

## Taking a Measured Leap into Emerging Markets

Point of View With Jeff Shen and Rodolfo Martell

While emerging markets have offered excellent opportunities for returns, they have come at the cost of volatility. We speak with BlackRock’s emerging markets experts about investing to mitigate the risks.

- ▶ As growth in the developed world slows, we believe emerging markets will remain the fuel for world growth, consumption and wealth creation over the next decade and beyond.
- ▶ A long/short strategy is an exceptional way to achieve excess returns from emerging markets equities, while minimizing overall exposure to market risk.
- ▶ A long/short equity strategy provides investors a risk-controlled way to access the growth potential of emerging markets, and should be a component of a diversified equity portfolio.

### What are the advantages of having an allocation to emerging markets?

We believe emerging markets will remain the fuel for world growth, consumption and wealth creation over the next decade and beyond. However, investing in emerging markets has exposed investors to substantial volatility and risk, motivating us to look for a better way to invest in these regions. Several secular themes are driving our views, including emerging markets population growth and expansion of the middle class, both of which are positive internal economic and consumption drivers. Furthermore, we believe emerging market GDP and wealth accumulation have great long term growth potential based on growing emerging markets exports and commodity production.

As the chart at right shows, emerging markets’ share of world stock market capitalization greatly lags these countries’ contribution to the global economy. They account for nearly 50% of world GDP (and growing), more than 50% of world energy consumption, more than 70% of total land mass and greater than 80% of world population. The equity markets in these regions have great capacity for growth, underscoring our view that the investment potential can be exceptional.

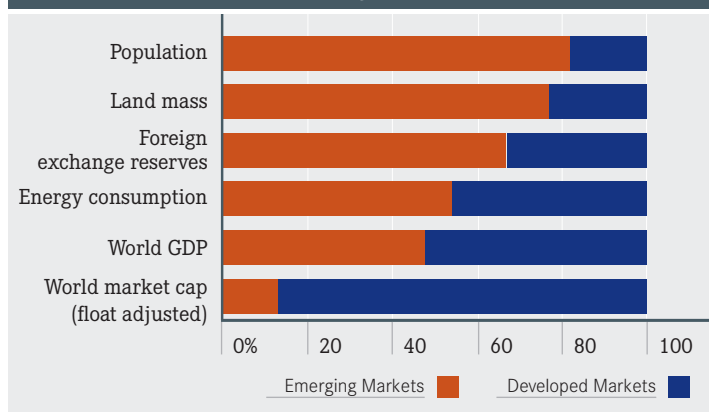


**Jeff Shen**, PhD, Managing Director and portfolio manager, is the Head of Asia Pacific and Emerging Market Equity within BlackRock’s Scientific Active Equity (SAE) Group. Dr. Shen’s service with the firm dates back to 2004, including his years with Barclays Global Investors (BGI), which merged with BlackRock in 2009. At BGI, he was the Head of Asia and Emerging Market equity investment. Prior to joining BGI, Dr. Shen was the global head of asset allocation research and macro absolute return investment at JP Morgan Asset Management.



**Rodolfo Martell**, PhD, Director and portfolio manager, is a member of BlackRock’s Scientific Active Equity Group. Dr. Martell’s service with the firm dates back to 2007, including his years with BGI, where he served as senior portfolio manager and worked on the development and implementation of Global Emerging Markets equity strategies within the International Scientific Equities Group. Prior to joining BGI, Dr. Martell was an assistant professor of finance at Purdue University.

### EM Share of Capitalization Does Not Reflect Stature in World Economy



As of 12/31/10. Sources: Merrill Lynch, BP, CIA World Factbook, IMF World Economic Outlook, MSCI Inc. Emerging economies as percentage of total world, 2009–2010.

Finally, but perhaps most importantly, with investors starved for returns, emerging markets offer tremendous opportunities. Given that the average US investor, with only a 2.5% allocation, is considerably underweight the sector, demand for emerging markets assets should remain strong for some time.

### Are emerging stock markets efficient and reliable like those in the US?

No. In fact, as professional investors, one of the things we find most attractive is the information inefficiency of these markets. Reliable, good-quality data is scarce. One of the key advantages of our platform here at BlackRock is our ability to scrub and clean the data to prevent a “garbage-in, garbage-out” scenario, which could hurt a manager with lesser resources.

