



The End of Emerging Markets?

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Everest Capital's staff of 50 professionals bring the economic and cultural perspectives of 17 nationalities, speak 14 languages and draw on business experience gained from having worked in 34 countries. Over the past two decades Everest Capital has invested in 87 countries globally, including 59 emerging markets.

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"Emerging Markets Update: Even After Recent Gains, Plenty of Upside" (June 2009)

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November 2009

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Executive Summary

We believe the distinction between emerging markets and developed markets is no longer useful. The differences that justified the segregation of emerging and developed markets have disappeared or are in the process of disappearing.

Emerging markets, because of their characteristics, should matter a great deal to investors today. Investors handicap themselves by limiting how much they invest in emerging markets.

The term “emerging markets” is obsolete. The end of emerging markets has arrived, as the distinction between emerging markets and developed markets has run the course of its usefulness to investors.

Distinctions are disappearing between emerging and developed markets. Emerging markets represent half of the world’s economy; they are large and liquid with volatility similar to that of developed markets; and their corporate governance and government policies are no worse than, and in some cases superior to, those of developed markets.

There is one measure by which there is still a distinction between emerging markets and developed markets: Growth. We believe that, for the foreseeable future, this differentiation in growth will remain, leading to more attractive investment opportunities in emerging markets than in developed markets. For this reason, investors should focus more on emerging markets than developed markets.

Introduction

On September 25, 2009, the Group of Twenty (G-20) Finance Ministers and Central Bank Governors officially replaced the G-8 as the premier forum for international economic cooperation, in recognition of the new reality of the global balance of power. Of the 19 countries that comprise the G-20 (the European Union is the 20th member), eleven are emerging markets.

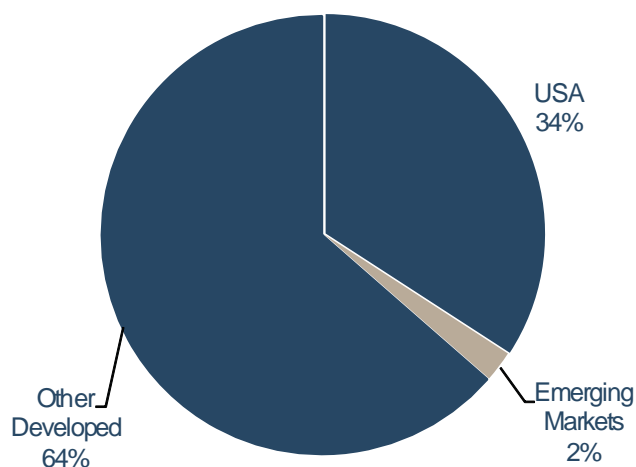
Of the 19 countries (plus the EU) that comprise the G-20, eleven are emerging markets

In this paper, we counter some of the common misperceptions that have historically limited investing in emerging markets. A good starting point might be to examine the existing indices against which many investors benchmark their portfolio allocations and which we believe massively under-represent the current importance of emerging markets in the global economy as well as the magnitude of the opportunities in these markets.

The MSCI All Country World Index would seem to indicate that emerging markets are not very large, warranting some interest but considerably less so than developed markets. In 1990, one year after the fall of the Berlin Wall and shortly after Deng Xiaoping liberalized China, emerging markets represented only 2% of this MSCI index. The U.S. was 34% of the

Exhibit 1: Why Haven't Emerging Markets Emerged Yet?

MSCI All Country World Index Weightings — 1990



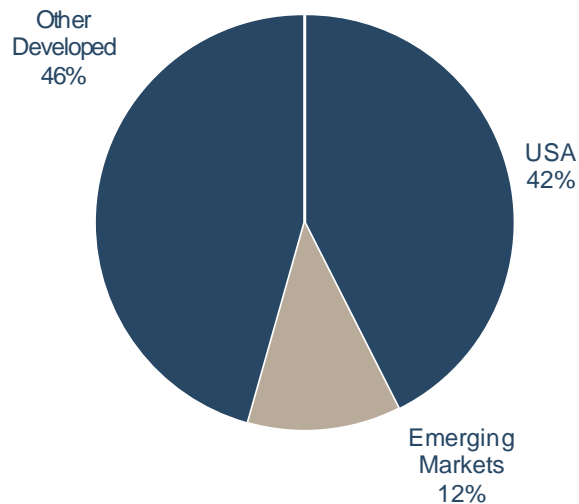
Source: MSCI, Everest Capital

index at the time, and the rest of the developed world was 64%, almost half of which was Japan (Exhibit 1).

