STANDARD & POOR'S

Sector Report

International Equities: Emerging Markets

(Incorporating the peer groups: global emerging markets, Asia ex-Japan, and China)

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Introduction

This is S&P Fund Ratings' inaugural review of the international equities emerging markets sector. The sector has been divided into three peer groups:

- Global emerging markets (GEM; seven managers)
- Asia ex Japan (eight managers)
- China (three managers)

The review examines a total of 14 managers (some managers are represented in more than one peer group), with S&P applying star ratings to 38 funds.

Overall, S&P has more than doubled its manager coverage in the international equities emerging markets sector (as evidenced by the number of new ratings

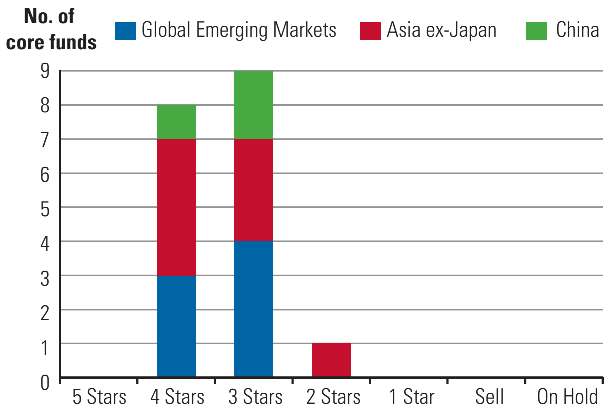
Table 1

Rated Managers

Manager	New Star Rating	Old Star Rating	Change
Peer Group: Global Emerging Markets			
Dimensional	4	4	Stable
Lazard	4	Not rated	New
Legg Mason	4	Not rated	New
Aberdeen	3	4	Downgrade
ABN AMRO	3	Not rated	New
ING	3	3	Stable
Vanguard	3	Not rated	New
Peer Group: Asia ex Japan			
Aberdeen	4	4	Stable
Advance	4	3	Upgrade
Challenger	4	On hold	N/A
Schroder	4	Not rated	New
BT	3	On hold	N/A
INVESCO	3	3	Stable
IOOF Perennial	3	3	Stable
Fidelity	2	Not rated	New
Peer Group: China			
Challenger	4	4	Stable
Aberdeen	3	4	Downgrade
Fidelity	3	Not rated	New

N/A—Not applicable.

Chart 1
Emerging Markets—Rating Distribution



applied). S&P's expanded coverage supports its new sector-based approach of assessing fund manager capabilities and further enhances peer group relativity.

Key Findings

- This sector review did not produce any five-star-rated managers. This reflects the relatively small number of managers and the relative inexperience of some of the portfolio managers in this sector. Overall, it has not produced what S&P considers are the highest-quality managers. It is foreseeable that the number of funds offered in the Australian market place will increase following strong market returns in emerging markets because it may spark investor appetite in the sector.
- The structural inefficiencies of emerging markets—that is being less developed, less liquid, and less researched—provide an environment for active managers to add value in this sector. An analysis of the historical performance of GEM funds provides evidence to support this view.
- Conviction in the Asia ex-Japan sector is tempered given that six out of seven managers included in this peer group has a lead portfolio manager that has commenced in the past two years. This reflects that some of the funds are new but reflects instability in others.
- Most managers in this sector review are either style-neutral or growth at a reasonable price (GARP), which indicates that style may not be a critical source of value adding in this sector.
- Managers in this sector typically have minimal or no exposure to securities purchased in mainland China. Rather, exposure to China is predominantly sought through Hong Kong-listed shares. The main reasons for this are the generally poor levels of transparency and corporate governance issues in mainland China. Although this is a sound rationale, it means that funds are not directly and broadly capturing Chinese markets.
- Despite higher exposure to the energy and materials sectors, emerging markets, overall, do not offer a high degree of sector or industry diversification when compared with the broader developed markets.
- S&P considers that the higher management fees in the international equities emerging markets sector, when compared with those in the mainstream international equities sector, is largely justified on account of the higher transaction costs for smaller trading volumes for emerging markets, the lack of scale in the funds under management (FUM), and for the potential for higher alpha.
- GEM equity markets have enjoyed a meteoric rise in performance. Over the past two and half years, the market has increased by more than 140% and has significantly outperformed the developed markets.
- The returns of the emerging markets and the broader developed market have become more highly correlated in the past 15 years and, accordingly, the GEM sector does not offer a high level of diversification of returns. Despite this, longer-term performance suggests that emerging market exposure can be a good potential source of alpha.
- Emerging market debt ratings are painting a rosy financial picture. In 2004, S&P raised 45% and lowered only 3% of the ratings on the 29 governments that make up the JP Morgan EMBI Global index. Emerging market noninvestment-grade debt defaults recorded in 2005 are at historic lows.

S&P's View on Managers

Tables 2, 3, and 4 summarise S&P's rating and opinion on each of the managers rated in the international equities—emerging markets sector review. For full details of each rating, please refer to the premium fund rating report for the relevant fund.

