

A Nationwide Financial® White Paper

EMERGING MARKETS

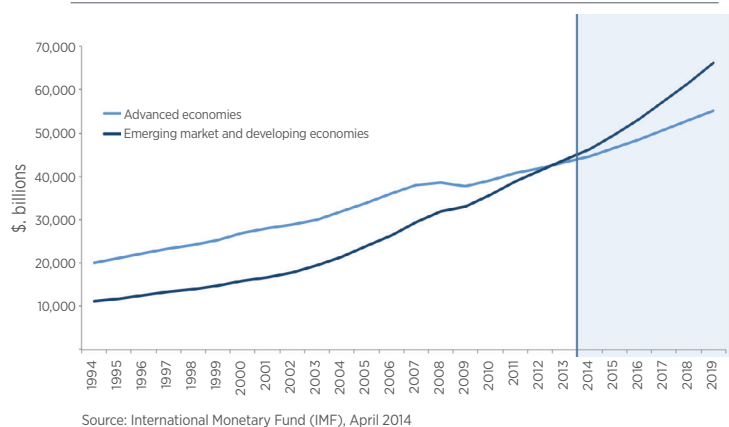
EXECUTIVE SUMMARY

- Emerging market economies have experienced faster population and economic growth than developed markets; a trend that is expected to continue.
- Over the past 30 years, emerging market equities have delivered stronger returns than developed markets, with a relatively low correlation to domestic returns. As emerging markets have underperformed and correlations with developed markets have increased, investors are likely reviewing the benefit of a secular allocation to emerging market equities.
- While performance has lagged and the diversification benefit is less significant, the current valuation discount to developed markets and the faster earnings growth could lead to a positive period of performance.

DEFINING “EMERGING MARKETS”

The term Emerging Markets originated in the early 1980's, coined by World Bank economist Antoine van Agtmael. Previously, this segment of the market was referred to as “less developed”.¹ There is no official definition of emerging markets, but most conventions used to categorize for inclusion in indexes are based primarily on per capita GDP. MSCI Inc. (creator of many global indexes, including MSCI EAFE and MSCI Emerging Markets) uses a proprietary combination of 23 variables, FTSE uses 13 factors and S&P uses 10 variables. As a result, the classification of a country as either developed or emerging is more of an art than a science. While the three providers are fairly consistent, there are two high-profile countries that have inconsistent classifications. South Korea is categorized as developed at FTSE and S&P, while it is emerging at MSCI. Greece is emerging at MSCI and S&P, but developed in FTSE. In addition to differentiating between developed and emerging markets, it is also important to understand the differences between emerging and frontier markets. MSCI characterizes frontier markets as having “limited market accessibility, small company size and low liquidity, while emerging markets are usually expected to provide higher levels of openness, investability and efficiency of the operational framework.” However, some characteristics of small emerging countries and large frontier countries are similar.

Figure 1. Gross domestic product growth — 1994-2013 (actual); 2014-2019 (IMF estimate)



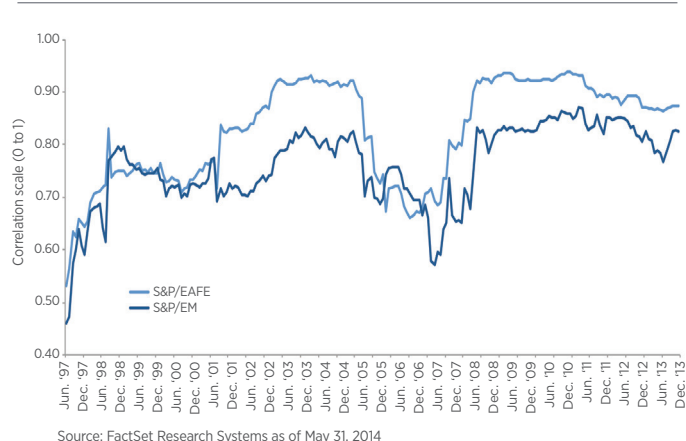
¹ Credit Suisse Research Institute, Credit Suisse Global Investment Returns Yearbook 2014, February 2014.