Nearly twenty years later, emerging markets still remain small in world index weightings (Exhibit 2). In 2009, they represent 12% of the world according to the benchmark, while the U.S. represents 42% and the other developed markets represent 46%.

Exhibit 2: Why Haven't Emerging Markets Emerged Yet?

MSCI All Country World Index Weightings – 2009



Source: MSCI, Everest Capital

We believe that this is a mistake. Because of this artificial classification, emerging markets are much smaller than they might otherwise be in investors' portfolios, which we think could lead to the unnecessary underperformance of these portfolios.

The arguments which have historically been used against emerging markets investments usually fall into four broad categories. We believe that these differences have disappeared or are in the process of blurring completely:

1. The size of the economies

These economies are no longer the small and insignificant players in the global economy they were once considered. The rapid growth of the past few years has made this distinction based on size largely obsolete.

2. The size of the financial markets

While once viewed as small and illiquid financial markets regardless of the size of their respective economies, we highlight that emerging markets are increasingly larger, more liquid and with volatility similar to that of developed markets.

3. Corporate governance

Improved corporate governance practices have largely laid to rest the view that these countries are not run as effectively, professionally or ethically as businesses in developed markets. We counter the belief that U.S. and European managements practice stewardship superior to that of their counterparts in emerging markets.

4. Government policies

Developed market governments are no longer the best role models for emerging markets; investors should not ignore the prudent, proactive and successful macro policies implemented by many emerging markets governments over the last few years and in response to the current global financial crises.

1. The Size of the Economies

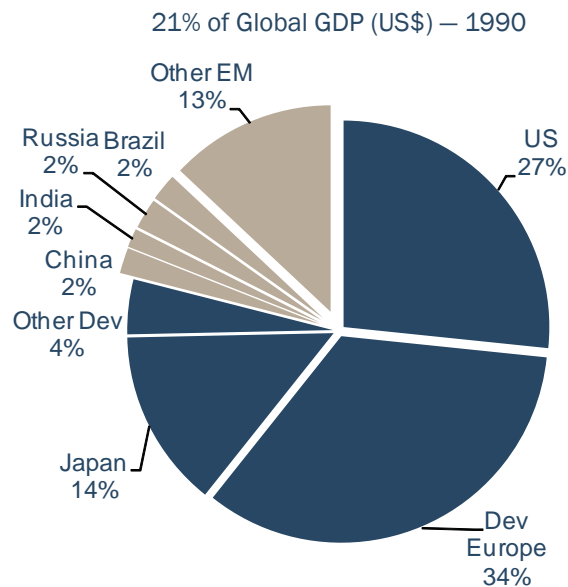
Even twenty years ago, the economies of emerging markets mattered. Now, they are as big as developed markets.

Eighty percent of the world's population lives in emerging markets, but many investors feel that from an investment standpoint these countries do not really matter. However, we believe that they do.

Emerging markets as a percent of the MSCI All Country World Index were a small sliver in 1990, even though they represented 21% of the world economy at the time (Exhibit 3). Brazil, Russia, India, China - the BRICs - represented about 8% of world GDP and the remaining emerging markets were about 13%. Although the U.S. and Europe were clearly the dominant economies back then, and Japan was fairly large at 14%, emerging markets were a meaningful portion of the world's GDP.

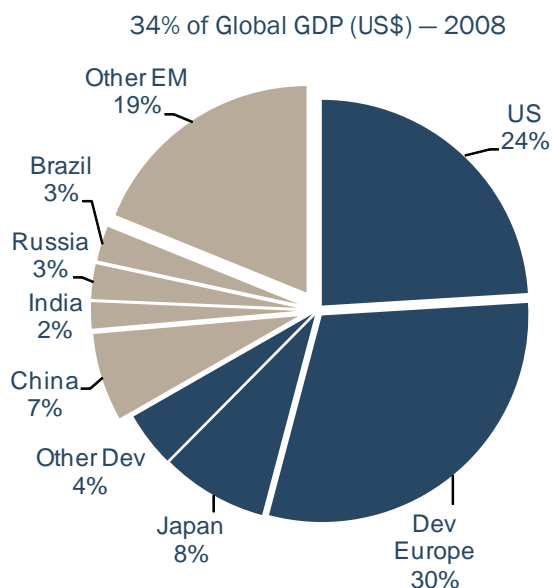
Fast forward 18 years: by 2008, emerging market economies had grown substantially. About one third of the world GDP is now represented by emerging markets (Exhibit 4). China clearly has gained significance at 7% of global GDP. The BRICs combined account

Exhibit 3: Emerging Markets Mattered Even Then...



