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Looking Beyond Traditional Benchmarks to Add Value in Emerging Markets

INTRODUCTION

As emerging markets have grown in size and importance, emerging market equities have become a core part of many portfolio allocations. In addition, the increased diversity and liquidity of emerging equity markets have made strategies commonly used to manage developed market portfolios (such as tactical allocations across regions and size segments) much more accessible to emerging market investors.

Despite these trends, the use of more complex asset allocation strategies within emerging market equities remains quite limited, as the vast majority of market participants continue to gain exposure to this asset class either via index-linked products that track traditional benchmarks or through active managers with mandates closely tied to those benchmarks. While accessing emerging markets through a single holding linked to a conventional benchmark can be an effective, low-cost way to obtain unbiased exposure to this asset class, evidence indicates that using a more discerning approach to managing emerging market portfolios may potentially add value in the same ways it can in the U.S. and other developed markets.

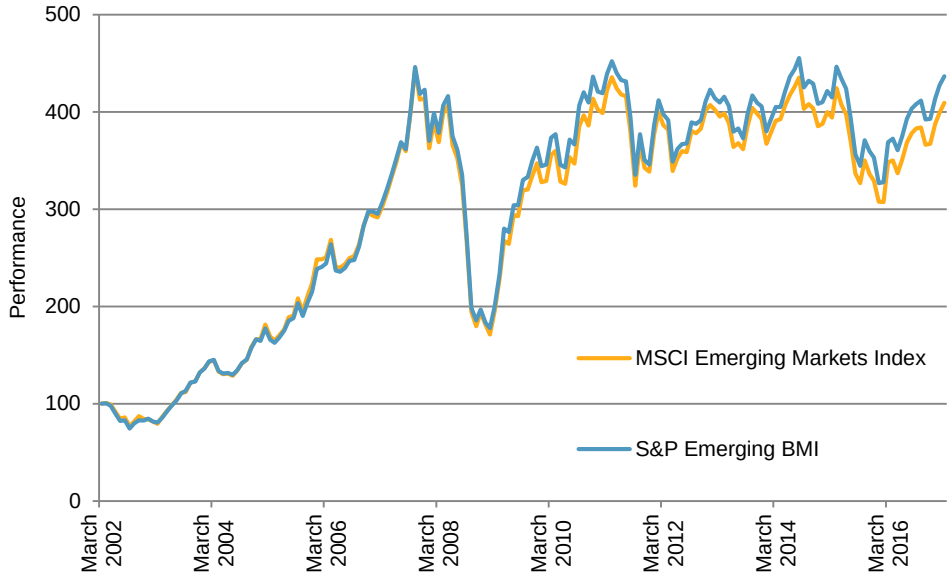
While most broad emerging market benchmarks tend to be highly correlated, there are methodological differences that can result in substantive performance differentials over time.

ALL EMERGING MARKET BENCHMARKS ARE NOT CREATED EQUAL

While most broad emerging market benchmarks tend to be highly correlated, there are methodological differences that can result in substantive performance differentials over time. Therefore, it is important to understand how emerging market benchmarks are constructed. For example, in the trailing 15-year period ending March 31, 2017, the S&P Emerging BMI gained 437% on a cumulative total return basis, while the MSCI Emerging Markets Index gained a comparatively smaller 409% for the same time period. Analysis shows that the difference in performance was driven by two main factors. First, the MSCI Emerging Markets Index has an approximate weight of 16% in South Korea, while South Korea has been ineligible for the S&P Emerging BMI since 2001, when it was reclassified as a developed market. South Korea has underperformed 11 of the 16 countries that have been classified as emerging markets by S&P

Dow Jones Indices over the 15-year period studied. Second, the S&P Emerging BMI has significantly broader coverage, including large-, mid-, and small-cap stocks, while the MSCI Emerging Markets Index includes only large- and mid-cap stocks. Over this period, the S&P Emerging SmallCap outperformed the S&P Emerging LargeMidCap by more than 168%.

Exhibit 1: The S&P Emerging BMI Has Outperformed the MSCI Emerging Markets Index Over Time



Source: S&P Dow Jones Indices LLC, MSCI. Data from March 31, 2002, through March 31, 2017. Chart is provided for illustrative purposes. Past performance is no guarantee of future results.

Emerging market small-cap stocks have distinct investment characteristics from their large- and mid-cap counterparts.