Table 2
S&P's View in Summary on GEM Peer Group Managers

Manager	Rating	S&P's View (Summary)
Dimensional	Four stars	Dimensional has a passive approach designed to be one component of a diverse global equities portfolio. This fund gives investors exposure to the returns of large companies in emerging markets. The manager currently does not invest in Russia and mainland China, and is no longer making new investments in Argentina. These restrictions come as a result of negative top-down views on these countries. The strategy reduces transaction costs and keeps portfolio turnover low, while being mindful of the after-tax returns to investors. S&P has a high conviction that Dimensional will continue to deliver its stated goals and to perform well relative to its active peers on a risk-adjusted basis.
Lazard	Four stars	Lazard has a relative-value approach focusing on stocks that have competitive return on equity and are inexpensively valued. Lazard has a strong track record in this sector, and S&P has a high conviction it will continue to provide good risk-adjusted returns relative to its peers.
Legg Mason (Formerly Citigroup)	Four stars	Legg Mason has an experienced and stable team implementing a disciplined and structured, style-neutral investment process. The investment team remains intact after Legg Mason's acquisition of the Citigroup asset management business.
Aberdeen	Three stars	Aberdeen has a bottom-up, focused investment process, which permits large active positions away from the index on stock, sector, and country, and has a bias to small caps. The downgrade of this fund (from four stars to three stars) was influenced by S&P's new sector-based approach (emphasising comparison with peers) and its view that the fund's London team (which manages half the portfolio) is not as well resourced as its peers. The fund's Asian team has been adding most of the value to the fund since inception.
ABN AMRO	Three stars	A large team of dedicated GEM analysts is located in three key regional markets. The team has undergone significant change and the fund has had weak past performance. Nevertheless, S&P considers that the appointment of a new portfolio manager in March 2005 and the subsequent changes to team structure and investment process are positive developments.
ING	Three stars	A large underlying team of analysts is widely dispersed in key regional markets. The manager's longer-term track record has been lacklustre, but S&P considers that the improving coordination of the manager's research efforts will support peer-competitive performance.
Vanguard	Three stars	Vanguard manages this fund in an index manner, using optimisation techniques. Vanguard has the ability to time trades to take advantage of market inefficiencies around index changes and has successfully added value through this method. A large buy-sell spread detracts from this offering.

Table 3

S&P's View in Summary on Asia ex-Japan Peer Group Managers

Manager	Rating	S&P's View (Summary)
Aberdeen	Four stars	Aberdeen has a bottom-up, focused investment process that permits large active positions away from the index on stock, sector, and country, and has a bias to small caps. The Singapore-based team has a long track record of adding value in the region.
Advance	Four stars	The fund is managed by Maple-Brown Abbot (MBA), a Sydney-based value manager. The upgrade of this fund (to four stars from three stars) reflects that MBA is devoting more of their resources to the Asian region and has now established a good track record of performance under its portfolio manager, ex-BT analyst Robert Nunley.
Challenger	Four stars	The fund is managed by HSBC Halbis Partners (Hong Kong). The portfolio manager, Kerry Series, has significant Asian equities experience and is supported by a large team. The investment process has undergone changes to improve idea generation and increase conviction levels in the portfolio. S&P has a strong conviction that the fund will perform well in comparison with its peers.
Schroder	Four stars	Schroder has the largest team in the peer group (about 20 portfolio managers and analysts). S&P views the appointment of Robin Parbrook to head Asia ex-Japan (in May 2005) as a positive move. He has implemented changes to the team-meeting structure, which better focus the research effort of a regionally dispersed team and has sharpened the investment process to help ensure that the portfolio contains the highest-conviction ideas.
BT	Three stars	The fund is managed by Putnam. The relocation of chief investment officer Simon Davis to London and his intention to concentrate more on core international equity portfolios have placed an extra burden on the team's ability to manage the Asia ex-Japan sector, because Mr. Davis represented much of team's experience in this sector. S&P has reviewed Putnam's business management and is satisfied that critical issues in relation to compliance and investment culture (the reason the fund was originally placed 'On Hold') have been adequately resolved.
INVESCO	Three stars	The large investment team is structured along country lines in the belief that share prices are driven more by country considerations than by those of sector. Large country bets have detracted value recently, but S&P considers that the fund will provide performance in line with its peers.
IOOF Perennial	Three stars	A five-person, Sydney-based team, led by Diane Lin, has fewer years of experience than do its peers and underwent a change of portfolio manager and team restructure after Kerry Series' departure in late 2004. Fund performance has been weak over the short term (due to poor stock picking), but despite this, S&P considers that the manager's value-biased approach will provide peer-competitive performance.
Fidelity	Two stars	The portfolio manager for the fund, Jess Tan, has gained the confidence of Fidelity, but is relatively inexperienced in managing regional portfolios compared with peers. S&P recognises the belief Fidelity has shown in Ms. Tan and her success in running country portfolios; however, it will take further time to build conviction that she can translate previous experience into a consistent performance track record at a regional level.

Table 4
S&P's View in Summary on China Peer Group Managers

Manager	Rating	S&P's View (Summary)
Challenger	Four stars	The fund is managed by HSBC Halbis Partners (Hong Kong). The portfolio manager, Richard Wong, has significant Asian (particularly Chinese) equities experience and has managed the China portfolio for the past eight years. He is supported by two dedicated country analysts and a large team of sector analysts. S&P has a strong conviction that the fund will perform well compared with its peers.
Aberdeen	Three stars	Aberdeen has a bottom-up, focused investment process that permits large active stock positions away from the index and has a bias to small caps. The downgrade of this fund (to three stars from four stars) was influenced by S&P's new sector-based approach (emphasising comparison with peers) and its view that the investment team, based in Singapore, is structured towards running a regional rather than a country-specific portfolio.
Fidelity	Three stars	A high conviction portfolio is supported by bottom-up stock-picking. The moderately experienced portfolio manager is supported by a good-sized investment team.

Sector Themes

No five-star funds.

Emerging markets investing is one investment capability among many that a mainstream active fund manager has to provide and one to which it needs to devote intellectual capital and other resources. Because the emerging markets are a relatively small segment of the investment market, large global managers might not necessarily devote their best resources to researching it. This sector review did not produce any five-star-rated managers and this reflects the relatively small number managers in this sector and that it is not producing what S&P considers are the highest-quality managers. There are no dedicated emerging markets (or Asia ex-Japan) managers in the Australian marketplace, and this means there are no managers squarely focused on dealing with the less liquid, less developed, and the relatively information-poor environment of this global sector. It is foreseeable that the number of funds offered in the Australian marketplace will increase following strong market returns in emerging markets because it may spark investor appetite in the sector.