Source: World Bank, Everest Capital

Exhibit 4: ... And Matter Even More Today



Source: World Bank, Everest Capital

for 15%. Furthermore, emerging markets excluding the BRICs account for 19% of global GDP, approaching the U.S.'s share. While investor attention has focused on the BRICs, the remaining emerging markets countries are also an important share of the global economy. Based on GDP, non-BRIC emerging markets equity investments should be about 80% (19% divided by 24%) of a typical global investor's investment in the U.S.A.!

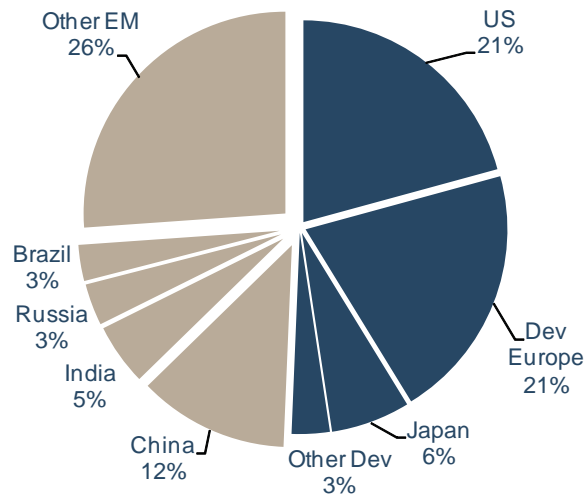
But we believe this representation of global GDP still does not give sufficient importance to emerging markets since it is calculated using current U.S. dollars. Depending on the local currency, this methodology may overvalue or undervalue a country or region's true percentage of world GDP. For instance, the euro is overvalued in our eyes, and that is one of the reasons why developed Europe's GDP in U.S. dollars is so large. Conversely, many Asian currencies are being kept undervalued through government interventions.

The representation of the size of an economy which we find more useful is the GDP on a purchasing power parity (PPP) basis (Exhibit 5). According to the World Bank, "By establishing purchasing power equivalence, where one dollar purchases the same quantity of goods and services in all countries, PPP conversions allow cross-country comparisons of economic aggregates on the basis of physical levels of output, free of price and exchange rate distortions." We view this as a

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**Exhibit 5: Emerging Markets Should Matter
A Great Deal to Investors**

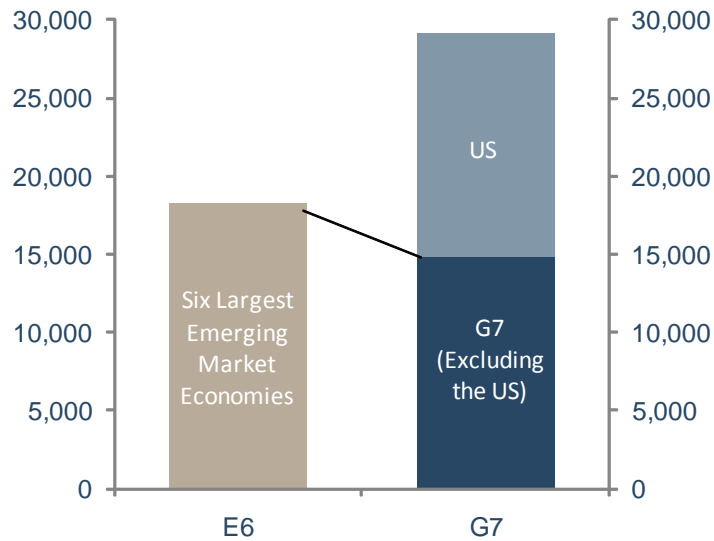
Nearly 50% of Global GDP (PPP) Adjusted in 2008



Source: World Bank, Everest Capital

Exhibit 6: The Six Largest EM Economies are Bigger than the G7 Economies ex the US

