EG/A
Emerging Global Advisors

EGA Wealth Management Expert Series

Emerging Market Volatility

Remedies for the Chronically Underweight

Wealth managers often contemplate aligning emerging market (EM) allocations with global market capitalization weights. Yet such increases may come at the price of higher overall portfolio volatility. It is possible to construct EM portfolios with lower volatility profiles. Doing so may not only allow for more meaningful EM allocations, but can also help wealth managers differentiate their value propositions.

We believe that U.S. investors will increasingly make choices in EM which reflect their own patterns and expertise. For example, if they consider volatility when choosing equities at home, we think they will also do so in emerging markets. In other words, they will view equity portfolio preferences more universally. We call this trend "normalization" of EM investing. This EGA Expert Series edition addresses normalization relative to volatility.

HIGHLIGHTS:

- Wealth managers who focus on EM volatility can differentiate their value proposition
- Emerging market volatility constrains allocations
- Conventional benchmark volatility is often driven by underlying countries and sectors
- Our approaches may help reduce volatility and better target desired EM exposures

EM allocations remain low

Many investors believe that emerging markets will be a driver of the global economy for the foreseeable future. These markets account for 40% of world Gross Domestic Product (GDP) and 70 cents of every dollar of GDP growth.[1] Still, a great number of U.S. investors remain underweight EM. Even though emerging markets represent 14% of world equity market capitalization, institutional EM allocations have averaged just 5% and private client allocations have been even smaller at 3% (Figure 1).

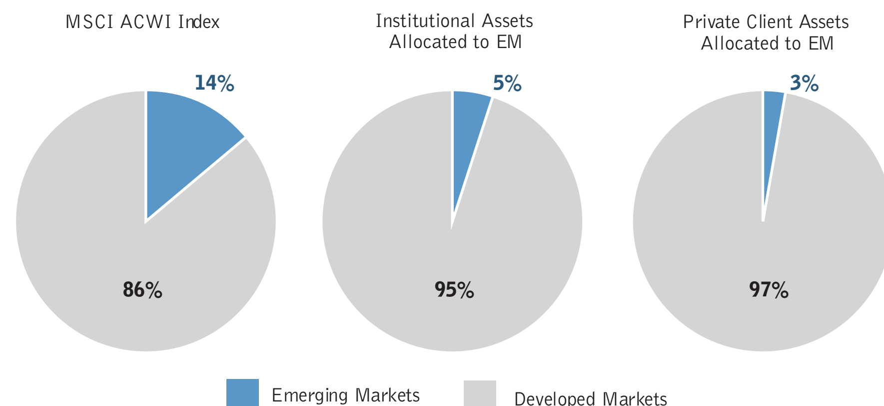
When asked why EM allocations remain low, wealth managers often respond that volatility is too high. This view is based on the performance of the conventional broad EM benchmarks that form the basis of many EM equity strategies. Ninety-four percent of U.S.-listed broad global EM equity exchange-traded fund (ETF) assets track either the MSCI EM Index (42%) or the FTSE Emerging Index (52%), and most active managers are benchmarked against the MSCI EM Index.[2]

Components drive volatility

A look at the components within broad EM benchmarks paints a different picture of volatility. One broadly used measure of volatility is beta. The MSCI EM and FTSE Emerging indices have been more volatile relative to the S&P 500 Index over the 10-year period ended December 31, 2012, with a beta of 1.33 and 1.32 respectively.[3]

These indices have dominant country and sector concentrations that are a natural consequence of their market-cap weightings. As risk trades drive assets in and out of emerging markets, these dominant exposures absorb the bulk of short-term capital flows and they play a leading role in the volatility of the indices.

FIGURE 1: The EM opportunity: widely followed but narrowly implemented



Sources: MSCI ACWI Index: Bloomberg data as of December 31, 2012; Institutional Assets Allocated to EM: Pensions & Investments Research Advisory Panel 2011 Emerging Markets Report, May 16, 2011; Private Client Assets Allocated to EM: Merril Lynch CIO Reports, September 2012.

