



Emerging Markets as ASTERISCS

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Executive Summary

Alexander Kozhemiakin explains why nearly 30 years after the term was first coined, “emerging markets” no longer does justice to a category of investments that cover a wide array of asset classes (e.g., equities, debt and currencies) as well as countries of widely differing levels of development, wealth and risk. In addition, he says, traditional divisions between so-called developed and emerging markets are blurring, as some countries in the former category display higher levels of risk and a more serious degradation of fundamentals than countries in the latter. Instead of “emerging markets,” he argues for a new concept of “assets tied to economies of risky countries,” or ASTERISCS.

This new label, he says, provides investors with a more transparent and differentiated way of combining risk exposures across different asset classes in portfolios, which could otherwise be masked by blanket allocations to “emerging markets.” The concept is also a far more accurate reflection of the realities of a rebalancing global economy in which rich and non-rich, risky and less risky countries no longer neatly fall into the categories of the past. He begins by arguing the importance of accurately defining investment concepts and why the emerging markets label is misleading. He discusses the difficulties of defining emerging markets, precisely because they encompass such a rich variety of countries, economies, risk profiles, and asset markets. Focusing on the appeal and risk of non-rich countries, he discusses ways of diversifying country risks by combining exposures to a variety of public markets across these countries. Finally, he reiterates the utility of using the notion of assets tied to economies of risky countries as a better way for investors to understand the risk exposures in their portfolios.

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I. The Importance of Labels

Linguists and philosophers have long debated whether language shapes the way we think about the world. “To have a second language is to have a second soul,” declared Charlemagne around 800 AD. It is indeed plausible that simple words are not only expressing our thoughts but also constraining them and, as a result, affecting our behavior as well. “Each language has its own cognitive toolkit,” echoes a present day proponent of Charlemagne’s view.¹ The difficulty of empirically verifying or rejecting this claim has prevented any definitive conclusions in this debate so far.

Less controversial is an argument that concepts – the more complicated labels purposefully created to group, describe, and mark out all sorts of phenomena and which often form our professional jargon – can channel thoughts, and not only those of their creators. “As we are... prisoners of the words we pick, we had better pick them well,” admonished Giovanni Sartori, an acclaimed Italian political scientist whose work included a prominent study on concept formation.² At the very least, I believe inaccurate, ambiguous, and otherwise deficient concepts do not aid our thought process in any way.

Given their potential impact, it is surprising that relatively little attention has been paid to the analysis of concepts in investment management. Which concepts work and which don’t? Identifying, clarifying and, if necessary, discarding deficient investment concepts are not just academic exercises in semantics but may enhance the way in which we allocate assets and manage portfolios. As a fixed income manager, for example, I have often wondered how useful the concept of “fixed income” really is, especially to investors who are total return-oriented and not intricately familiar with the disparate segments that make up that asset class. Fixed income segments range from ones with relatively little risk to ones with great risk, from very liquid to illiquid, from straightforward to extremely complex. As a result, they can behave very differently in different market environments. Is the blanket concept of fixed income then a good guide for an asset allocator? This might be one reason why many investors were genuinely surprised by the magnitude of losses incurred in their fixed income portfolios when the global financial crisis escalated in 2008.

Unfortunately, specifying that I am an emerging markets fixed income manager, while adding a bit of precision, opens up another conceptual can of worms. This is because the term “emerging markets” – an undeniably catchy phrase introduced nearly 30 years ago with a marketing purpose – is yet another deficient investment concept because it masks important distinctions. Nevertheless, if clearly defined, the concept of non-rich countries with high growth potential across different asset classes could be highly useful, as it marks out important investment opportunities sharing a distinct type of risk. This discussion seeks to identify a more rigorous concept for characterizing that opportunity set. After much contemplation of the conceptual deficiencies of “emerging markets” as a descriptor and what would be required in a more accurate label, I believe referring to these investment opportunities as ASTERISCS, or ASsets Tied to Economies of RISky Countries does a far better job. This acronym better conveys the appeal and risks of emerging markets, whether referring to equities, bonds, currencies, or any other asset class, and better illuminates their place in a broader portfolio.

II. Emerging Markets as an Accurate Investment Concept

The term “emerging markets” traces back to the early 1980s. Antoine van Agtmael is generally credited with coining it. Mr. Agtmael, then an economist at the International Financial Corporation (the World Bank’s private sector arm), wanted to make a fund that was investing in what was at the time commonly and fairly pejoratively referred to as “third-world equities” appear more attractive to Western investors. “Emerging markets,” he thought, sounded much more uplifting and enticing. Since then, from a marketing perspective, the term has become a smashing success. Today, trillions of US dollars are invested in countless strategies that have a reference to emerging markets in their name.

¹ Lera Boroditsky, “How Language Shapes Thought,” *Scientific American* (February 2011).

² Giovanni Sartori, “Guidelines for Concept Analysis,” *Social Science Concepts: A Systematic Analysis*, ed. Giovanni Sartori (Beverly Hills: Sage, 1984), 60. Also see, Giovanni Sartori, “Concept Misformation in Comparative Politics,” *The American Political Science Review*, Vol. 64, No. 4 (December 1970), pp. 1033-1053.

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However, besides being catchy, there are several other criteria a good concept should fulfill, according to experts who have studied the problem.³ While the following list is taken from a framework created for the social sciences, I have adjusted it somewhat to make it more relevant to investment management. Thus, a good investment concept should have at least several of the following seven characteristics:

1. Resonance: Is the term catchy?
2. Consistency: Do the attributes that define the concept “belong” to one another?
3. Differentiation: Is the concept clearly delineated, marked out from other similar concepts?
4. Ease of measurement: Can the distinctive attributes be easily measured?
5. Richness: How many attributes does the concept “bundle”?
6. Collateral benefits: Does this concept improve existing ones by forcing us to critically re-examine them?
7. Utility: How useful is the concept?

For example, “high yield” – a label for speculative-grade rated bonds – meets some criteria of a good investment concept. It is catchy, while avoiding pejorative connotations of its popular alternative – “junk bonds.” It is consistent, as it refers only to bonds with higher levels of yield required to compensate for their higher credit risks. It is clearly differentiated from investment-grade rated bonds and can be easily measured either by the level of yield or a credit rating. The concept is also useful in portfolio construction, as high-yield bonds have different risk/return characteristics than investment-grade rated securities. High-yield bonds are more volatile due to their elevated credit risk, more sensitive to swings in risk appetite, but also carry the promise of higher returns.

In contrast, I believe the concept of emerging markets performs rather poorly against these criteria. Most importantly, it is used in two inconsistent ways. On one hand, the concept describes characteristics of the actual market. For example, an emerging market is a nascent market of a smaller size and low liquidity, with few participants, and a relatively underdeveloped infrastructure. On the other hand, it also refers to a country. For example, an emerging market is an asset class tied in some way (e.g., location of business, owners, issuers) to a country with an emerging economy.

Often the concept is used in these two ways simultaneously. This is potentially problematic, considering that a single country can have multiple markets (e.g., equities, bonds, currencies, real estate, etc.) with different characteristics. In particular, it is possible that a country classified as “emerging” can have a relatively mature, liquid market. For example, the Mexican peso (MXN) has been a free-floating currency without any restrictions on purchases or sales since 1994. The MXN foreign exchange market is one of the most widely traded in the world, with daily turnover of approximately US\$ 20 billion.⁴ Is this market less developed than, say, the European high-yield corporate bond market, which was virtually non-existent prior to 1997 and still could be improved in terms of liquidity and industry diversification? As such, the concept of emerging markets also fails to provide adequate delineation. Lower liquidity is not always characteristic of emerging markets, nor is it an attribute exclusive to them.