Gross Domestic Product (PPP Weighted) – 2008 in US\$ Billions



Source: World Bank, Everest Capital

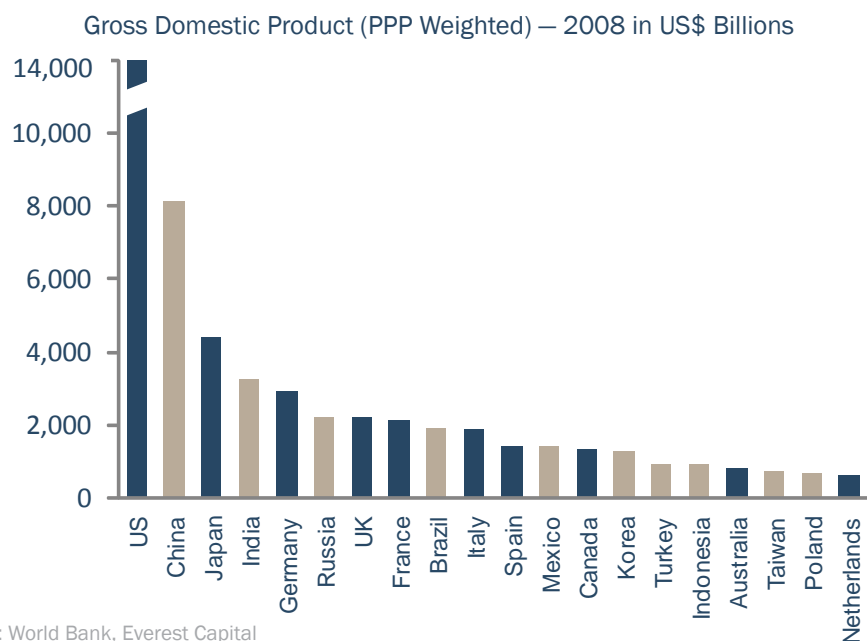
more accurate way of looking at the world because it incorporates not only exchange rate undervaluations and overvaluations but also the fact that items in an emerging market might sell and cost a fraction of what they do in a developed market. If income in emerging country E is half of what it is in developed country D, but the cost of a phone call is only one quarter in E of what it is in D, then the size of the opportunity for a phone operator in E is superior to what it is in D.

Using PPP-adjusted GDP gives a very dramatic illustration of the true size of emerging markets: basically half of the world's GDP on a purchasing power parity basis is now generated by emerging markets. In fact, the six largest emerging market economies are bigger than the G7 excluding the U.S.! (Exhibit 6).

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On a PPP basis China, is larger than Japan, India is larger than Germany, and Russia is larger than the U.K. Brazil has a larger economy than Italy; Mexico has a larger economy than Canada; Korea, Turkey and Indonesia each has an economy larger than Australia (Exhibit 7). The BRIC economies are obviously important, but what is very interesting is that the non-BRIC emerging markets such as Indonesia, Nigeria, Colombia, etc., while not large individually are, at 26% of global GDP, larger collectively than the economies of the U.S. or of developed Europe (each at 21%). For investors, this is a very important point to keep in mind.

Exhibit 7: Emerging Markets are 10 of the Top 20 Largest Economies



Source: World Bank, Everest Capital

2. The Size of the Financial Markets

Even though emerging markets are very large economies, one often thinks of them as having fairly small, illiquid financial markets; however, this is not the case.

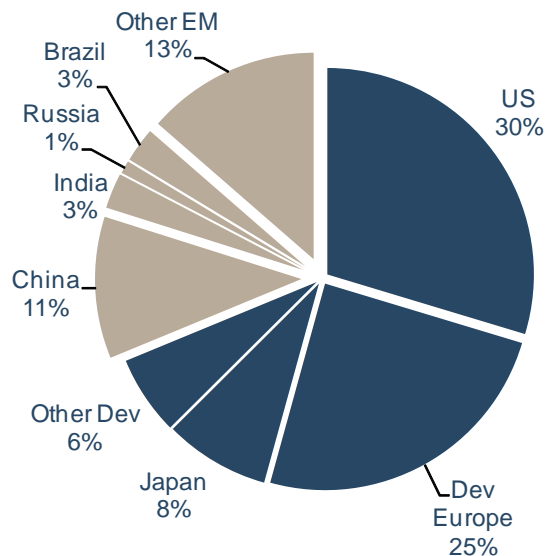
The market capitalization of emerging markets has increased substantially over the last decade due to faster economic growth versus developed economies. The listing of many private and government-owned companies during this period has also contributed to the expansion of equity markets. As a result, emerging markets are larger and more liquid, and offer an opportunity for investors to increase their exposure despite remaining a relatively small part of commonly used equity indices.

