BEACON POINTE ADVISORS

BEACON POINTE RESEARCH
WHITE PAPER

THE CASE FOR EMERGING MARKETS EQUITIES
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CONFIDENTIAL – PROPRIETARY

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Introduction

In 2004, Beacon Pointe made the case for emerging markets citing factors such as strong economic growth, diversification, structural reforms, accommodating monetary and fiscal policies, ensuing dollar weakness, and attractive valuations.

Until recently, emerging markets have been one of the best performing equity asset classes benefiting from the factors cited above. However, in recent times, concerns of a slowing U.S. economy have resulted in a significant pullback in emerging markets. In light of recent developments, our clients may be wondering about the future course of this asset class.

Beacon Pointe has conducted extensive interviews with and studied materials published by reputable firms in the industry regarding their emerging market perspectives. Beacon Pointe believes that the long-term bull case for emerging markets is still intact and we welcome the recent correction in a market that has appreciated in almost linear fashion for more than three years. We believe that there is potentially more global downside due to the uncertainty of future interest rate hikes. In the past, slowdown in the U.S. has had some impact on the prospects for emerging markets. We believe that the growth prospects, although still tied to the growth rates in the U.S. and other developed markets, are not as tightly coupled to the growth rates in the developed world as they were in the past. Although Beacon Pointe does not believe in market timing, we believe it is prudent to sit on the sidelines and wait for more visibility – at the risk of missing some of the initial upside – before committing capital to this volatile, yet high return asset class.

Emerging Markets – Encouraging Factors

The factors outlined below were illustrated in the paper entitled "The Case for Emerging Markets" released in May of 2004 and this is a recap of the same factors as they are still valid with some minor updates. These factors 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 Brazil, Russia, China, and India. Many of the countries in the emerging markets have evolved into consumer-based economies. In addition, many emerging market countries are rich in natural resources and are likely to benefit from the secular long-term global growth.

- **Diversification** – Emerging markets have shown a tendency of higher correlation with U.S. markets in recent times, nullifying the diversification benefits. This is primarily due to the low volatility that prevailed until recently in the global markets. We believe we are now seeing some reversion to the mean in terms of volatility across all asset classes, bringing back the opportunity to make emerging markets a good diversifier.

- **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. Companies in the emerging markets have shown higher return on equity than the rest of the world.

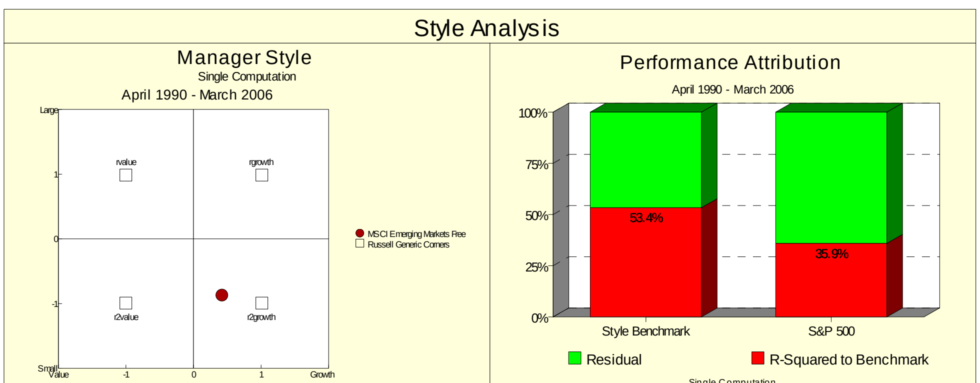
- **Cyclical Factors** –The aggressive implementation of very accommodative monetary and fiscal policies by worldwide governments, in order to avoid a deep recession starting in 2001/2002, has resulted in a synchronized global recovery and promoted global growth. These factors have supported improved performance from the emerging markets.

- **Currency Decline** – Massive U.S. trade and budget deficits, in conjunction with expected high inflation, are likely to lead to a decline in the value of the U.S. dollar based on economic theory. The decline of the U.S. dollar implies more attractive emerging market equity returns when translated back 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 at an approximate 19% discount to global equities despite the tremendous performance shown since 2003. We believe that over time investors will develop a level of comfort based on continued structural reforms in the emerging market countries to narrow this discount.

- **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. As shown below, when using the S&P 500 benchmark, the emerging markets, as measured by MSCI Emerging Markets Free Index, have shown an alpha[1] of 2.2% versus the S&P 500 Index for the period April 1990-March 2006.

