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Newsflash

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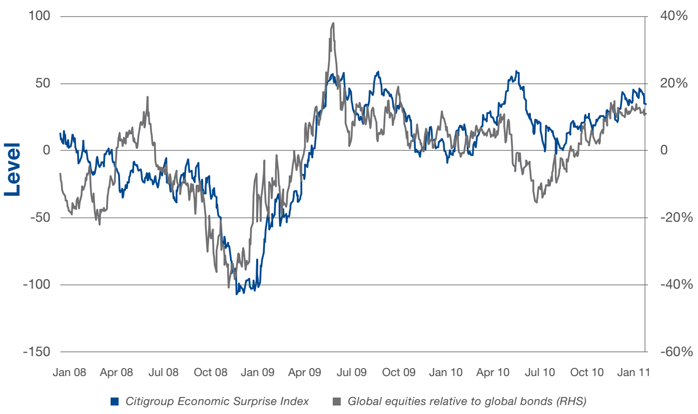
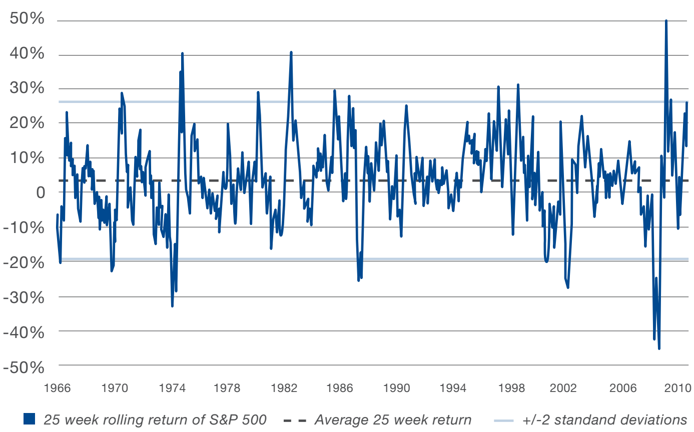
The majority of investors will have enjoyed a reasonable start to 2011, as equity and credit markets generally advanced in January. Such gains probably serve as a good indicator of overall market sentiment, since there was no shortage of bad news for market participants to latch onto if they so wished, but instead it seems the glass is being viewed as half full rather than half empty. The majority of concerns for investors in January were from ongoing problems which may arguably already be priced in to asset values, such as the sovereign debt crisis in Europe and Chinese policy responses to the overheating property market, but there were further negative surprises such as the UK's Q4 GDP contraction (-0.5% compared to +0.5% expected) as well as social unrest in Egypt. This news was not enough to knock the sharp risk rally off its stride though, as markets instead focused on numerous positive economic surprises, such as increasing evidence of strength in the US economy alongside some positive developments for peripheral Europe. The first graph (overleaf) shows the current high level of upward economic revisions (measured across major economies) and the recent relationship that this series has shown compared to the performance of global equities relative to global bonds. Positive news flow has benefited most risky assets over the last six months leading to the underperformance of bonds, whilst implied equity market volatility – as measured by the VIX index – has continued to fall and has returned to pre-Lehmans levels. However, with a number of purchasing managers index (PMI) levels around the world having reached peak levels – as with a number of other measures of economic activity – it seems that there is a higher probability of negative surprises from this point on.

Economic surprise index / rolling 3 month performance of equities vs bonds



There are a number of other indicators that suggest the current risk rally is getting long in the tooth, and looking at the absolute level of returns in the past six months (see graph below) it is clear that this rally has been sharp relative to history. Following on from strong gains in 2010 several equity indices in the US have now recovered to levels last seen before the collapse of Lehman

25 week rolling return of S&P 500 (ie. since September 2010



Brothers: the S&P 500 Index is back at August 2008 levels, while the tech-heavy Nasdaq Index has returned to November 2007 levels. Interestingly, the Merrill Lynch Global Fund Manager Survey stated that "a net 67% of asset allocators say that they are overweight global equities, the highest reading since the survey began asking this question in April 2001…The difference between equity overweights and bond underweights has also reached its highest level since the survey began." Anecdotally this suggests that investors are not concerned about current valuations, and indeed some areas of developed markets do remain attractively valued, but the current pace of share price gains cannot be sustained and markets may be due a slight setback.

Most regional equity indices posted gains in January, but one of the overriding themes for the month was the outperformance of developed markets versus emerging markets: while the MSCI World Index rose 2.3% in US Dollar terms the MSCI Emerging Markets Index declined by 2.7%. This was the fourth successive month of this trend but the first time that there was a meaningful differential between the two indices; indeed, the underperformance of emerging markets in January was the largest since the height of the global financial crisis in October 2008 and it eroded almost all of the outperformance versus developed markets during 2010.