Market Capitalization

Emerging markets in total currently represent 31% of the world's market capitalization (Exhibit 8), and an agile investor can take advantage of them. Some of the larger emerging markets are viable alternatives to some of the better known developed markets. China now has a larger market capitalization than Japan; Korea and Taiwan together, two emerging

Exhibit 8: Emerging Markets are a Large Portion of the World's Market Capitalization

World Market Capitalization — September 2009



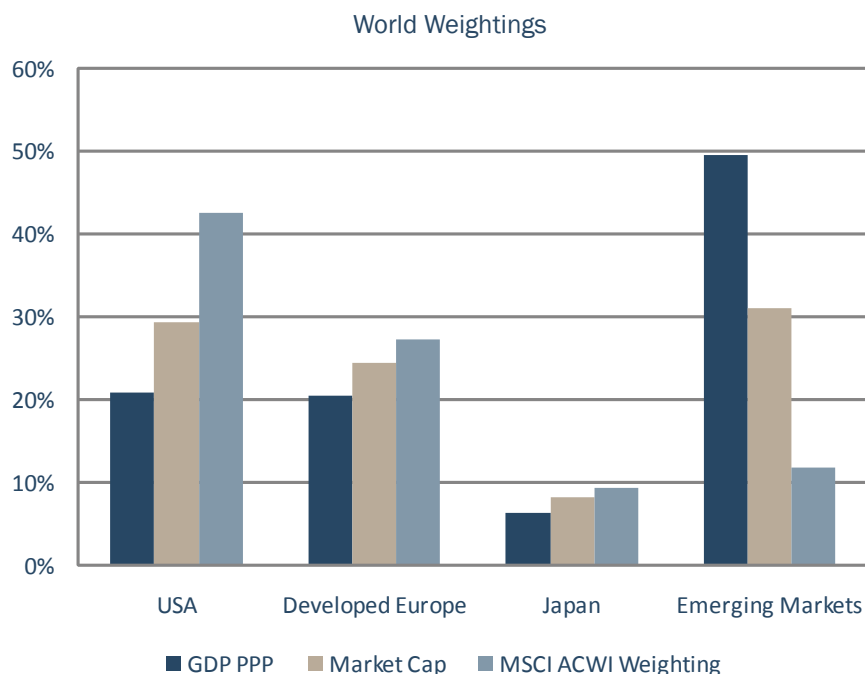
Source: Bloomberg, Everest Capital

industrial powerhouses, are larger than Germany; and Brazil has a larger market than Australia.

In 2004 the top ten emerging markets represented 11% of world market capitalization; in 2009, they represent nearly 25%. Not only do emerging markets have substantial market capitalizations, but liquidity has also increased fairly dramatically; they are truly “regular” markets with over \$10 trillion of investable assets among them.

Even for active investors who do not try solely to mimic a benchmark, index statistics do play a role in the way they look at the world. The U.S. is by far the most over-represented, with a much larger weighting in the world index than its market capitalization or GDP would warrant. Europe and Japan are also over-represented (Exhibit 9).

Exhibit 9: Benchmarks are Not Doing You a Favor



Source: World Bank, Everest Capital

But the emerging markets, which represent 50% of the world’s GDP on a PPP basis and represent nearly a third of world market capitalization, represent only 12% of the MSCI All Country World Index, due to the index construction process. Therefore, benchmarks are placing investors at a disadvantage, as they under-represent the current and future impact

Anyone investing based on benchmarks is looking in the rear view mirror

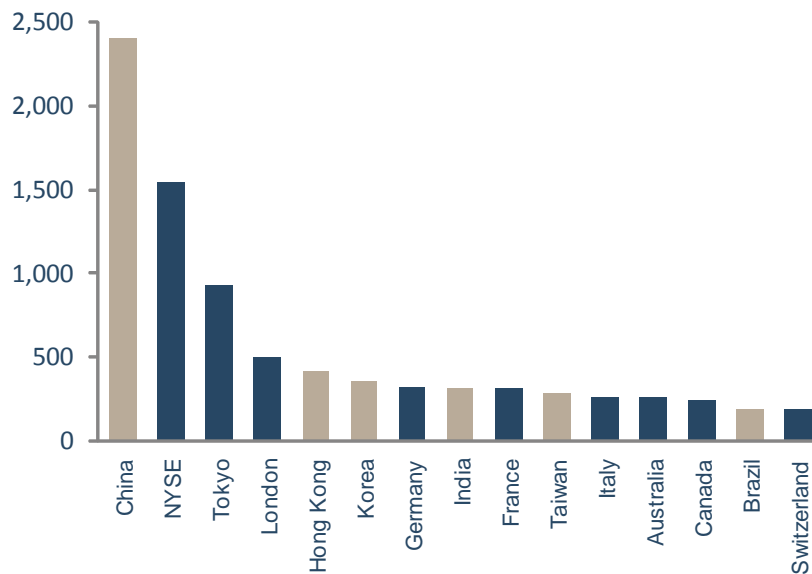
of emerging markets. Anyone investing based on benchmarks is looking in the rear view mirror.

