

BEACON POINTE

ADVISORS

**BEACON POINTE RESEARCH
WHITE PAPER**

**THE CASE FOR EMERGING MARKETS
MAY 2004**

CONFIDENTIAL – PROPRIETARY

These materials are confidential and being furnished solely to clients and prospective clients for informational purposes only and are not to be distributed. The materials may not be reproduced or disseminated without the express prior consent of Beacon Pointe Advisors, LLC. This information is obtained from internal and external research sources that are considered reliable, but the information's accuracy is not guaranteed by Beacon Pointe Advisors. Neither the information nor any opinion that may be expressed constitutes a solicitation, an offer to sell, or advertisement by Beacon Pointe Advisors, LLC. This material has been prepared for the general information only. It does not take into account the particular investment objectives, financial situation or needs of individual or the institutional investors. Before acting on any advice or recommendation in this material, you should consider whether it is suitable for your particular circumstances. Opinions expressed are the author's current opinions as of the date appearing on this material only. While the author may strive to update on a reasonable basis the information discussed in this material, there may be some factors or reasons that may prevent the author from doing so.

500 Newport Center Drive, Suite 125, Newport Beach, CA 92660
TEL 949.718.1600 FAX 949.718.0601 www.bpadvisors.com

Introduction

In the past, emerging markets have promised much in the way of growth—only to disappoint investors with poor returns. Several factors, already evident since 2001, seem to point to the possibility that emerging markets may finally outperform most other equity classes. Current market conditions are very similar to the early 1990s when emerging markets saw a sharp and sustained increase in prices. This increase was based on slower earnings growth in the U.S., declines in interest rates, positive global cyclical factors, and attractive valuations—all of which are present in today's environment.

Emerging Markets – Encouraging Factors

Some of the factors that have been given in the past as reasons for investing in emerging markets are finally coming to realization. These make for compelling reasons to invest in this asset class.

- ◆ **Growth Rates** – The fundamental thesis for investing in emerging markets is the superior growth prospects in countries like China and India. These countries have evolved into consumer-based economies.
- ◆ **Diversification** – Emerging market countries today exhibit lower contagion effects in times of crises. This points to possible diversification benefits of investing in emerging markets as they have shown to exhibit low correlation to most major equity classes.
- ◆ **Structural Reforms** – Most countries in emerging market economies are structurally stronger due to the economic reforms carried out in these countries. These reforms, combined with a more disciplined capital allocation at the corporate level, have led to improved profitability in emerging market countries.
- ◆ **Cyclical Factors** – The aggressive implementation of very accommodative monetary and fiscal policies by worldwide governments in order to avoid a deep recession has resulted in a synchronized global recovery. These factors have supported improved performance from the emerging markets.
- ◆ **Currency Decline** – Massive trade and budget deficits, in conjunction with expected high inflation, will ultimately lead to a decline in the value of dollar. The decline of the dollar normally translates to more attractive emerging market equity returns when translated to U.S. dollars.
- ◆ **Attractive Valuations** – From a valuation perspective, emerging markets are looking more attractive than even global equities. Currently, emerging market equity is trading in excess of a 30% discount to global equities despite the tremendous performance shown in 2003.
- ◆ **Attractive Risk Return Profile** – Over a long period of time, emerging markets have proven to provide attractive risk adjusted returns versus developed markets outside the U.S.

Emerging Markets - Growth Rates

Companies in emerging markets are expected to benefit from the growing and developing economies. The prospects of these economies are supported by higher population growth, positive demographics of a younger population base, and growing income levels. The GDP growth rates in countries like China and India are in excess of 8%--far more than the rates seen in the developed world.

Although the labor productivity of emerging markets is lower than that of developed economies, this disparity is beginning to collapse with advances in technology, communication, cross border transfer of knowledge, and investments. While this phenomenon may take some time to proliferate in some countries, others, particularly in Asia and Eastern Europe, with a highly educated and technically perceptive workforce, are strategically positioned to reap benefits from improving productivity.