Figure 1



	S&P 500			Asset Allocation							Style	
	Alpha (%)	Beta	R2 (%)	Sb3mtb	rvalue	rgrowth	r2value	r2growth	Alpha (%)	R2 (%)	Value-Growth	Small-Large
MSCI Emerging Markets Free	2.23	1.0657	35.94	0.1271	0.0000	0.0000	0.2239	0.6489	3.53	53.39	0.4250	-0.8729

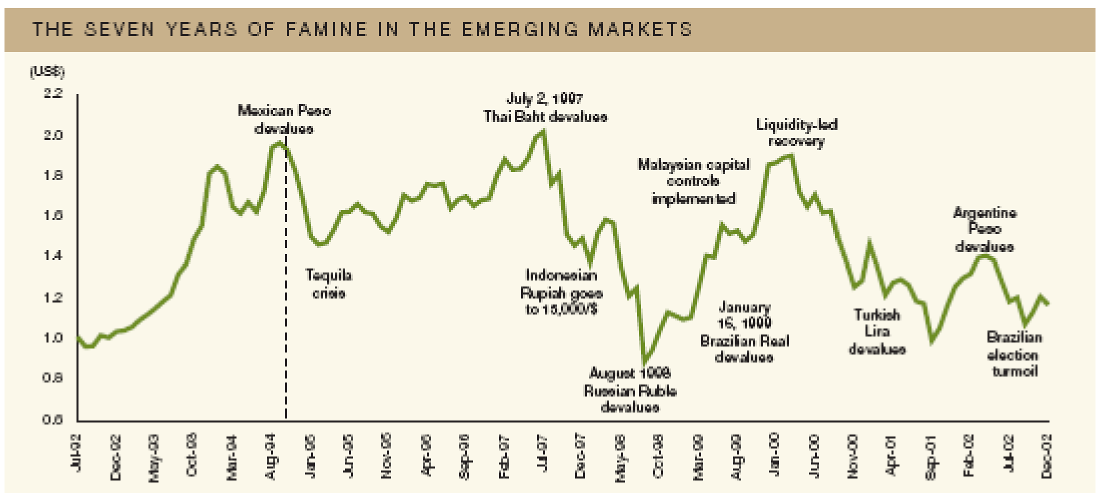
[1] Alpha is a measure of risk-adjusted value add over the benchmark.

Emerging Markets - Looking Ahead

There was an interesting study by International Monetary Fund back in 2003 that explored the herding mentality of mutual funds in emerging markets. Their study showed that herding is more widespread among open-ended mutual funds than closed-end funds. We believe from the recent sell-off, a similar behavioral phenomenon is exhibited by hedge funds as well, scampering for the exits at the first sign of weakness.

Beacon Pointe believes that long term fundamentals that support the factors mentioned earlier for emerging markets are still intact. Having said that, emerging markets have in the past shown a tendency for anemic returns as shown in the "Seven Years of Famine" chart (see next page) in a Lazard Asset Management publication titled - Emerging Markets: Looking Ahead, dated December 2005.

Figure 2



Source: Bloomberg and MSCI Emerging Markets Index. As of December 31, 2002. Growth of a dollar from 7/19/1992 to 12/20/2002.

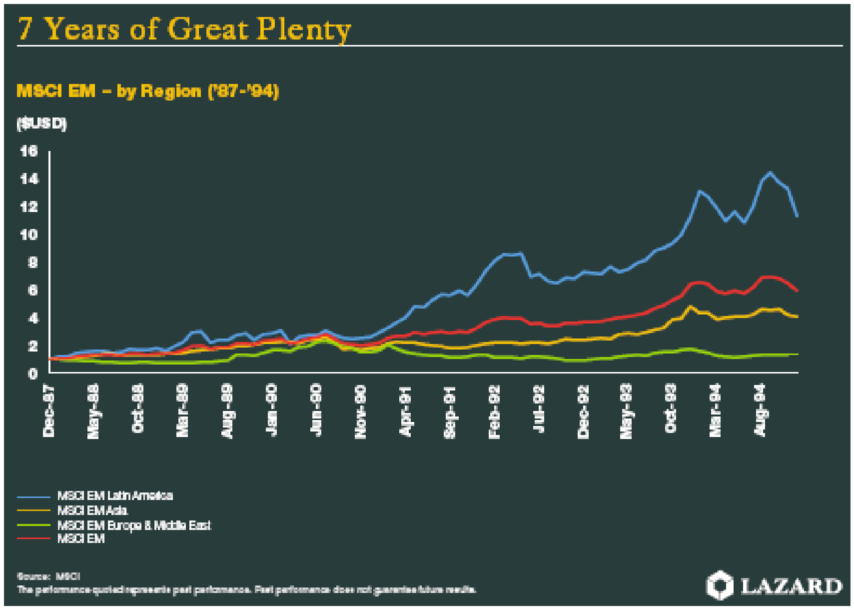
Adapted from Emerging Markets – Looking Ahead by Lazard Asset Management.