Moreover, the concept of emerging markets is ambiguous, if not outright misleading. What exactly does the “emerging” classification tell us? For instance, do the markets or countries have to undergo some positive structural transformations to be classified as “emerging”? Occasional sarcastic references to at least some emerging market countries with steady institutional degradation (e.g., Venezuela under President Hugo Chavez) as “submerging” are understandable. The concept of emerging markets may bundle together many attributes, but it is not clear what exactly they are or how they can be measured.

³ John Gerring, “What Makes a Concept Good? A Criterial Framework for Understanding Concept Formation in the Social Sciences,” *Polity*, Vol. 31, No. 3 (Spring 1999), pp. 357-393.

⁴ *Emerging Markets Local Markets Guidebook*, Morgan Stanley (March 2011).

Does the concept of emerging markets encourage us to critically reexamine other investment concepts? In my view, not really. If anything, I believe it makes us take too much comfort from its counterpart, “developed markets.” “Developed” implies that a certain stable, mature equilibrium stage has been reached. Is this right? Can “developed” markets regress and behave as “emerging”? Are developed markets always less volatile than emerging markets as the name “emerging,” conveying a certain fragility, seems to suggest? As recent sovereign debt crises in several developed countries (e.g., Ireland, Portugal, Greece) indicate, these questions are not just theoretical.

I would argue it is more important than ever to find a more accurate concept and label for these countries and their asset markets, because their universe is growing dramatically. According to the International Monetary Fund (IMF), emerging market countries now account for almost one half of the world’s economy.⁵ The capitalization of emerging market equities, as measured by the MSCI EM, is over four trillion US dollars as of June 30, 2011. The capitalization of the most liquid, investable emerging market bonds is over 1.5 trillion US dollars.⁶ The latter are dominated by local currency-denominated government bonds at almost a trillion, followed by US dollar-denominated sovereign and quasi-sovereign bonds at just below half a trillion and US dollar-denominated corporate bonds at approximately two hundred billion, as measured by the JPMorgan GBI-EM Global, EMBI Global, and CEMBI benchmarks respectively.⁷ According to EMTA (Trade Association for Emerging Markets), in 2010 the overall emerging market debt trading volume reported by participants was over US\$6.7 trillion.⁸ In addition, there are plenty of opportunities in emerging market currencies. The notion of market capitalization does not directly apply to currencies but their trading volumes can be measured. Thus, more than a dozen emerging market currencies have a daily turnover of several billion US dollars each. What do all these asset classes have in common? What role can they play in a well-diversified portfolio? I believe a proper definition should make apparent the appeal as well as the risks of these assets.

III. Markets or countries?

The term emerging markets does not always adequately reflect the reality on the ground. This is because emerging markets currently span almost the entire spectrum of development and liquidity. For example, the offshore market for the Chinese renminbi (RMB) in Hong Kong is still truly “emerging” following the “Regulation on RMB Bond Issuance of Domestic Financial Institutions in Hong Kong SAR” introduced by the People’s Bank of China only in June 2007. The investor base is still shallow, just a handful of brokers are active in the market, and issue sizes are small. Nevertheless, the offshore RMB market appears poised for spectacular growth. At the same time, few would argue that the actual market for US dollar-denominated emerging market sovereign bonds is still “emerging.” The market has been in existence for approximately two decades, has a solid investor base, and can relatively easily absorb large issues with long maturities. In 2010, for instance, Mexico successfully issued a 100-year bond denominated in US dollars.

Of course, relative to government bond or large-cap stock markets in the U.S., Germany, and Japan, most other asset classes appear much less liquid. The market capitalization of the MSCI EM is only about one third of that of the S&P 500. Undeniably, there is a lot of potential for further financial market deepening in emerging market countries. According to IMF data, in 2009, capital market assets (the sum of stock market capitalization, public and private debt securities outstanding, and total bank assets) in emerging market countries were 186% of their GDP, compared to 431% in the United States.⁹

But today’s investors are not just buying US Treasury bonds and exclusively investing in large-cap companies comprising the S&P 500. They own small-cap equities, corporate bonds of different credit quality, hedge funds, private equity, a variety of structured products, real estate, timber, etc. The mere fact that these asset markets may be

⁵ *World Economic Outlook*, IMF (April 2011). The IMF uses the “emerging and developing” classification.

⁶ The market cap would be substantially higher if currently non-accessible (from the perspective of foreign investors) local fixed income markets of China and India were to open up.

⁷ *Emerging Markets Bond Index Monitor*, JPMorgan (May 2011).

⁸ “EMTA Announces Annual Emerging Markets Debt Trading Stood at US\$6.765 Trillion,” EMTA (March 22, 2011).

⁹ David Lubin, “When Too Much Money Chases Too Few Assets,” Citi Investment Research & Analysis (May 2011).

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located in countries called developed does not necessarily make them more liquid than those in emerging markets. Liquidity in the largest emerging market stocks, e.g., Gazprom, Petrobras, Samsung Electronics, Vale, America Movil, China Mobile, exceeds that of the vast majority of developed equities. Note that although MSCI, a provider of widely followed international equity indices, includes liquidity and accessibility as criteria in its market classification, liquid and accessible equity markets are still going to be classified as emerging if the economic development of the country in which they are located is not sufficiently advanced. I believe that is another disconnect in the concept of “emerging markets.”

The liquidity of most US dollar-denominated emerging market sovereign bonds is at the very least not lower than that of comparably rated corporate issues in the United States or Europe. The U.S. Treasury market dwarfs that of Malaysian local currency-denominated government bonds, but the latter trade with bid/ask spreads of under 5 basis points – a far better level of liquidity than that of many fixed income asset classes in developed countries. Not to overstate the point, but real estate in California and Florida is likely at the moment to be more illiquid than real estate in Moscow or Istanbul.

Thus, I believe the description of emerging markets as nascent markets fails to provide their defining characteristic – something that distinguishes them from most other classes. In fact, more recently, a different concept – “frontier markets” – has appeared to describe less liquid emerging markets. For instance, according to MSCI, “frontier markets are typically characterized by limited market accessibility, small company size and low liquidity, while emerging markets are usually expected to provide higher levels of openness, investability and efficiency of the operational framework.”¹⁰

In contrast, when the term emerging markets is used to refer to asset classes with strong ties to emerging market countries, I believe it relies on a better differentiating criterion. However, in my view it suffers from a serious flaw in that it leaves undefined what an emerging market country is. The proper definition of an emerging market country then becomes of critical importance.

IV. Defining an emerging market country

The lack of a well-accepted definition of what constitutes an emerging market country makes writing investment guidelines for emerging market portfolios a difficult task. Some institutional investors just specify an exhaustive list of what they consider to be emerging market countries. Some use a shortcut, such as inclusion in a relevant emerging markets index. Many others opt for greater flexibility, allowing portfolio managers to invest in countries “generally considered emerging markets” or even leaving the composition of the universe entirely to the manager’s discretion.

There are two distinct approaches to defining an emerging market country, sometimes used in combination. The first relies on a credit rating. I come across many investors who still think of emerging market countries as having a credit rating below investment grade. This definition is not surprising, as it is reinforced by historical experience. A decade ago, many more emerging market countries (e.g., Brazil, Russia, Mexico) were rated as speculative and painful memories were still fresh of the Tequila crisis in Mexico, the Asian crisis, and the Russian and Argentinian defaults. The perception that emerging market countries have poor creditworthiness is apparent when, for example, emerging market bonds are often broadly grouped together with, and compared against, high-yield corporate debt as portfolio allocation decisions are made. I think this comparison is misleading. High-yield bonds, by definition, are a ratings-based asset class. One does not normally expect to find investment-grade rated bonds in high-yield portfolios. In contrast, emerging market countries exhibit varying levels of creditworthiness. Today, many of the countries we commonly refer to as emerging markets (Brazil, Russia, India, China, Mexico, Malaysia, Poland, South Africa, Chile, etc.) are rated investment grade.

