FINALLY! INVESTING IN EMERGING MARKETS EQUITY *WITHOUT* ALL THE BENCHMARK RISK

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UNCORRELATED ANSWERS®

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Key Ideas

Most investors use cap-weighted global benchmarks as a starting point for establishing emerging markets equity (EME) allocations. Some were early adopters; others were late adopters. Regardless of when one turned to emerging markets as a strategic asset class, its influence on portfolio risk warrants greater attention than in the past, especially given the high volatility and increasing correlation of emerging markets equity to developed markets equity. Plan sponsors are embracing the merits of emerging markets investing, in large part, to access the return premium that emerging markets equity has historically delivered over their developed markets equivalents. And if institutional consultants believe this return premium will persist into the future, this trend is likely to continue.

When returns were high, investors could look the other way. However, with slowing growth, and liquidity no longer abundant, investors could not ignore the risks associated with these developing economies. As risk allocation is now taking center stage for many institutional investors, we ask: "Is it possible to capture the return premium offered by emerging markets equity as a strategic asset class, capture alpha from the inefficiency of the index and at the same time meaningfully lower the risk associated with it?" At Intech®, we believe the answer is emphatically "yes."

HARNESS VOLATILITY®

Investing in adaptive volatility strategies means that investors need not sacrifice the growth potential associated with emerging markets in exchange for risk reduction. One can exploit the inefficiencies of emerging markets indexes while dynamically controlling risk at the portfolio level and, by extension, at the plan level. Until recently, the application of managed volatility strategies had been limited to developed market equities. But now, adaptive volatility equity strategies that invest in emerging markets are also available. These strategies offer institutional investors a potential source of much-needed alpha, while potentially lowering the expected risk by as much as 35% as compared to the benchmark – for most investors, a sound outcome to meet long-term obligations.

As more and more investors increase their allocation to emerging markets equity to meet their long-term return objectives, the risks of investing in the world's developing economies should not be ignored. These risks include:

- Annual returns for EME have varied significantly over time as a result of high stock-price volatility;
- Emerging markets tend to be less liquid than developed markets; and
- Currency volatility is a significant contributor to the risk of emerging markets equity.

Taking these risks into consideration, it wouldn't be unrealistic to see investors temper their enthusiasm for EME. It appears, however, that due to the realized return premium from yesteryear, discussions of EME implementation have focused mainly on its virtues, rather than on concerns about its accompanying risks – in essence, giving emerging markets equity a free pass when it comes to risk – until recently.

First among these concerns should be the long-term volatility forecast for emerging markets equity compared to other regional equities. Research shows volatility levels for emerging markets to be about 50% higher than that of the U.S.

Second, while risk is important at the individual asset level, ultimately what pension officers care about most is risk at the overall plan level. Emerging markets equity, by virtue of its high risk and high correlation to developed equity markets, is a meaningful contributor to portfolio risk at the overall global equity structure level.

Recognizing the need for alpha, is there anything a plan can do to help mitigate these risks?

Including an adaptive volatility strategy as part of the overall global equity structure can help to lessen these risks, while targeting some level of excess return above the capitalization-weighted benchmark. Adaptive volatility strategies are markedly different from the cap-weighted benchmark in that they have a dual objective of lowering volatility and capital loss, especially at times of market stress. Over an entire market cycle, one can expect a risk reduction of up to 35% from EME adaptive volatility strategies when compared to the standard EM equity benchmark. This risk mitigation enables investors to increase their allocation to emerging markets to generate higher returns, without taking on additional risk at the global equity structure level.

> Above all else, investors do not need to sacrifice the growth potential associated with emerging markets equity in exchange for risk reduction.

When emerging markets are delivering performance that exceeds that of the developed world, many investors are lulled into ignoring the risks associated with investing in developing economies – this despite the fact that EME represents one of the most volatile strategic assets within institutional portfolios. Yet, as more investors set their minds to de-risking, or increasing the risk efficiency of their portfolios, it may be time to reassess emerging markets equity from a risk standpoint, without losing sight of the potential return opportunities.

At Intech, we believe an emerging markets adaptive volatility strategy provides three key benefits for institutional investors:

1. Serves as an anchor and a complement to fundamental stock-picking strategies in a multimanager structure;

2. Lowers overall portfolio risk by counterbalancing the extra risk taken on by traditional active managers in a global equity structure; and

3. Brings the relative risk of emerging markets equity closer to the risk levels of non-U.S. developed markets equities, with the potential for higher returns.

Adaptive volatility strategies provide a straightforward, highly effective way to mitigate risk within emerging markets and, more broadly, within global equity structures. Above all else, investors do not need to sacrifice the growth potential associated with emerging markets equity in exchange for risk reduction. In the current environment, where risks abound and returns are hard to come by, emerging markets adaptive volatility equity strategies may help plan sponsors meet their future funding obligations.

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