WHV Emerging Markets Equity Strategy

Third Quarter 2012 Commentary

The world equity markets resumed their "risk-on" stance during the third quarter and most of them produced impressive returns. The following is a summary of total return performance for broad market indices during the third quarter of 2012:

Select Market Indices	3 Months Ended 09/30/12	9 Months Ended 09/30/12
Large Cap – Standard & Poor's 500 Index	6.35%	16.44%
Mid Cap – S&P 400 Index	5.44%	13.77%
Small Cap – Russell 2000 Index	5.25%	14.23%
International – MSCI EAFE Index	6.92%	10.08%
Emerging Markets – MSCI Emerging Markets (EM) Index	7.74%	11.98%

The MSCI EM Index (+7.74%) outperformed the MSCI EAFE Index (+6.92) and the S&P 500 (+6.35%) for the quarter. On a year-to-date basis the MSCI EM Index (+11.98%) outperformed the MSCI EAFE Index (+10.08%), but underperformed the S&P 500 (+16.44%).

The MSCI EM Asia (+8.67%) component of the Index performed better than the MSCI EM EMEA (+8.39%) – EM countries in Europe, the Middle East, and Africa – and MSCI EM Latin America (+4.69%) components.

The best performing countries for the quarter were Egypt (+22.63%), India (+15.43%), and Poland (+12.26%); the worst performers were Morocco (-3.39%), Chile (+1.22%), and Colombia (+2.30%). BRIC countries (+6.96%) collectively underperformed the overall MSCI EM Index (+7.74%). Among the BRIC countries, India (+15.43%) and Russia (+9.34%) had stronger returns than China (+4.67%) and Brazil (+4.75%).

On a year-to-date basis, MSCI EM EMEA (+15.09%) and MSCI EM Asia (+14.07%) have performed better than MSCI EM Latin America (+4.19%). On a year-to-date basis, the worst performers were Morocco (-13.08%), Brazil (-3.31%), and Indonesia (+3.58%), while the best performers were Egypt (+64.88%), Turkey (+38.68%), and Philippines (+31.33%). Among the BRIC countries, Brazil (-3.31%) was again the laggard relative to China (+8.75%), Russia (+10.93%), and India (+25.36%).

As the “risk-on” investment scenario returned in the third quarter of 2012, EM resumed their strong relative performance vis-à-vis Developed Markets (DM) after the relative underperformance in the second quarter of 2012. The MSCI EM year-to-date performance still lags the US stock indexes, but outperforms the MSCI EAFE.

The world stock markets continue to be strongly influenced by a plethora of macro factors. While past negative news gave ample reason for investors to worry, positive actions kindled an equivalently strong rebound in world markets. The world’s central banks continue to fuel strong stock market advances as conventional and non-conventional measures are being used in an attempt to offset a distinct lack of credible fiscal policy initiatives in developed countries. The Federal Reserve Bank initiated the latest quantitative easing program (QE3) involving the large scale acquisition of mortgage-backed securities in an attempt to somewhat offset the anticipated recessionary effects caused by the previously discussed advent of the “Fiscal Cliff”. Incidentally, the US economy might be able to better handle the onset of this event as residential real estate appears to have bottomed and employment statistics are showing signs of improvement.

Not to be outdone, the European Central Bank initiated its Outright Monetary Transactions program, creating the latest euro zone crisis-related acronym “OMT” in the process. This policy initiative involves unlimited purchases of short-term debt issued by the weakest euro zone members. Market tensions related to the euro zone sovereign debt and banking crisis were further reduced by the decision of Germany’s Federal Constitutional Court to allow Germany to participate in the USD $650 billion European Stability Mechanism (ESM), which is also referred to as “the bazooka”. We have commented on previous occasions that the efficacy limits of monetary policy measures appear close to being reached. It is increasingly obvious that the various budget, sovereign debt, and banking crises bedeviling most developed countries will not be solved in short order and require painful, long-term adjustments. Unfortunately, that will be commented on time and again in the future.

The IMF reduced its forecast for world economic growth as this commentary is being written. The growth forecasts were only marginally reduced for EM countries. As a group, a 5%+ growth rate is being forecasted. The IMF assumes a reacceleration of China’s economic growth rate bringing it to 8% and above for 2013 and 2014. China’s stock market has continued to produce inferior returns and is trading at 1Q 2009 levels as investors are concerned about continued economic weakness. The Chinese stock market appears very inexpensive at a P/E ratio of 8.9x given next twelve months consensus earnings growth of 11%. We remain constructive on our Chinese holdings and expect improved stock price developments in the foreseeable future.

The Brazilian stock market has underperformed the EM universe for almost two years due to a combination of weaker commodity demand from China and intervention by Dilma Rousseff’s government in the Oil and Mining, Banking, and Utility sectors to suppress price increases in an effort to stimulate the economy without re-accelerating inflation. Some market observers see troubling similarities to Argentinean government interference, an analogy we feel to be overwrought and exaggerated.

India’s strong stock market performance appears to be linked to a renewed commitment to economic reforms by the government, which recently initiated changes in regulations to allow foreign majority ownership in the retail sector. While substantive changes will require a new government, expected after elections in about fifteen months, the current economic focus is beneficial to India's economy which has struggled to maintain the high growth rates seen throughout the last decade.

The Russian stock market is the most attractively valued among the major EM markets, but appears to lack any sustainable catalyst besides rising oil prices. The Putin presidency (version 2.0) appears to lack direction and has not outlined any concrete policies to move the economy away from its extreme dependence on oil.

Turkey has benefitted from lower inflation and lower interest rates, though it faces the risk of a large current account deficit that is financed through short term capital flows. The more benign macro environment has resulted in strong year-to-date performance by the stock market, with domestic consumption sectors doing particularly well.

In our last quarterly commentary, we commented on the strong economic growth and relative stock market performance of many medium- and smaller–sized EM countries. Poland's recent stock market performance mirrors the country's attractive economic fundamentals. As the euro zone is sliding into a gnarly recession due to the sovereign debt/banking crisis, Poland's growth outlook remains intact as it benefits from currency sovereignty and has a sizeable domestic economy with a population exceeding 38 million people. This country was the only major EU country not to slide into recession in 2009 and looks poised to repeat this feat again.

Most emerging stock markets continue to be valued attractively by historic standards and we continue to anticipate relatively attractive investment returns for the foreseeable future. The MSCI EM Index trades at a forward P/E of 10.2x, P/B of 1.6x, and dividend yield of 2.8% with projected 2012 EPS growth of 11.6%, which has historically suggested strong six- and twelve-month forward returns for investors.[i,ii,iii]

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[i] MSCI, Factset, 30 September 2012

[ii] Morgan Stanley Research

[iii] Past performance is not a guarantee of future returns.