

The Growing Importance of Emerging Markets

MARCH 2010

FOR PROFESSIONAL INVESTORS ONLY

An established asset class

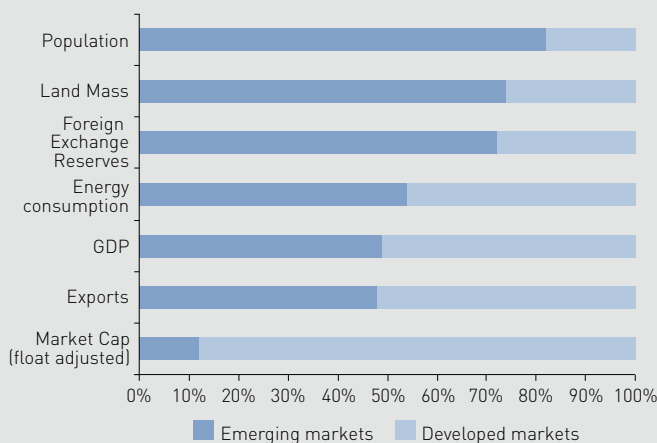
The term 'emerging market' was coined in the early 1980s. At that time, the emerging markets investment universe included eight countries: Argentina, Brazil, Chile, Jordan, Malaysia, Mexico, Philippines and Thailand. Today, 22 emerging markets are included in the MSCI Emerging Market Index.

The MSCI index is the most widely used emerging market benchmark. Its constituents are typically considered to be fast growing countries with low to medium per-capita income levels that have undertaken economic development and reform programmes, and 'emerged' as significant players in the global economy. Emerging market economies are expected to continue experiencing rapid growth over the next few years, while economic expansion in industrialised countries is forecast to remain modest.

Figure 1 illustrates the scale and importance of emerging markets on the global stage today. They now represent:

- ▶ 86% of the world's population;
- ▶ 75% of the world's land mass and resources;
- ▶ 68% of the world's foreign reserves, and;
- ▶ 50% of world GDP (at purchasing power parity).

Figure 1: Emerging economies as percentage of total world (2008-2009)



Source: Merrill Lynch, BP, CIA World Factbook, IMF World Economic Outlook, MSCI. GDP at PPP.

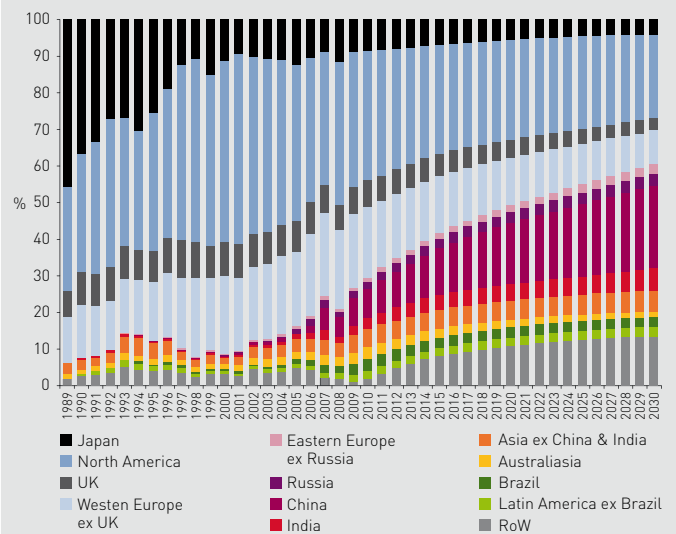
Despite their size, growth prospects and increasing significance on many measures, these markets are still under-represented in investors' portfolios. Emerging markets only make up approximately 12% of the global equity market capitalisation on a float-adjusted basis (i.e. freely traded shares).

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Looking ahead, the proportion of the global equity and debt market capitalisations attributed to emerging markets is set to continue to expand. BlackRock's research* highlights the extent of that ongoing shift using GDP estimates from EIU, reported official economic data and conservative assumptions of the relationship between GDP and market capitalisations.

