

The Emerging Market Benchmark Bear Hug: Competitive Opportunity for Wealth Managers

January 2013 (originally published January 2012)

Many wealth managers are investing in emerging markets via products that track market capitalization weighted broad benchmarks, including the MSCI Emerging Markets (EM) Index. We believe that the use of these vehicles in emerging markets represents an investment view, whether intended or unintended. The continued maturation of emerging markets has allowed wealth managers to make choices beyond broad benchmarks, thereby differentiating client portfolios and their own value propositions.

Broad Benchmarks as Default Investment Positions

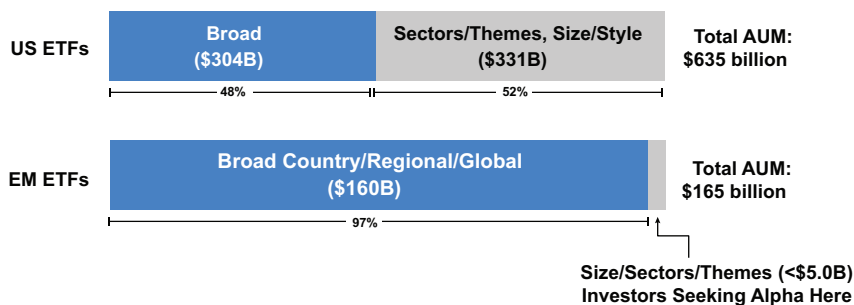
When wealth managers are asked why they don't own a product that tracks the S&P 500 Index as their primary U.S. equity holding, they usually provide a robust answer. Our experience is that these investors rarely extend their own logic and investment acumen into emerging markets, instead choosing investments that replicate broad benchmarks. While they may favor sectors, themes, dividends, and other approaches when investing domestically, they do not differentiate in EM.

To observe this tendency, we use ETF assets as a proxy for investor behavior. As of December 31, 2012, U.S. listed ETFs providing exposure to U.S. equities totaled \$635b, with less than half of these assets invested in broad based index products. However, 97% of the \$165b of EM equities tracked broad country, regional, or global EM benchmarks (See Fig 1).

Highlights:

- Wealth managers often default to broad emerging market benchmarks as investment positions
- Index components represent an implied point of view
- Wealth managers who compete against this approach can differentiate their value proposition

Figure 1 - Equity ETF Asset Flows Are A Proxy For Investor & Advisor Behavior



Source: Bloomberg data as of December 31, 2012. Domestic and emerging market ETF assets as percent of total.

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Index Components Represent an Investment View - Whether Intended or Unintended

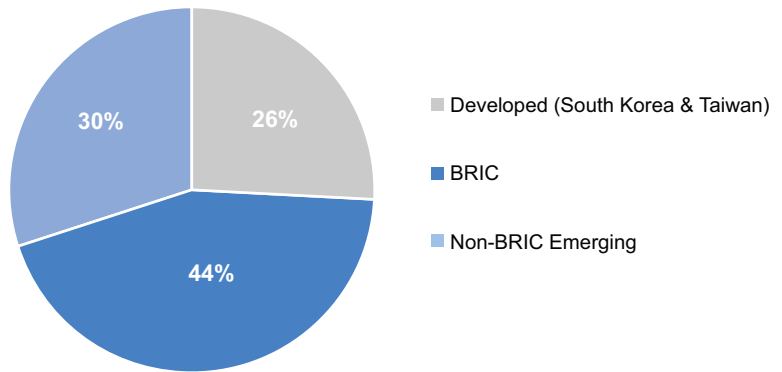
A review of the 800+ stock MSCI EM Index is likely to remind investors that it was designed as an appropriate broad EM benchmark. However, when repurposed as an investment product, the index components represent implied investment views. Given its composition, these views may be hard to justify.