ECONOMIC AND MARKET CHARACTERISTICS

While index providers rely heavily on per capita GDP to categorize countries as emerging markets, there are other factors that are important to consider, particularly for investors and asset managers in selecting investments. These factors differentiate the emerging markets not only from developed markets, but also frontier markets. Demographic changes, particularly in Asia, support the growth in domestic consumer demand and the development of a middle class. Also, the maturation of the financial systems are an important factor for continued growth and future market returns. As the financial markets develop, capital flows should improve within each country and across borders, which should improve economic and market volatility. Historically, the primary benefits of investing in emerging markets are faster secular growth (presumably leading to higher equity market returns) and lack of correlation with developed market performance (resulting in lower portfolio volatility when combined).

As the emerging market economies have matured, and the global marketplace has become more integrated, the growth disparity between emerging and developed economies has increased, as has the correlation of returns. Figure 1 shows annual economic growth of

Figure 2. Correlation of MSCI EAFE and MSCI Emerging Markets to S&P 500, 3-yr trailing correlation

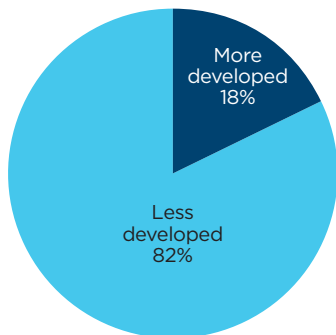


advanced economies compared with emerging market and developing economies.² Between 1994 and 2013, emerging economies grew at an average rate of 8%, 4% faster than the average rate of developed economies. According to the International Monetary Fund (IMF), the growth gap is expected to be 3% over the next five years (7% compared with 4%).³ Figure 2 shows that the correlation of monthly returns between the MSCI Emerging Markets index and the S&P 500 has increased over time (currently 83% compared with an average of 76% since June, 1997), but it is lower than the correlation between the MSCI EAFE Index and the S&P 500 (currently 87%). As a result, the growth and diversification benefit of investing in emerging markets has diminished, but the emerging markets still have faster growth and lower correlation with domestic equity markets than the developed markets.

As shown in Figures 3, 4 and 5, emerging markets and developing economies account for 82% of global population, 51% of economic activity, but only 13%

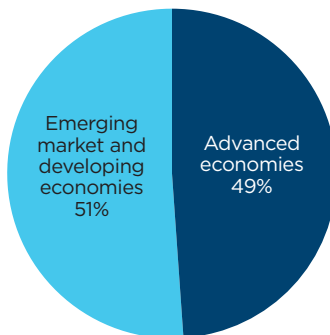
of equity market capitalization. Growth rates in all three categories are much faster for emerging than developed. In fact, according to MSCI Inc., emerging equities accounted for 1% of global markets in 1998, and now account for 13%. Much of this expansion is attributable to the differential in performance (11% annual return for the emerging markets index, 4% for the MSCI World Index), but is also due to a much faster growth in outstanding shares. There has been modest growth in developed market share expansion, as the majority of share issuance has been offset by repurchase activity. Emerging markets, however, have seen robust activity in initial public offerings and secondary equity offerings. According to the IMF, the growth differential is expected to continue, as emerging market and developing economies will account for more than 50% GDP for the first time in 2014, and is expected to grow to 54% by 2019. This compares to only 36% in 1994.

Figure 3. 2013 Population



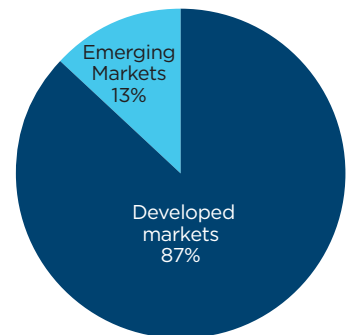
Source: Population Reference Bureau as of December, 2013

Figure 4. 2014 Estimated GDP



Source: IMF World Economic Outlook Database, April 2014.