Figure 2 shows the historic and expected composition of the global equity market capitalisation. Based on our modelling, we expect the share attributed to emerging markets to climb from today's unadjusted levels of around 15% to in excess of 30% of the global total by 2030. This shift should be reflected in global equity portfolios, with significantly larger allocations to emerging markets over time.

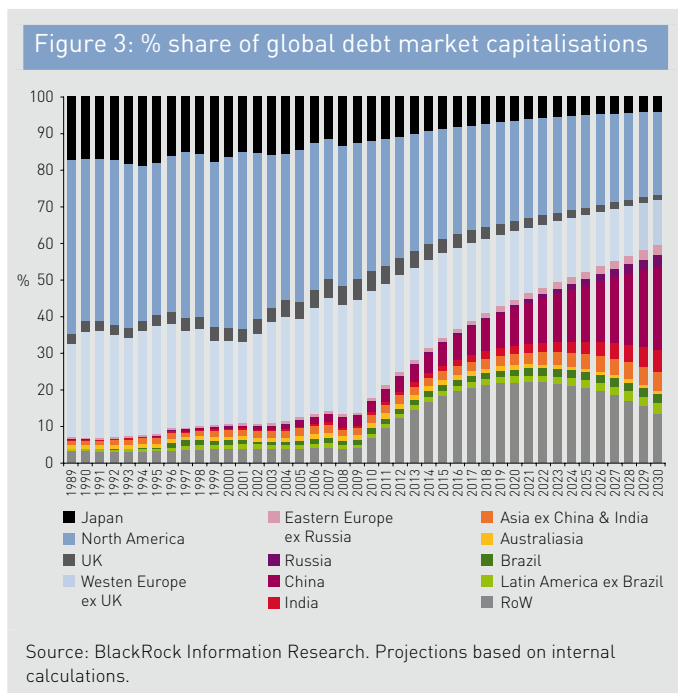
Figure 2: % share of global equity market capitalisations



Source: BlackRock Information Research. Projections based on internal calculations.

Figure 3 looks at the percentage share of global debt market capitalisation represented by various markets. Assuming levels of tradable debt to GDP reach similar levels to those of developed countries (G7) over 20 years, projections show developing countries' debt markets, like their equity markets, expanding at a faster pace than developed markets and to eventually make up a substantially larger proportion of global financial markets in the future. As a result, there may be similar consequences for global debt portfolio allocations over time.

Of course, rapid growth in stock and bond market capitalisation does not translate directly into superior returns from these assets, particularly since the growth in part merely represents a shift from using private capital to finance companies to financing via the capital markets.

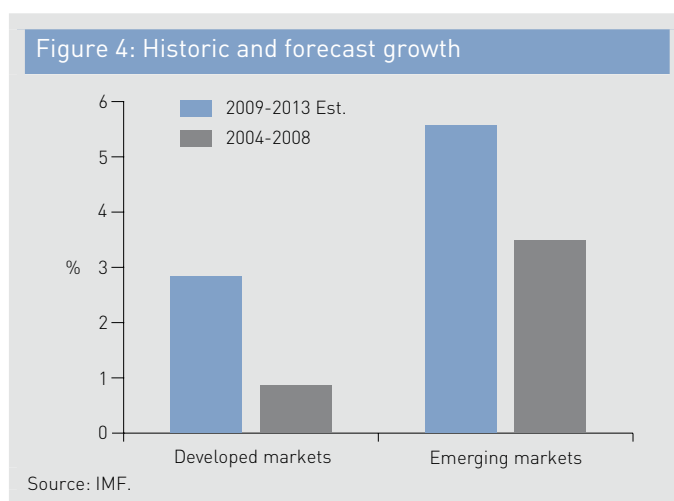


The case for emerging markets

The potential for higher rates of long-term GDP growth from emerging markets relative to developed markets provides the key investment rationale for allocating equity and credit investments to these markets. This outlook is supported by positive long-term demographic trends, while emerging markets are also well-positioned relative to many developed markets on a number of economic measures, including debt levels and saving ratios. While developed markets offer exposure to emerging economies through the foreign earnings of multinational companies, they are not an adequate substitute for the potential diversification and return benefits resulting from direct investment in emerging market.