However, many of the factors that were responsible for the previous downturns are not present in today's environment. The seven years of famine in the emerging markets were precipitated by significant withdrawal of investor capital due to devaluations of the Mexican Peso (1994), the Thai Baht, the Indonesian Rupiah (1997), the Russian Ruble (1998), the Brazilian Real (1999), the Turkish Lira (2001), and the Argentine peso (2002).

The declines in the emerging markets were typically precipitated by these countries taking on too much foreign currency debt and running large trade deficits. As a result, they were forced to devalue their currencies, leading to a meltdown in their stock and bond markets.

These seven years of famine were preceded by seven years of plenty as shown in the Figure 3 on the next page.

Figure 3



Source: Lazard – Emerging Markets: The Evolving Asset Class, March 2006

This time around, the weakness in emerging market is primarily due to a combination of rising global interest rates resulting in a possible global slowdown. However, factors such as large foreign debt and huge current account deficits are not in place at this time. If anything, the reversal of these factors makes emerging markets an attractive asset class. Many of the emerging markets have paid off a significant amount of foreign debt while a few countries even sport current account surplus leading to the possible strengthening of local currencies. Strong local currencies, when translated back to U.S. dollar, will enhance returns for U.S. investors.

The table below illustrates the strength of emerging economies in recent times.

Emerging Economies – Financially Stronger

	Foreign Reserves $ Bln		Current Acct- % of GDP		Govt. Balance- % of GDP	
Country	1999-2003	2005	1999-2003	2005	1999-2003	2005
The "BRICs"						
Brazil	38	62	-2.9	1.7	-7.0	-3.3
Russia	50	176	9.1	11.0	2.1	7.5
India	62	145	0.7	-2.5	-5.5	-4.1
China	248	819	2.1	7.2	-2.9	-1.1
South Korea	110	210	2.8	2.1	0.7	0.7
Taiw an	141	254	6.9	4.7	-2.8	-2.0
South Africa	6	19	-0.3	-4.2	-1.8	-1.5
Turkey	25	51	-2.2	-6.4	-12.4	-2.0
Thailand	36	51	6.9	-2.4	2.2	-0.5

Source: JPMorgan

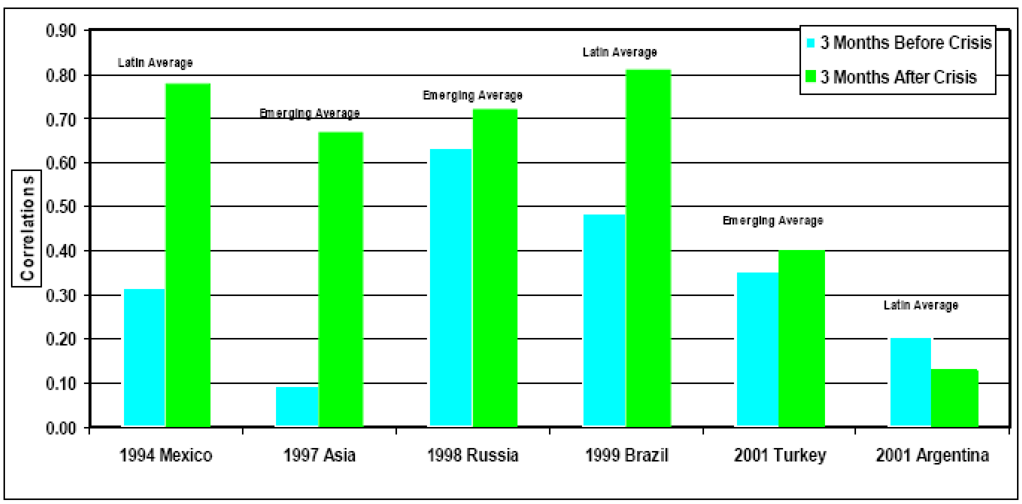
Table: Courtesy of ING Investment Management – ING Investment Weekly June 26. 2006

The following statistics observed by *The Economist* illustrates the growing importance of emerging market countries:

- In 2005, the combined output of emerging economies rose above half of the global total.
- In terms of global exports, the emerging markets share increased from 20% in 1970 to about 42% in 2005.
- These countries hold about two thirds of the world's foreign exchange.
- Emerging economies consume about 50% of the world oil.
- Yet, these countries account for only 14% of global market capitalization.