Figure 5. 2013 Equity Markets



Source: FactSet Research Systems as of December, 2013

²“Emerging market” is a stock market classification, as defined by MSCI, while “developing economies” is an economic definition, as defined by the IMF.

³ International Monetary Fund, World Economic Outlook Database, April 2014

The higher relative economic growth in the emerging markets has resulted in strong earnings growth and strong relative performance through the past 20 years, as shown in Figures 6 and 7. Over the past several years, however, the emerging markets index has underperformed the developed market indexes despite continued strong earnings growth, as investors have driven U.S. equities higher, while avoiding emerging markets.

Figure 6. Relative earnings growth

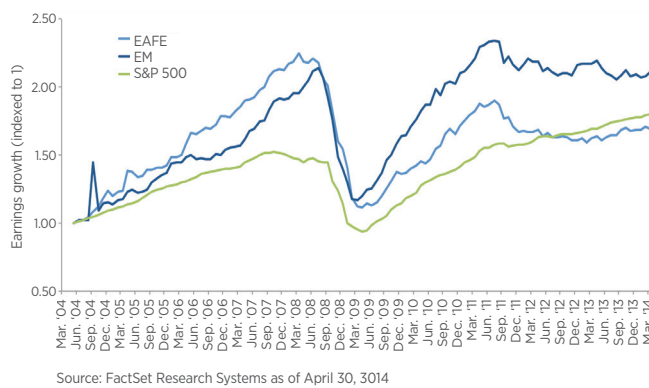
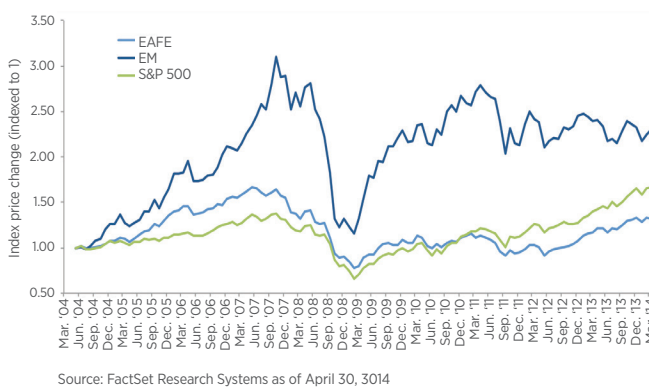
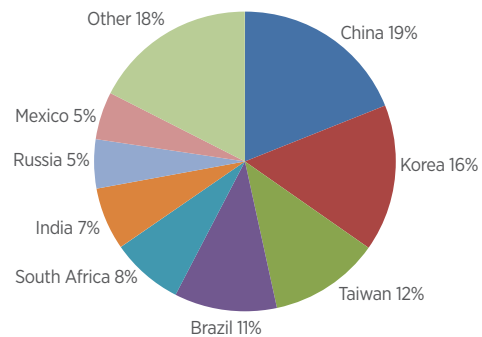


Figure 7. Relative performance



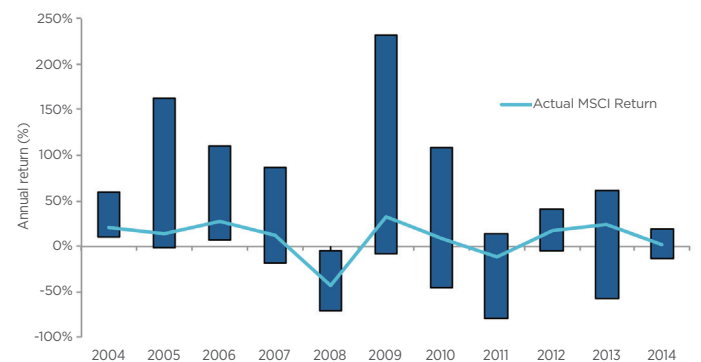
The emerging markets index is fairly concentrated, with eight countries accounting for 80% of the weight, and China, Brazil, South Korea and Taiwan accounting for more than 50% (Figure 8). Despite this concentration, there is significant dispersion of returns in individual countries and stocks, adding to the diversification benefit. Figure 9 shows the range of returns within the MSCI World Index from 2004 through the first quarter of 2014. In each of the years, there is a wide range between the best-performing and worst-performing countries' returns. It visually explains the dispersion that is inherent in international, and particularly emerging market, investing.