Positive potential

In terms of economic growth, since 1992 the average global emerging market economy has grown by 116%, versus 37% for the average G7 developed economy (source: EIU). Figure 4 shows more recent historical and forecast GDP growth rates for the developed and emerging markets. As the chart shows, emerging markets have delivered impressive growth during this period, although it must be noted that the performance of these markets is highly dependent on the time period used, and we have seen periods of relative underperformance (e.g. 1976 to 1986). IMF forecasts, however, suggest this recent outperformance is expected to continue.

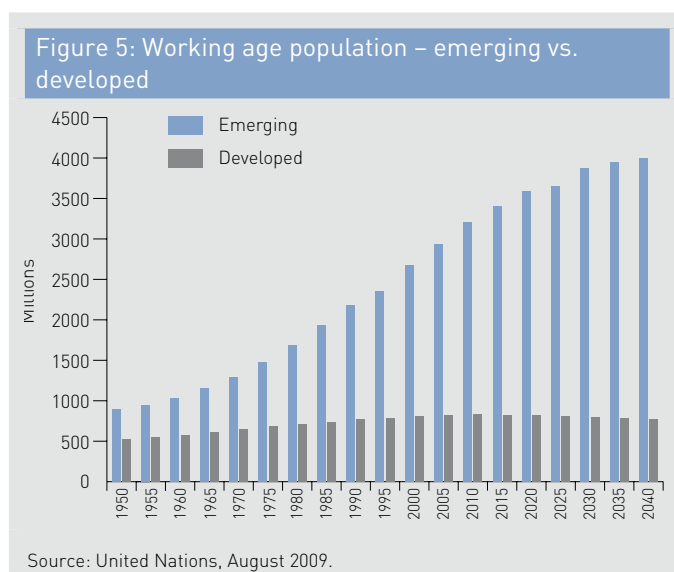


Demographics drive long-term prospects

A mainstay of emerging market growth potential is positive demographic trends. Strong population growth in these markets has provided a demographic 'sweet-spot' with a rapidly increasing number of people in these economies that are of working age. Figure 5 shows this segment of the population, taken as being between the ages of 15 and 64 years, in developed and emerging markets. While this group is increasing rapidly in the emerging world, the reverse is actually occurring in the developed economies, where the working population is actually expected to peak this year.

This expanding working population is driving the emergence of a huge domestic consumer base in many emerging markets, which is set to form the foundation of private consumption growth in the developing world. As a result, many emerging economies are expected to become less reliant on exports as domestic demand becomes an increasingly significant engine of growth.

Estimates from the United Nations suggest that there are around 1.7 billion people in the emerging economies that earn between US\$5,000 to US\$20,000 per annum. Looking at global consumption, emerging markets were reported to have surpassed developed markets during 2008 and the potential for further household consumption is impressive.



Positive economic factors

The financial crisis of the past few years has highlighted the relatively strong position that emerging markets are in today.

A key threat to global growth that has weighed on confidence is the high debt burden carried by public and private sectors. Generally, emerging markets have stronger balance sheets than the developed world. These lower levels of consumer and government leverage allowed them to emerge from the credit crisis of the past few years in a much stronger position than the developed world.

Emerging markets are now also in a strong position compared to their developed peers. While the banking sector in the US and Europe has been severely impacted by the sub-prime debt market collapse, the banking system in emerging markets had very little or no exposure to these issues. As a result, these banks are well capitalised and not suffering from the lending constraints that remain evident in the developed world.