Barclays Capital, a large bond index provider, relies on credit ratings to define emerging market countries in its recently introduced benchmark for US dollar-denominated emerging markets debt, the Barclays Capital U.S.

¹⁰ MSCI Barra Launches MSCI Frontier Emerging Markets Index, MSCI Barra Press Release (September 30, 2008).

Emerging Markets Index. It bypasses the problem that many emerging market countries are now investment grade by simply raising the maximum rating to BBB+, three notches above speculative grade. While more descriptively correct, this definition raises the question of why BBB+ was chosen as a threshold and not another ratings category. Somewhat inconsistently, Barclays then uses the maximum rating of A+ (three notches above BBB+) as one of the criteria for including local currency-denominated emerging markets debt in its index.¹¹ In the same vein, to be deemed an emerging market by the EMBI+, JPMorgan's older US-dollar emerging markets debt benchmark, a country must be rated Baa1/BBB+ or below by Moody's and S&P.¹²

The second, more popular approach is to define an emerging market country by its per capita national income – an indicator of a country's wealth. MSCI takes this approach for its emerging markets equity index, JPMorgan for most of its widely followed emerging market bond indices, and Barclays partially for local currency-denominated bonds. According to MSCI, for example, a developed country should have a gross national income (GNI) per capita that is 25% above the World Bank high income threshold for three consecutive years. If this requirement is not met, the country is classified as either emerging or frontier. By JPMorgan's rules, an emerging market country in its EMBI Global benchmark for US dollar-denominated emerging market sovereign and quasi-sovereign debt must be classified as having a low or middle per capita income by the World Bank for at least one of the past three years, based on data lagged one year.¹³

A country's wealth bundles many attributes, as per capita national income exhibits a strong (but not perfect) correlation with a number of other characteristics investors typically want to know about: stability of the country's institutional framework, the strength of rule of law, protections of property rights, social indicators such as the level of education, the extent of corruption, economic competitiveness, development of the banking system, creditworthiness, even the extent of democratization.¹⁴ To me, this makes sense. With the exception of smaller countries heavily endowed with natural resources, a lot of socio-economic and institutional prerequisites have to be met for a country to become rich. Causality also runs in the opposite direction. Rich countries can invest more in education, have the ability to develop more sophisticated economic institutions, and create an environment conducive to political democratization. For example, according to Samuel Huntington, the level of economic development creates “new sources of wealth and power outside the state and a functional need to devolve decision making.”¹⁵

Regardless of the direction of causal effects, per capita income is thus an excellent summary term. Not surprisingly, the World Bank considers gross national income (GNI) per capita its main criterion for classifying economies for operational and analytical purposes.¹⁶ GNI is closely related to the concept of gross domestic product (GDP). GDP is based on location, while GNI is defined by ownership. To convert GDP into GNI, one should add the income received by residents from abroad and deduct the income created by production in the country but transferred abroad.¹⁷

Per capita income also has two advantages of being relatively easy to measure and being more objective than a credit rating, which reflects the opinion of ratings agencies. The per capita income tables are made publicly available by the World Bank. As of 2009, the GNI per capita cut-off for high income countries was US\$12,196, according to the World Bank Atlas method.

¹¹ *Barclays Capital Emerging Markets Local Currency Government Bond Indices*, Barclays Capital (June 2010).

¹² *Emerging Markets Bond Index Plus (EMBI+): Rules and Methodology*, JPMorgan Securities (December 2004).

¹³ *Introducing the J.P.Morgan Emerging Markets Bond Index Global (EMBI Global)*, JPMorgan (August 1999).

¹⁴ See, for example, Jess Benhabib, Alejandro Corvalan, Mark Spiegel, “Reestablishing the Income-Democracy Nexus,” Federal Reserve Bank of San Francisco, Working Paper Series (February 2011). See also Richard Cantor and Frank Packer, “Determinants and Impact of Sovereign Credit Ratings,” *FRBNY Economic Policy Review* (October 1996), pp. 37-54.

¹⁵ Samuel P. Huntington, *The Third Wave: Democratization in the Late Twentieth Century* (University of Oklahoma Press, 1991), p.65.

¹⁶ *How We Classify Countries*, World Bank (2011).

¹⁷ Francois Lequiller and Derek Blades, *Understanding National Accounts* (OECD, 2006), p. 18.

V. The appeal and risks of non-rich countries

If emerging markets are differentiated by their ties to emerging market countries and emerging market countries are not rich, then emerging markets encompass the asset classes affected by developments in non-rich countries. Defined in this way, the appeal as well as risks of emerging markets become more clear.

Ultimately, the appeal is based on a promise that economies of emerging market countries can grow at higher rates than those of their developed counterparts. This promise is embedded in the very definition of an emerging market country. By definition, a non-rich country is starting with a lower base and thus has more room to catch up, to grow at faster rates than other, richer countries. In the words of Robert Barro, taken from his influential work on the determinants of economic growth:

The empirical findings for a panel of around a hundred countries strongly support the general notion of conditional convergence. For a given starting level of real per capita gross domestic product (GDP), the growth rate is enhanced by higher initial schooling and life expectancy, lower fertility, lower government consumption, better maintenance of the rule of law, lower inflation, and improvements in the terms of trade. For given values of these and other variables, growth is negatively related to the initial level of real per capita GDP.¹⁸

One can also use the results to ask, somewhat more speculatively, whether some changes in institutions or policies could move the United States, the United Kingdom, or another advanced country to the high-growth list, that is, raise the long-term per capita growth rate from 1 1/2 to 2 percent to around 4 percent. Unfortunately, the answer seems to be no. The institutions and policies in the advanced countries are already reasonably good (despite possible excesses of transfer programs and regulations), and long-term per capita growth much above 2 percent seems to be incompatible with the prosperity that has already been attained.¹⁹

Importantly, the promise of relatively more vigorous economic growth in emerging market countries rests not only on the potential for faster increases in the real GDP per capita but also on the fact that, on average, their population is likely to grow at higher rates than that in the developed world. At the most basic level, the more positive demographic trend in emerging market countries has been a result of the differential between birth rates and death rates. For a variety of socio-economic reasons (attitudes, literacy, female work participation, etc.), non-rich countries tend to have higher birth rates. At the same time, their death rates, while also generally higher than those in rich countries, have been significantly lowered over the past several decades due to medical advances and better nutrition. In 1950, China had a life expectation of 41 years and it may have been as low as 38 years in India. They now stand at approximately 74 and 65 years respectively.²⁰

More recently, however, the adoption of population control measures, such as China's controversial one-child policy, as well as changes in cultural attitudes have been causing birth rates to plunge in several emerging market countries. The skewed gender ratios (a result of preference for boys over girls) in countries like China and India also present a long-term demographic threat. The United Nations now classifies several large emerging market countries such as China, Brazil, and Russia as low-fertility countries; that is, countries where women are not having enough children to ensure that, on average, each woman is replaced by a daughter who survives to the age of procreation. Still, much of the projected increase in world population from approximately 7 billion today to 9.3 billion by the middle of this century is expected to come from non-rich countries in Africa, Asia, Oceania, and Latin America that are still characterized by high fertility rates. In contrast, European countries and Japan are characterized by low fertility. The United States is an intermediate-fertility country.²¹

In sum, it is a lower starting base and, at least in some cases, more favorable demographics that underpin the structural appeal of investing in non-rich countries – the promise of higher economic growth rates. The promise of