Although events in Egypt no doubt played a part and served as a useful reminder of the risks faced by investors in emerging markets, this underperformance versus developed markets also reflects ongoing investor concerns over the risks posed by inflation in emerging markets. With headline CPI figures having been pushed up worldwide by the recent sharp spike in food and energy prices this poses a significant risk to the bull market in equities. Although equities can offer protection against the erosion of purchasing power, several studies suggest that this is only true when inflation is contained within a range of around 1 to 5%, and at levels much above or below this, equities are highly vulnerable. A key concern for markets is inflation in China, but for the time being the problem is largely within the real estate market as a result of borrowing costs that have been too low relative to the economy's rampant growth rate. It is not clear that attempts by the Chinese government to rein in inflation have had sufficient impact yet and therefore there is likely to be further tightening to come.

The gains from developed market equities were led by continental Europe and the US with respective local currency returns of 2.7% and 2.3%. The best performing markets by far in January where to be found in Europe as equity indices in Greece, Spain and Italy grew by 15.2%, 11.3% and 8.7%

Source: RMB Asset Management / Bloomberg. January 2011. Past performance is not indicative of future returns.

respectively in euro terms, to pair the losses suffered during 2010. The tightening in sovereign spreads for these countries during January was likely to have been a contributing factor. In terms of sector returns, energy stocks outperformed on the back of a rising oil price, while the financial and IT sectors also produced strong gains. More defensive sectors generally lagged the market as the consumer staples sector declined by 2.4%, with rising agricultural prices potentially playing a part in this given the impact on profit margins.

Within the fixed income markets government bonds produced flat to negative returns across the major Western regions while Japanese bonds gained 0.8%. Peripheral European bond spreads narrowed over the month, as the countries benefited from supportive comments from Japan and China regarding future issuance, a successful issue from the European Financial Stability Fund and speculation that authorities will look to expand the size and scope of the current rescue programme. The JP Morgan Global Government Bond Index returned -0.1% for the month in US Dollar terms. Investment grade credit outperformed government bonds across most regions, reflecting a small degree of spread tightening, but the theme for the month was the outperformance of high yield bonds relative to their higher rated investment grade peers. This is a result of a number of factors including the ongoing rally in risky assets, a reduction in credit spreads and the lower degree of sensitivity that this area of the market has to rising government bond yields. High yield bonds in Europe and the US ended the month 2.4% and 2.2% higher to rival the returns from equities in these regions.

Somewhat unsurprisingly the best performing assets during January were to be found in the commodities space. The RICI Commodity Index gained 3.2% in US Dollar terms driven to a large extent by the soft commodity component which gained 5.7% over the month. Brent crude oil gained 5.1% with the unrest in Egypt being a notable contributing factor to this rise. Meanwhile gold produced very poor returns over the month as the precious metal declined by 6.0% in US Dollar terms.

Across currencies the euro and Sterling strengthened versus the US Dollar during January while the Japanese Yen and Australian Dollar weakened. The South African Rand was by far the weakest currency over the month with a decline of 7.9% versus the greenback.

Source: RMB Asset Management / Bloomberg. January 2011. Past performance is not indicative of future returns.

Asset Class Performances

Asset Class/Region	Index	Currency	Jan 2011	YTD 2010
Equities				
United States	S&P 500 NR	USD	2.3	14.4
United Kingdom	FTSE All Share TR	GBP	-0.5	14.5
Continental Europe	MSCI Europe ex UK NR	EUR	2.7	8.6
Japan	Topix TR	JPY	1.3	1.0
Australia	S&P/ASX 300 TR	AUD	0.1	1.9
Global	MSCI World NR	USD	2.3	11.8
Global Emerging Markets	MSCI World Emerging Markets TR	USD	-2.7	18.9
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	0.0	6.1
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	0.1	6.3
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	0.2	9.0
Us High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	2.2	14.9
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	-2.0	7.5
UK Corporate (investment grade)	Merrill Lynch Sterling Non Gilts TR	GBP	-0.6	8.4
Euro Government Bonds	Citigroup EMU GBI TR	EUR	-0.5	1.0
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	-0.4	4.8
Euro High Yield	Merrill Lynch Euro High Yield 3% constrained TR	EUR	2.4	14.7
Australian Government	JP Morgan Japan Government Bond Index TR	AUD	-0.6	2.5
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	0.8	5.3
Global Government Bonds	JP Morgan Global GBI	USD	-0.1	6.4
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	0.3	4.4
Global Convertible Bonds	UBS Global Convertible Bond	USD	1.8	11.8
Global Emerging Market Bonds		USD	-0.6	11.8

Source: RMB Asset Management / Bloomberg / Morgan Stanley. February 2011.