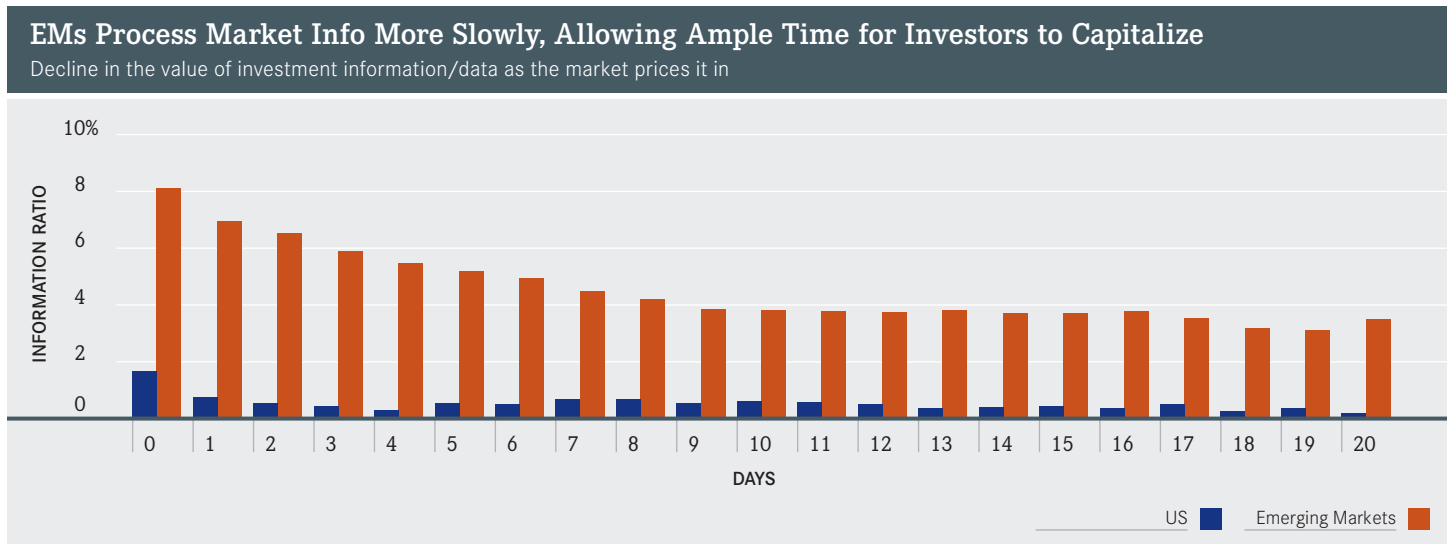
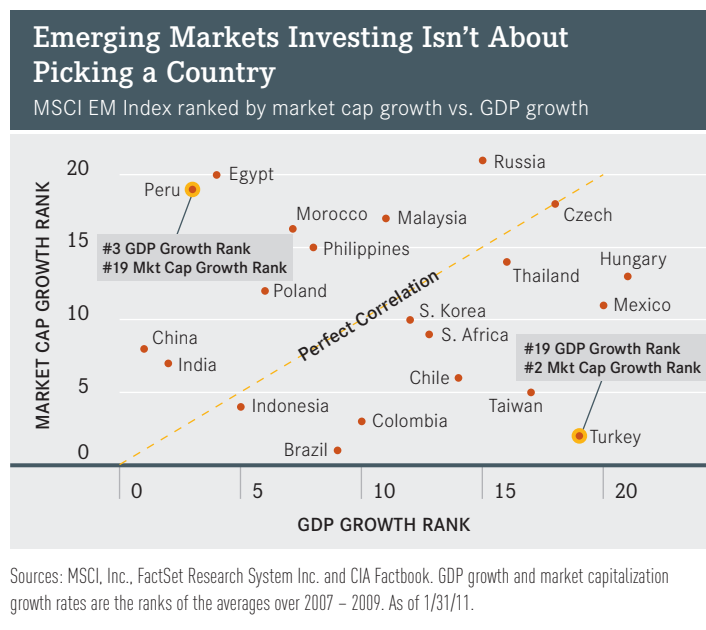
The deficiency of data means that information is priced in slowly across emerging markets, which can be a big advantage for sophisticated investors. For example, information is factored into equity prices in developed markets, such as the US or Japan, in a matter of minutes or hours. In emerging markets, it can take days, weeks or even months for information to be priced into securities. Our portfolio management team is immersed in market and security research and can often capitalize on an event before the market prices in its realization. The chart below shows how slowly information gets arbitrated away in emerging markets (three months), versus how quickly in the US (30 minutes). That’s a powerful example of the potential inefficiency in this market that makes us very excited about investing in emerging markets.