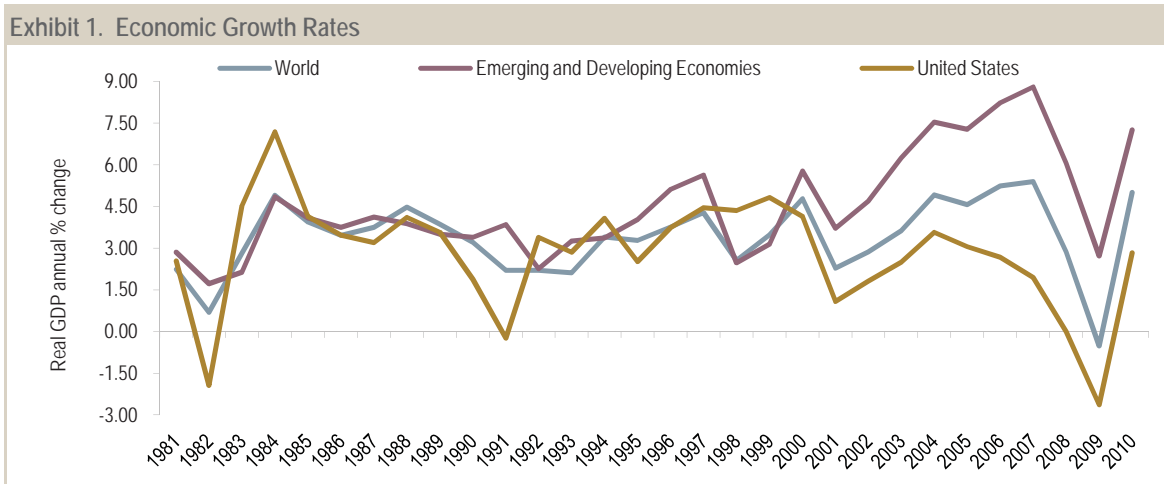
¹⁸ Robert J. Barro, *Determinants of Economic Growth: A Cross-Country Empirical Study* (MIT, 1997), p. xi.

¹⁹ Robert J. Barro, *Determinants of Economic Growth: A Cross-Country Empirical Study* (MIT, 1997), p. 46.

²⁰ Sanjeev Sanyal, "The Wide Angle: The End of Population Growth" (Deutsche Bank, May 2011).

²¹ United Nations, *World Population Prospects. The 2010 Revision*.

higher growth rates, however, does not necessarily mean that it will be realized. Indeed, it is only in the past decade that emerging market countries started to live up to their potential, as reflected in the positive differentials between their growth rates and those of the rest of the world.



Source: Standish, International Monetary Fund (IMF) World Economic Outlook (WEO) as of March 31, 2011

Together with the structural reforms of the 1990s (e.g., privatization, deregulation), it was a series of financial shocks starting with the Asian crisis of 1997 that may explain the recent growth outperformance of emerging market countries. The Asian crisis, the Russian default of 1998, and their severe contagion effects, prompted many of them to tighten fiscal belts, build up buffers against external volatility, implement more credible monetary policies, devalue currencies, and adopt more flexible exchange rate regimes. These actions, in turn, have created favorable conditions for the more rapid economic expansion. The improving terms of trade for those emerging market countries which are commodity exporters also helped.

At the same time, the definition of emerging market countries based on their GNI per capita also warns investors about some of the main risks of investing in them. There is definitely information in the fact that these countries are not rich. Something has been holding them back. It could be civil strife, unstable institutions, corrupt bureaucracy, a weak legal system, imprudent fiscal and monetary policies, high debt burden, an underdeveloped or impaired financial system, low levels of education and poor skills, uncompetitive corporate sector, excessive government intervention, consequences of past mismanagement, bad luck or some combination of these factors. The greater the potential for the catch-up, the more severe the extent of handicaps is likely to be.

VI. Economic growth rates and returns

Economies of non-rich countries carry the promise of higher growth rates. Aggregate corporate earnings typically grow more or less in line with the entire economy. Yet, investors cannot assume that higher growth rates always directly translate into higher rates of return. Above all, valuation levels – what is already priced in – matter a lot. Expectations of future robust GDP growth could already be reflected in prices today. In other words, market returns may lead GDP growth and react more strongly to expectations about the future rather than to actual economic performance.²²

In addition, for equity investors, publicly listed companies comprising the stock market may not always constitute a representative sample of the economy and therefore might not provide the kind of exposure needed to take advantage of the country's growth potential. Enterprises that are not publicly traded may provide a significant contribution to

²² Jim O'Neill, Anna Stupnytska, and James Wisdale, "Linking GDP Growth and Equity Returns," *Goldman Sachs Asset Management* (May 2011).

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economic growth. This is especially relevant for emerging markets where closely held companies as well as state-owned enterprises may account for a large share of the corporate sector. Finally, capital increases through additional share issuance may contribute to economic growth but also dilute the stake of existing investors.²³ These factors may explain, for example, why some studies have failed to find a strong relationship between economic growth rates and equity returns.²⁴

Beyond equities, there is stronger evidence linking economic growth rates to the performance of risky asset classes, such as credit spreads and currencies. For example, the pick-up in economic growth in emerging market countries over the past decade has coincided with the significant improvement in their creditworthiness. The share of investment grade-rated countries in JPMorgan's EMBI Global benchmark for US dollar-denominated sovereign and quasi-sovereign debt rose from less than 10% in the mid- 1990s to almost 60% as of the end of 2010.²⁵ Not surprisingly, the improved creditworthiness has led to the impressive tightening of emerging market bond spreads over this time.

Similarly, according to Kenneth Rogoff, for every 1% increase in a country's real per capita income (in a cross-section), its real exchange rate is stronger by 0.366%.²⁶ This is consistent with the oft-cited Balassa-Samuelson effect, which describes the mechanism through which price levels in poorer countries catch up to those in richer countries when converted to a common currency using the nominal exchange rate.²⁷ As the poorer countries develop and increase their productivity in the tradeable goods sector, the prices in the non-tradeable sector rise (while the prices in the tradeable sector are pegged by global supply and demand). This happens because real wage gains in the tradeable sector boost wage levels throughout the entire economy. The effect, the appreciation of the real exchange rate, can manifest itself not only via higher inflation but also through stronger nominal exchange rates or some combination of both.

In fact, defining emerging market countries as non-rich allows emerging market currencies to become an asset class with a positive long-run expected return from the perspective of investors based in developed, rich countries. This is in contrast to developed market currencies which are typically viewed as contributing to volatility but not long-run returns. The Balassa-Samuelson effect implies that as emerging market countries grow richer, exposures to their currencies via forward currency contracts or local money market instruments should either offer positive carry (i.e., local money market yields are higher than those in the developed world) reflecting higher local inflation and/or these currencies should exhibit nominal appreciation. Either way, this creates a positive expected return for investors in the developed world.

Furthermore, in some instances, positive carry of emerging market currencies may also reflect compensation for higher country risk and/or expected currency depreciation. This was, for example, the case across several emerging market currencies more than a decade ago, during the Asian crisis and Russian default. More recently, however, the carry on several emerging market currencies has been depressed by improved sovereign creditworthiness, reduced probability of a sudden large-scale currency devaluation (this is due, in part, to the general transition to more flexible exchange rate regimes), inflows of foreign capital, and lower policy rates. The chart below presents the yield on emerging market money market instruments included in JPMorgan's ELMI+ benchmark against the 3-month US\$ LIBOR since 1994, the longest period for which the ELMI+ data are available.

²³ William Bernstein and Robert Arnott, "Earnings Growth: The Two Percent Dilution," *Financial Analyst Journal* (September/October 2003), pp.47-55.

