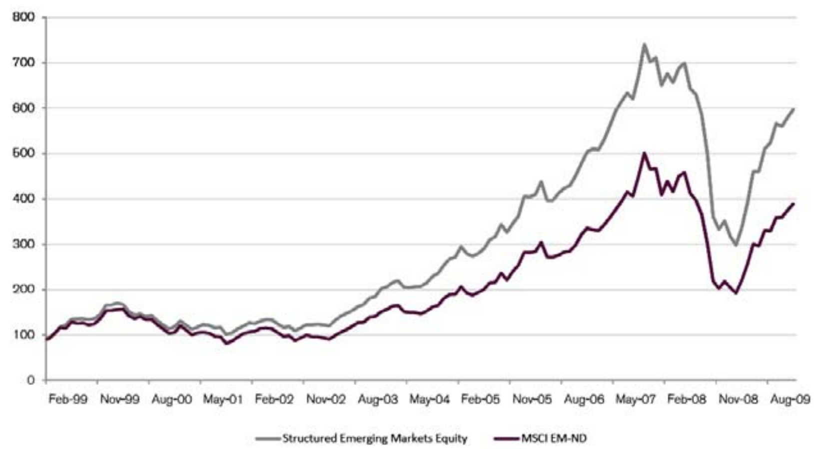
Source: Bloomberg

HAVE WE SEEN THIS BEFORE?

The short answer is yes.

Since the mid-nineties we have seen various ups and downs, global crises and recoveries. The emerging markets are by nature a risky asset class; extreme volatility is embedded in these markets and returns. When examining the Structured Emerging Markets composite track record, there are several instances of underperformance during times of initial market recoveries; yet the strategy went on to outperform the Index over the long-term.

Exhibit 4:
STRUCTURED EMERGING MARKETS EQUITY VS MSCI EMERGING MARKETS NET OF DIVS



Source: Bloomberg

Looking across returns of managers during 2008 and 2009 (as well as over longer periods of time), one finds that it is exceedingly difficult to outperform with any level of consistency. The eVestment Alliance data indicates that the Structured Emerging Markets Strategy is one of only five managers to have exceeded the benchmark 9 out of 10 years. The SEM strategy has provided consistent long-term risk-adjusted exposure to the emerging markets.

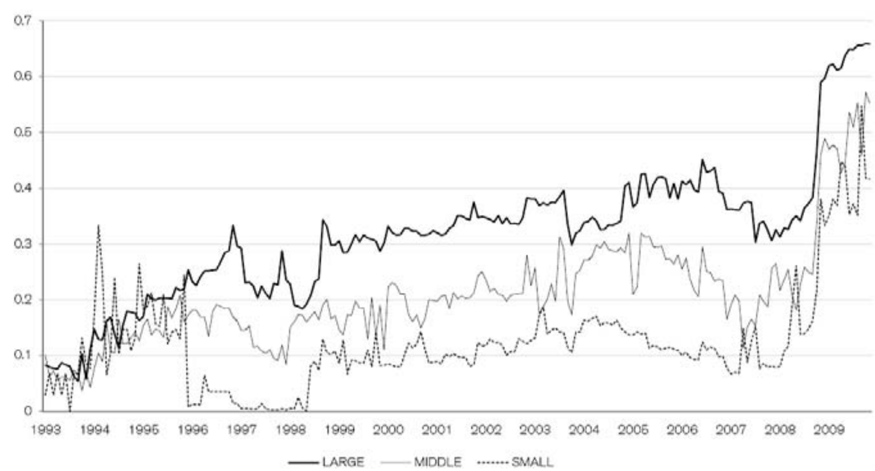
LOOKING FORWARD IN THE EMERGING MARKETS

Many market participants are again pointing to the emerging and frontier markets to be areas of growth and continued recovery in the global marketplace. Some have argued that the more conservative asset allocations are now outdated and out of line with actual market capitalization and global economic and demographic activity. As this paradigm shift takes hold, it stands to reason that the emerging markets will continue to be a growing portion of the global marketplace.

At the same time, the old adage that "the more things change the more they stay the same" seems to be true here as well. Historically, emerging markets have experienced a wide range of returns over various countries and various timeframes. We posit that volatility of returns will continue to be the norm – expect the unexpected.

When looking at the correlations of different market capitalizations across the emerging and frontier markets some very interesting results begin to emerge. We assigned these markets into three groups: The large countries (defined as the top 80% of the market capitalization), the middle countries (representing the next 15%) and the small countries (the bottom 5%, think frontier markets). We observe that for some time the correlations across these markets have moved on an upward trend. Then in 2008, correlations spiked across all size groups during the market fallout. However, it is the largest countries in the Index that continue to exhibit the highest levels of country cross-correlation, with the smaller markets well positioned to provide the benefits of diversification over time.

Exhibit 5:
AVERAGE ROLLING 5 YEAR CORRELATIONS BETWEEN THE S&P/IFCI MAJOR AND S&P/IFCG FRONTIER SIZE GROUPS AND MSCI WORLD INDEX



Source: S&P/IFCI Index

Since 1994, Parametric has managed assets in the emerging markets. Through a tiered approach spanning 45 countries, Parametric implements a structured, rules-based strategy, investing in more than 1,500 securities across the globe. Looking forward, we seek to continue to provide one of the most diversified exposures to the emerging and frontier markets.

It is our position that a structured investment philosophy provides effective long-term diversified exposure to the emerging markets asset class. Especially during times of uncertainty, a consistent rules-based approach mitigates negative investor behaviors. With this long-term risk-adjusted focus, Parametric endeavors to invest in a consistent fashion despite record setting levels of volatility. It is through thoughtful disciplined implementation that Parametric strives to effectively manage volatility in even the most challenging markets.

Brian Dillon
Director – Institutional Services & Institutional Portfolio Manager

Brian has responsibility for the development and distribution of Parametric's institutional investment products. As a member of the portfolio management and product management teams, he works to implement and develop Parametric's structured investment strategies as well as oversees ongoing client service needs. Brian joined Parametric in 2008 as a member of the Structured Emerging Markets portfolio management team. He has been in the investment industry since 1996 with specific experience in the institutional marketplace. Before joining Parametric, he spent seven years as Senior Portfolio Manager, with Russell Investments where he worked closely with institutional clients to design, develop and implement complex asset transitions for both defined benefit and defined contribution plans. Brian has also worked in sales, trading and underwriting in the fixed income securities market. He holds a B.S. in Business Systems with a minor in Economics from Taylor University.

About Parametric

Parametric is an industry-leading provider of structured portfolio management, headquartered in Seattle, Washington. Parametric and its affiliate, Parametric Risk Advisors, offer a variety of structured portfolio solutions, including customized core equity portfolios (U.S., Non-U.S., global Tax-Managed Core™), options strategies (DeltaShift℠), emerging markets (Structured Emerging Markets™), and overlay portfolio management (OverlayOne™). Parametric is a majority owned subsidiary of Eaton Vance.

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