### How has investing in emerging markets changed in recent years?

Investing in emerging markets has changed dramatically in the past few years. These countries have shown dramatic financial, economic and political development. Going back to the turn of

the millennium, investing in emerging markets was more about the individual countries an investor chose. It’s different now. These countries have become more like the developed markets in the sense that it’s not about choosing a specific country or a specific sector. It’s about going deeper, doing your homework and choosing individual companies.

Take Brazil as an example. Once unstable, following the new presidency of Lula da Silva in 2004, the country dramatically turned the page, gaining political and economic stability that was not present earlier. But even though Brazil has shown only average GDP growth, it has experienced high market capitalization growth (see chart below). Another example is evident in the chart featuring Turkey and Peru. As you can see, there is no correlation between GDP growth and market capitalization in these two countries, so picking GDP growth of a country does not necessarily result in successful investment performance. It’s about knowing the individual companies.



Note: Information ratio is the expected active return divided by tracking error. Source: BlackRock.

## One of the main concerns investors have had with emerging markets has been their higher risk profile relative to developed markets. What is your perspective?

While this elevated market risk is real, investors should not lose sight of the tremendous opportunities for investing. In response to the risks and opportunities, we have developed a unique and we believe better way to invest in emerging markets, through a fundamentally-driven, systematically implemented long/short equity strategy. This kind of strategy seeks to neutralize the volatility and market risk while focusing on the enhanced returns from specifically researched and picked investments. Given the risks and opportunities, we believe it makes a lot of sense for investors to gain their exposure to emerging markets through a professionally-managed and diversified portfolio.

## What do you mean by a long/short strategy?

A long-short equity investment strategy means that we buy (long) stocks that we believe will appreciate in price, and at the same time sell (short) those stocks we believe will go down in price. This type of strategy seeks to avoid macro risk where the entire market goes down and impacts the portfolio, and take advantage of the stocks chosen through our fundamental research process.

The example that we like to use compares the relative returns between Korean Car Company A versus Korean Car Company B. We're not trying to make a bet on Korea. We're not trying to make a bet on the auto industry. We are trying to figure out whether Korean Car Company B is an outperformer or underperformer relative to Korean Car Company A. So while most investors are looking at macroeconomic and country performance, we are focusing on bottom-up fundamentals.

Taking it a step further, when we like a particular stock, by definition, we would dislike another stock. So in the Korean auto example, we would actually look at 20 stocks within the Korean auto sector and essentially rank them from one to 20. And we would go long the stocks that we like, those ranked high; and we would go short the stocks that we don't like, those ranked low.

## Your long/short approach is unique in the marketplace. What are the benefits of such a strategy for emerging markets?

A dedicated long-short approach is a very efficient way to access these markets because it allows us to mitigate market risk within the portfolio. By matching both long and short equity positions, we have the ability to dial up or down our exposure to market risk from 0% ("market neutral") up to 40% exposure. This means we seek to deliver above-market, excess returns (referred to as alpha) out of our investments, while minimizing our overall exposure to market movements (referred to as beta).

In an ideal world, an investor would be perfectly insulated against market movements. We strive to achieve that, while maintaining the option to gain up to 40% exposure to the market. Through our approach, we will get a high degree of insulation, such that for the most part, the portfolio will be uncorrelated to overall market moves. The nice feature of this approach comes when the market might be down significantly (which is very common in emerging markets given the volatility). In this market drop scenario, the portfolio that can go fully market neutral would have an advantage by avoiding the impact of the negative index drop. At the same time, the portfolio would retain whatever excess returns it would generate.