Figure 8. MSCI EM Country Exposure



Source: FactSet Research Systems as of March 2014

Figure 9. Range of returns of countries in the MSCI World Index



While the diversification benefit has historically incited investors to allocate a portion of their portfolio to emerging markets, this diversification benefit has been muted in periods of market stress. Historically, when global economic activity is robust, and equity markets are rallying, emerging market investments have tended to provide a strong complement to a portfolio, adding high returns that are noncorrelated with developed markets. During periods of global market stress, like what was experienced in 2008, emerging markets have normally experienced a more negative return with high volatility. Additionally, the correlation with developed markets during these periods has generally increased, negatively impacting diversification within a portfolio.

EXPLANATION OF RECENT WEAK PERFORMANCE

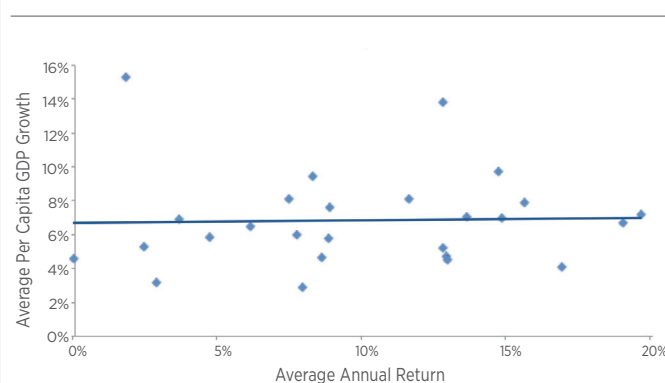
While the emerging markets index has performed well over the long term, returns have been weak over the last three years. Between April 2011 and April 2014, the S&P 500 returned 38%, the MSCI EAFE Index returned 17%, while the MSCI Emerging Markets Index declined by 17%, falling in absolute returns and significantly underperforming the developed markets indexes. The last period of underperformance with this severity and duration was between 1994 and 1998, when most emerging market countries, including Thailand, Russia and Argentina, had severe economic and currency crises. During the current period, the economic challenges have been far less severe, but investor sentiment has been negatively impacted by global economic uncertainty and headline risk caused by geopolitical situations (i.e. Russia and Ukraine). Also, with the strength of performance in developed market equities, investors have had little motivation to diversify into the emerging markets.

Another more recent factor impacting investor sentiment has been the increase in long-term U.S. interest rates and the scaling back of stimulus activity by the Federal Reserve, specifically the tapering of the Quantitative Easing program. Many of the emerging market countries are dependent on low global interest rates in order to fund growth through low-

While the outperformance of the emerging markets index relative to developed markets has been correlated to the relatively high level of economic growth, there is very little correlation between economic growth and market performance for individual countries. Figure 10 shows the average annual market return compared with the per capita GDP growth between 2000 and March of 2014. Each dot represents an individual country. The horizontal line representing best-fit shows the lack of correlation.

This shows that an approach of managers seeking to outperform by simply selecting the fastest growing economies would have not added value during the period. However, this lack of correlation combined with the wide range of country returns (shown on Figure 9 on page 4) shows the opportunity to add relative performance for managers that can identify the countries with the highest return.