Brazil, Russia, India, China ("BRICs") and the advanced economies of South Korea and Taiwan account for 70% of the MSCI EM Index, and five out of six of these countries have had a beta greater than 1.0 relative to the Index. Conversely, 11 of the 15 EM countries outside this group, the "Beyond BRIC" countries, had a beta less than 1.0 (Figure 2).

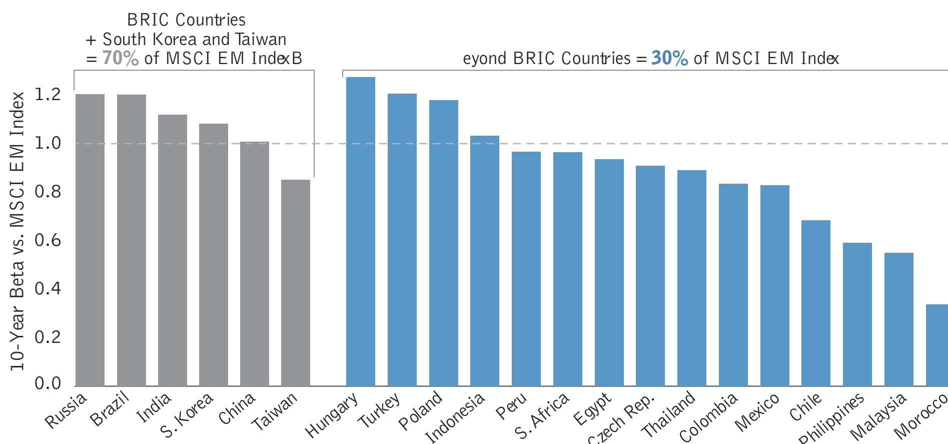
Three of the largest sector weights in both benchmarks, Financials, Energy and Materials (the "FEM" sectors), also have three of the highest betas. These sectors, which helped lead many frontier economies to emerging status, make up over 50% of each index. As a result, they crowd out the less mature sectors—many of which have had a beta of less than 1.0, relative to the MSCI EM Index (Figure 3). Just as investors may seek less volatile sector exposures in the U.S.—including Telecom, Utilities, Health Care and Consumer Staples—they can use these sectors in emerging markets for similar reasons.

Lower volatility doesn't have to mean lower return

Away from emerging markets, strategies that target below-market volatility are common. In fact, some studies have shown that a low volatility approach within a given equity asset class can produce higher alpha. A *Financial Analysts Journal* article demonstrated that low beta, low volatility stocks have long outperformed high beta, high volatility stocks.[4] Another study showed that lower beta equities outperformed a broad benchmark over a longer-term period (Figure 4).

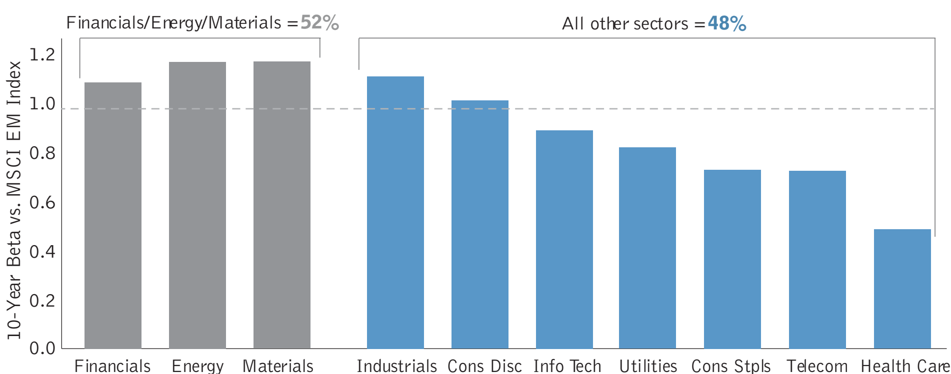
One reason for the success of lower volatility equities is that they tend to decline less in market pullbacks. When the market reverses course, they start from a higher value and have less of a hurdle to get back to breakeven. Over time, lower volatility exposures may benefit from this compounding.