Many of the players in the emerging markets have expanded beyond the limitations of their borders in search for a bigger marketplace. In addition, due to increased globalization, many of the companies in the emerging markets have become world-class leaders in their respective areas. Thus, these companies benefit from their own domestic growing markets while also expanding in larger global markets. For example, Samsung (the world's largest DRAM producer, located in Korea), Infosys (the world's number two in size and the most profitable IT outsourcing company, located in India), and Checkpoint Software (the world's leading security software company, located in Israel) are benefiting from this type of expansion.

Emerging Markets - Diversification

Exhibit 1

<i>Index</i>	<i>MSCI EAFE</i>	<i>MSCI EMG Free</i>	<i>Russell 3000</i>	<i>S& P 500</i>
MSCI EAFE	1.00			
MSCI EMG Free	0.57	1.00		
Russell 3000	0.55	0.61	1.00	
S& P 500	0.55	0.59	0.99	1.00

Source: Wilshire Compass based on monthly returns for the period April-1984 to April-2004.

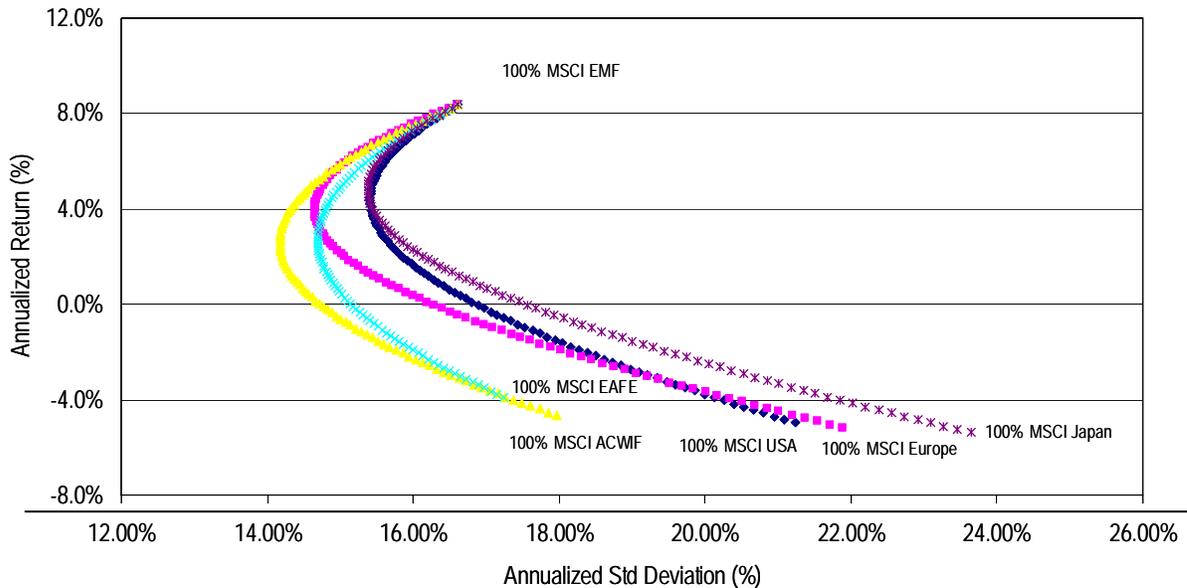
Although the correlation between the indices such as MSCI EAFE and MSCI Emerging Markets Free have increased in recent times, the long time average over the last twenty years are below 0.60.

In addition to the lower correlation to other major equity classes, the efficient frontier for MSCI EMF Index versus other major equity asset indices (based on trailing three-years) has shown to be more positive as seen in Exhibit 2 on the following page.