The above points were illustrated by Acadian Asset Management Research News published in June 2006. The article also proceeded to examine if contagion effect still persists among the emerging capital markets that led to losses in the past for investors. According to their study, emerging markets now have a much lower, if any, contagion effect within regions when crisis hits a particular country. The figure 4 below illustrates the correlations between emerging markets and regions before and after a crisis situation. As can be seen from the lower correlations, the contagion effect seen in the 1990s was significantly lower in 2001 when Turkey's high inflation hurt their stock market or when the Argentine currency crisis hurt their stock market.

Figure 4



Source: Acadian Asset Management – Research News, June 2006

At this time, questions may arise as to the valuations after a solid three year run. The emerging markets back in 2002 were trading at a discount of 30%-40% relative to the developed markets. However, that discount narrowed to 20% or less. Investors have penalized emerging markets in the past due to factors such as high debt, high borrowing costs, local currencies pegged to the U.S dollar, and trade deficits coupled with poor company fundamentals, and as such, significant discounts were warranted.

Beacon Pointe believes that over time, going forward, this discount is likely to diminish. This is due to the evolution of fiscal and monetary policies in the emerging market countries. In addition, most countries have a much lower trade deficit with a few even sporting trade surpluses, lower debt levels, lower cost of capital, improved legal rights for minority shareholders, better intellectual property protection, and free floating currencies.

In recent times, investors have expressed some concerns regarding investments in emerging markets. The past few years have been exceptionally positive for most investors worldwide as most markets rose in a synchronized manner displaying little volatility. Beacon Pointe released a white paper in April 2006 titled "Quality Matters" that highlighted this low volatility and opined that it was just a matter of time before volatility returned to normal levels. In early May, of 2006 investors worldwide saw an increase in volatility, primarily from interest rate hikes and inflation fears in the U.S., having a potential impact on global growth.

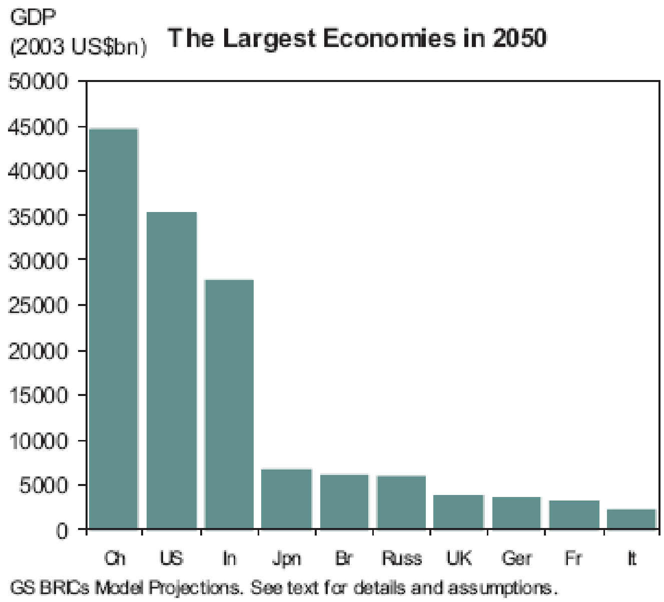
This return to volatility was also highlighted in our due diligence paper on AllianceBernstein after our site visit to their offices in New York City in March 2006. Beacon Pointe had an extensive interview with Mr. Henry D'Auria, Co-CIO, International Value, and CIO, Emerging Markets Value. AllianceBernstein has similarly expressed their long-term bullish views on emerging markets and the paper highlights the reasons why they think emerging markets is an attractive asset class. Please contact your Beacon Pointe consultant for the paper on AllianceBernstein's perspectives[2].

Beacon Pointe believes that for long-term investors, despite the higher volatility of the emerging markets asset class, it makes prudent sense to have an allocation to these high-return albeit higher risk asset classes. Some of the salient features of the evolution in emerging markets have already been discussed. In addition, looking out to the future over the long-term, some of these developing countries are expected to be significant global players as outlined in a Goldman Sachs study, somewhat appropriately titled, "Dreaming With BRICs": The Path to 2050.