FIGURE 2: Most Beyond BRIC countries have had below-market volatility



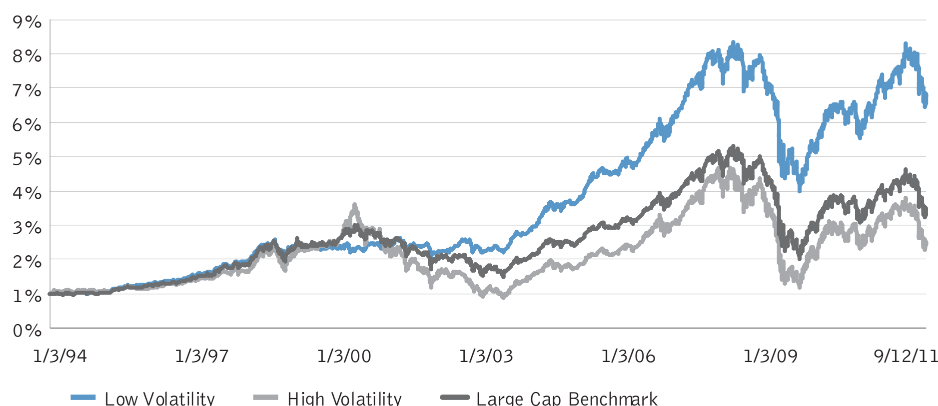
Past performance does not guarantee future results. Source: Bloomberg data as of December 31, 2012. Beta is calculated using monthly return data of individual MSCI Country Indices.

FIGURE 3: Less mature sectors compare favorably to FEM volatility



Past performance does not guarantee future results. Source: Bloomberg data as of December 31, 2012. Beta is calculated using monthly return data of individual MSCI Sector Indices.

FIGURE 4: Low volatility equities have historically outperformed*



* Sefton, J. and Jessop, D. (2011) "Why is low-risk investing successful?" UBS Investment Research Q-Series: Low Risk Investing. Pg 4. The European universe of the largest 500 companies by market capitalization is based on the Dow Jones European Universe at the end of each month from January 1994 through August 2011. The Low Volatility portfolio is a value-weighted basket of the bottom third of these stocks as measured by their daily return volatility in the previous 12 months, and the High Volatility portfolio is the top third on the same measure. All portfolios are rebalanced at the end of every month.

Allocating "within" EM rather than "to" EM

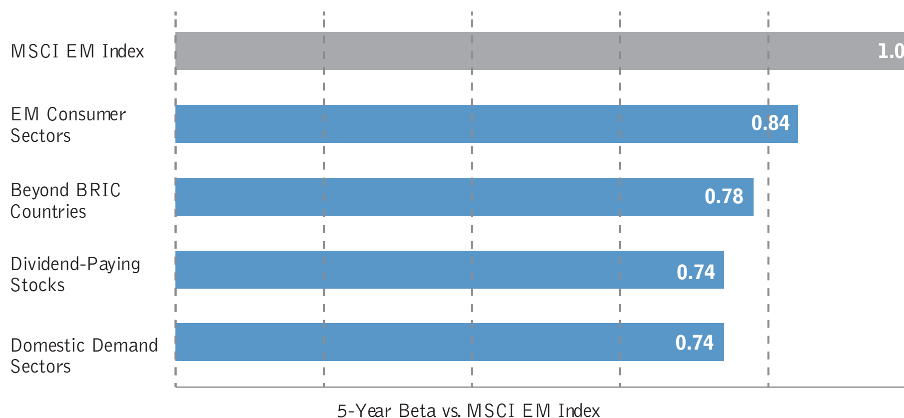
We believe that investing in emerging markets does not have to be a binary choice of being "in" or "out." Just as investors use specific U.S. exposures to express a point of view or change portfolio volatility characteristics, opportunities to do the same exist in emerging markets. Using investments that have different country and sector allocations or have been screened for volatility and dividends may produce lower risk properties (Figure 5).

Dividends and Volatility

Dividend-payers have tended to be less volatile than the broad market, in part because of the meaningful contribution dividends have made to total return. In fact, dividends accounted for more than 25% of the performance of broad EM equities over the last decade.* EM earnings have allowed dividend growth to be robust.

While dividends have played a significant role in broad EM market performance, they can make an even greater contribution in a deliberate strategy in which dividend screens are applied. Screens can be utilized to filter both historical payout level and consistency. To further attempt to reduce volatility, beta and correlation screens can be added to the dividend screens. Beta is used to screen out more volatile equities while correlation is used to identify stocks that perform differently and therefore may enhance diversification.