Asset Class/Region	Index	Currency	Jan 2011	YTD 2010
Property				
US Property securities	MSCI US REIT TR	USD	3.3	27.0
UK Property securities	FTSE EPRA/NAREIT United Kingdom TR	GBP	-1.0	4.9
Europe ex UK Property securities	FTSE EPRA/NAREIT Europe ex UK TR	EUR	-1.6	21.5
Asia Property securities	FTSE EPRA/NAREIT Asia TR	USD	-0.5	13.2
Australian Property securities	FTSE EPRA/NAREIT Australia TR	AUD	-0.4	14.4
Global Property securities	FTSE EPRA/NAREIT Global TR	USD	1.2	15.9
Currencies				
Euro		USD	2.2	-6.5
Sterling		USD	2.3	-3.1
Yen		USD	-1.0	14.8
Australian Dollar		USD	-2.7	14.0
Rand		USD	-7.9	11.3
Commodities				
Commodities	RICI TR	USD	3.2	19.0
Agricultural Commodities	RICI Agriculture TR	USD	5.7	36.3
Oil	ICE Crude Oil CR	USD	5.1	20.1
Gold	Gold index	USD	-6.0	25.4
Interest rates	**Last meeting**		**Current rate**	**Change at meeting**
United States	26 January 2011	USD	0.25%	No change
United Kingdom	10 February 2011	GBP	0.50%	No change
Eurozone	03 February 2011	EUR	1.00%	No change
Japan	14 February 2010	JPY	0.10%	No change
Australia	01 February 2011	AUD	4.75%	No change
South Africa	20 January 2011	ZAR	5.50%	No change

Source: RMB Asset Management / Bloomberg / Morgan Stanley. February 2011.

Focus: frontier markets – the next big thing?

With economies in the developed world growing at a pedestrian pace, emerging markets under pressure due to historically rich valuations and the "next 11" being used as much as a public relations slogan as a proper investment strategy, investors will be forgiven for being unable to identify the next big thing to simulate emerging markets returns in the "naughties". In this quest, it would not come as a surprise if frontier markets appeared on more than one radar screen, and it is for this reason that FOCUS deemed a brief overview of this unknown (and perhaps untamed) animal appropriate.

The term "frontier markets" mainly refers to the equity opportunity set across 31 countries that are not included in the emerging markets category. MSCI has created a series of indices (MSCI Frontier Markets Indices) that provides broad representation of this universe. It includes large, mid and small cap representation and covers approximately 98% of the investable equity universe across all frontier markets countries. The table below shows the regions and countries that make up the frontier markets (with 26 of these making up the MSCI Frontier Markets :

Americas	Central & Eastern Europe & CIS	Africa	Middle East	Asia
Argentina *Jamaica** Trinidad & Tobago	Bulgaria Croatia Estonia *Herzegovina** Kazakhstan* Lithuania Romania Serbia Slovenia Ukraine	*Botswana** Ghana* Kenya Mauritius Nigeria Tunisia *Zimbabwe**	Bahrain Jordan Kuwait Lebanon Oman Qatar United Arab Emirates (UAE)	Bangladesh Pakistan Sri Lanka Vietnam

The MSCI Bosnia Herzegovina Index, MSCI Botswana Index, MSCI Ghana Index, MSCI Zimbabwe Index and MSCI Jamaica Index are currently stand-alone country indices and are not included in the MSCI Frontier Markets Index.

The question that naturally arises is whether an astute investor should necessarily invest in a market just because it has an index. Based on recent events in Tunisia and Bahrain it must be clear that frontier markets are at times (most of it really) at the forefront of change and new developments, and could as a result be fraught with unknown risks. It is said that fortune favours the brave, but the fixed expression that come to FOCUS's mind is that fools rush in where angels fear to tread. At this juncture it may be useful to refer to the performance of these markets over the past few years where developed and emerging markets alike enjoyed rollercoaster like performance to say the least. Not that past performance gives any indication or guarantee of what the future may hold…