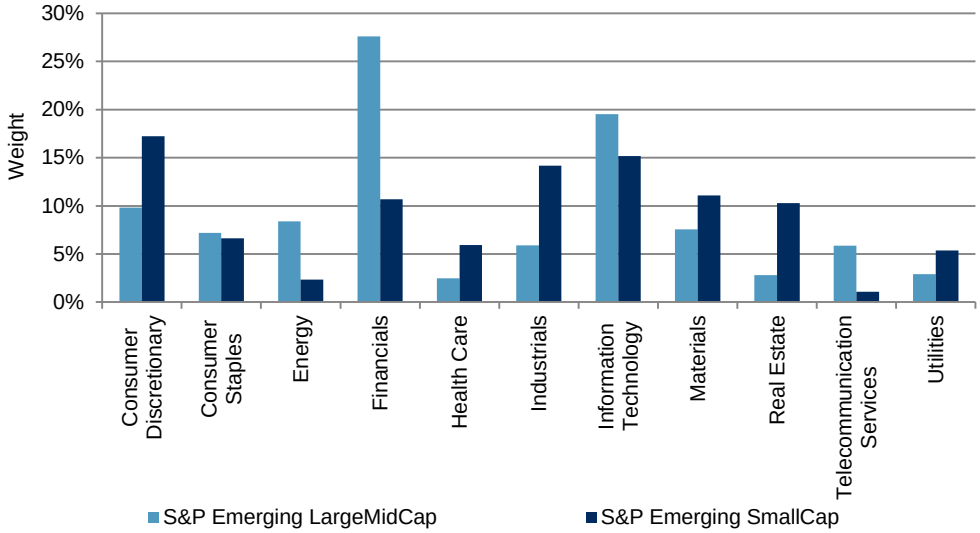
ARE EMERGING MARKET SMALL CAPS OVERLOOKED?

The exclusion of small caps from the MSCI Emerging Markets Index raises an important issue.[1] Since many market participants access emerging markets via an index-linked product tracking this index or through active managers whose mandates are closely tied to this benchmark, they, perhaps inadvertently, may not have exposure to emerging market small caps. Emerging market small-cap stocks have distinct investment characteristics from their large- and mid-cap counterparts (apart from their smaller size).

As illustrated in Exhibit 2, large- and mid-cap stocks are typically concentrated in financials and export-oriented sectors, such as energy and materials, which tend to be largely driven by global market forces. On the other hand, emerging market small caps have higher weights in consumer discretionary, consumer staples, health care, and utilities, which are more closely associated with domestic economic activity.

[1] It is important to note that some widely used indices, such as the MSCI Emerging Markets Investable Market Index, do include small caps.

Exhibit 2: Comparative Sector Weights for the S&P Emerging SmallCap and S&P Emerging LargeMidCap

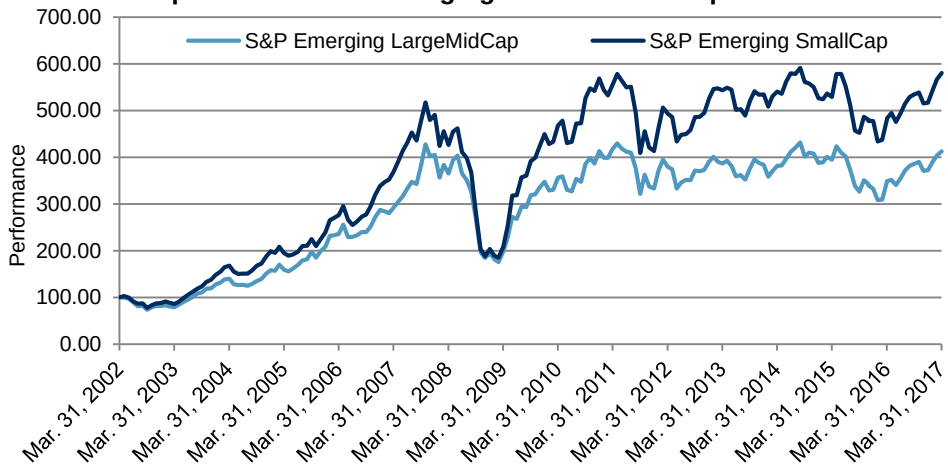


Source: S&P Dow Jones Indices LLC. Data as of March 31, 2017. Chart is provided for illustrative purposes.