Exhibit 2

Emerging Markets - Structural Reforms

Easy access to capital in the early 1990s led to excessive poor lending and investment



Source: Adapted from Citigroup Report – The Case for Emerging Market Equity, January 2004

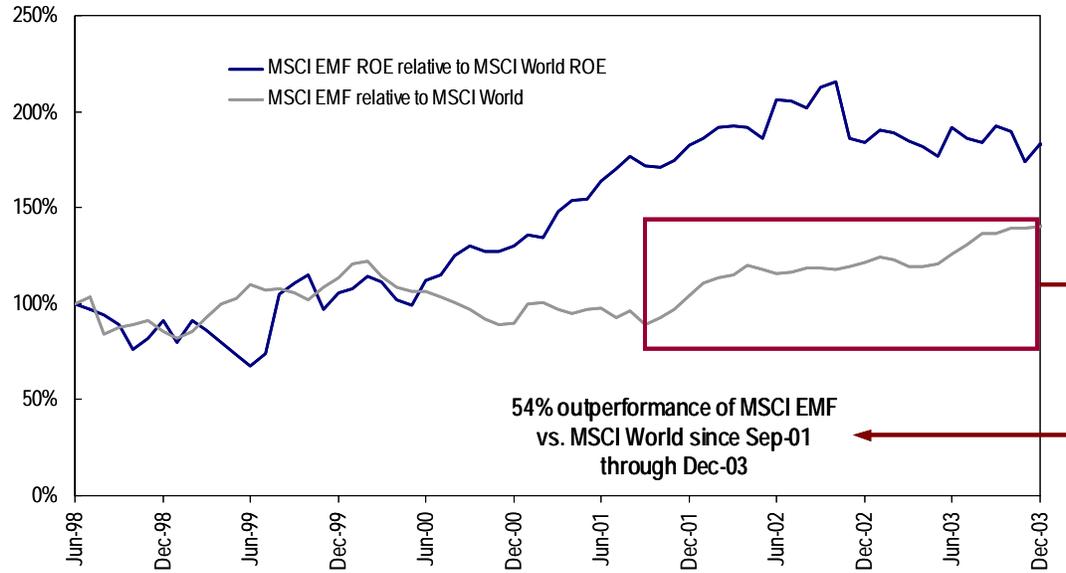
practices by both domestic and foreign investors in emerging markets. This resulted in over capacity in many industries. Moreover, excessive valuations in several markets increased their vulnerability to both indigenous and exogenous shocks.

In recent times, however, significant reduction in capital flows into these markets have forced both government and corporations to become much more disciplined and selective in their capital allocation process and investment decisions. In addition, most emerging market economies have become considerably less reliant on external financing sources as they have balanced their fiscal accounts, curbed their current account deficits, and lowered their debt burden. Stronger banking systems, in the wake of the Asian crisis, have enabled an expansion of consumer credit, an important element of consumer spending.

Few of the crises witnessed in the emerging markets can be blamed on poor economic policy and management alone. Exogenous factors such as oil shocks, interest rate cycles, and effects of contagion, have all detrimentally affected the emerging markets environment. In addition, there are execution risks and economic disruptions associated with rapidly evolving economies undergoing positive market-oriented reforms on economic, political, and social fronts. Examples of this are the inflation-stabilization programs in Latin America and movement towards a market economy in many of the former Eastern bloc countries such as Czech Republic, Hungary, and Poland.

Limited access to capital and higher borrowing costs in the late 1990s have forced companies in the emerging markets to become much more disciplined in their capital allocation. Unlike most of 1990s when U.S. companies had higher relative ROEs due to significant improvement in profitability, the more disciplined capital allocation has led to an improvement in relative ROEs. The improvement in ROE levels should help support the potential for continued outperformance of emerging market equities. Exhibit 3 below illustrates the improvement in relative ROEs for companies in the emerging markets.

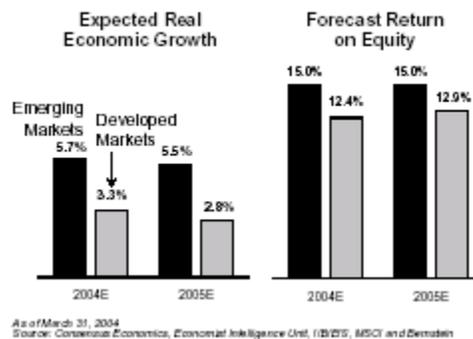
Exhibit 3



Source: MSCI, period Dec – 1990 to Dec- 2003.