Active versus passive management.

The securities markets of emerging markets in securities are smaller, less developed, and less liquid than developed markets. They also tend to be less researched. These inefficiencies should give rise to opportunities for active managers to add alpha. The Mercer's survey of emerging markets managers (as at Dec. 31, 2005) reveals that (before fees) the median manager outperformed the MSCI Emerging Markets Index by 1.8% over five years. Over the same period, the top quartile of managers in this survey outperformed the index by a minimum of 4.6% and a maximum of 8.2%. This survey of 17 GEM managers includes only funds available to the Australian marketplace and accordingly is only a smaller subset of total funds that are available in the global marketplace, but does demonstrate that active managers can provide performance well above the benchmark.

Investment team.

The experience, skill, and track record of the portfolio manager and investment team are critical factors in building S&P's conviction level. Also critical is whether the structure and location of the investment team best supports its research efforts.

Investment teams may be structured in several ways, including as sector specialists, country specialists, generalists, or a combination of these, and they may be located either centrally (which supports team dynamics) or they might hold a number of regional desks (which provides proximity to key markets).

Historically, country-specific factors have been significant contributors to emerging markets portfolio risk and, accordingly, many managers in this sector are structured to include country specialists. The Schroder investment team is structured so that portfolio managers each have specific-country research responsibilities to provide input on macro and political views. The underlying pool of analysts is structured along sector lines. With approximately 20 investment staff, Schroder has one of the largest teams in the Asia ex-Japan sector, located across four regional desks (Hong Kong, Singapore, Taipei, and Seoul). The dispersion of the investment team is not ideal for team dynamics but it does allow for proximity to key markets in the region. Schroder has recently altered the team's meeting structure into smaller meeting groups to improve the dynamics of the team and to maintain a sharper focus on key research priorities. There are weekly regional portfolio construction meetings attended by the portfolio managers and stock meetings set up along country lines attended by analysts.

Aberdeen's investment team, in contrast, are centrally located in Singapore and are structured as a team of generalists. Aberdeen does not employ country specialists, which reflects that its main source of value adding tends to be stock rather than country selection. This relatively unique approach to those reviewed in the peer group supports the manager's bottom-up focus and consensus team-based approach to portfolio construction. The centralised location supports team dynamics but probably requires relatively more travel time than some of its competitors that operate more regional desks need. S&P considers that this is an appropriate structure for this manager. There is no one right way to structure an investment team, but S&P considers it important to assess the appropriateness of team's structure relative to its investment process.

High portfolio manager turnover in the Asia ex-Japan peer group.

Six out of seven managers included in the Asia ex-Japan peer group has a lead portfolio manager that has commenced in the past two years. This reflects that some of the funds are new but reflects instability in others. Table 5 lists the start dates of the current lead portfolio managers and illustrates the relative inexperience of many portfolio managers in the Asia ex-Japan sector. In particular, the portfolio managers of the BT and Advance funds had largely Asian equity analytical roles before being promoted, and the portfolio managers of the Fidelity, Schroder, and IOOF Perennial funds were managing Asian country-specific portfolios rather than Asian regional portfolios before taking up their current roles.

Table 5

Start Dates of Lead PMs in Asia ex Japan Funds

Manager	Lead PM	Start Date
Fidelity*	Jess Tan	September 2005
Schroder	Robin Parbrook	May 2005
Challenger (HSBC)	Kerry Series	October 2004
IOOF Perennial	Diane Lin	October 2004
INVESCO	William Yuen	July 2004
BT	Avo Ora	June 2004
Advance (MBA)**	Robert Nunley	May 2004
Aberdeen	Peter Hames	March 1990

**Fund began September 2005. **Fund began May 2005. Source: S&P.*

The appointment of a new or less experienced portfolio manager to a fund is not necessarily a bad thing, especially if it injects new ideas and leads to improved performance. For some managers, a mandate to run money in a relatively small international equities sector such as Asia ex-Japan, is a good proving ground for identifying new portfolio management talent. Fidelity is an ideal example of this philosophy, in which successful analysts are provided the opportunity to become portfolio managers of, initially, small mandates, then, if successful, to run larger mandates.

Not all managers fit this bill. Kerry Series, for example, has close to 15 years as an Asian equities-specialist and joined HSBC after his departure from IOOF Perennial as portfolio manager in October

2004. Peter Hames from Aberdeen has also been focused on Asian equities since the early 1990s, and has been with Aberdeen's Asian operation since its inception.

Manager style.

Table 6
Investment Style

	Style
Global Emerging Markets	
ABN AMRO	GARP*
Aberdeen	GARP*
Dimensional	Passive
ING	GARP*
Lazard	Value
Legg Mason	Style neutral
Vanguard	Index
Asia ex Japan	
Aberdeen	GARP*
Advance	Value
BT	Style neutral
Challenger	Style neutral
Fidelity	Style neutral
INVESCO	GARP*
IOOF Perennial	Value
Schroder	GARP*
China	
Aberdeen	GARP*
Challenger	Style neutral
Fidelity	Style neutral

**GARP = growth at a reasonable price. Source: S&P.*

Table 6 lists the investment styles of the managers covered in each peer group of the international equities emerging market sector review. Interestingly, there are no growth managers and only a few value managers. The majority of managers are either style-neutral or GARP, which indicates that style may not be a critical source of value adding in this sector. Some managers in the sector review commented that style divergence (between the excess returns of value or growth shares) in emerging markets has been generally less pronounced than in the developed markets.