Emerging market small caps have performed well over the long term, and while highly correlated to them, have exhibited significant performance differentiation from large and mid caps.

Emerging market small caps have performed well over the long term, and while highly correlated to them, have exhibited significant performance differentiation from large and mid caps. Over the past 15 years, the S&P Emerging SmallCap returned an annualized 12.4%, outpacing the 9.9% compound annual growth rate of the S&P Emerging LargeMidCap, at a modestly higher level of volatility (15-year annualized standard deviation of 23.0% versus 21.2%). Performance since the end of the financial crisis has been particularly distinct. In fact, since the beginning of March 2009, the S&P Emerging SmallCap had a cumulative return of 213%, outpacing the 135% cumulative total return of the S&P Emerging LargeMidCap. This has been at least partially reflective of the sector differences across the size ranges, as consumer staples and consumer discretionary were sector leaders, while energy lagged.

Exhibit 3: Outperformance of Emerging Market Small Caps



Source: S&P Dow Jones Indices LLC. Data from March 31, 2002, to March 31, 2017. Chart is provided for illustrative purposes. Past performance is no guarantee of future results.

Although performance differentials between size ranges are, to some extent, driven by differences in sector and geographic allocations, there is compelling evidence of a small-cap premium in emerging markets. Over the past 15 years, small caps have outperformed large and mid caps across all major regions and across 7 of 10 sectors, as depicted in Exhibits 4 and 5.

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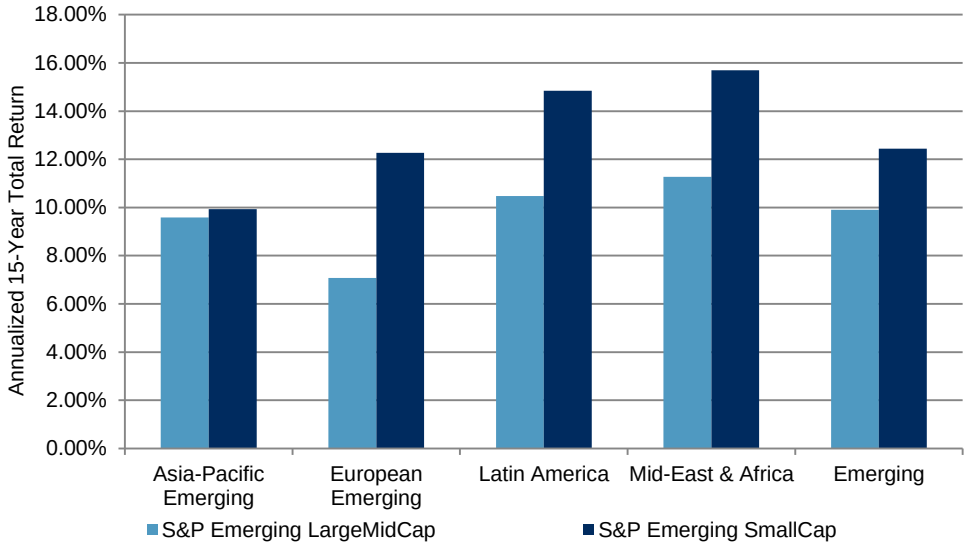
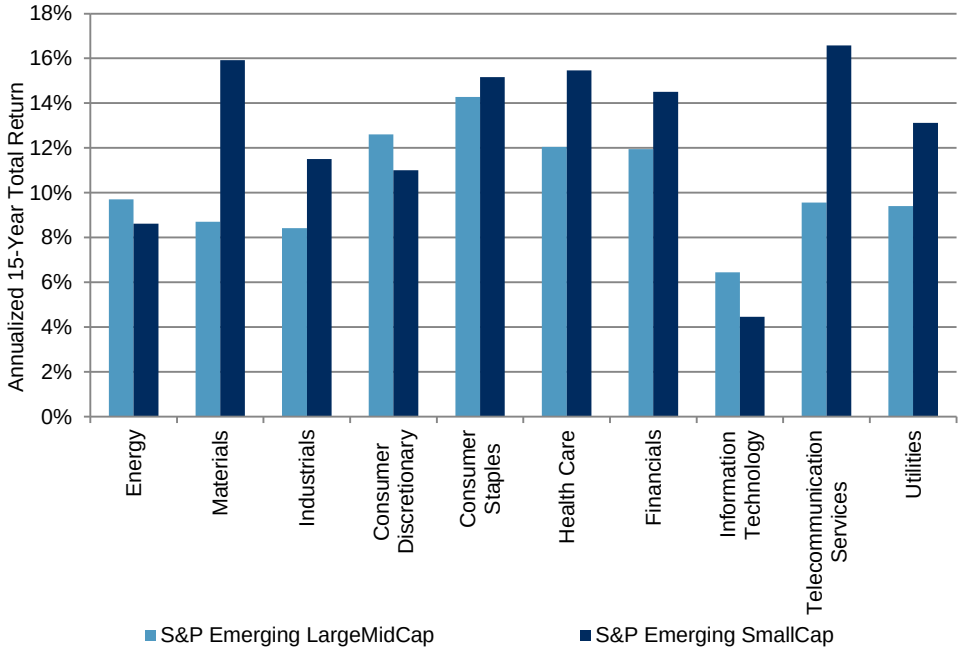
Exhibit 4: Small Cap Outperformance Across Emerging Market Regions