Credit cycle

In terms of lending, emerging markets also appear to be at the beginning of a supportive credit cycle. Household debt levels are low and the penetration of products such as bank accounts is at nascent levels in many markets. Household savings rates are also high - in China, for example, households saved in excess of 30% of their disposable income during 2008 versus 5% in the US (source: Credit Lyonnaise Securities Asia).

The growth of credit from relatively low levels should provide a boost for emerging economies. The range of goods available, the increasing affordability of products and the number of people who are now able to purchase them provide further impetus for the growth of domestic consumer demand. These factors support the increasing influence of domestic demand driving economic expansion in emerging economies.

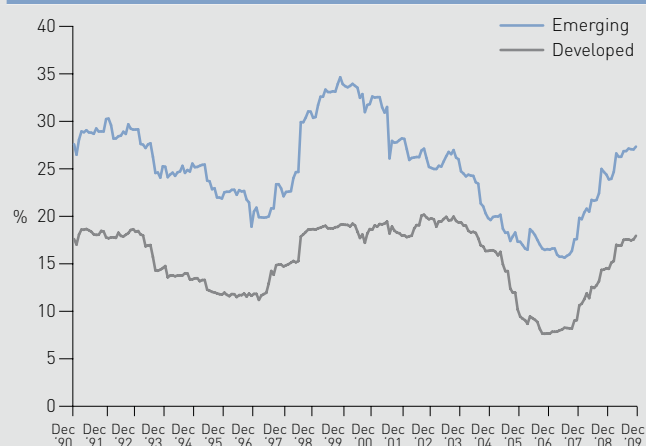
Of course, even if superior economic growth occurs and this is associated with superior corporate profit growth, this provides no assurance of superior returns on emerging market assets. In particular, investors and their advisers also need to consider the price at which they can buy this superior growth potential. However, at the time of writing, we do not regard emerging market assets as overvalued.

Risk, diversification and risk management

Emerging market equities

Risk levels in emerging equity markets are typically higher than in developed markets. For example, figure 6 shows the three-year rolling volatility of emerging market and developed market equities. Emerging equity volatility has been consistently higher.

Figure 6: Three-year rolling volatility



Source: MSCI Barra and BlackRock. Monthly returns December 1990 to December 2009. Euro unhedged.

Further, although their returns do not move in lock-step, developed and emerging market equity returns have been quite highly correlated in recent years. This may well reflect economic and financial market globalisation. So increasing the proportion of an equity portfolio invested in emerging markets is likely to raise the overall volatility of the portfolio, though the impact should be modest for an emerging equity investment of, say, 10-15% of total equities. Despite this modest volatility increase, if our house views on the prospects for emerging markets returns over the next few years are correct, the trade-off between expected reward and risk should improve when emerging markets are included.

Financial theory ('The Capital Asset Pricing Model') also suggests that if assets are fairly priced the best risk-reward trade-off comes from fully diversifying your exposure to risk-bearing assets (specifically by holding assets in proportion to their market capitalisation).

Along with greater volatility, emerging markets are perceived as bringing greater political and operational risks. As a result, effective risk management is crucial. Investment managers must demonstrate extensive research and investment experience in these markets to offer investors the comfort they should demand. Sophisticated risk management techniques must attempt to ensure that investments are made where there is a beneficial trade-off between return, risk and cost. Unintentional and unrewarded risks should be identified and minimised where possible.

Emerging market debt

Similarly, emerging market debt is higher risk than developed market debt. Nevertheless, fiscal deficits in emerging countries are much smaller than in the developed world, and the strong expected growth of these economies should further underscore the merits of emerging market debt alongside developed market sovereign issues.

For many developed market investors, including a modest proportion of emerging market government debt within fixed income portfolios that are dominated by issues from developed market governments should enhance expected return and improve the overall balance between expected reward and risk.

Corporate investing

On a longer-term view, investing in corporate debt in the developing world is supported by many of the same factors that provide a case for investing in equities. Strong economic growth rates, positive demographic trends and domestic demand provide a positive long-term backdrop for corporate issuers.

