

AGF INVESTMENT INSIGHTS

EMERGING MARKETS: The Three Pillars of Future Growth

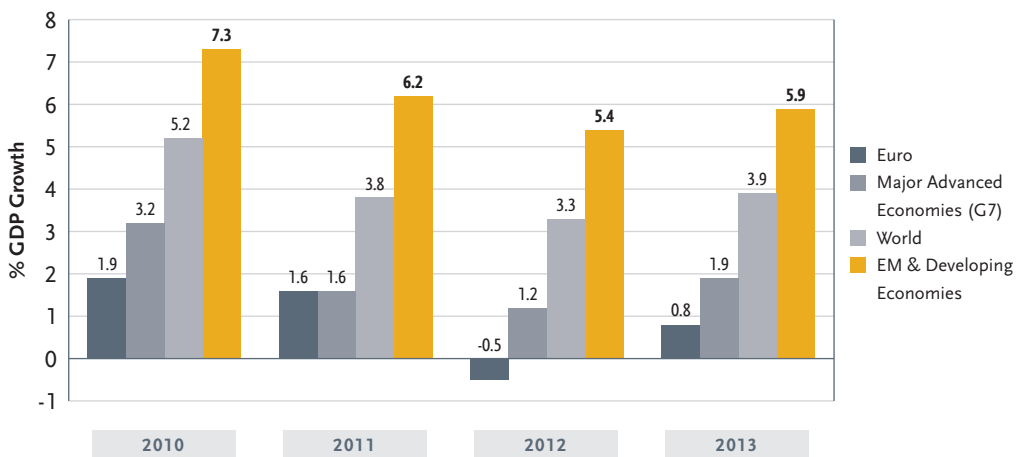


A dramatic and fundamental change has occurred in the global economy during the last decade. Emerging market countries have experienced stunning growth as the developed world struggles under the weight of rising public debt. We believe investors that do not respond to this shifting economic reality risk missing out on significant growth opportunities for their portfolio.

Foundations for Growth

By far, the biggest driver of expansion in emerging market economies comes from basic demographics – massive population growth and the subsequent rise of a robust and savings-oriented middle class. These factors are rapidly transforming developing nations into dominant players on the global economic stage. Exhibit 1 below shows how emerging market growth rates are expected to remain higher than the rest of the world.

EXHIBIT 1: EM Growth Expected to Outperform Other Markets



Source IMF, World Economic Outlook update, January 24, 2012. % change year-over-year, annualized

Strong domestic growth is evident not just in the leading growth economies like China, India and Brazil, but also in smaller growth economies like Mexico, South Africa and Turkey (see Exhibit 2). However, stock markets have not always reflected the new reality, particularly in the last year, when European sovereign debt concerns and fears of a U.S. slowdown contributed to a divergence between valuations and fundamentals. Such divergence presents a compelling opportunity for investors to add EM exposure to their portfolios.

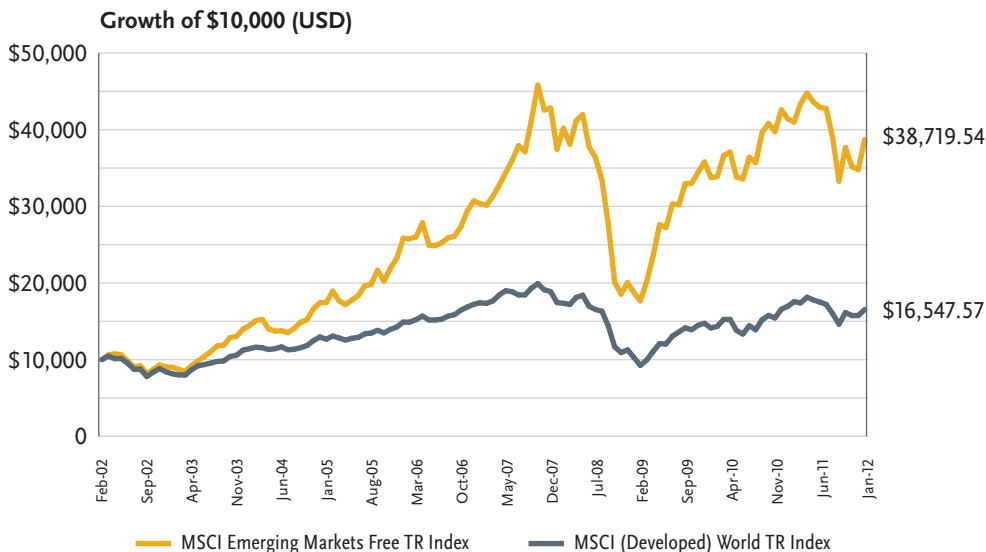
Investors in EM should always look beyond short-term performance for the long-term growth opportunity in EM. For example, the MSCI Emerging Market Index posted a one-year return of 79.0% in 2009 – more than double the MSCI Developed Index return of 30.8% following the global financial crisis in 2008. Despite short-term shocks, emerging markets have outperformed developed markets over the last ten years (see Exhibit 3). This ‘decoupling’ from the developed world has been a game changer on the global stage, as these countries begin to develop their own thriving consumer base domestically.