Views implied using broad benchmarks as investments:

“Developed Market Companies Fit in EM Portfolios”

Morningstar categorizes the funds that follow the MSCI EM Index as 73% emerging markets and 27% developed markets¹. The International Monetary Fund graduated South Korea and Taiwan to developed status in 1997², yet these two nations comprise more than 25% of the index. The Korean and Taiwanese securities in the index derive approximately 75% of revenues from domestic sales and sales to other developed countries³. This developed market exposure diminishes the weighting of both BRIC and non-BRIC EM securities within the index (See Fig 2).

Figure 2 - MSCI Emerging Markets Index Has Significant Developed Market Exposure

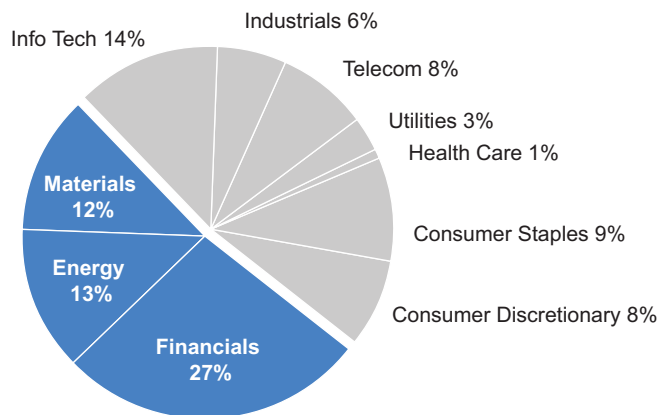


Sources: MSCI, Bloomberg data as of December 31, 2012.

“Financials, Energy, and Materials are the Most Important Sectors in EM”

Market cap weighting, when applied to broad EM indices, tends to emphasize those sectors that led nations from frontier to emerging market status. As a consequence, 3 sectors (Financials, Energy and Materials) make up 51% of the MSCI EM benchmark. Domestic demand sectors represent smaller weightings⁴. These sectors (Telecommunications, Utilities, Consumer Staples and Discretionary, and Health Care) play a critical role in a nation’s ability to move from emerging to developed status (See Fig 3).

Figure 3 - Market Cap Weighted Strategies Have Implied Sector Preferences



Sources: MSCI and Bloomberg data as of December 31, 2012. Index weights are subject to change.

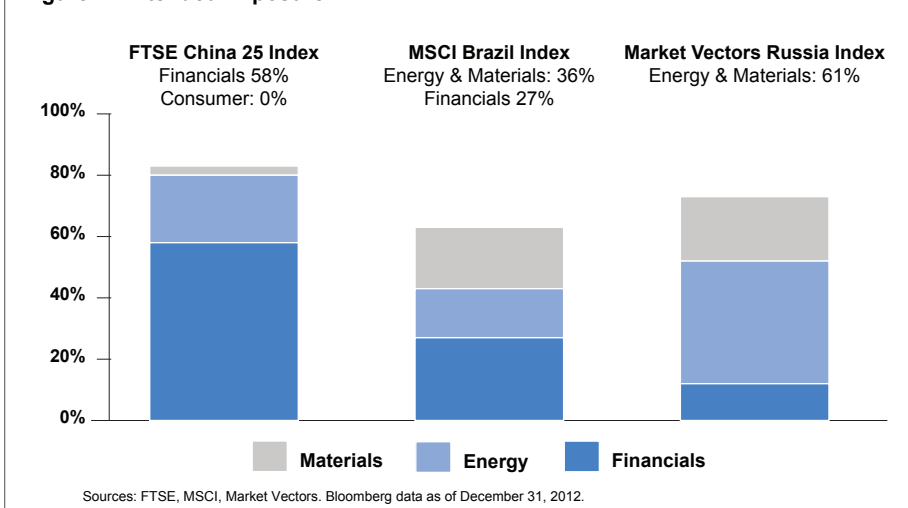
Developed market influence may also be an issue when considering sector allocation. For instance, the MSCI EM benchmark’s Consumer Staples and Consumer Discretionary exposure is 17%⁵. However, several of the names are South Korean and Taiwanese. Emerging market based consumer companies make up only 12% of the index.