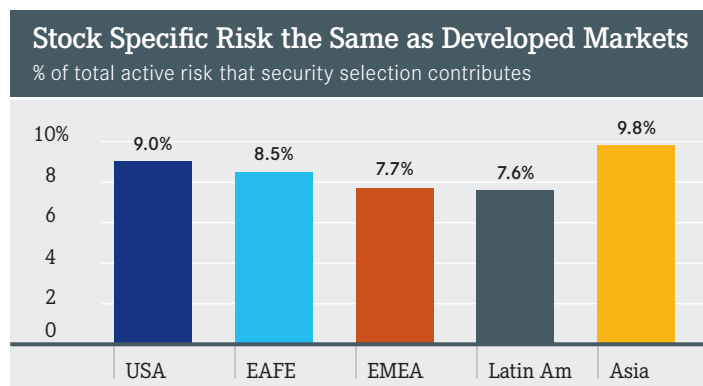
So this strategy is not about hitting home runs every once in a while. It's about achieving a continuous succession of singles that ultimately brings the investor attractive returns with minimal risk. In summary, the long/short, low volatility approach is designed to outperform long-only, high beta strategies on a risk-adjusted basis.

## Describe your investment process and how you choose the best investments?

Our approach is a fundamental, bottom-up stock picking approach that we implement systematically. Because emerging market stock-specific risks are essentially the same as developed market risks (see chart below), we prefer to look deeper at the specific-stock level to make investments. We rely on three main measures of value in picking stocks to own or to sell short: earnings quality, sentiment and relative valuation. Our process is agnostic in terms of having favorite countries or favorite industries.

We do an enormous amount of work to collect the data on earnings quality, sentiment and relative valuation because they form the basis for our rankings and thus our buy/sell decision. One example of our unique ability to gather valuable information is that we conduct a poll of about 800 sell-side analysts every month to get their views on the companies, sectors, and industries they cover. This provides unique insight that not all managers have.

With all these factors, we get a comprehensive view of how likely it is that a given stock is going to outperform its peers over the next



Sources: BlackRock, Barra. Stock specific risk is computed by decomposing the effects of all common sources of return variation, i.e., country, currency and industry effects, as well as other risk factors. As of 12/31/10.

three to 12 months. The portfolio management team uses that output to construct portfolios.

## Tell me about your team?

The emerging markets equity team has been together since 2003. The team is an interesting mix of people who have come from emerging markets and who have a lot of work or study experience in the U.S. or Europe. We think about the team as a bit of a sea turtle in the sense that we can walk on the global ground, having the global perspective on emerging markets, but at the same time, we can swim in the local ocean to really dive deep into what's going on in the markets. We have team members in Asia, Europe, and the East and West Coasts in the US, and we go to the emerging market regions quite often. So we really try to get the best of the blend between global and local.

## Are there size and scale advantages in emerging markets investing?

The best way to capture those three insights that we mentioned earlier — value, quality, sentiment — is through a large-scale effort. In fact, we have approximately 100 individuals that support the core 12-professional portfolio management team. These 100 individuals are separated into specific tasks. For example, we have a dedicated data-scrubbing team that makes sure the 17 different databases to which we subscribe deliver accurate data every month, and make sure that it's all consistent.

Supporting these activities is a variety of other key groups. For example, a dedicated internal team gives us access to the full book of securities available to be shorted in the region. This is a critical function that allows for trading, portfolio construction and making sure we can short stocks at a low cost. Our investment team is located around the globe in Sydney, London, Hong Kong

and San Francisco, so the sun never sets on our ability to manage the portfolio.

## How should an investor incorporate this strategy into their broader investment portfolio?

Given the importance of the emerging economies to global growth going forward, we believe most investors should add some level of exposure to the space. On average, the US investor is underweight emerging markets, with only 2.5% of long-term assets allocated to the sector. For an investor who already has an allocation to emerging markets, traditional long-only offerings in the marketplace have more exposure to market risk and the volatility that can come with it. So adding an allocation that mitigates market risk is a good way to gain returns that are not correlated to other strategies of investing in emerging markets. For those investors without exposure to the space, gaining exposure through a lower-volatility allocation could be a good way to begin to take advantage of emerging markets growth trends. Each investor should discuss allocations with their financial advisor, taking into consideration their time horizon, risk appetite and portfolio composition.

## What additional advice do you have for investors?

Our advice for any investor considering an allocation to emerging markets is to do your homework and get comfortable with the asset class. There are heightened risks that come with investing in emerging markets. So it's important to understand what kind of exposure you want, and then who's going to provide that exposure for you.

It is clear to us that investors should have an allocation to emerging markets, but how much market risk can you tolerate? We believe the distinctiveness of our long/short approach offers investors the opportunity to diversify their exposure to emerging markets, taking advantage of the return potential while minimizing risk.

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