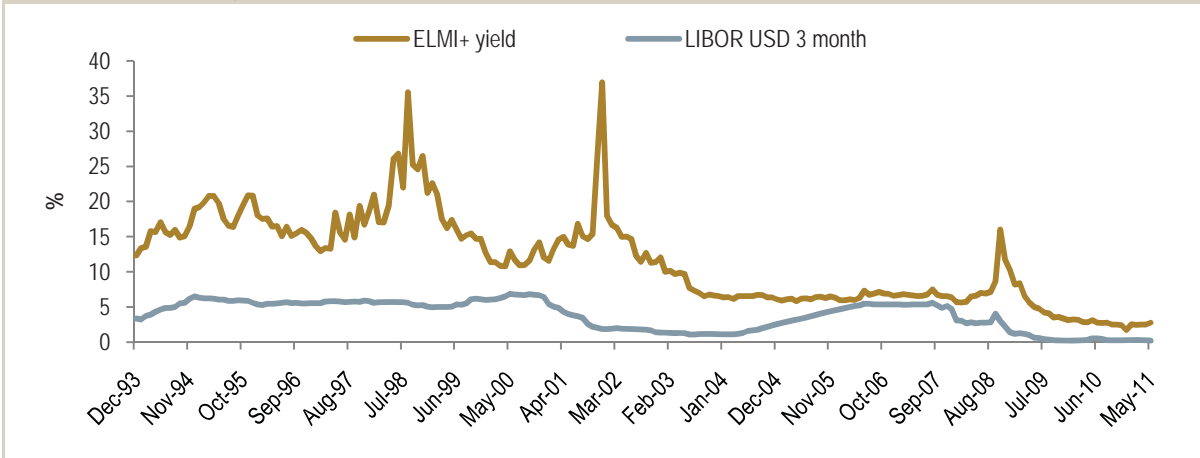
²⁴ See, for example, Jay Ritter, "Economic Growth and Equity Returns," *Pacific-Basin Finance Journal* 13 (2005), pp. 489-503. *Is There a Link Between GDP Growth and Equity Returns?* MSCI Barra Research Bulletin (May 2010).

²⁵ *EM Moves into the Mainstream as an Asset Class*, JPMorgan (October 2010), pp.46-47.

²⁶ Kenneth Rogoff, "The Purchasing Power Parity Puzzle," *Journal of Economic Literature* vol.34, no.2 (June 1996), pp. 647-68.

²⁷ Bela Balassa, "The Purchasing Power Parity Doctrine: A Reappraisal," *Journal of Political Economy* vol.72, no.6 (1964), pp. 584-596. Paul Samuelson, "Theoretical Notes on Trade Problems," *Review of Economics and Statistics* vol.46, no.2 (1964), pp. 145-154.

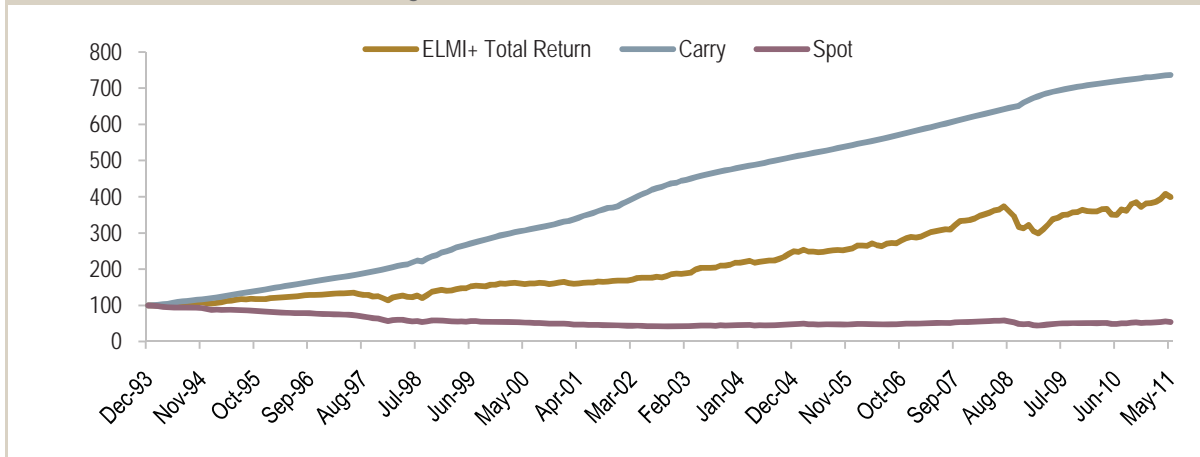
Exhibit 2. The ELMI+ yield versus the 3-month US\$ LIBOR



Source: Standish using Bloomberg, JPMorgan, BBA as of May 31, 2011

The performance (in US\$ terms) of emerging market local-currency-denominated money market instruments has been impressive over the past two decades. The long-term Sharpe ratio of the ELMI+ is 0.60 – higher than that of emerging market equities, the S&P 500, and US High Yield corporate debt.²⁸ As the chart below illustrates, the returns for ELMI+ came primarily from carry, with appreciation of emerging market spot rates providing a positive contribution to returns only since 2002. It is also important to note that nominal appreciation of emerging market currencies over the past decade has been considerably slowed down by the intervention of their respective monetary authorities. These interventions are conspicuously reflected in the dramatic rise of foreign exchange reserves in emerging market countries as diverse as Brazil, Russia, and China.

Exhibit 3. US\$ Return Index for JPMorgan ELMI+ (Dec 31, 1993 = 100)



Source: Standish using JPMorgan data as of May 31, 2011

VII. ASTERISCS

For all its advantages (consistency, differentiation, ease of measurement, richness), the concept of a “non-rich” country fails to encompass all countries that could be classified as emerging markets. In particular, it leaves out rich countries with a high external threat (e.g., South Korea), high domestic political risk (e.g., Bahrain), or major debt sustainability

²⁸ Emerging Markets Bond Index Monitor, JPMorgan (May 2011), p.3.

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problems (e.g., Greece). While differences of opinion certainly exist, most investors would at the very least pause before classifying these countries as developed. Some would put these countries outright in the emerging markets category.

We therefore should construct a more comprehensive definition of an emerging market country using the presence of relatively high country risk of any type as the main differentiating criterion. In the vast majority of cases, the risk would be captured by the reasons the country is not yet rich or by the attributes of a non-rich country. At the same time, this broad definition leaves the door open for other types of risks as well. Regardless of their specific nature, country risks share a common characteristic – the potential to affect the performance of all asset classes with strong ties to that country. We at least implicitly acknowledge this potential if, for example, in addition to thinking about Samsung Electronics as a world-class manufacturer of electronic equipment, we put a mental asterisk next to it when considering the inclusion of its stock in the portfolio, with the asterisk reminding us that it is also a South Korean company.

In a world enamored of acronyms, we can therefore define emerging markets as ASTERISCS – assets tied to economies of risky countries. This definition is supported by empirical evidence. Numerous academic and industry studies have highlighted the importance of country level risks in emerging markets. For example, MSCI notes that “the country MAD [mean absolute deviation from the index return] for emerging markets is often twice as large, and sometimes even three times larger than that for the developed stock markets.”²⁹ Similarly, another study focusing on equities finds that “[In Emerging Markets] country allocation generates a higher dispersion in returns... than does industry allocation. Our results also imply that, for investors in emerging markets, country analysts may be more important than industry analysts.”³⁰ For bonds, spreads on emerging market US dollar-denominated corporate debt exhibit a strong positive correlation with those on debt issued by their respective sovereign. In fact, the presence of foreign currency transfer risk (a country-level risk) lends support to the argument that ratings for foreign-currency sovereign bonds should in some cases act as a ceiling for foreign-currency debt ratings of corporations domiciled in these countries.³¹ As an illustration of the tight relationship between sovereign and corporate spreads in emerging markets, Exhibit 4 presents the average spreads of Russian corporate bonds against those of bonds issued by Russia and its quasi-sovereign entities.