Vanguard manages its emerging markets fund in an index manner using optimisation techniques. Vanguard has the ability to time its trades to take advantage of market inefficiencies around index changes and has successfully added value through this method.

Dimensional, a passive manager, uses a quantitative approach to capture about 80% of each market's capitalisation by investing in most of the largest companies. The manager currently does not invest in China and Russia and is not making any new investments in Argentina. The restriction comes as a result of negative top-down views on these countries. Dimensional's investment approach is based on the academic research of Kenneth French and Eugene Fama, with the company investing heavily in research on financial markets and providing the most efficient exposure to investment markets. Dimensional believes that this approach is more efficient than a traditional index fund, but investors should note that the fund's tracking error will be higher than that of index funds.

Capturing China's growth.

Managers in this sector typically have minimal or no exposure to securities purchased in mainland China (A and B shares). Rather, exposure to China is predominantly sought through H shares (a Chinese company listed on the Hong Kong Stock Exchange) or Red Chips (a company incorporated and listed in Hong Kong with controlling Chinese shareholders). The main reason for this are the generally poor levels of transparency and corporate governance issues in mainland China. Although some fund managers have investment teams available on the ground in mainland China, fund mandate guidelines tend not to permit investment in this market. To establish a licence to trade shares in mainland China, firms must also overcome many regulatory hurdles. The Hong Kong Stock Exchange, where H shares are traded, has much tighter reporting standards and higher levels of transparency and, accordingly, managers have a higher level of comfort gaining their China exposure through this market.

The Dimensional Emerging Markets Trust excludes China from investment because of foreign exchange controls, weak property rights, and unequal treatment of foreigners through the splitting of A and B class shares (i.e. A shares may only be owned by Chinese citizens and B shares are publicly traded shares that foreign investors are permitted to invest in the stock exchanges in China).

The Aberdeen China Opportunities Fund buys predominantly Hong Kong-listed stocks but may also hold stocks listed in other countries (e.g. Japan and Singapore) that have a large proportion of their operations in China. Gaining exposure to China this way also demonstrates that many of China's neighbours are benefiting from its fast-growing economy.

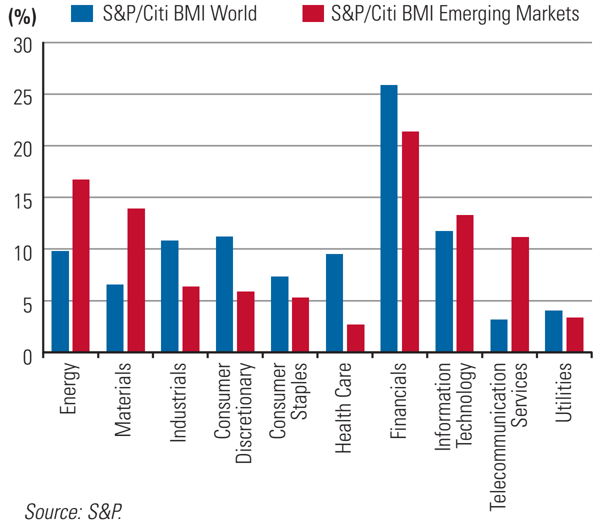
Investors need to be aware that funds in this sector are not typically buying mainland Chinese stocks. Although there is a sound rationale for this, it means that funds are not directly and broadly capturing Chinese markets. Not all mainland Chinese companies are listed in Hong Kong and, accordingly, company exposure will differ to the mainland markets.

An investment process for emerging markets.

There are investment risks that are particularly relevant to emerging markets, such as political, macro, and corporate governance risks. Accordingly, managers that have established mainstream equities investment processes and are applying them to emerging markets are compelled to make adjustments for these additional risks. Manager approaches vary and include applying a uniform country-specific discount rate to all stocks based on qualitative and other assessment, to explicitly assessing and scoring company-specific corporate governance issues. Researching and assessing corporate governance issues require additional resources beyond the traditional fundamental research that managers apply. Managers such as Aberdeen and Lazard have made assessment of corporate governance and transparency at a company level central to their investment processes. Other managers, such as Dimensional and ABN AMRO, form views at market level and may exclude entire countries from their universe if they are uncomfortable with the investment environment.

Chart 2

GICS Sector Exposures as at Jan. 31, 2006



Source: S&P.

Sector diversification.

Chart 2 compares the sector weightings of the S&P/Citi BMI World Index with those of the S&P/Citi BMI Emerging Markets Index. The most notable difference is the weighting to the energy, materials, and telecommunications services sectors, with the emerging markets' exposure significantly higher to these sectors than the broader developed market. Also pronounced is the higher exposure of the broader market to the healthcare and consumer discretionary sectors. Although there are some notable differences in sector exposures between emerging markets and the broader market, overall, emerging markets do not offer a high degree of sector diversification.

Fees.