FIGURE 5: Differentiated EM exposures have been less volatile than broad EM



Bloomberg data as of December 31, 2012. Beta is calculated using daily return data. EM Consumer and Domestic Demand Sectors are based on equal-weighted baskets of MSCI Sector Indices. Domestic Demand Sectors are defined as Consumer Staples, Consumer Discretionary, Telecom, Utilities and Health Care. Beyond BRICs Countries are based on equal-weighted baskets of MSCI Country Indices. Dividend-Paying Stocks are based on the Wisdom Tree Emerging Markets Equity Income Index.

Beyond BRICs

The Beyond BRIC universe includes 15 emerging markets and excludes Brazil, Russia, India and China and the advanced economies of South Korea and Taiwan. These countries are becoming a more important force in the global economy, with a rising share of world equity market capitalization and a higher population growth rate than the BRICs, South Korea and Taiwan.[5]

While the Beyond BRIC economies are less mature than the BRICs and are believed to involve higher political, currency and economic risk, they have offered lower volatility. An equal-weighted basket of the 15 Beyond BRIC countries had a beta of 0.78 versus the MSCI EM Index, while the BRICs, South Korea and Taiwan had a higher beta of 1.08. Additionally, the basket of Beyond BRIC countries demonstrated other risk and risk-adjusted performance measures that compared favorably to the Index (Figure 6).

FIGURE 6: Portfolio statistics of differentiated EM exposures (5-Year Time Period)

	MSCI EM Index	FEM Sectors	BRICs, South Korea & Taiwan	Dividend-Paying Stocks	Domestic Demand Sectors	EM Consumer Sectors	Beyond BRIC Countries
Beta to MSCI EM Index	1.00	1.15	1.08	0.74	0.74	0.84	0.78
Standard Deviation (annualized)	31.00	36.25	33.97	24.21	23.77	26.97	26.91
Sharpe Ratio	0.10	0.03	0.12	0.48	0.42	0.68	0.41

Bloomberg data as of December 31, 2012. Beta is calculated using daily return data. EM Consumer and Domestic Demand Sectors are based on equal-weighted baskets of MSCI Sector Indices. Beyond BRIC Countries are based on equal-weighted baskets of MSCI Country Indices. Dividend-Paying Stocks are based on the Wisdom Tree Emerging Markets Equity Income Index.

*Past performance is no guarantee of future results. Source: Bloomberg data as of December 31, 2012.

Domestic Demand and the Consumer

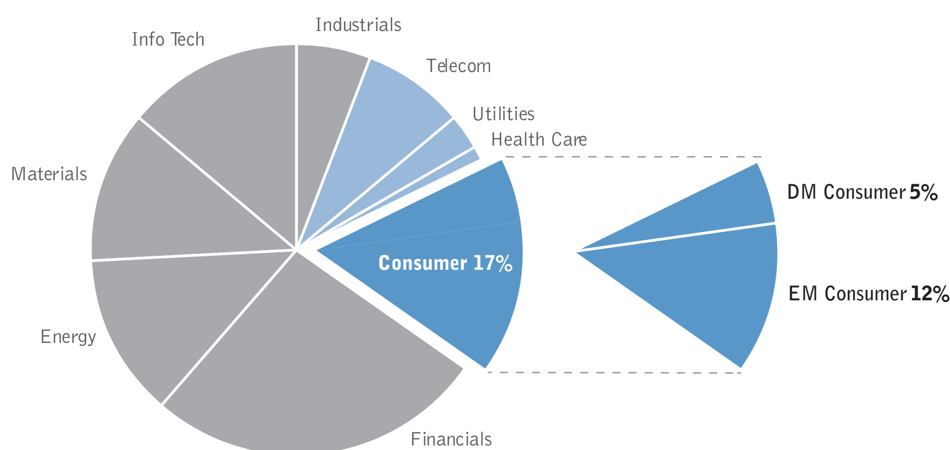
One of the leading research topics in EM has been the theme of domestic demand: the increase of local, organic growth as EM countries work to decrease their dependence on exports to developed markets (DM). A subset of this theme—the strengthening EM consumer—is also the preferred investment focus of many EM investors. While all 10 equity sectors can benefit from domestic demand, we believe that there are five sectors that will be most influenced by this dynamic: Consumer Staples, Consumer Discretionary, Telecom, Utilities and Health Care.