Source: S&P Dow Jones Indices LLC. Data as of March 31, 2017. Chart is provided for illustrative purposes. Past performance is no guarantee of future results.

Exhibit 5: Small Cap Outperformance Across Emerging Market Sectors



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EMERGING MARKETS ARE NOT HOMOGENOUS

Although emerging markets tend to be viewed as a single asset class, there are significant differences across countries and regions within the group. Emerging markets vary greatly in their level of economic development, their level of political risk, the types of companies that drive their economies, and many other important factors.

One way of taking a more tactical approach to emerging market investing is to view emerging markets by regional groupings.

One way of taking a more tactical approach to emerging market investing is to view emerging markets by regional groupings. As illustrated in Exhibit 6, sector weights vary widely across emerging market regions. For example, the Asia-Pacific region has significant exposure to information technology, a sector that has virtually no representation in other emerging market regions. On the other hand, Latin America and Emerging Europe have relatively higher weightings to energy and materials, as these regions are home to natural resource-rich countries such as Russia and Brazil.

Exhibit 6: Regional Emerging Market Sector Weights (%)

SECTOR	ASIA-PACIFIC	LATIN AMERICA	EUROPE	MIDDLE EAST AND AFRICA
Consumer Discretionary	10.15	8.27	5.18	26.42
Consumer Staples	5.22	15.94	6.25	7.55
Energy	5.61	7.61	30.24	0.86
Financials	23.40	28.86	28.04	28.37
Health Care	3.48	1.24	1.01	3.92
Industrials	7.51	7.50	4.94	5.63
Information Technology	27.02	1.54	3.13	0.61
Materials	5.99	14.72	11.19	9.95
Real Estate	3.98	2.79	1.09	7.97
Telecommunication Services	4.97	4.01	4.97	8.32
Utilities	2.66	7.51	3.94	0.39

Source: S&P Dow Jones Indices LLC. Data as of March 31, 2017. Table is provided for illustrative purposes.

These differences tend to translate into large variances in stock market performance across regions, particularly over the short and medium term. As illustrated in Exhibit 7, performance has varied widely across emerging market regions. In the trailing one-year period through March 31, 2017, the S&P Latin America BMI has gained nearly 24%, far outpacing the 10% return of the S&P Mid-East & Africa Emerging BMI.

Exhibit 7: Regional Performance Differentials

REGION	1-YEAR	3-YEAR	5-YEAR	10-YEAR	15-YEAR
EMERGING MARKETS (%)					
Asia-Pacific	19.4	6.4	6.2	6.2	9.6
Europe	17.0	-3.8	-3.9	-3.8	8.1
Latin America	23.9	-3.7	-5.6	1.5	11.3
Middle East and Africa	9.9	-2.1	0.1	3.4	12.1
Difference Between Best and Worst Performer	**14.0**	**10.1**	**11.8**	**10.0**	**4.0**
DEVELOPED MARKETS (%)					
Asia-Pacific	15.8	5.0	6.3	2.5	7.2
Europe	9.8	-0.6	6.6	1.5	6.8
North America	18.0	8.6	11.5	7.1	7.6
Difference Between Best and Worst Performer	**8.2**	**9.1**	**5.1**	**5.6**	**0.9**

Source: S&P Dow Jones Indices LLC. Data as of March 31, 2017. Table is provided for illustrative purposes. Past performance is no guarantee of future results.