Table 7 lists the current management expense ratios (MERs) for the funds included in this review. Most of the funds are targeted to the wholesale or institutional market. ABN AMRO and Aberdeen have a minimum investment level that is more akin to a retail fund though; therefore, the slightly higher MER for these funds. The lower fee levels for Dimensional and Vanguard reflect the passive nature of these investment processes. Vanguard offers the lowest MER of all managers, but its fund has a very high buy-sell spread (2.72%), which detracts from the offering. The Schroder Asia Pacific Fund is the

Table 7

Management Expense Ratios (MERs)

Fund Name	MER (%)
Peer Group: Emerging Markets	
Vanguard Emerging Markets Shares Index Fund	0.56
Dimensional Emerging Markets Trust	0.97
Lazard Emerging Markets Trust	1.05
ING Wholesale Global Emerging Markets	1.10
Legg Mason Emerg Markets Trust A Class	1.21
Aberdeen Emerging Markets Fund	1.50
ABN AMRO Emerging Markets Equity Fund	1.74
Peer Group: Asia ex Japan	
Schroder Asia Pacific Fund Standard Class Fund	0.95
INVESCO Wholesale Asia Ex Japan Share Fund	1.05
Challenger Funds Management Asian Share W Fund	1.12
Aberdeen Asian Opportunities Fund	1.18
BT Wholesale Asian Share Fund	1.23
Advance Asian Equity Fund Wholesale Units	1.25
IOOF Perennial Wholesale Asia Trust	1.33
Peer Group:China	
Fidelity China Fund	1.20
Challenger Funds Management China Share Fund	1.50
Aberdeen China Opportunities Fund	2.00

Source: S&P.

cheapest active manager. No manager in this review applies a performance fee.

Broadly, fees in the international equities emerging markets sector are slightly higher than the mainstream international equity sector. This is largely justified on account of the higher transaction costs for smaller trading volumes for emerging markets, the lack of scale in the FUM, and the potential for higher alpha. Please refer to discussion below under 'Sector Performance'

Sector Performance

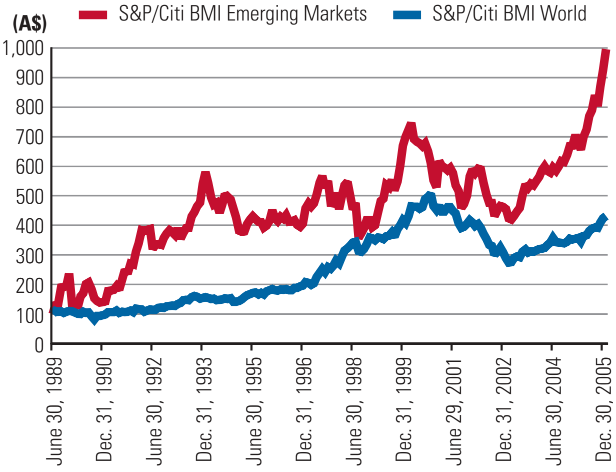
Chart 3 compares the performance of the S&P/Citi BMI World Index with the S&P/Citi Emerging Markets Index from June 1989 to January 2006. The most striking aspect of this chart is the significant outperformance of the GEM sector during this period. Also evident from the well-defined number of peaks and troughs is the higher level of volatility of the GEM sector. Volatility in recent years has lowered though, in part due to the improving quality of companies in the sector.

From June 2003 to January 2006, the GEM sector has enjoyed a meteoric rise, with the S&P/Citi BMI Emerging Markets Index (A$) rising more than 140% during this time. This can be attributed to factors including the improved health of company earnings in the sector on the back of improving global economic conditions and the sector's higher exposure to energy and materials (refer to chart 2 on sector exposure) when commodity prices are rising. Also contributing is the improving liquidity level in the sector, which has come from the increased participation from mutual funds and hedge funds. According to data published by Emerging Portfolio Fund Research, GEM funds experienced massive inflows of US$3.3 billion in a single week in February 2006, the largest recorded net weekly inflow. It seems that "hot money" is helping to prop up the performance of the sector at present. These inflows are not sustainable and there is the possibility of funds taking profits. A worst case scenario would be a flight of capital in the event of a market shock, such as the Asian crisis in 1998. This seems less likely though given the current healthier state of financial affairs at both government and corporate levels in the emerging market sector.

Chart 3

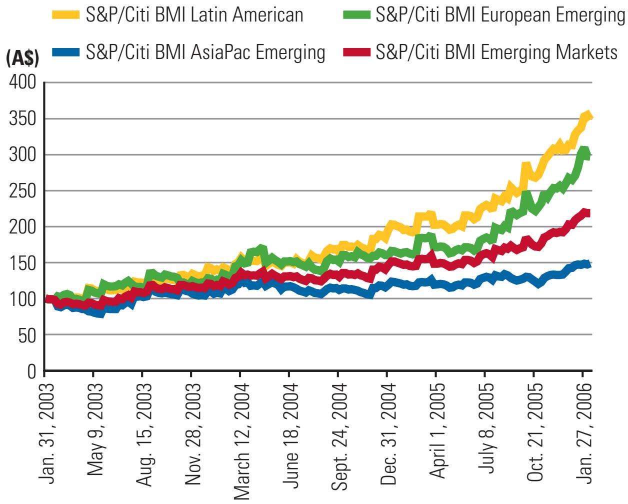
Growth of $100—GEM vs World in A$

1989-2005



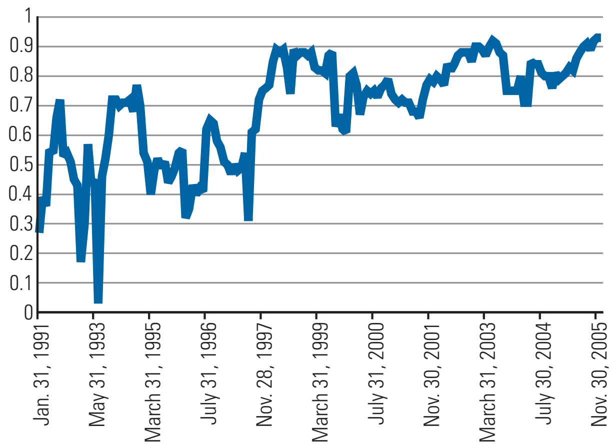
Source: S&P.

Chart 4
Growth of $100—Emerging Markets by Region in A$
Jan 2003-Jan 2006



Source: S&P.