Figure 10. Comparison of GDP growth and market return — January 2000 to May 2014



Source: IMF, FactSet Inc. as of May 31, 2014

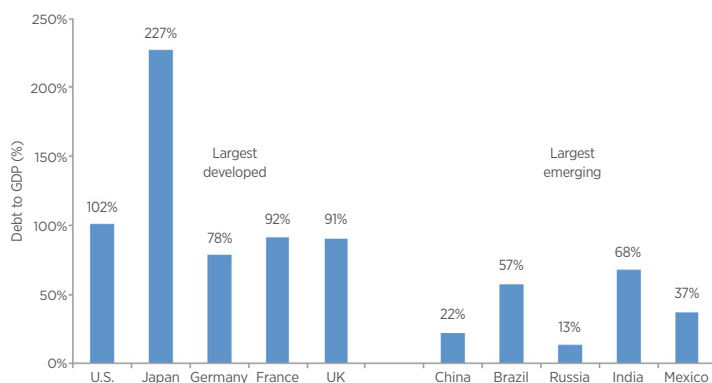
cost borrowing. Additionally, considering many of the countries' currencies are tied to the movement of the U.S. dollar, a weak dollar relative to global currencies provides a tailwind for exports of their manufactured goods. If U.S. short- or long-term rates rise, it will have a positive impact on the dollar, impacting the competitiveness of goods exported from countries with currencies tied to the U.S. dollar, while providing an opportunity for exporters in markets whose currencies aren't tied to the dollar.

RISKS IN INVESTING IN THE EMERGING MARKETS

While there are many positive aspects to investing in the emerging markets, there are several risks that investors need to consider.

- **Relatively immature governance systems:** Although globalization has caused many of these countries to mature, their economic, political, accounting and legal systems are still developing.
- **High industry/company concentration:** Within countries, there is relatively high concentration in a limited number of industries and companies. This is somewhat mitigated by the fact that there is relatively high dispersion in performance from country to country, (as shown on Figure 9 on page 4).
- **Limitations on growth:** While economic and earnings growth are relatively high, there are limitations on growth, including natural resource constraints, underdeveloped infrastructure, volatile capital market inflows and reliance on equity issuance due to lack of bond market depth.
- **Managed exchange rates:** Many of the countries have exchange rates linked to the U.S. dollar, limiting flexibility and creating the potential for imbalances. In the past, during periods of economic stress and high inflation, rather than choosing to raise interest rates to stabilize the economy, leaders often have chosen to devalue their currency to avoid slow growth and austerity measures. Prevalent during the 1990's, this has had a significantly negative impact on foreign investors causing severe negative returns.

Figure 11. Government debt to GDP — Largest developed countries compared with largest emerging countries



Source: Trading Economics as of December 31, 2013

POSITIVE FACTORS TO CONSIDER

Over the past 20 years, emerging market economies have growth rates in excess of those of developed economies, and based on IMF projections, this trend is expected to continue over the next five years. Economic growth will be influenced by increases in population, a maturation of the middle class, and the continued transformation from rural to urban societies. As a result of these trends, consumer spending, infrastructure spending and residential construction will continue to expand. Supportive of these trends is the relatively low-debt levels of the governments, companies and consumers in many of the emerging market countries. Figure 11 compares the government debt to GDP levels for the five largest-developed countries and the five largest-emerging countries. The average for the developed countries is 118%, compared with 39% for the emerging countries.

Given the underperformance of emerging markets equities over the past three years during a period of strong earnings growth, the valuation of the MSCI Emerging Markets Index (using forward earnings) is currently at a 34% discount to the S&P 500, a level not often seen over the past 10 years (Figure 12). The average level over that period was a 21% discount. Considering that the earnings environment is healthy for emerging market companies (as shown on Figure 6 on page 4), the valuation disparity may be, perhaps, based more on sentiment than on fundamentals.