Exhibit 4. Spreads on Russian Sovereign and Corporate US\$-Denominated Bonds



Source: Standish using Bloomberg, JPMorgan data as of May 31, 2011

²⁹ *Country and Industry Effects in Global Equities*, MSCI Barra Research Bulletin (October 2008), p.3. Also see Anton Puchkov, Dan Stefek, and Mark Davis, “Sources of Return in Global Investing,” *Journal of Portfolio Management* vol. 31, no.2 (Winter 2005), pp. 12-21.

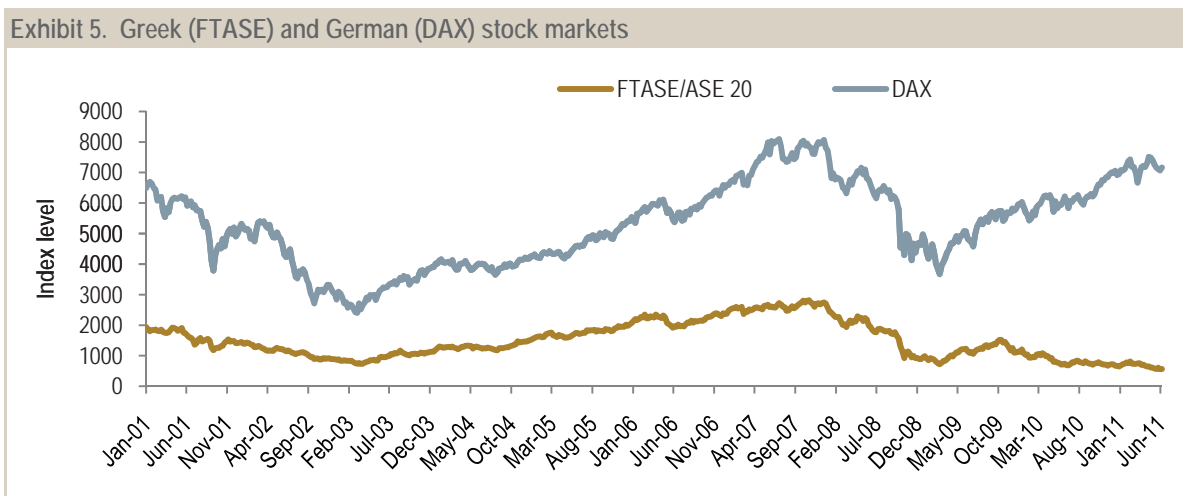
³⁰ Javier Estrada, Mark Kritzman, and Sebastien Page, “Countries Versus Industries in Emerging Markets: A Normative Portfolio Approach,” *The Journal of Investing* (Winter 2006).

³¹ See, for example, Vincent Truglia and Pierre Cailleteau, *Piercing the Country Ceiling: An Update*, Moody’s Investor Service (January 2005).

The biggest problem with the definition of an emerging market country on the basis of its level of country risk is that it does not tell us in advance which countries should be part of this group. In other words, measuring high country risk is much easier ex post rather than ex ante. Still, at least one of the following characteristics is present in all cases of high country risk:

- (1) GNI per capita below the high income threshold;
- (2) impaired creditworthiness;
- (3) existence of an external threat; and
- (4) a non-democratic political regime.

As we have already mentioned, the reasons a country is not rich or the attributes of a non-rich country capture the vast majority of potential country level risks. Impaired creditworthiness, as reflected for example in a speculative-grade credit rating, also creates a situation in which rich, developed countries regress back to “emerging” with their markets becoming ASTERISCS. Impaired creditworthiness is a country risk because default on public debt is a systemic event that has the potential to negatively affect the performance of all asset classes tied to the economy of that country by undermining investor confidence, potentially severely damaging the financial system, and significantly raising the cost of capital. Consider, for example, the underperformance of the Greek equity market in the past couple of years, during which the country’s credit rating was cut several times from investment grade to the lowest rating levels. Exhibit 5 contrasts the performance of Greek and German equities. Note the divergence in their returns since 2009 – German stocks rebounded swiftly, while the Greek market plunged to new depths.



Source: Standish using Bloomberg data as of June 30, 2011

The presence of an external threat requires no explanation, with wars and lesser types of military conflicts constituting important risk factors. Yet, I believe using a non-democratic political regime as an indicator of higher country level risk deserves a more detailed examination.

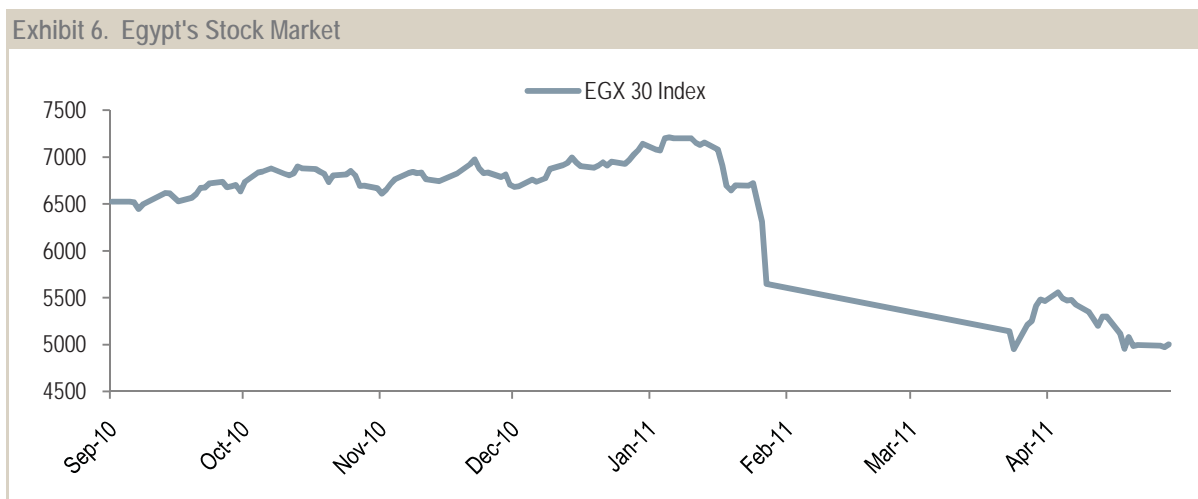
With the thorny exception of issues related to human rights and other socially responsible considerations (which some investors may understandably choose not to ignore), it is not obvious to me why the non-democratic nature of political regimes should increase country risk or, more generally, be a consideration in investment decisions. In fact, one could argue the reverse is true – authoritarian regimes are less risky for investors because they are more stable than democracies. I think that argument is misleading. Some authoritarian regimes may indeed appear more stable. However, the perceived stability is a result of a rigid political structure that suppresses dissent. This rigidity, in turn, creates the possibility of an eventual dramatic regime change which could be highly disruptive for the markets. In contrast, democracies “institutionalize uncertainty.”³² Electoral outcomes are unpredictable, political alliances in

³² Adam Przeworski, *Democracy and the Market* (Cambridge University Press, 1991).

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democracies are constantly shifting and governments can change quickly. Yet, it is exactly this fluidity and flexibility of a democratic system that safeguards it from the risk of a more sizeable political upheaval plaguing authoritarian regimes. In my view, the “institutionalized uncertainty” of a democracy is thus a lesser risk than the possibility of an abrupt, outsized change in the entire political regime.

Exhibit 6 offers a recent example of the effect of political upheavals in non-democratic countries by graphing the performance of the Egyptian stock market around the time of Hosni Mubarak’s ouster in 2011. Mubarak was Egypt’s authoritarian ruler for three decades. The stock market lost approximately one-third of its value in just a few weeks.