Chart 5
Return Correlation: S&P/Citi BMI Emerging Markets vs S&P/Citi BMI World over Rolling 12 months
1991-2005



Source: S&P.

Despite handsome gains in the past two and a half years, the emerging markets still seem relatively cheap. According to S&P/Citigroup Global Equity Indices, as of year-end 2005, developed markets were trading at higher price/earnings ratios (P/E) than emerging markets. Austria, for example, is trading at a 12-month trailing P/E of 22.5, France at 23.5, and the U.K. at 22.8. In contrast, emerging markets such as Argentina (P/E of 13), Brazil (11), India (16.2), Mexico (8), and Russia (11.4) seem inexpensive. As a whole, the emerging markets are trading at a P/E of 13.5 against 18.8 for the eurozone and 20.9 for the U.S. S&P notes that part of the discount may reflect the greater risks inherent in emerging market investing.

Asia emerging markets left behind.

Chart 4 shows that the bull run in global emerging markets over the past three years has been led by stellar returns in Europe and Latin America. While Asia was the darling of the emerging markets in the early to mid 1990s, it has been well behind the returns achieved by the rest of the emerging markets over recent years.

Diversification benefits.

Chart 5 illustrates the correlation level of returns between GEM and the broader market in the period from 1991 to 2005. In this time, the trend has been towards a higher correlation of returns and for the past eight years correlation has hovered around 70% to 90%. Overall, the GEM market cannot currently be characterised as countercyclical with the broader developed market and, accordingly, it does not offer a high level of performance diversification. Despite this, longer-term performance suggests that emerging market exposure can be a good source of alpha.

Improving balance sheets.

A consistent theme in discussion with fund managers in this sector was the improving health of financial statements of emerging market companies. Of particular note is the improving cash flow and more disciplined capital management of firms in recent years. Table 8 provides default rates of noninvestment-grade emerging markets companies and supports this picture of improving financial fortunes. Emerging markets companies have benefited from improving global economic conditions that have supported earnings growth.

The rise in the quality of companies (e.g. those that have conservative debt levels and offer good return on equity) seems to be a factor that is contributing to the lower levels of volatility currently seen in the emerging markets. Refer to 'Sector Performance' for more discussion on the volatility characteristics of the sector.

Sovereign emerging market debt is also showing signs of improving health. In 2004, S&P raised 45% and lowered only 3% of the ratings on the 29 governments that make up the JP Morgan EMBI Global index.

Table 8

Annual Speculative Grade Default Rate for Emerging Markets

1998-2004

Year	Default Rate
1998	8.09%
1999	7.95%
2000	1.77%
2001	5.81%
2002	14.80%
2003	2.81%
2004	0.48%

Source: S&P.

Appendix 1

Full List of Funds Rated in the S&P International Equities—Emerging Markets Sector Review

		New Rating	Old Rating	Change
Peer Group: Global Emerging Markets				
ETL0032AU	Aberdeen Emerging Markets Fund	3	4	Downgrade
ARO0010AU	ABN AMRO Emerging Markets Equity Fund	3	Not rated	New
ANZ0456AU	ANZ OA Alloc Pen-ING Global Emerging Markets Shares EF	3	Not rated	New
ANZ0457AU	ANZ OA Alloc Pen-ING Global Emerging Markets Shares NEF	3	Not rated	New
ANZ0360AU	ANZ OA Inv Pfolio-ING Global Emerging Markets EF	3	Not rated	New
ANZ0361AU	ANZ OA Inv Pfolio-ING Global Emerging Markets NEF	3	Not rated	New
ANZ0547AU	ANZ OA Per Sup-ING Global Emerging Markets Shares EF	3	Not rated	New
ANZ0548AU	ANZ OA Per Sup-ING Global Emerging Markets Shares NEF	3	Not rated	New
ANZ0697AU	ANZ OA TAP ING Global Emerging Markets Shares EF	3	Not rated	New
ANZ0698AU	ANZ OA TAP ING Global Emerging Markets Shares NEF	3	3	Stable
DFA0107AU	Dimensional Emerging Markets Trust	4	4	Stable
GMO0102AU	GMO Emerging Markets Trust	Not rated*	4	Withdrawn
MMF0450AU	ING Integra Super ING Global Emerging Markets Share	3	3	Stable
MMF0293AU	ING OA Alloc Pen-Global Emerging Markets Shares EF	3	Not rated	New
MMF0317AU	ING OA Alloc Pen-Global Emerging Markets Shares NEF	3	Not rated	New
MMF0786AU	ING OA TAP ING Global Emerging Markets Shares EF	3	Not rated	New
MMF0787AU	ING OA TAP ING Global Emerging Markets Shares NEF	3	Not rated	New
MMF0265AU	ING OneAnswer Investment Portfolio Global Emerging Markets	3	3	Stable
MMF0270AU	ING OneAnswer Investment Portfolio Global Emerging Markets NEF	3	3	Stable
MMF0305AU	ING OneAnswer Personal Super Global Emerging Markets Share	3	3	Stable
MMF0329AU	ING OneAnswer Personal Super Global Emerging Markets Share NEF	3	3	Stable
MMF0275AU	ING Wholesale Global Emerging Markets	3	3	Stable
LAZ0003AU	Lazard Emerging Markets Trust	4	Not rated	New
SSB0124AU	Legg Mason Emerging Markets Trust A Class	4	Not rated	New
JPM0005AU	Legg Mason Emerging Markets Trust X class	4	Not rated	New
VAN0005AU	Vanguard Emerging Markets Shares Index Fund	3	Not rated	New
Peer Group: Asia ex Japan				
EQI0028AU	Aberdeen Asian Opportunities Fund	4	4	Stable
ADV0082AU	Advance Asian Equity Fund	4	3	Upgrade
ADV0083AU	Advance Asian Equity Fund Wholesale Units	4	3	Upgrade
BTA0026AU	BT Asian Share Fund	Not rated**	On Hold	Withdrawn
BTA0054AU	BT Wholesale Asian Share Fund	3	On Hold	N/A
WAR0012AU	Challenger Funds Management Asian Share Trust	4	On Hold	New
HBC0010AU	Challenger Funds Management Asian Share Wholesale Fund	4	On Hold	New
CSA0028AU	Credit Suisse Asset Management Wholesale Asian Shares Fund	Not rated*	Withdrawn	N/A
FID0010AU	Fidelity Asia Fund	2	Not rated	New
GTU0022AU	INVESCO Wholesale Asia Ex Japan Share Fund	3	3	Stable
IOF0203AU	IOOF Perennial Wholesale Asia Trust	3	3	Stable
SCH0006AU	Schroder Asia Pacific Fund Standard Class Fund	4	Not rated	New