Going forward, the forecast return on equity for emerging markets is expected to be higher than that of the developed markets. As such, the continued outperformance of emerging markets with respect to the developed markets stems not from investors' appetite for risk, but from an appreciation of better fundamentals—stronger expected economic growth and higher forecast return on equity than the developed markets.

Please see Exhibit 4 on the following page for an illustration of this phenomenon.

Exhibit 4**Stronger Growth and Higher Returns Expected**

Source: Adapted from *Emerging Markets Value – AllianceBernstein First Quarter 2004*

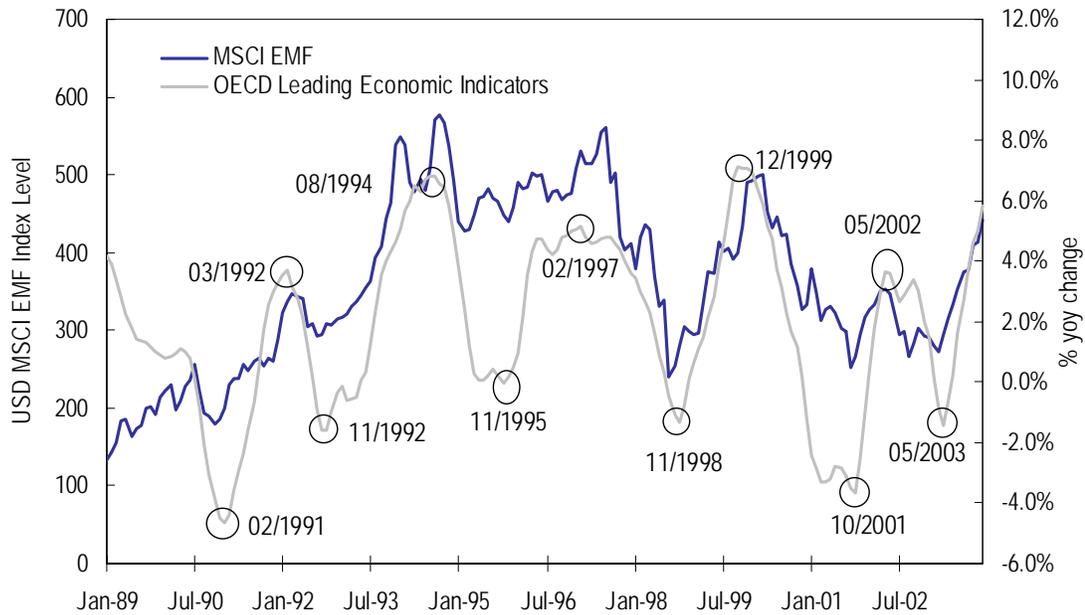
Lack of access to financial and economic information in the emerging markets has historically discouraged investors. However, in recent times, as the participants in the emerging markets have sought access to selective markets, increased transparency is required. These companies and organizations have been willing to be more transparent, leading to a decline in the contagion effect as investors have been better able to assess the relative value of each market based on its own merits and fundamentals. For example, the recent crises in Turkey and Argentina remained largely confined to those two countries and had little or no impact on the emerging markets as a whole.

Political and economic reforms in India (that opened the markets to foreign investors for more than 50% stake in joint ventures) have also helped the emerging markets. Prior to these reforms, foreign investments were restricted to 49% or less. Some industries were totally protected against foreign investments. This has led to significant improvement in the level of competition amongst the companies for the overall benefit of the consumer.

Emerging Markets - Favorable Cyclical Factors

According to the Organization for Economic Co-operation and Development (OECD) leading indicators, current data suggests a bottoming of specific indicators, suggesting a recovery in key global economies in the near- to medium-terms. Typically, emerging markets have shown a fair degree of correlation to the recovering environments of these leading indicators and tend to outperform other asset classes.