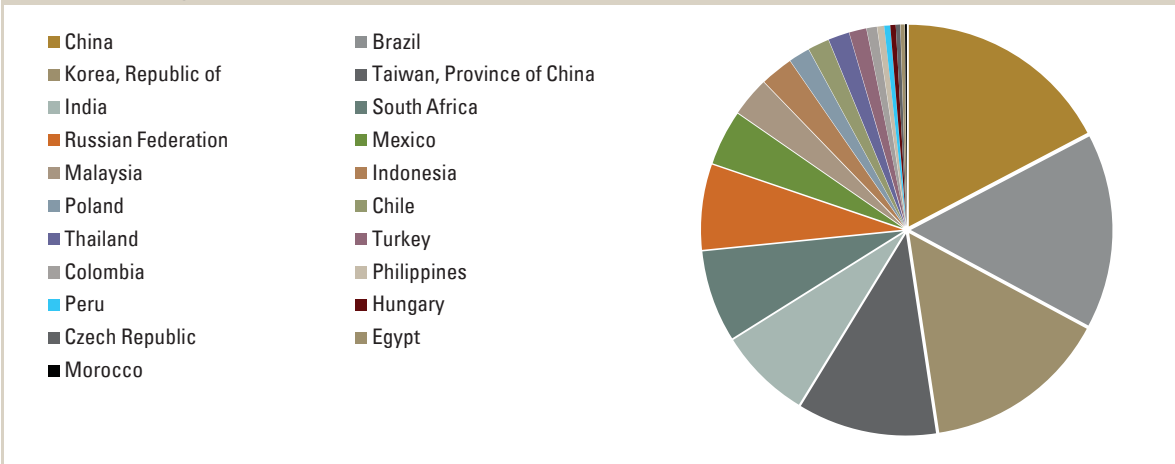
Source: Standish using Bloomberg data as of April 30, 2011

The diverse nature of country risks and their differing magnitude used to confer the moniker “emerging market” make for a very heterogeneous collection of countries. For example, as countries, Chile and Pakistan are literally and figuratively worlds apart, yet both are categorized as emerging markets. This heterogeneity poses an extra challenge for managing an allocation to ASTERISCS. The recent proliferation of constrained, qualified emerging market mandates (e.g., investment-grade only emerging market bonds, Asia-only emerging market currencies, country-specific emerging market equities) reflect an attempt by investors to cope with this heterogeneity.

VIII. Diversifying country risk

One of the most important benefits of defining emerging markets according to a high level of country risk is that it highlights the importance of country diversification in emerging markets. Diversifying country exposures is not an easy task in emerging market equities. Just eight countries comprise approximately 80% of the market capitalization of MSCI EM, with the top four (China, Brazil, South Korea, and Taiwan) accounting for more than a half.

Exhibit 7. Country Composition of MSCI EM

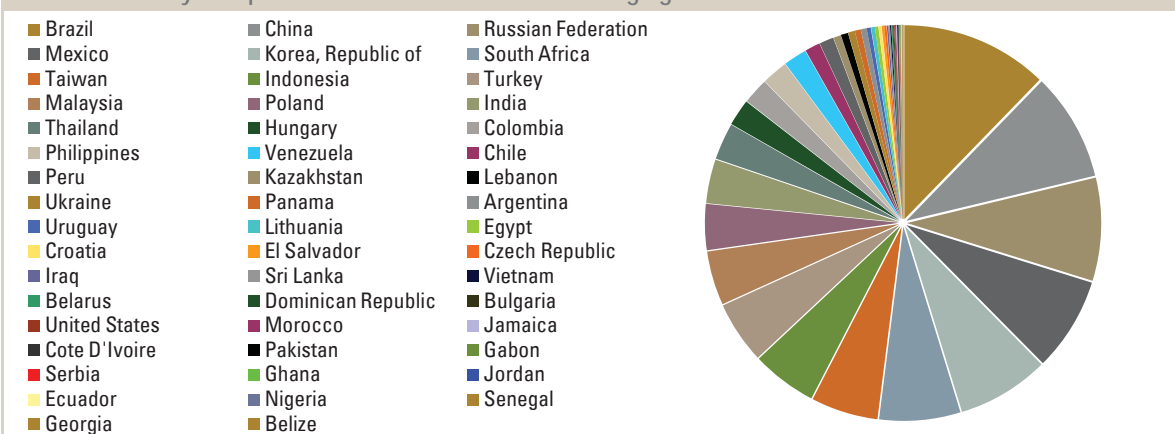


Source: Standish using MSCI data as of June 30, 2011

A commonly suggested solution to the problem of country diversification in emerging markets is to add frontier markets. However, adding frontier markets, by definition, results in taking on illiquidity risk. A more efficient, albeit less obvious, way of enhancing country diversification without necessarily sacrificing liquidity is to combine equity and fixed income (credit spreads, currencies, local rates) exposures. Achieving greater country diversification by spreading emerging market investments across all publicly traded asset classes is possible because the country universes for emerging market equity and fixed income only partially overlap. For instance, countries like Argentina and Kazakhstan may not have a large equity market but offer relatively liquid US dollar-denominated bonds. In contrast, while India's local debt market is sealed off to foreign investors by capital controls, its equities are accessible and investors can also get exposure to the Indian rupee via forward currency contracts.

As an illustration, Exhibit 8 presents the country composition of a naïve "total" emerging markets benchmark consisting of 50% MSCI EM (equities), 25% JPMorgan GBI-EM Global Diversified (local currency-denominated government bonds), and 25% JP Morgan EMBI Global (US\$-denominated sovereign and quasi-sovereign bonds). The combined multi-asset benchmark achieves a higher degree of country diversification than a pure equity index.

Exhibit 8. Country Composition of a Multi-Asset Class Emerging Market Benchmark



Source: Standish using MSCI, JPMorgan and proprietary data as of June 30, 2011

Importantly, as equity and fixed income universes partially overlap, there is a strong case to be made in favor of taking emerging markets equity and fixed income decisions jointly rather than separately as in the more traditional "fund-of-funds" approach in which equity and fixed incomes sleeves are managed independently of one another. The integrated decision-making process is needed to ensure that there is no excessive concentration of investments in

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countries that are well represented in both universes (e.g., Russia, Brazil, Mexico). Indeed, the proposed definition of emerging markets as ASTERISCS implies that in considering the risk of their portfolios, investors should not only ask “How much emerging markets equity or fixed income, do I have?” but also “How much emerging markets do I have overall?” and even more importantly “How much exposure do I have to a particular high-risk country?” Unfortunately, the current industry set-up characterized by a separation of fixed income and equity departments does not often make it possible even to ask these types of questions, let alone answer them. Yet, the country risk in emerging markets cuts across all asset classes.

IX. Emerging markets in a broader portfolio

Defining emerging markets as assets tied to economies of risky countries also helps to illuminate their place in a broader portfolio. Essentially, emerging markets play two roles. First, by taking on the elevated country risk (in addition to other types of risks specific to their respective asset classes), emerging markets can potentially enhance returns. Second, even though they expose investors to countries with higher risk, emerging markets can also diversify the country risk of existing portfolios. Most portfolios exhibit a strong home bias (i.e., concentration of the portfolio in the investor’s domestic market). According to the Bank of England’s calculations, for example, the home bias in equity allocations remains very pronounced.³³ The weighted average home bias in the US, UK, Germany, France, Italy, Japan, Canada, and Australia was 0.61 in 2007 (a measurement of 1 means a country holds no foreign equity in its investment portfolio).³⁴ The home bias is projected to have declined only marginally to 0.56 in 2010. This still means that portfolios are overly concentrated. By definition, the country risk of developed markets is not high. However, it is not zero and can potentially rise.