These positive trends should encourage investors looking to increase their allocation to traditional emerging market corporate debt (i.e. US dollar denominated), particularly in light of the return potential and diversification benefits within the overall emerging market exposure offered by this asset class.

During the past few years, there has also been an important evolution in local currency emerging market debt. A rapid increase in the debt issued in local currency, rather than US dollars, provides a range of additional investment opportunities, with the prospect of further diversification benefits. Again, investors and their advisers need to take into account entry-level valuations when they make investment decisions.

Investing in emerging markets

Investors can no longer afford to ignore the potential of emerging markets. Exposure to these markets offers the prospect of participating in strong growth over time that is underpinned by supportive, long-term demographic trends.

Investors should, however, remain mindful that the performance of their emerging market investments will be influenced significantly by their investment time horizon and entry-level valuations. Nevertheless, investing in these markets can help investors to improve the overall trade-off between risk and expected reward in their portfolios.

Overview of BlackRock's emerging market capabilities:

BlackRock is one of the largest emerging market managers in the world, with over US\$124 billion in dedicated emerging market equity mandates (as at 31 December 2009).

We have been managing emerging markets strategies since 1991 and have developed considerable experience in these markets, underpinned by a local presence in many of these countries. This expertise pervades our product suite, from index to active and market-neutral emerging markets strategies. BlackRock also provides a range of fixed income strategies investing in emerging market sovereign and corporate debt, as well as an emerging market currency strategy.

For further information about emerging markets and our capabilities, please contact your usual BlackRock account manager or institutional.enquiries@blackrock.com

About us

BlackRock is a premier provider of asset management, risk management, and advisory services to institutional, intermediary, and individual clients worldwide. As of 31 December 2009, the firm manages US\$3.35 trillion across asset classes in separate accounts, mutual funds, other pooled investment vehicles, and the industry-leading iShares® exchange-traded funds.

Through BlackRock Solutions®, the firm offers risk management and advisory services that combine capital markets expertise with proprietary-developed analytics, systems, and technology. BlackRock Solutions currently provides risk management and enterprise investment services for US\$9 trillion in assets.

BlackRock serves clients in North and South America, Europe, Asia, Australia, Africa, and the Middle East. Headquartered in New York, the firm maintains offices in 24 countries around the world.

* Please note the following: The projections to 2030 are based around several broad assumptions, these are as follows for developed countries: Because stock market cycles create huge variations in the market capitalisation to GDP ratio each year, a long historic average of market capitalisation to nominal GDP ratio is used to incorporate several cycles, alongside EIU's projected nominal GDP numbers, to project market capitalisation for the next 20 years out. The latest (current) 2009 market capitalisation to GDP ratio is assumed to gradually approach the long historic average over the projected horizon for which nominal GDP figures are available (i.e. up to 2030). To smooth the trend growth towards the long historic average, a constant annualised growth rate is applied to the projected market capitalisation to GDP ratio. For developing countries the same assumptions are made, with the difference that their current low market capitalisation to GDP ratio will reach similar levels to those in developed countries. Using the long-term historic average of G7 members' total market cap to GDP as a proxy of the developed world to projected market capitalisation for developing countries, this is also adjusted for an annualised growth rate to smooth the rate at which the market capitalisation to GDP ratio grows over time. The same reasoning is applied the debt market capitalisation, which is the sum of all the bonds and notes outstanding, both of government and private (financial and corporate) issuers. Note that these are tradable securities, so other major sources of debt, most notably the outstanding loans of banks and private placement of debt by pension funds and insurers are not included. When applying the same assumptions as with equity market capitalisation, a theme to highlight is that as the recent credit boom unfolded into the recent debt crisis across developed countries, the debt market capitalisation to GDP is likely to have reached a peak. So as governments and banks deleverage their balance sheets, the debt market capitalisation to GDP ratio is likely to revert back to more sustainable levels and, over the next 20 years, is assumed to gradually fall and reach its long historic average (which, relative to the emerging countries is still high).

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