Helvetic Investments Pte. Ltd.
6 Battery Road, #23-04, Singapore 049909
DID: +65 6438 0383, Fax: +65 6438 3430
Reg. No. 200912670W

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The following article on emerging country equities is written by 2 guest writers of Helvetic Investments, the partners of OLZ, Mr. Pius Zgraggen and Mr. Michael Frei; and published in the Swiss financial newspaper "Finanz und Wirtschaft" on March 27 2013.

OLZ www.olz.ch/en/ is a Swiss based, FINMA regulated provider of alternative (smart) index investments. OLZ's philosophy is based on the empirical evidence that an alternative weighting of markets, sectors, companies and even countries and regions – instead of the commonly used weighting methods by most ETFs, that is based on capital weighting – can in fact over time increase the investment yield while reducing portfolio risk.

For our qualified investors, we refer to further information on OLZ Efficient World® Fund, which received the maximum Morningstar rating of five stars in 2011 www.olz.ch/?uid=54

This article is written in order to enhance investors' knowledge of investing into emerging market equities and the problems often caused when relying only on most ETFs. This article is not meant to create an offer of any product.

Emerging Country Equities can stabilise Portfolios – Economic Growth is less relevant

The facts regarding the emerging markets are impressive: About 85% of the world's population lives in emerging countries. There is adequate availability of labour, (foreign) capital and technology. These countries' share of the world economy, adjusted for purchasing power, is already around 50%. The International Monetary Fund (IMF) forecasts a growth rate of 5.5% for 2013, compared to 1.4% for the industrialised countries. According to the IMF, this gap will be maintained in the coming years.

The weight of the market capitalization of the emerging markets in the global equity universe has also increased significantly; from 2% at the end of the 1980s to 13% – and rising. According to a study by Ernst & Young, some 50% of IPOs take place in the emerging countries, particularly in Asia.

Disputed Higher Returns

One argument for investing in equity in emerging markets is the anticipation of above-average returns, which is ascribed to the high growth rates of the real economy. However, a number of empirical studies question this correlation. Analyses by Dimson et al. (2002) and Ritter (2005) have shown that, historically, there is no long-term correlation between economic growth and returns on equity.

However, more recent studies (e.g. Goldman Sachs, 2011) argue that the results until now are substantially dependent on the periods selected for analysis and on country-specific factors. Over the past decade, a positive correlation between growth rates and returns on equity can be seen. Nevertheless, the further back the period covered by the analysis goes, the weaker this correlation becomes. But if the anticipation hypothesis applies, then the assumed future growth should already be priced into current equity prices.

Rating and National Debt

Industrialised Countries	Rating 1	Debt ratio in % 2
Germany	AAA	82
UK	AAA	93
USA	AA+	112
Japan	AA-	245
Italy	BBB+	128
Ireland	BBB+	119
Spain	BBB-	97
Portugal	BB	124
Emerging Countries	**Rating 1**	**Debt ratio in % 2**
China	AA-	20
South Africa	A-	43
Brazil	A-	61
Russia	BBB+	10
India	BBB-	67

1 Standard % Poor's (Local Ccy Rating)

2 National Debt in relation to GDP, IWF (Forecast 2013)

Source: OLZ

Weight of the Top-5-Companies

Country	in % 1	Country	in % 1
Hungary	97,5	Poland	41,5
Czech Republic	87,2	Turkey	41,3
Columbia	60,7	Peru	41,2
Russia	58,1	India	36,0
Mexico	57,6	Chile	35,6
Morocco	56,6	South Korea	31,3
Egypt	55,0	Brazil	31,3
South Africa	49,6	Thailand	30,1
Malaysia	43,5	Indonesia	28,1
Philippines	41,5	Taiwan	25,3
China	41,5		

1 Share in the respective Equity Market

Source: OLZ, Markets of the respective countries (as per 27.7.12)

The days of the great emerging country crises, such as Mexico's 1994/95 Tequila crisis or Russia's national bankruptcy in 1998, are long past and, since then, emerging countries have become more stable, both politically and economically. The above table illustrates that today, it is rather the industrialised countries which are faced with high national debt and thus tend to face declining ratings. Nevertheless, the investor should be conscious of the special risks involved in the emerging markets. Investments may be directly at risk (nationalisation, expropriation) or indirectly (control, regulation, discriminatory taxation) due to government instability or uncertainty regarding legislation. Limitations on rules relating to contracts and ownership may inhibit the development of listed companies.

In addition, the emerging countries' financial markets are still comparatively small and within a narrow range, and sometimes even with access restrictions. Investors must also consider the liquidity situation, so that investments can be liquidated when necessary.

The individual taxation implications must also be considered. Capital Gains Tax of 22% in South Korea and 15% in Thailand, or Trade Tax of up to 30 basis points for sales in South Korea and Taiwan place a burden on returns.

Potential for Diversification

The introduction of emerging country equities into a global equity portfolio makes sense, both from an economic and an investment point of view. The implementation should be based on individual stocks and not on a capital-weighted index; as index-based investments are made primarily in the largest countries and the largest companies. China, South Korea, Brazil, Taiwan and South Africa together makes up 65% of the index, and with about 70% correlation, show a high degree of synchronicity between themselves. In the emerging markets universe, the correlation coefficients range between 38 and 72%.

The overall market is often dominated by just a few companies; thus a passive index replication leads to a statistical focus on a few stocks. Diversification can be improved by giving greater consideration to smaller emerging markets and medium-sized firms. A minimum-variance optimisation on the basis of projected volatility and correlation for example provides an efficient weighting.

Pius Zgraggen and Michael Frei are partners of OLZ