It should be emphasized that country diversification does not necessarily protect investors against sharp global crises. Unfortunately, there is little evidence to dispute the old adage that “diversification works least when you need it most.” For example, in the immediate aftermath of the Lehman Brothers collapse in the fall of 2008, correlations of all liquid risky asset classes spiked. However, recent research indicates that while in the short run diversification is at its weakest, over longer periods globally diversified portfolios outperform in a meaningful way portfolios held by home-biased investors.³⁵ The outperformance is due to diversification protecting investors against the adverse effects of holding portfolios concentrated in a country on a poor long-term economic trajectory. For investors in developed countries, the case for an allocation to emerging markets on pure diversification grounds is even stronger given that the average correlation of equity returns of a developed market with emerging markets is lower than the average correlation of a developed market with other developed markets.³⁶ The lower correlation could be explained by the larger role played by idiosyncratic country risk factors in the performance of emerging markets.

The much debated “optimal” level of allocation to emerging markets (with most suggestions falling within a broad 5-30% range) is then not only a function of the stand-alone appeal of investments tied to economies of higher-risk countries but should also reflect the realistic assessment of alternatives – asset classes of countries normally considered to pose lower risks. There has been, therefore, a considerable amount of interest in exploring ways to increase an exposure to emerging markets in the wake of the recent global financial crisis, which highlighted the vulnerabilities of developed countries. At present, the most plausible mechanism for a rise in country risk in developed markets appears to be additional deterioration in the creditworthiness of their public sectors. Recent downgrades or negative changes in the outlook for credit ratings for a number of developed countries, including the United States and Japan (not to mention countries on the periphery of the eurozone), certainly send a cautionary signal.

³³ Andrew Haldane, “The Big Fish Small Pond Problem,” Speech, Bank of England (April 2011).

³⁴ A country’s home bias is given by $1 - \text{Country's holdings of foreign equity compared to country's total global equity holdings} / \text{Other countries' total share of world equity market capitalization}$.

³⁵ Clifford Asness, Roni Israelov, and John Liew, “International Diversification Works (Eventually),” *Financial Analysts Journal* vol. 67, no. 3, May/June 2011, pp. 24-38.

³⁶ Peter Christoffersen, Vihang Errunza, Kris Jacobs, Hugues Langlois, “Is the Potential for International Diversification Disappearing?” Working Paper (March 2011).

In fact, according to some observers, we may be entering a situation in which the demand for emerging market assets begins to exceed the available supply.³⁷ On one hand, demand has been strong. The Institute of International Finance estimates that net equity portfolio flows into emerging markets rebounded from US\$153 billion in 2009 to US\$199 billion in 2010 and are projected to stay at approximately this level in 2011 and 2012. Similarly, nonbank net credit inflows into emerging markets are forecast to increase from US\$142 billion into 2009 to US\$222 billion in 2012.³⁸ On the other hand, the supply of financial assets from emerging market countries has been relatively limited. First of all, a saving-investment surplus (or current account surplus) in several emerging market countries (most importantly, China) means that whatever new financial assets are created, they wind up predominantly domestically owned.³⁹ The economy with the savings surplus does not need external financing. In addition, financial markets in emerging market countries are generally not as deep as those in rich countries and the former also often exhibit a preference for bank lending as opposed to a capital markets-based model of credit intermediation. As a result, the existing publicly traded emerging market asset classes that are accessible to foreign investors run the risk of being overwhelmed by large global capital inflows.

Note that this does not mean that emerging markets are nascent or illiquid, just that there is a shortage of emerging market financial assets relative to the size of potential global demand. If most asset allocators have decided today that emerging markets should have a weight of 10-20% in their portfolios, the flows into the asset classes of emerging market countries would be staggering. For example, while precise data is hard to find, anecdotal evidence suggests that an average allocation to emerging markets in the public and private pension systems of OECD countries is currently not more than a couple of percentage points.⁴⁰ Pension funds in the OECD area had assets under management of approximately US\$17 trillion in the first half of 2009.⁴¹ The size of assets is most likely higher today, given the general market appreciation since then. Thus, just a 10% increase in the allocation to emerging markets from OECD pension funds would mean the inflow of approximately US\$ 2 trillion.

In the absence of capital controls or other types of efforts to smooth portfolio flows, the supply-demand imbalance might make emerging markets susceptible to boom-bust cycles. To be fair, emerging markets today are, on average, in a much better position to cope with volatile portfolio flows than they were more than a decade ago, around the time of the Asian crisis. Many emerging market countries have built up foreign exchange reserves, reduced their external debt, and adopted more flexible exchange rate regimes. In contrast to the historical experience, most emerging market countries are also now able to pursue counter-cyclical fiscal and monetary policies to smooth their respective macro-economic fluctuations. These improvements, however, only reinforce the appeal of emerging market countries. It is, therefore, not surprising that measures to stem capital inflows are currently near the top of policy agenda in several emerging markets, with Brazil re-introducing in 2010 and subsequently increasing the tax on foreign purchases of local securities and China still clinging to more strict capital controls.

X. Better Labeling Breeds Better Understanding

I have tried to highlight the shortcomings of the traditional emerging markets label for a far more diverse and differentiated universe of countries and assets than that term would imply. Instead, I believe thinking in terms ASTERISCS – assets tied to economies of risky countries, will help investors better understand the kinds of risks they are combining in their portfolios. In my view, the vast majority of country risks can be captured by the reasons these countries are not yet rich or by the attributes of a non-rich country. Although the fact that a particular country is not rich is definitely not a mark of strength, it does not mean that assets tied to the performance of its economy are always more vulnerable to various types of shocks.

³⁷ Jiaqian Chen and Patrick Imam, "Causes of Asset Shortages in Emerging Markets," IMF Working Paper, May 2011. See also Andrew Haldane, "The Big Fish Small Pond Problem," Speech, Bank of England (April 2011).

³⁸ Institute of International Finance (IIF), *Capital Flows to Emerging Market Economies*, IIF Research Note (January 24, 2011).

³⁹ David Lubin, "Emerging Markets Macro and Strategy Outlook: When Too Much Money Chases Too Few Assets," Citi Investment Research & Analysis (May 2011).

⁴⁰ See, for example, *EM Moves into the Mainstream as an Asset Class*, JPMorgan (October 2010), p. 61.

⁴¹ *Pension Markets in Focus*, OECD (July 2010), Issue 7, p.3

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Indeed, reverting to the notion of concepts shaping our thoughts, I think the idea of a “non-rich” country is better at explaining why many emerging market countries fared relatively better than most of the developed world during the most recent global financial crisis. By contrast, “emerging market” implies a certain fragility and suggests those countries will be the first ones to be crushed when the global risk aversion spikes. Ironically, it is partly because many “non-rich” countries felt compelled to strengthen their defenses against external volatility and learnt to live with only intermittent access to global capital markets that they avoided many of the credit excesses currently plaguing some of their “rich” counterparts. That did not protect emerging markets from a sharp sell-off in 2008, but it did ensure a quick recovery for them.

I believe the promise of emerging markets is embedded in the potential of economies of non-rich countries to grow at faster rates or, more generally, in the potential of countries with higher risks to reduce them. Investors should keep in mind that this potential might not always be realized or be directly reflected in the returns of emerging market asset classes, equities in particular. In addition to potentially enhancing returns, an allocation to ASTERISCS can also help diversify the country risks of a portfolio. This is a significant benefit, especially considering the home bias of many portfolios and the growing recognition that the asset classes of developed countries in which they tend to be concentrated are not necessarily totally immune from becoming ASTERISCS themselves.



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