An equal-weighted basket of the five domestic demand sectors had a beta relative to the MSCI EM Index of 0.74. Similarly, an equal-weighted basket of the two consumer sectors had a beta versus the Index of 0.84. Both baskets had other favorable risk and risk-adjusted performance characteristics as well (Figure 6).

These exposures, which many investors desire and have lower volatility characteristics, are only minor components of conventional EM benchmarks. The five domestic demand sectors are less than a third of both the MSCI EM Index and the FTSE Emerging Index. The two consumer sectors represent only 17% of the MSCI EM Index, and that weighting is reduced to 12% when consumer companies based in the advanced economies of South Korea and Taiwan are excluded (Figure 7).

In other words, when using a broad EM benchmark to implement the domestic demand or consumer thesis, investors experience the aggregate volatility of the benchmark while getting a diluted implementation of their investment view. On the other hand, investing directly in the domestic demand or consumer sectors has the potential to offer a less volatile EM portfolio.

FIGURE 7: DM constituents limit EM consumer exposure in the MSCI EM Index



Past performance does not guarantee future results. Source: Bloomberg data as of December 31, 2012.

Wealth manager differentiation through lower volatility EM portfolios

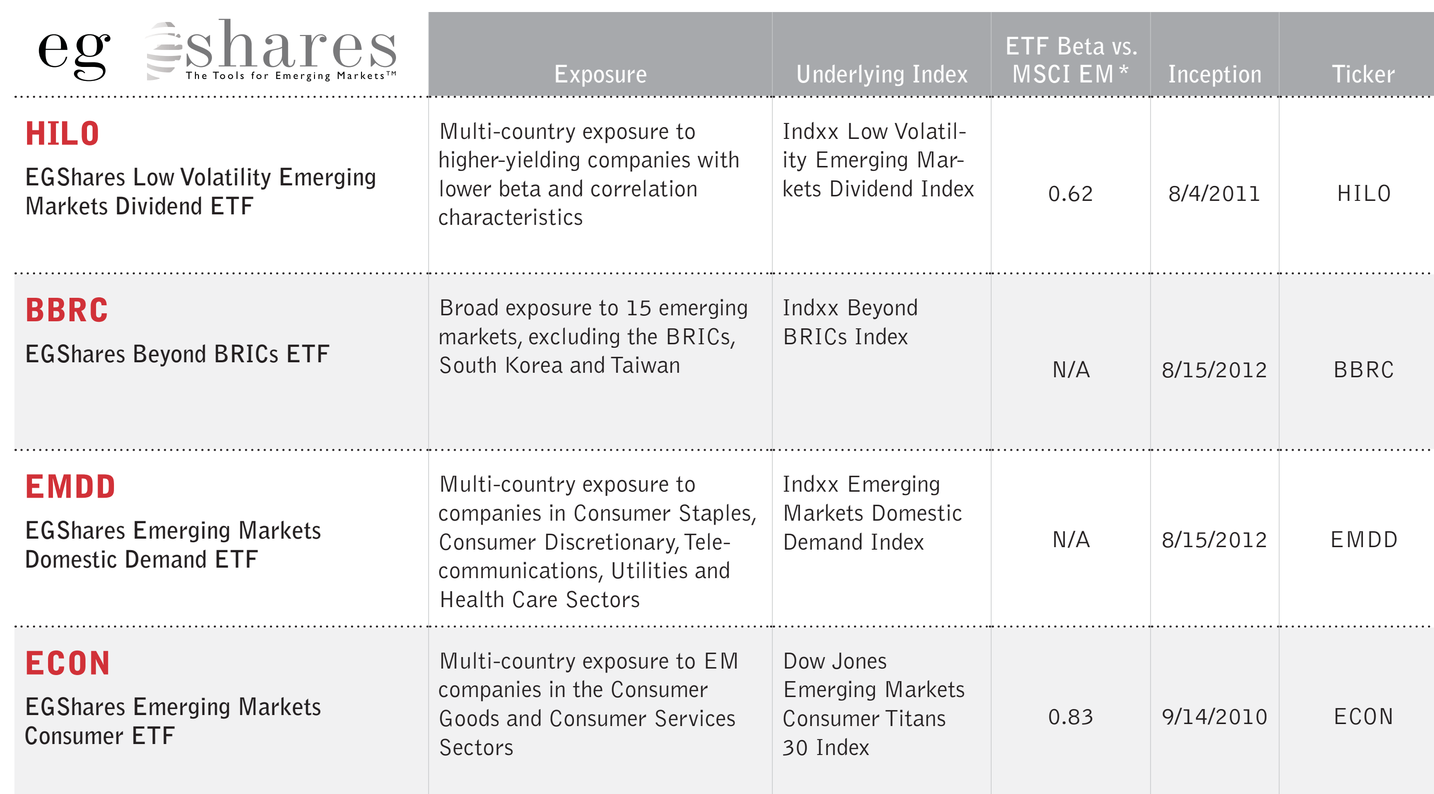
Many wealth managers recognize the EM opportunity, yet few act on it, as evidenced by low allocations. While EM volatility remains a chief concern, it is also an opportunity for differentiation. Wealth managers have the ability to discriminate within EM in an effort to lower volatility. In particular, products that focus on dividends and less mature countries or sectors may help wealth managers achieve a better risk/reward balance within EM allocations—one that allows wealth managers to increase allocations if desired.