Liquidity

Emerging markets liquidity has increased dramatically. In the third quarter of this year, Chinese markets (granted there is a lot of retail turnover there) traded more than the NYSE; Hong Kong and Korea traded more than Germany; India traded more than France; and Taiwan traded more than Italy, Australia or Canada (Exhibit 10). Clearly liquidity is more than adequate in many of these markets.

Exhibit 10: Emerging Markets are Liquid

Market Value Traded on Exchanges July-September 2009 in US\$ Billions



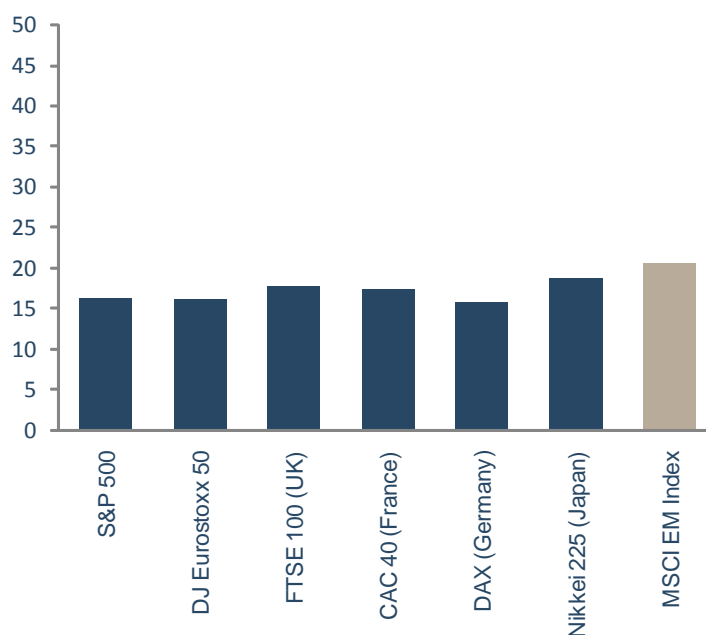
Source: Bloomberg, Everest Capital

Volatility

Some cite volatility as an argument against investing in emerging markets. However, looking at recent quantitative volatility measures, emerging markets in 2007 were only slightly more volatile than developed markets, with volatility of about 20 versus 15-18 for the U.S., Japanese and major European markets (Exhibit 11).

Exhibit 11: EM Volatility Similar to Developed Markets Pre-Crisis

250 Day Volatility – 2007



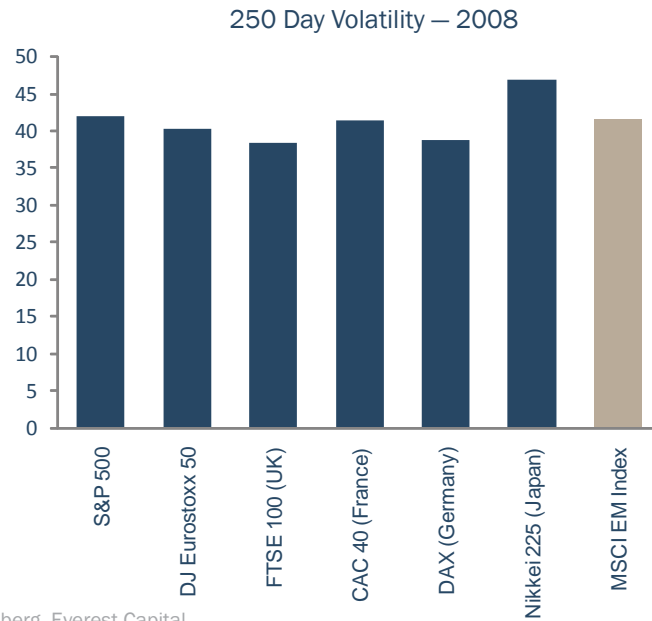
Source: Bloomberg, Everest Capital

Interestingly, in the extreme market environment of 2008, emerging markets were about as volatile as the S&P 500 and Europe and less volatile than Japan; all of these markets' volatilities were in the high 30s to mid 40s (Exhibit 12). In this crisis, emerging markets behaved similarly to developed markets.