Figure 12. Emerging Markets P/E compared with the S&P 500



Source: FactSet, Inc. as of June 15, 2014

Also, due to the strong earnings fundamentals and the recent 4 year period of underperformance, emerging market equities produce a relatively high-dividend yield. The Index is yielding 3.0% as of May 31, 2014, in line with the ten year average and materially higher than the S&P 500 (2.08%). It also compares favorably to the yield on the 10-year U.S. Treasury, yielding 2.48% as of May 31. According to analyst estimates, the Emerging Markets Index is poised to earn \$140 per share over the next 12 months (compared with the index value of 969 on May 31), and estimated to pay out dividends of \$66 per share, or 47% of earnings. This compares with a 32% payout ratio for the S&P 500, showing emerging market companies' willingness to historically pay out more of their earnings in the form of dividends.

Investors may also consider including emerging markets in their portfolio for diversification. The U.S. accounts for 54% of the MSCI World Index, resulting in a fairly concentrated exposure for a benchmark widely viewed as diversified. Despite the fact that correlations have risen over time, the relatively low correlation of the emerging markets to domestic equities (shown on Figure 2 on page 2) may provide enhanced diversification of a portfolio.

ADDITIONAL FACTORS TO CONSIDER

When investing in emerging markets, there are several factors to consider, including active versus passive management, the importance of country selection, and

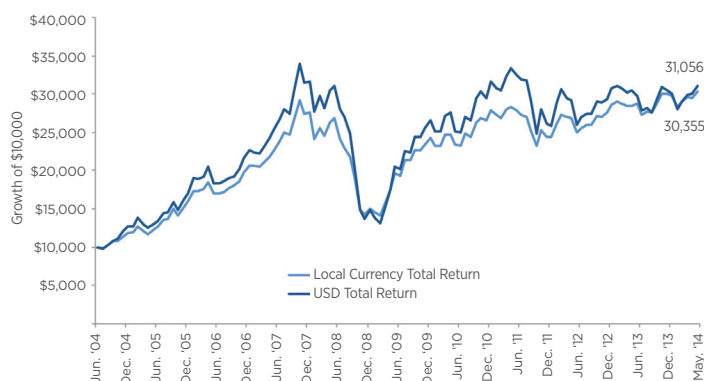
the difference between hedged versus unhedged portfolios. Because of the heavy concentration of the emerging markets index in a few countries, and due to the substantial deviation in performance among the countries in the index, active management has the potential to add value. In fact, over the past three years, 62% of funds in the Lipper peer group outperformed the MSCI Emerging Markets, and over the last five years, 58% of funds outperformed.³

Many portfolio managers choose to limit the impact from currency fluctuations through hedging of their portfolios. Currency fluctuations have not, however, been a significant contributor to return or volatility over the past ten years, as displayed on Figure 13. The U.S. Dollar return was slightly higher (2%) than the local currency return, but the standard deviation of the local currency return was actually lower than the U.S. dollar return (5.2% versus 6.9%).

CONCLUSION

Historically, investors chose to allocate a portion of their portfolio to emerging markets for the relatively high level of economic growth and the diversification benefits they offer. In recent years, the underperformance of emerging markets relative to domestic and developed markets, and the rise in correlation between developed and emerging market returns have triggered debate on the value of investing in emerging markets. However, over the long term, population and per capita GDP growth should continue to outpace developed markets. Also, while globalization and interdependency have caused the diversification benefit to decline, the correlation between emerging markets and domestic markets continues to be substantially lower than the correlation between domestic and developed international returns. Lastly, while short-term volatility is higher than developed markets, the long-term returns have been attractive. Investors with a long-term horizon and a willingness to endure short-term volatility may consider including an allocation to emerging markets equities as part of a diversified portfolio strategy.

**Figure 13. MSCI EM Index:
Local currency versus USD total return, Growth of \$10,000**



Source: FactSet Research Systems from June 2004 to May 2014

³ FactSet, Inc., Lipper US.

Important Disclosures

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The MSCI EAFE Index is an equity index which captures large and mid cap representation across Developed Markets countries around the world, excluding the US and Canada. With 906 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

S&P 500® Index: An unmanaged, market capitalization-weighted index of 500 stocks of leading large-cap U.S. companies in leading industries; gives a broad look at the U.S. equities market and those companies' stock price performance.

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