Exhibit 5



Source: OECD, MSCI, period Jan-1989 to Dec-2003

Another factor, although it may run contrary to conventional thinking, is the fact that most of the OECD economies are at the trough in terms of interest rates. The early stages of global economic recovery would lead to rising interest rates.

Although these interest rate spikes would normally be detrimental to equity returns, it is a sign that these economies are in an environment of rising economic activity and business cycle recovery.

Past Fed tightening cycles have led to increasing returns from emerging markets as these economies increase their outputs to meet the demands of the developed markets in the throes of a recovery.

Emerging Markets - Inflation and Currency Decline

A stimulative monetary and fiscal policy combined with massive deficits – current account and budget – indicate we may be in for a long-term secular decline in the value of the U.S. dollar. A significantly high appetite for U.S. investments drove the dollars up by over 40% between 1995 and 2002¹. This progressively undermined the competitive position of U.S. companies by accelerating the growth of imports. Combined with the faster growth of the U.S. economy, the U.S. dollar's appreciation caused the U.S. trade deficit to soar up to over \$500 billion. That is the largest annual deficit ever run by a single country.

However, the downturn in the equity markets has caused the shift in dollars to move to bonds for some time. Continued low interest rates, however, have made even the bonds unattractive for foreign investors—causing them to sell dollars in the exchange markets. This has led to a decline in the U.S. dollar relative to most other currencies.

U.S. dollars may continue to pour out in large amounts for quite sometime—pointing to a prolonged and steep depreciation of the dollar. Although over time the depreciation of the dollar will lead to better competitiveness of U.S. manufactures and thus reduce the trade deficit, in the meantime, emerging market equity returns will get a boost from the secular decline in the value of the U.S. dollar (combined with other factors favoring investments in emerging markets).

Emerging Markets - Attractive Valuation

A prolonged correction in equity prices experienced by emerging markets over the past six years before 2003 has resulted in depressed valuation levels. Based on a research study by the Citigroup Asset Management Group, emerging market equities are not only trading at a discount to their fair value based on a dividend discount value model, but also trading at a significant discount of over 30% to their developed market peers.

Exhibit 6 on the next page shows a study by AllianceBernstein that illustrates the fact that emerging markets are trading at compelling discount despite record profitability.

¹ Source: AllianceBernstein – The Case Against the US Dollar

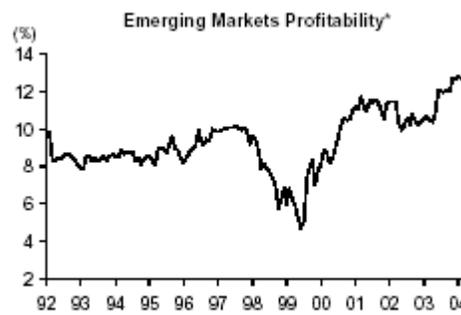
Exhibit 6

Emerging Markets Still at a Large Discount



Through March 31, 2004
Source: MSCI and Bernstein

Profitability Remains at Record Levels



*Earnings-to-book value, through March 31, 2004
Source: MSCI and Bernstein

Very Attractive Opportunities Remain



Representative account as of March 31, 2004
Source: MSCI and Bernstein

Source: Adapted from *Emerging Markets Value – AllianceBernstein First Quarter 2004*

Emerging Markets - Conclusions

- Beacon Pointe believes that emerging markets offer compelling investment opportunities in as many of these companies are trading at significant discount to their own fair value in addition to trading at significant discount to their developed market peers.
- We believe that many of the factors that hurt investors in the late 1990s have been eradicated at this time. Other factors, including growth rate, diversification, structural reforms, cyclical factors, U.S. dollar depreciation, attractive valuations, and attractive return/risk profile, all combine to make a strong case for investing in the emerging markets.
- Current market conditions are similar to those in early 1990s when emerging markets showed sharp and sustained increases in prices in the face of a slower earnings growth in the U.S., low interest rates and, positive global cyclical factors. Over the long-term, the on-going structural reforms, disciplined capital allocations, and an improvement in return on equity should support continued outperformance of this asset class.