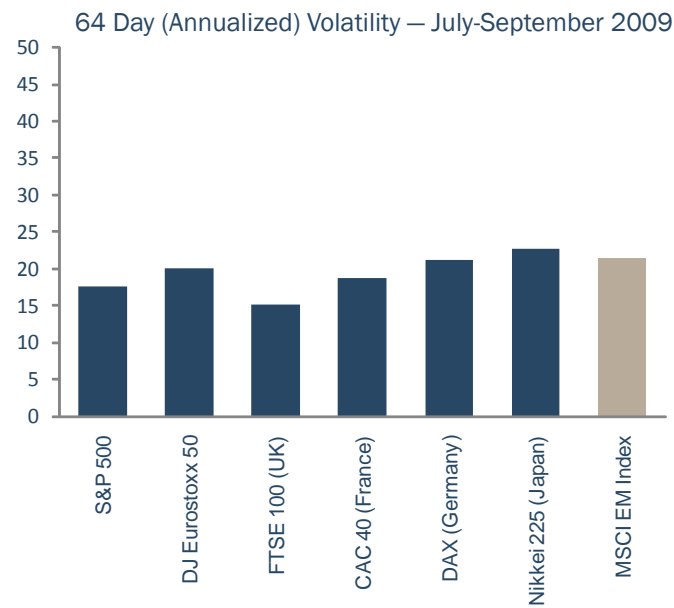
In the past quarter, in what was a more normal environment, emerging market equities have had about the same volatility as European or Japanese stocks and only slightly higher volatility than the S&P 500 (Exhibit 13). Emerging markets volatility is certainly in the neighborhood of what is occurring in developed markets.

In terms of market size, liquidity and volatility, emerging markets are comparable to developed markets and should not be discriminated against based on these criteria.

***In this crisis,
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Exhibit 12: EM Volatility Similar to Developed Markets During Crisis

Source: Bloomberg, Everest Capital

Exhibit 13: EM Volatility Similar to Developed Markets Currently

Source: Bloomberg, Everest Capital

3. Corporate Governance

In the case of corporate governance, it is not just that emerging markets have risen to the standards of developed markets; it is also that the developed markets' aura of quality has diminished.

Another popular knock against emerging markets is that they suffer from poor corporate governance practices relative to those in developed markets. This criticism is no longer warranted. Not only have emerging markets significantly improved their corporate governance standards, but there has also been an alarmingly long list of companies both in the U.S. and Europe that either committed outright fraud, manipulated their books or abused shareholders (Enron, Parmalat, Countrywide and WorldCom represent only a handful of examples in this regard); took advantage of loopholes that, even if they were technically legal, were certainly unethical (e.g. Porsche); or otherwise exhibited very poor judgment (rarely in emerging markets do we see the outsized compensation packages and bonuses of the West).

In terms of egregious behavior, we can think of only a very few cases - the Indian company Satyam, which committed outright Enron-type fraud, comes to mind - where shareholders in an emerging markets company have had problems.

The belief that companies in the U.S., Western Europe or Japan are better managed than in emerging markets is also no longer valid. For instance, it is generally agreed that banks in emerging markets have been managed much better than banks in the U.S. and Western Europe during the last few years. Ten years ago, in the midst of the Asian crisis, there were emerging market companies that were poorly managed and did not survive, such as some of the Indonesian or Thai companies that suffered not from outright fraud but simply poor management. However, this is much less the case today. We meet a large number of managements in emerging market countries, and it is impressive to see how quickly they have adopted best practices in terms of disclosure, governance and creating shareholder value. Many of these current managers have graduated from U.S. or Western European educational systems, and we see few differences when we speak with them versus with managers in some of the developed markets. The management distinction between emerging and developed markets is largely gone.

There has been an alarmingly long list of companies both in the U.S. and Europe that either committed outright fraud, manipulated their books, or abused shareholders

4. Government Policies

Who is leading by example?

Uneven and unpredictable policy decisions in much of the developed world over the last year beg the question of whether developed markets are leading by example. Inconsistent behavior, such as the decision to rescue Bear Stearns only to decide not to rescue Lehman Brothers three months later despite being twice as large, highlights an alarming lack of consistency in U.S. policy making. The apparent favoritism of certain constituencies despite established legal precedent (unions for example, in the nationalization and appropriation of GM and Chrysler from their existing bondholders) point to a policy mix that would be more befitting a country like Venezuela, a pariah within emerging markets.