FOOTNOTES

1. Source: International Monetary Fund; World Economic Outlook Database, October 2012.
2. Source: Bloomberg data as of December 31, 2012.
3. Source: Bloomberg data as of December 31, 2012.
4. Benchmarks as Limits to Arbitrage: Understanding the Low-Volatility Anomaly, *Financial Analysts Journal,* Volume 67, 2011.
5. Source for equity market capitalization: World Bank data as of 12/31/11. Sources for population growth: Department of Economic & Social Affairs of the United Nations Secretariat; Goldman Sachs, "Population Growth and Ageing in the BRICs," May 2011.

EGShares Tools to Potentially Lower Volatility

Investors can target desired EM exposures while also potentially reducing volatility. Consider the following EGShares ETFs, which may help to better align desired exposures with specific EM themes and historically lower volatility profiles.



eg shares The Tools for Emerging Markets™	Exposure	Underlying Index	ETF Beta vs. MSCI EM *	Inception	Ticker
HILO EGShares Low Volatility Emerging Markets Dividend ETF	Multi-country exposure to higher-yielding companies with lower beta and correlation characteristics	Indxx Low Volatility Emerging Markets Dividend Index	0.62	8/4/2011	HILO
BBRC EGShares Beyond BRICs ETF	Broad exposure to 15 emerging markets, excluding the BRICs, South Korea and Taiwan	Indxx Beyond BRICs Index	N/A	8/15/2012	BBRC
EMDD EGShares Emerging Markets Domestic Demand ETF	Multi-country exposure to companies in Consumer Staples, Consumer Discretionary, Telecommunications, Utilities and Health Care Sectors	Indxx Emerging Markets Domestic Demand Index	N/A	8/15/2012	EMDD
ECON EGShares Emerging Markets Consumer ETF	Multi-country exposure to EM companies in the Consumer Goods and Consumer Services Sectors	Dow Jones Emerging Markets Consumer Titans 30 Index	0.83	9/14/2010	ECON

* Source: Bloomberg data as of December 31, 2012. ETF betas were calculated using the weekly return data as of the inception dates for HILO (8/4/2011) and ECON (9/10/2010). The EGShares Beyond BRICs ETF and the EGShares Emerging Markets Domestic Demand ETF were incepted on August 15, 2012, and therefore have limited performance history.

About Emerging Global Advisors

Emerging Global Advisors is an asset management company specializing in truer exposures to emerging market assets. Our targeted approach makes it possible for investors to use similar investment strategies in emerging markets as they do in developed markets. EGShares, our exchange-traded fund (ETF) offering, enables investors to allocate not merely to, but also within emerging markets through core holding, thematic and sector ETFs. These portfolio construction tools allow more accurate targeting of emerging market opportunities. For additional information, contact EGShares at +1 888 800 4347 or visit www.egshares.com.