EXHIBIT 2: Economic Growth versus Stock Market Returns (%)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Brazil											
GDP growth	1.32	2.66	1.15	5.71	3.16	3.96	6.09	5.16	-0.65	7.49	3.77
MSCI Brazil	-21.77%	-33.78%	102.85%	30.49%	49.96%	40.52%	75.35%	-57.64%	121.25%	3.78%	-24.85%
China											
GDP growth	8.29	9.10	10.00	10.10	11.30	12.70	14.20	9.60	9.22	10.33	9.47
MSCI China	-26.05%	-16.13%	80.27%	-0.71%	15.65%	78.68%	63.54%	-52.23%	58.86%	2.59%	-20.41%
India											
GDP growth	3.89	4.56	6.85	7.59	9.03	9.53	9.99	6.19	6.77	10.09	7.84
MSCI India	-18.57%	5.33%	65.49%	10.96%	40.17%	46.47%	52.49%	-56.82%	91.51%	14.74%	-26.33%
Mexico											
GDP growth	-0.92	0.08	1.37	4.03	3.18	5.15	3.24	1.19	-6.16	5.42	3.79
MSCI Mexico	15.93%	-15.04%	29.82%	44.98%	45.22%	39.04%	9.28%	-43.98%	53.07%	25.99%	-13.46%
Peru											
GDP growth	0.22	5.02	4.04	4.98	6.83	7.74	8.91	9.80	0.86	8.79	6.25
MSCI Peru	15.26%	26.77%	88.39%	-0.22%	28.51%	52.13%	86.00%	-42.40%	69.30%	49.24%	-23.89%
Russia											
GDP growth	5.09	4.74	7.25	7.15	6.39	8.15	8.54	5.25	-7.80	4.00	4.29
MSCI Russia	53.17%	13.87%	70.31%	4.07%	69.50%	53.71%	22.88%	-74.16%	100.32%	17.18%	-20.95%
South Africa											
GDP growth	2.74	3.67	2.95	4.56	5.28	5.60	5.57	3.58	-1.68	2.84	3.40
MSCI South Africa	26.33%	-11.83%	8.82%	18.72%	39.63%	30.34%	11.20%	-18.81%	22.18%	17.42%	0.94%
Turkey											
GDP growth	-5.70	6.16	5.27	9.36	8.40	6.89	4.67	0.66	-4.83	8.95	6.59
MSCI Turkey	43.85%	-27.54%	88.23%	32.89%	51.94%	-4.85%	40.72%	-51.78%	86.46%	21.53%	-22.42%

* International Monetary Fund, World Economic Outlook Database, September 2011. Annual price returns for MSCI indexes

EXHIBIT 3: Emerging Markets Continue to Outperform Developed Markets



Source: Bloomberg, as of January 31, 2012

Emerging economies have also taken hard-learned lessons from the 1990s – countries have worked to bolster their capital markets through reforms and regulations. These markets are now far more regulated and benefit from rising foreign direct investment and investment inflows from beyond their borders.

Because of their shifting role in global finance, emerging markets are of vital importance from an asset allocation perspective. The decoupling phenomenon we are seeing in these economies has helped their markets not only survive but also recover far more quickly from the global financial crisis. Today, emerging markets represent a unique opportunity to diversify, manage risk and achieve excess relative returns throughout various market conditions. Correlations between emerging markets and their developed market peers are still low and this provides a key benefit for investors seeking diversification in an increasingly correlated global marketplace.

Three Pillars of Future Growth

There are three main pillars which we believe will drive performance in the coming years: decreasing risk premium, sustainable growth and innovation.