While the U.S. and Europe lectured Asia and Latin America in the 1990s on government best practices, the reverse is occurring now

While the U.S. and Europe lectured Asia and Latin America in the 1990s on government policy best practices and how to let the free market take care of itself, the reverse is occurring now. The West criticized emerging market government intervention, and yet resorted to similar intervention ten years later. Highlighting how this about-face in policy making is viewed in emerging markets, U.S. Treasury Secretary Geithner went to China in June of this year to give a speech at Peking University, where he told students how sound U.S. Treasury bonds were. The students laughed at the Secretary, a sign of the times and how the world's perspective has changed. So we do not believe that developed market government policies are particularly astute, or that they are necessarily good models for emerging markets to follow.

We believe that the combination of starkly improved government policies in emerging markets (discussed at greater length in our November 2008 paper, "The Compelling Case for Emerging Markets") and contradictory policy making in developed markets have clearly led to a closing of the gap that historically made the U.S. and Europe the models of prudent, responsible, market-friendly policy making.

The One Surviving Distinction: Growth

There is one measure we believe which continues to clearly distinguish emerging markets from developed markets: Growth.

Looking at the growth of revenues, EBITDA cash flow and net income of what we call Emerging Markets, Inc., an aggregation of publicly traded companies in emerging markets, versus World, Inc., the corresponding aggregation for developed markets, highlights a dramatic difference (Exhibit 14). While the past is not necessarily a predictor of the future, we believe this differential in growth will continue. The differentials in GDP and population growth are there and will continue to be there for the foreseeable future.

Exhibit 14: Emerging Markets, Inc. has been Growing Much Faster than World, Inc.

	2003-2009 ¹	
	Compound Annual Growth	
	World, Inc. ²	EM, Inc.
Income Statement		
Sales	4.9%	11.1%
EBITDA	4.5%	6.6%
Net Interest Expense	6.0%	2.3%
Net Income	3.9%	8.0%

¹2003-2008 actual, 2009 estimate
²World, Inc. (ex EM)
Source: UBS, Everest Capital

Source: UBS, Everest Capital

Businesses are growing faster in emerging markets than in developed markets. This makes sense: starting from a lower basis, many of these country's needs have not yet been met, so consumption and investments will continue to grow faster .

These businesses are also in better financial shape than their developed market peers. For World, Inc. and Emerging Markets, Inc. we looked at net debt-to-EBITDA (a measure of leverage) and EBITDA-to-net interest expense (an interest coverage measure). In both cases, emerging markets were less leveraged in 2003 and continue to be less leveraged in 2009 than developed markets; the ratios are almost 2:1 (Exhibit 15). Developed markets

From a balance sheet standpoint, emerging markets are stronger than developed markets

have actually worsened somewhat, which makes sense given the global crisis; the net debt-to-EBITDA ratio, while not alarming, is two times, and interest coverage is about 11 times, unchanged from 2003. Emerging markets, on the other hand, have kept the same leverage, which was lower and is still lower by about half versus developed markets. Their coverage ratios have improved significantly to 16.1x because interest rates in emerging markets have come down dramatically. From a balance sheet standpoint, emerging markets are stronger than developed markets.

Exhibit 15: Emerging Markets, Inc. Balance Sheet is Much Stronger than That of World, Inc.

Balance Sheet Strength	World, Inc.*		EM, Inc.		
	2003	2009e	2003	2009e	
Net Debt/EBITDA	1.8	2.0	1.0	1.0	Less debt
EBITDA/Net Interest	11.8	10.9	12.6	16.1	Higher interest coverage

*World, Inc. (ex EM)

Source: UBS, Everest Capital

Conclusion

We hope this paper helps elucidate the blurring of the distinction between emerging markets and developed markets. Emerging markets represent half of the world's economy. Their equity markets are large and liquid with volatility similar to that of developed equity markets. Their corporate governance and government policies are at par or superior to those of developed markets. These distinctions between developed and emerging markets have disappeared.

But we believe there is one surviving distinction, and that is *growth*.

The world has changed and continues to change because of the fast growth of these economies. We believe that for the foreseeable future, and maybe the balance of our investing lives, this differentiation will remain; and this will mean also that there will likely be more attractive investment opportunities in emerging markets than in developed markets.

We think investors have access to a very significant opportunity set in emerging markets. For investors using the standard model – a U.S. allocation, an EAFE allocation, an emerging market allocation – who want to continue to use that model, we believe they should at a minimum reshuffle their weightings to more accurately reflect current economic reality.

***Investors
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