Disclosures and Risks

Carefully consider the Funds' investment objectives, risk factors and charges and expenses before investing. This and other information can be found in the Funds' prospectuses, which may be obtained by calling + 1 888 800 4347 or by visiting the Funds' website www.egshares.com to view or download a prospectus. Read the prospectus carefully before investing. Investing involves risk, including possible loss of principal.

A supplement to the EGShares Beyond BRICs ETF prospectus was filed on August 26, 2013. Effective October 25, 2013, the investment objective for the EGShares Beyond BRICs ETF is revised as follows: "The Fund seeks investment results that correspond (before fees and expenses) to the price and yield performance of the FTSE Beyond BRICs Index." Please review the prospectus for details.

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.

The value of an investment denominated in a foreign currency could change significantly as foreign currencies strengthen or weaken relative to the U.S. dollar.

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.

These funds are non-diversified and, as a result, may have greater volatility than diversified funds.

These funds will concentrate their investments in issuers of one or more particular industries to the same extent as the underlying index. Concentration risk results from maintaining exposure to issuers conducting business in a specific industry. In certain circumstances, these funds might not be able to dispose of certain holdings quickly or at prices that represent true market value preventing them from tracking the underlying index. As ETFs, fund shares are not individually redeemable securities.

There is no assurance that an active trading market for fund shares will develop or be maintained.

Small-cap and mid-cap companies generally will have greater volatility in price than the stocks of large companies due to limited product lines or resources or a dependency upon a particular market niche. One cannot invest directly in an index.

Diversification does not assure a profit or protect against loss.

EGShares Funds ("Funds") are distributed by ALPS Distributors, Inc. ALPS and Emerging Global Advisors are unaffiliated entities.

Definitions

Alpha represents the excess return of an investment relative to its benchmark.

Beta is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole. A beta of 1.0 indicates that the security's price will move with the market. A beta of less than 1.0 means that the security will be less volatile than the market. A beta of greater than 1.0 indicates that the security's price will be more volatile than the market.

Beyond BRICs Universe includes the nations of Chile, Colombia, Czech Republic, Egypt, Hungary, Indonesia, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, South Africa, Thailand and Turkey and excludes the largest emerging market economies (Brazil, Russia, India and China) and the advanced economies of South Korea and Taiwan.

Correlation is a statistical measure of how two securities move in relation to each other.

Dividend Yield is a financial ratio that shows how much a company pays out in dividends each year relative to its share price.

Dow Jones Emerging Markets Consumer Titans 30 Index is an index that measures the stock performance of 30 leading emerging market companies in the Consumer Goods and Consumer Services Industries as defined by the proprietary classification system used by Dow Jones Indices.

Emerging Markets Domestic Demand is the total amount of money that is spent on goods and services by governments, businesses and consumers domiciled in emerging markets.

Frontier Markets is a term used to represent economies that are in the early stages of their economic development.

FTSE Beyond BRICs Index is a capitalization weighted stock market index comprised of leading developing market companies that FTSE International Limited determines to be representative of all industries in developing market countries, excluding Brazil, Russia, India, China and Taiwan.

FTSE Emerging Index is a market-capitalization weighted index representing performance of over 790 large- and mid-cap companies in 22 emerging markets. FTSE makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any claims contained herein.

Indxx Beyond BRICs Index is a 50-stock free-float market-capitalization weighted index designed to measure the market performance of companies domiciled in emerging markets excluding Brazil, Russia, India and China.

Indxx Emerging Markets Domestic Demand Index is a 50-stock free-float market-capitalization weighted index designed to measure the market performance of companies in the domestic demand industry.

Indxx Low Volatility Emerging Markets Dividend Index is a 30-stock dividend-yield weighted index designed to measure the market performance of companies in emerging markets that have a high dividend yield and low beta.

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.

S&P 500 Index is a broad-based measure of domestic stock market performance.

Standard Deviation is a measure of the dispersion of a set of data from its mean. The more spread apart the data, the higher the deviation.

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