Frontier markets (which are essentially made up of those developing countries falling outside of the 21 conventional emerging markets of the MSCI EM Index) came late to the parties that were the equity rallies in 2006 and 2009. In both these years, when developed markets posted strong double digit returns, frontier markets trailed by some margin. In fact, USD100 invested at the end of 2005 would have done much better in the relatively lower risk developed markets (116) and emerging markets (182) than in frontier markets where it would have been worth only USD82 at the end of 2010. So far, not so good…
The more recent past has seen frontier markets perform much better as the MSCI Frontier Markets Index (+24.2%) beat the more established MSCI World (+12.3%) and MSCI Emerging Markets (+19.2%) indices in 2010 when measured in US Dollar terms. So, what was not much more than a catch-up story up to the end of 2009 has (perhaps) turned into more of a story of discovery where the first mover may reap the most lucrative rewards. In spite (or perhaps because) of the recent political turmoil frontier markets provide compelling characteristics to which many investors may respond favourably. These include

Source: RMB Asset Management / Bloomberg / Morgan Stanley. February 2011.

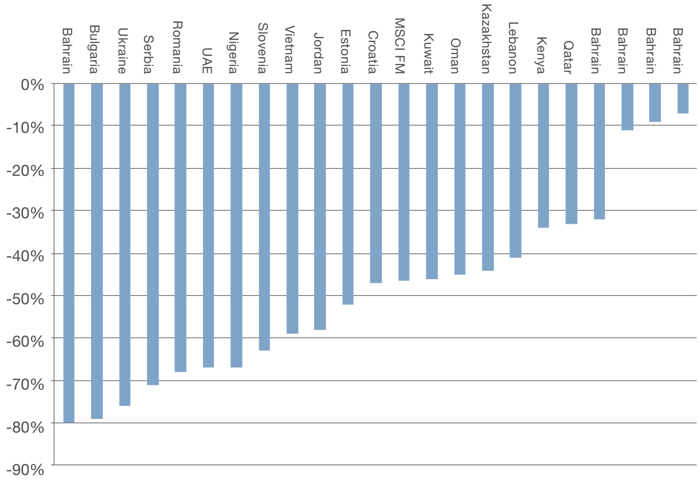
attractive valuations, (currently) sound economies with solid growth and the ability of domestic companies to translate the robust growth into healthy company earnings. One may be forgiven for mistaking the previous description for a reference to emerging markets shortly after the EM crises in 1997 and 1998.

Like most investment considerations it is not only the asset allocation (investment in frontier markets) that is important, but also the regional allocation (end eventually stock selection). Country allocation is critical because within this universe there has been a wide dispersion of returns, with 2010 being no different. Whilst the index delivered 24% last year, Argentina gained 77% but Bahrain shed 18%. Even in the same neighbourhood, returns varied widely with Estonia posting a 62% return against a backdrop of emerging European markets declining by nearly two percent. The risks associated with investment in these countries come hand in hand with opportunities for significant reward in taking on these risks. In many ways, these countries have more differences than similarities in terms of development levels, demographics, labour skills, growth and political liberalisation. In short an investor who considers both the top-down risks (macro-economic outlook and political situation amongst others) as well as sound stock selection is sure to find opportunities that are more likely to increase invested capital than to permanently impede it. It is in inefficient market environments like these (as opposed to US Treasuries, for instance) where FOCUS certainly advocates active management over the passive approach that investment in an index tracking fund or ETF may bring.

Many a contrarian pointed out in 2009 that the broad brush of risk aversion towards frontier markets on the back of Dubai World's debt dilemma and the International Monetary Fund's (IMF) support packages for Romania and Ukraine have tainted the asset class. It arguably made for attractive buying opportunities in frontier markets that did not face the same troubles, with the index's 12 month trailing P/E at 14.5x at the end of 2009 (versus 20.6x for the MSCI EM Index). It resulted in the majority of these countries' main indices doing particularly well in 2010. Some could argue that they have done too well – at the end of 2010 the 12 month trailing P/E for the MSCI FM Index was 15.8x, versus 14.6x for emerging markets. If FOCUS considered an allocation to frontier markets we would argue that now is perhaps not the right time to dip our toe in the water, as they look somewhat expensive relative to other markets with fewer political and macro-economic risks.

Notwithstanding their decent performance in 2010, frontier markets still have some way to go to return to their pre financial crisis peaks of 2007 and 2008. Markets including Nigeria, the UAE, Romania, Bulgaria and Bahrain are still between 70% and 80% below their peaks. Overall, the MSCI Frontier Markets Index remains 50% off its peak, while the MSCI EM Index is down only 13% from its highest pre-Lehmans level. This is illustrated in the graph overleaf:

Current market performance to peak



There are a number of good reasons for the disparities in investor interest across frontier countries. Unlike developed (and probably even emerging) markets there is no single convincing theme that unites all of these markets. By and large frontier markets are in an earlier development stage than the conventional emerging markets, and also lag in areas such as corporate governance, shareholder activism, transparency, established judicial institutions and often political stability. The recent turmoil in a number of countries in the Middle East is an excellent case in point. As is the custom with global press coverage the success stories – double digit economic growth and peaceful political transformation to name a few – often go unnoticed while the moments of weakness receive excessive attention from the international media.