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Broad country specific benchmarks may also provide unintended exposure. Investors often have a theme in mind when choosing to allocate to a particular country. That theme may not be reflected in these benchmarks. For example, as of December 31, 2012 the FTSE China 25 Index included 58% exposure to the financial sector and no exposure to the consumer. The Market Vectors Russia Index was 61% Energy and Materials. Energy, Materials and Financials made up 63% of the MSCI Brazil Index, with Financials as the largest sector weight at 27% (See Fig 4). Furthermore, three companies account for 37% of this index: Petrobras, Vale and Itau Bank.⁶

Figure 4 - Intended Exposure?



“High Relative Volatility is a Given in EM”

The MSCI EM benchmark has a beta to the S&P 500 of 1.31 and a yield of 2.72%⁷. Some investors who default to this index might not select a basket of U.S. stocks with similar characteristics. They might instead choose to screen for a less volatile or higher yielding portfolio (dividends are a large portion of emerging market total return and are growing faster in emerging markets than developed markets)⁸. Not doing so in emerging markets fuels the notion that EM is a “risk on/risk off” trade. Wealth managers seeking total return opportunities may want to extend this part of their value proposition into EM.

Allocation Within Versus To Emerging Markets

As illustrated above, the fact that many wealth managers default to a broad based approach (*allocating to EM*) creates a competitive opportunity. Using broad indexes as investments rather than benchmarks may endorse a given point of view, whether intended or not. These exposures often imply that certain sectors always merit large weights, dividends don’t matter, and that developed market countries belong in an EM allocation.

In recent years, product innovation has made it possible for investors to discriminate between sectors and themes in emerging markets. Wealth managers can now use these products to build portfolios that represent either a long-term strategic allocation or a more tactical view (*allocating within EM*). Efforts to customize EM allocations by recognizing the implications of broad benchmarks and realigning EM portfolios with the wealth managers overall outlook will set them apart from their competition.

¹ www.morningstar.com

² www.imf.org

³ Bloomberg data as of 12/31/12

⁴ MSCI data as of 12/31/12

⁵ Bloomberg data as of 12/31/12

⁶ MSCI data as of 12/31/12

⁷ Trailing 12-month index dividend yield as of 12/31/12. Source: Bloomberg data.

⁸ Bloomberg Data as of 12/31/12. Monthly returns of the MSCI EM Price return index, and Total Return index. Dividends are derived from the spread between returns of the Price and Total Return indexes. Data is run from 12/31/1987 through 12/31/12. Dividends per share annualized over the 3-, 5- and 10 year period through 12/31/12. Past performance does not guarantee future results.

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Disclosures

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Emerging market investments involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles, from economic or political instability in other nations or increased volatility and lower trading volume. This fund will concentrate its investments in issuers of one or more particular industries to the same extent that its underlying index is so concentrated and to the extent permitted by applicable regulatory guidance. Concentration risk results from maintaining exposure to issuers conducting business in a specific industry.

Shares are not individually redeemable and owners of the shares may acquire those shares from the Funds and tender those shares for redemption to the Fund in Creation Units only, typically consisting of aggregations of 50,000 shares.

Definitions

- i. MSCI Emerging Markets Index is an index created by Morgan Stanley Capital International (MSCI) that is designed to measure equity market performance in global emerging markets. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any claims contained herein.
- ii. S&P 500 Index, Standard & Poor's 500 Index, is An index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.
- iii. FTSE China 25 Index is an index that includes the largest 25 Chinese stocks (H Shares and Red Chips) listed on the Stock Exchange of Hong Kong, ranked by full market capitalization. Constituents are capped at 10% of the total index.
- iv. DAXglobal Russia+ Index is a transparent, rule-based and tradable index for the emerging market of Russia. The index currently comprises American Depository Receipts (ADRs) on public limited companies in Russia that are traded on various stock exchanges across the globe.
- v. MSCI Brazil Index is an index designed to measure equity market performance in Brazil.

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