Full List of Funds Rated in the S&P International Equities—Emerging Markets Sector Review (cont.)

		New Rating	Old Rating	Change
Peer Group: China				
ETL0031AU	Aberdeen China Opportunities Fund	3	Not rated	New
HBC0027AU	Challenger Funds Management China Share Fund	4	4	Stable
FID0011AU	Fidelity China	3	Not rated	New

**This manager did not participate in this Review and accordingly the rating for this fund has been changed to 'Not rated'. ** The wholesale version of fund is rated. Refer to BTA0054AU.*

Appendix 2

Fund Rating Definitions

FUND RATING ★★★★★	Standard & Poor's has very high conviction that the manager will consistently generate risk-adjusted fund returns in excess of relevant investment objectives and relative to peers.
FUND RATING ★★★★☆	Standard & Poor's has high conviction that the manager will consistently generate risk-adjusted fund returns in excess of relevant investment objectives and relative to peers.
FUND RATING ★★★☆☆	Standard & Poor's has conviction that the manager can generate risk-adjusted fund returns in line with relevant investment objectives and relative to peers.
FUND RATING ★★☆☆☆	Standard & Poor's has conviction that the manager will not generate risk-adjusted fund returns in line with relevant investment objectives and relative to peers.
FUND RATING ★☆☆☆☆	Standard & Poor's has high conviction that the manager will not generate risk-adjusted fund returns in line with relevant investment objectives and relative to peers.
FUND RATING ON HOLD	Issues potentially affecting the management of the fund have emerged, and the fund rating is temporarily suspended, pending clarification.
FUND RATING SELL	A manager with significant issues that have the potential to adversely impact performance. Existing investors should consider obtaining advice regarding switching or redemption.
— NEW —	**Fund Rating Subscript** Where the investment process, fund manager or analytical team has changed significantly, or where the fund has a relatively short history, but a relevant and demonstrable track record can be shown on similar funds.

S&P's Sector-Based Approach

S&P has rated managers in this sector for many years (previously as Assirt Research), but this is the first time that all managers have been reviewed simultaneously. This new approach provides greater relativity in our ratings outcomes.

When rating a manager, the key areas that S&P examines are the investment team dedicated to the management of the fund and the investment process and philosophy applied. Consideration is also given to specific issues with each fund, such as the appropriateness of its objectives, its fees and features, and business management issues. Each rating is a product of all these considerations, although each manager is also assessed in comparison with competitors.

Appendix 3

What is an emerging market?

There is no hard and fast definition on what constitutes an emerging market country. Some commonly accepted criteria include those countries that have:

- Low-to-middle per capita income (typically less than US$10,000 p.a.);
- Have embarked on economic development and reform programs;
- Increasing levels of local and foreign investment (direct and fund);
- Increasing political freedoms and improving legal systems; and
- Sovereign debt rating that is below investment grade.

These criteria are fairly broad and not all emerging market countries would satisfy all these criteria. Accordingly, countries with quite varying levels of economic development may fit the emerging market 'bill'. Countries such as Brazil, Russia, India, and China (collectively known as the BRICs) are prominent emerging market economies, with large populations and have produced economic growth well in excess of that achieved by developed nations in recent times. Some countries such as Israel, South Korea, and South Africa are considered likely to transition to developed market status in the not too distant future.

The countries invested in by GEM managers typically include the following.

Asia: China, India, Indonesia, South Korea, Malaysia, Pakistan, the Philippines, Taiwan, and Thailand.

ex-Asia: Argentina, Brazil, Chile, Colombia, Czech Republic, Egypt, Hungary, Israel, Jordan, Mexico, Morocco, Peru, Poland, Russia, South Africa, Turkey, and Venezuela.

The Case for Investing in Emerging Markets

According to the International Monetary Fund (IMF), emerging market economies share of global gross domestic product (GDP) has risen to nearly 50% in 2005 from 40% in 1980 and almost surpassed the output of developed countries. Emerging markets account for approximately 80% of the world's population and have higher rates of population growth than developed countries, so there is a large potential upside (particularly on a consumption basis) if these economies continue to blossom. As an emerging market, a country is embarking on an economic reform program that will eventually lead to stable economic growth, as well as transparency and efficiency in capital markets.

One key characteristic of emerging market economies is an increase in both local and foreign direct investment. Growth in investment often indicates that a country has been able to build confidence in the local economy. Furthermore, foreign investment is a sign that the world has started to take notice of the emerging market. Capital inflows and the injection of foreign currency support the country's stock market and the development of infrastructure.