Source: RMB Asset Management / Bloomberg / Morgan Stanley. February 2011.

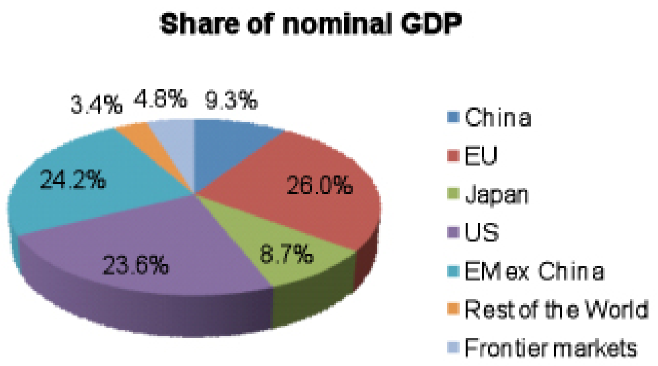
Conventional wisdom would suggest that many of the frontier markets should benefit from a commodity bull market as many of them are commodity rich. However it turns out that their equity markets have very low commodity index representation. The most recent data indicates that energy and materials combined account for only 10% of the total MSCI Frontier Index. This is in stark contrast to the 29% weight of the same sectors in the MSCI Emerging Markets Index, and 39% in the MSCI BRIC Index. As a result of this relatively low commodity exposure frontier markets have had a lower correlation to oil price moves than what proved to be the case for emerging markets.

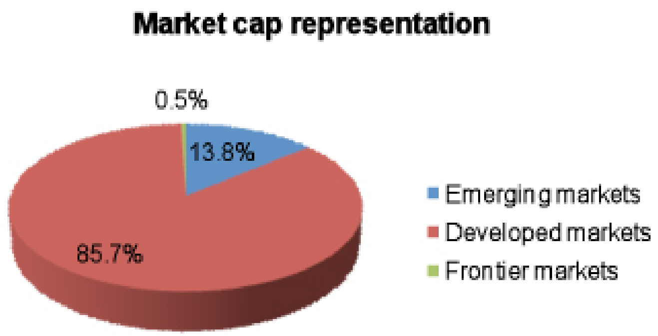
Another factor that may have a large influence on the future performance of frontier markets is of a demographic nature. The continued development of a middle class in these markets should boost consumer demand (both staples and discretionary). Access to credit, in the form of home loans and motor vehicle finance, should be another important driver to growth in domestic demand. The low commodity exposure, coupled with improving local demand for consumer goods may lead to a return profile which could add some diversification benefits when frontier markets are included in global multi-asset portfolio. Whereas these markets generally have a low exposure to commodity companies in their main equity indices, financials are quite heavily represented – the sector made up more than 53% of the index as at 31 December 2010.

Taking the size of their economies and their high economic growth rates into account it seems as if the market capitalisation of frontier markets is significantly underrepresented. Frontier countries represent one seventh of the world's population and contribute around one twentieth of global GDP, yet they only have one two hundredth of the global equity market capitalisation. As we have witnessed with the development in emerging markets over the last decade, it appears obvious that this gap will also narrow over time.

Investment in frontier markets does not come without a number of risks, and these could be negative drivers in the short term. Included amongst these risks is the current high levels of liquidity, brought about by further quantitative easing in the US and low interest rates throughout the developed countries. Such policy decisions could steadily drive commodity (energy, metals and agricultural) prices higher leading to new asset bubbles. Another concern is that European sovereign debt problems could lead to contagion in the frontier markets. Lastly (and perhaps supported by more recent examples) political turbulence in one or more of the frontier markets could fuel negative sentiment for the overall asset class.

A very important lesson learnt from investment in emerging markets is that investors do well when an economic or political situation improves. Countering all the potential risks in the longer term are the frontier advantages of strong growth, rising incomes and access to credit, improving demographic trends, reasonable valuations and low correlations to developed and emerging markets. Even if, in our view, it is probably too early to include exposure to broad based frontier markets in a global equity or multi-asset portfolio, astute investors should keep this topic on their radar screens as their never-ending search for undervalued securities continue.





Source: RMB Asset Management / Bloomberg / Morgan Stanley. February 2011.

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