Goldman Sachs[3] has written a determining piece on the emerging markets, in particular referring to Brazil, Russia, India, and China (or commonly referred to as BRIC) being significant players in the global economy by 2050. In fact, they have concluded that China will be the largest economy followed by U.S., India, and Japan in that order. This is illustrated in the Figure 5 on the next page.

[2] AllianceBernstein – International and Emerging Markets, Site Visit March 2006
[3] For the full paper, please visit http://www.gs.com/insight/research/reports/99.pdf

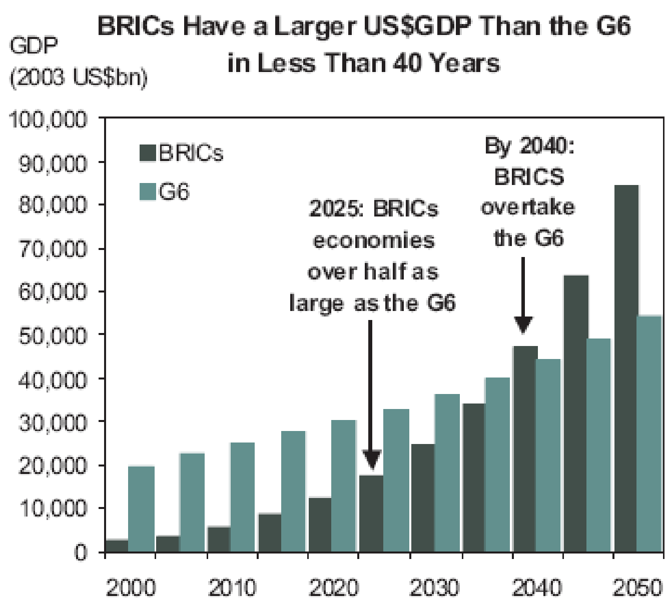
Figure 5



Source: Dreaming With BRICs – Path to 2050.

In addition, they have also concluded, based on their assumptions, that BRICs will have a larger U.S. $ GDP than G6[4] in less than 40 years, as illustrated in Figure 6 on the next page. Furthermore, they also stated that the BRICs share of the GDP will exceed 60% as shown in Figure 7 also shown on the next page.

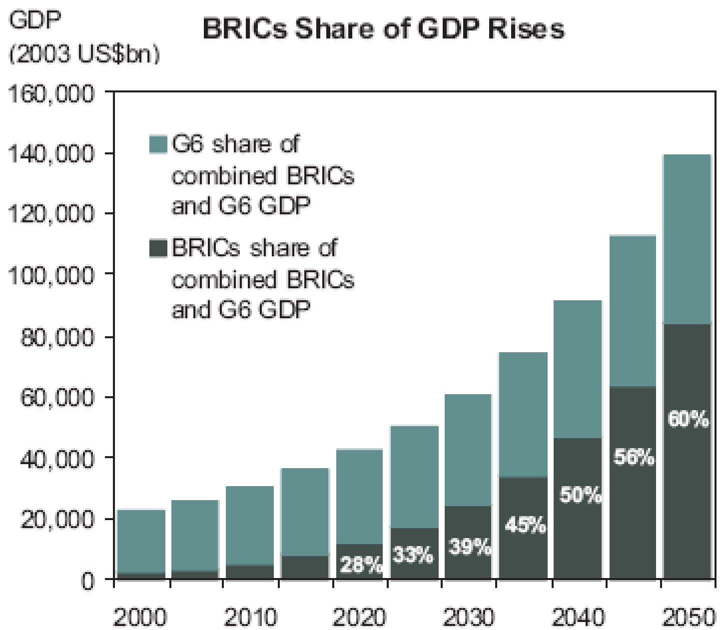
Figure 6



Source: Goldman Sachs - Dreaming With BRICs – Path to 2050.

[4] G6 – Group of Six developed countries that include USA, Japan, Germany, France, Italy, and UK.