For foreign investors, emerging market economies may provide a platform for expansion courtesy of lower labor costs and new sources of revenue. For the recipient country, employment levels rise, labour and management skill levels become more refined, and a transfer or sharing of knowledge technology occurs. Looking forward, emerging market GDP should subsequently rise and the development gap between them and their developed world counterparts should lessen. The World Bank reported in 2003 that six of the top 10 world spenders on information and communications technology (spending measured as a percentage of GDP) were emerging markets. If spending on technology is used as a forward-looking indicator for future productivity, then this report bodes well for emerging market economies.

The transition to a developed status comes with many potential hurdles and, accordingly, investment risk. For the investors, there are risks related to currency fluctuations (which apply to any unhedged international exposures), foreign exchange controls, and adverse social and political developments. In markets such as China and Russia, there are particular issues relating to weak property rights. Furthermore, the securities markets of emerging market countries are substantially smaller, less developed, less liquid, and more volatile than those of more developed countries.

Does Economic Growth Imply Share Market Growth?

Emerging markets tend to be characterised by high levels of economic growth. Table 9 shows that emerging markets outperformed developed markets by an average of 1.1% p.a. between 1990 and 2003.

Table 9
Economic Growth—Developing versus Developed Markets

	Average Annual GDP Growth 1990 - 2003
Emerging Markets	3.7%
Developed Markets	2.6%

Note: Emerging Markets defined as countries with per capita income <US$10,000 p.a. Developed Markets defined as countries with per capita income >US$10,000 p.a. Source: World Bank.

Table 10 shows that developed markets have a higher level of share market capitalisation as a proportion of GDP than do emerging markets. Although emerging markets substantially increased their level of capitalisation levels from 1990 to 2003, they still significantly lag the developed markets. This lag reflects the vastly different levels of asset securitisation between the two markets and that economic growth may not immediately be reflected in share market growth. As public listing of companies continues to grow in emerging markets, it is likely that the gap between the two markets' securitisation levels will narrow.

Table 10
Relative Capitalisation of Sharemarkets—Developing versus Developed Markets

Share market capitalization as % of GDP	1990	2003
Emerging Markets	18.8	43.5
Developed Markets	51.6	100.1

Note: Emerging Markets defined as countries with per capita income <US$10,000 p.a. Developed Markets defined as countries with per capita income >US$10,000 p.a. Source: World Bank.

Depository Receipts

An alternative way managers may gain exposure to individual stocks in emerging markets is to purchase an American depository receipt (ADR) or a global depository receipt (GDR). An ADR is a negotiable certificate issued by a U.S. bank representing a share in a foreign stock that is traded on a U.S. exchange. ADRs are denominated in U.S. dollars, with the underlying security held by a U.S. financial institution. GDRs are very similar to ADRs but are issued by non-U.S. banks.

For those who hold an ADR, dividends and capital gains are realised in U.S. dollars, but ADRs do not eliminate the currency and economic risks for the underlying shares in another country. Emerging market companies that have ADRs are subject to the Sarbanes-Oxley Act on corporate governance, which provides minority investors greater recourse in the event of a conflict. Accordingly, many managers have greater comfort in gaining access to companies in this way. There are also practical reasons to invest in ADRs because managers can obtain stock and country exposure without the need to set up operating licenses in each market that they wish to invest in.

Which Benchmark?

For the GEM peer group, the predominant index in use by managers is the MSCI Emerging Markets Index (A$). This index includes 26 countries. Because S&P is an index provider, it uses S&P/Citi indices as benchmarks for the respective peer groups in this sector review (i.e. what fund performance is compared with in premium fund reports). S&P acknowledges that it and MSCI have differing methodologies for categorising constituent members and their respective weightings in indices and that this will lead to performance differences.

A key difference is the classification of South Korea. S&P considers South Korea to be a developed country, whereas MSCI classifies it as an emerging country. Because most managers in the sector review use the MSCI index, South Korea is included in their investable universe. Table 11 highlights the differing regional exposures of the S&P/Citi BMI Emerging Markets Index and MSCI Emerging Markets Index and the impact of the exclusion of South Korea (the largest individual country in the MSCI index). The most obvious difference is that the S&P/Citi has a much lower exposure to Asia than MSCI.

Table 11

Regional Exposure of the S&P/Citi BMI Emerging Markets Index vs MSCI Emerging Markets Index as at January 2006

	S&P	MSCI
Asia Pacific Emerging	43%	54%
Latin America	23%	20%
European Emerging	15%	11%
Mid-East and Africa	19%	15%

Source: S&P/Citi & MSCI.

For the Asia ex Japan peer group, the two predominant indexes in use by managers are:

- MSCI All Countires Far East ex Japan Index (A$); and
- MSCI All Countries Asia ex Japan Acc Index (A$)

The main difference between the indices is that the MSCI All Countries Asia ex Japan Index includes India. Of the Asia ex-Japan managers included in this sector review, Aberdeen, Advance (MBA), and BT (Putnam) currently invest in India, and Schroder has advised that it will commence doing so in early 2006. For this peer group, S&P has used the S&P/Citi Asia Emerging +SI +HK Index as the peer group benchmark. Again, the key difference between this index and the two MSCI indices in use is that South Korea is not included in the S&P/Citi index.

The MSCI China Index is used by all three China Funds in this review. For this peer group S&P have used the S&P/Citi China Index as the peer group benchmark.

Singapore and Hong Kong

The Asia ex-Japan managers included in this review typically invest in the developed markets of Singapore and Hong Kong. At benchmark weight, these two countries would together comprise approximately 25% of a portfolio. In constructing relevant and meaningful peer groups, S&P decided that Asia ex-Japan managers were a 'better fit' in the international equities emerging markets peer group than in a developed market peer group. This decision was made because most exposure in this peer group was typically in emerging market countries.

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