Decreased risk premium

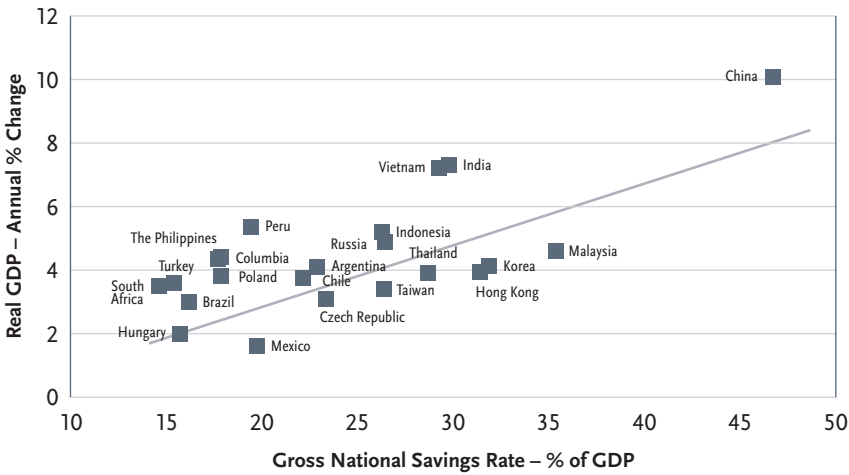
The fundamentals that have led to growth and stability in emerging markets (i.e. high savings rates, better regulation and a growing middle class) have significantly decreased the risk premium. Volatility is now in line with developed markets and even during the credit crisis the risk premium in emerging markets remained at comparable levels to more developed regions. Today, the kind of speculation and short-term credit that touched off disasters like the Mexican peso crisis (1994) and the 1998 Brazilian currency crisis have given way to a solid capital base and strong, stable fund flows that make these markets far less susceptible to such risks. Specifically, Brazil, Indonesia, Colombia and Malaysia have followed macro policies that have reduced systemic risk. At the same time, developed countries themselves have experienced a massive systemic failure and are paying the price for it – evidence that regulatory risk is not just limited to developing economies.

Sustainable growth

As we have seen, the big story coming out of emerging markets stems from a pivotal shift in global economic growth and demographics, as developed markets stagger under the weight of huge debt levels and emerging market countries grow and thrive under very different conditions. Populations are saving, governments are investing in infrastructure and emerging market companies are investing in capital spending. This is a remarkably different picture than we see in the developed world, where austerity measures and persistent unemployment are dragging down growth in the U.S. and Europe.

Growth in emerging markets is also sustainable: it is being driven by their ability to produce and sustain long-term demand amongst their own populations – populations that are better at saving and are now able to consume. Consumer spending in emerging markets has already topped that of the U.S. and savings rates remain very high, an average of 20 to 25%. Past experience from the developing world has shown a clear correlation between savings rates and economic growth and this has certainly been the case for China (Exhibit 4).

EXHIBIT 4: GDP Growth Driven By Savings Rates in Emerging Markets



Note: All series shown smoothed. From: Economist Intelligence Unit.

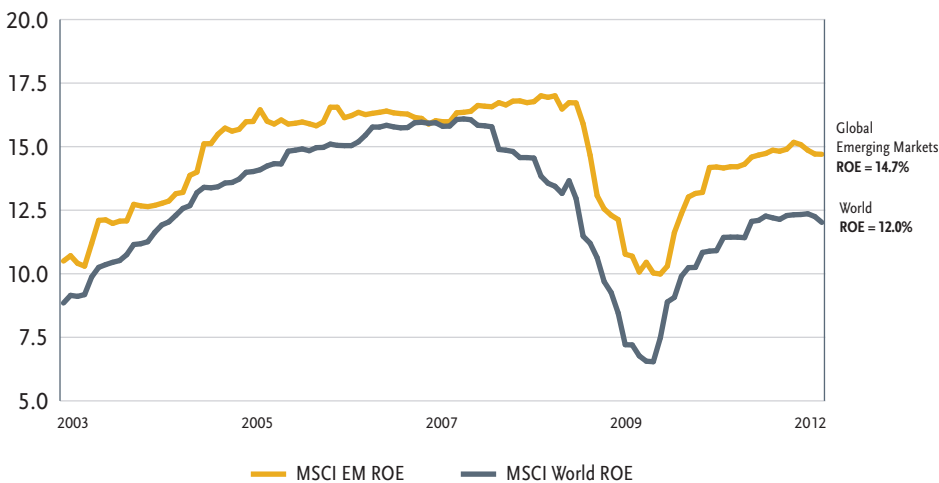
Source: BCA Research, October 15, 2010

Savings and investment, along with stronger capital spending, are key variables that make the emerging markets growth story so compelling. Moreover, very few emerging economies saw investment spending contract at all during the global credit crisis.