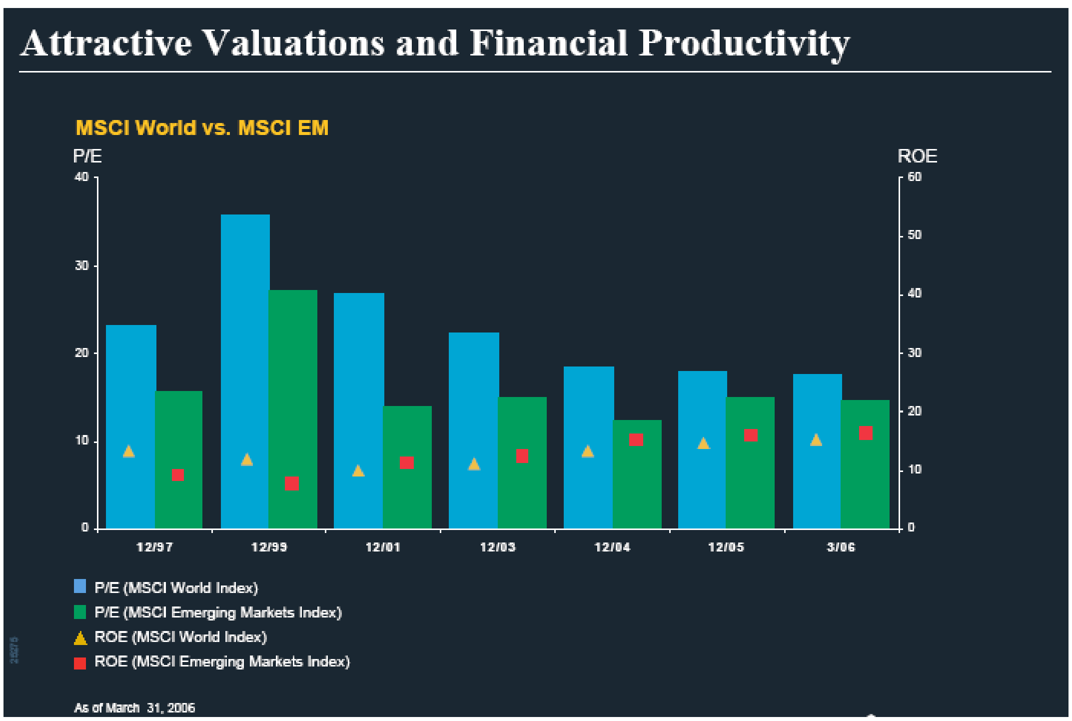
Figure 7



Source: Goldman Sachs - Dreaming With BRICs – Path to 2050.

After the strong run in recent times, investors may be concerned about the valuation levels in the emerging markets. However, even before the recent corrections, valuations were still reasonable for emerging markets despite higher profitability. This is illustrated in Figure 8 below.

Figure 8



Source: Lazard Asset Management – Emerging Markets: The Case for BRIC, July 2006

As seen from the table below, emerging markets are trading at a discount of about 19% despite higher profitability. Even from a growth perspective, emerging markets have an advantage over the global growth prospects as many emerging market countries have a domestically driven demand. As such, lower valuations than global markets with better growth prospects and higher profitability make emerging markets an attractive place to invest.

Emerging Markets: Cheaper and Offering Higher Growth

Country/region	Price/Earnings Ratio		EPS Growth (%)		Return on Equity	Price/Book Ratio	Dividend Yield (%)
	2006	2007	2006	2007	2006	2006	2006
Emerging Market Equities	11.5	10.0	18.8	14.7	16.7	1.9	2.9
Developed World	14.1	12.6	14.5	12.8	15.5	2.2	2.5
Euro Zone	12.7	11.4	13.1	11.5	14.0	1.8	3.4
United Kingdom	11.9	10.5	15.2	12.7	17.2	2.0	3.5
Japan	19.7	18.0	12.4	10.0	9.3	1.8	1.1
United States (S&P 500)	14.4	12.9	12.9	12.8	18.0	2.6	2.0

Source: UBS

Table: Courtesy of ING Investment Management – ING Investment Weekly June 26. 2006

Emerging Markets - Conclusions

- Beacon Pointe believes that emerging markets offer compelling investment opportunities 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.

- Beacon Pointe believes the recent correction in the markets provide an attractive entry point to an asset that has the potential for higher returns in public equity albeit at a higher volatility than developed markets. However, for investors with longer horizon, we believe they should have some exposure to emerging markets. Depending on their risk tolerance, we believe that allocation to emerging markets should range from 5%-10% of assets.

- 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, possible U.S. dollar depreciation, attractive valuations, and lower contagion, all combine to make a strong case for investing in the emerging markets.

- Current market conditions are similar to those in the early 1990s when emerging markets showed sharp and sustained increases in prices in the face of 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.

- Please contact your Beacon Pointe consultant should you have any questions.