At the company level, improved balance sheet quality and rising profitability from strong domestic demand have facilitated greater productivity through investment in capital. This has contributed to a boost in return on equity (ROE) over the last ten years. As these companies continue to grow, it is expected that the spread between developed and developing market ROE will widen further (see Exhibit 5).

Clearly both micro and macro factors are working in favour of continued growth in emerging markets.

EXHIBIT 5: Emerging Markets Return on Equity to Outperform



Source: Credit Suisse, January 31, 2012

Innovation

Emerging market economies have transformed into centres of business innovation as companies find new ways to produce products and services more cheaply and efficiently than their counterparts in developed markets (notably, India's Tata Motors now produces the world's cheapest car). To make this happen, emerging market companies are redefining how they do business and produce and distribute goods. Emerging market multinationals are now global leaders in nearly every industry, including the fields of science and technology. India's Infosys and TCS are two of the world's leading information technology companies while China's Haier is the fourth biggest home appliance company in the world (source: The Economist, June 2011). Emerging nations are developing brainpower domestically by pouring resources into education – every year, China produces 75,000 people with higher degrees in engineering or computer science and India 60,000 (source: The Economist).

Innovation is also dramatically changing the size and depth of the marketplace and access to wireless technology across huge emerging market populations has opened up opportunities for explosive growth. The proliferation of mobile networks is giving people in these regions their first touch point for the global economy, allowing them to become more informed consumers. A recent McKinsey report noted that every 10% increase in cell phone penetration in India corresponds to a 0.6% rise in the national GDP. In the emerging world, this is happening on a massive scale.

The emerging markets story is about the future of capital markets and the global economy. As emerging markets evolve into centres of finance and innovation, institutional investors will need to address the importance of emerging markets and the potential effect on long-term return in their global equity portfolios. To do this, however, they must ensure that they diversify and access experts that really know these marketplaces and their opportunities – and risks. We believe emerging markets are in the most exciting phase of growth and development in our lifetime – and we urge investors to learn more about them and the benefits they offer for the long term.

Brazil

NAME: Federative Republic of Brazil
 CAPITAL: Brasilia
 GDP CURRENT PRICES: \$2.5 trillion
 GDP GROWTH: 3.8%
 CURRENCY: Brazilian real
 INFLATION: 6.6%
 POPULATION: 195 million
 CURRENT ACCOUNT DEFICIT: \$58 billion
 MARKET CAPITALIZATION: \$1.5 trillion



Russia

NAME: Russian Federation
 CAPITAL: Moscow
 GDP CURRENT PRICES: \$1.9 trillion
 GDP GROWTH: 4.3%
 CURRENCY: Russian rouble
 INFLATION: 8.9%
 POPULATION: 142 million
 CURRENT ACCOUNT SURPLUS: \$104 billion
 MARKET CAPITALIZATION: \$1 trillion



India

NAME: Republic of India
 CAPITAL: New Delhi
 GDP CURRENT PRICES: \$1.8 trillion
 GDP GROWTH: 7.8%
 CURRENCY: Indian rupee
 INFLATION: 10.6%
 POPULATION: 1.2 billion
 CURRENT ACCOUNT DEFICIT: \$40 billion
 MARKET CAPITALIZATION: \$1.6 trillion



China

NAME: People's Republic of China
 CAPITAL: Beijing
 GDP CURRENT PRICES: \$7 trillion
 GDP GROWTH: 9.5%
 CURRENCY: Chinese yuan
 INFLATION: 5.5%
 POPULATION: 1.5 billion
 CURRENT ACCOUNT SURPLUS: \$361 billion
 MARKET CAPITALIZATION: \$1.8 trillion



Sources: International Monetary Fund, World Bank, as of February 2012

TORONTO

BOSTON

DUBLIN

HONG KONG

BEIJING

SINGAPORE

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