The performance differentials between the best- and worst-performing regions have been significantly larger in emerging markets than in developed markets over most periods.

Although it is difficult to predict in advance which regions will outperform, the high variation in performance across countries provides compelling evidence that significant alpha generation is possible by implementing a tactical asset allocation strategy based on geography within the emerging markets. In fact, as illustrated in Exhibit 7, performance differentials between the best- and worst-performing regions have been significantly larger in emerging markets than in developed markets over most periods.

TAPPING INTO THE GROWTH OF THE EMERGING MARKET CONSUMER THEME

The emerging market consumer theme has been highlighted by consultants, investment strategists, and other market participants as a long-term strategy for targeting the organic growth of emerging market economies. Consumption generally represents a relatively small share of economic output in developing economies. However, as these economies achieve greater wealth, consumption typically overtakes investment as the primary driver of economic growth. Large and fast-growing populations, increasing incomes, and lifestyle changes all drive consumption growth in emerging markets as these countries transition to a more mature stage of economic development. Because of this, many believe that consumer companies represent a key opportunity to access growth in emerging markets.

Additionally, accessing emerging market consumption growth is challenging via conventional index solutions, because broad, market-cap-weighted, emerging market benchmarks are dominated by banks and other financial companies, as well as export-oriented sectors such as energy and materials. Given these factors, market participants have demonstrated interest in dedicated exposure to emerging market consumer companies.

The Dow Jones Emerging Markets Consumer Titans 30 Index seeks to measure the performance of 30 leading emerging market companies (excluding those domiciled in Taiwan) that are classified in the consumer goods and consumer services industries, according to the Dow Jones Industry Classification System.

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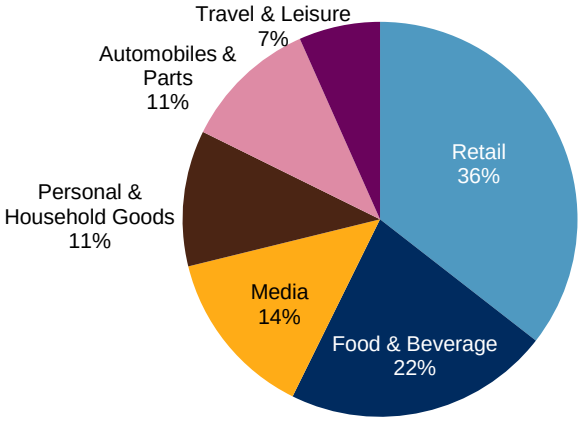
The index tracks a diverse range of companies operating in consumer-oriented industries, from retailers and food & beverage distributers to media companies and automakers. Retail represents the largest portion of the index, at just over one-third of the index weight, followed by food & beverage at around 22% and media at 14% (see Exhibit 8).

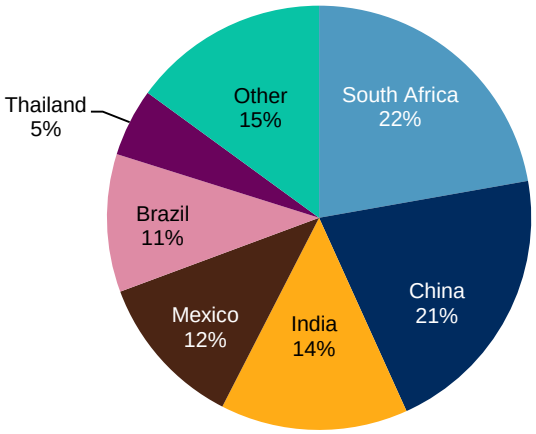
Exhibit 8: Dow Jones Emerging Markets Consumer Titans 30 Index – Supersector Weights



Source: S&P Dow Jones Indices LLC. Data as of March 31, 2017. Chart is provided for illustrative purposes.

As depicted in Exhibit 10, South Africa, China, and India represent the largest country weights in the index. Of note, South Korean and Taiwanese companies are not eligible for inclusion in the index, as the large global consumer companies based in these markets tend to generate a substantial portion of their sales from developed market countries.

Exhibit 9: Dow Jones Emerging Market Consumer Titans 30 Index – Country Weights

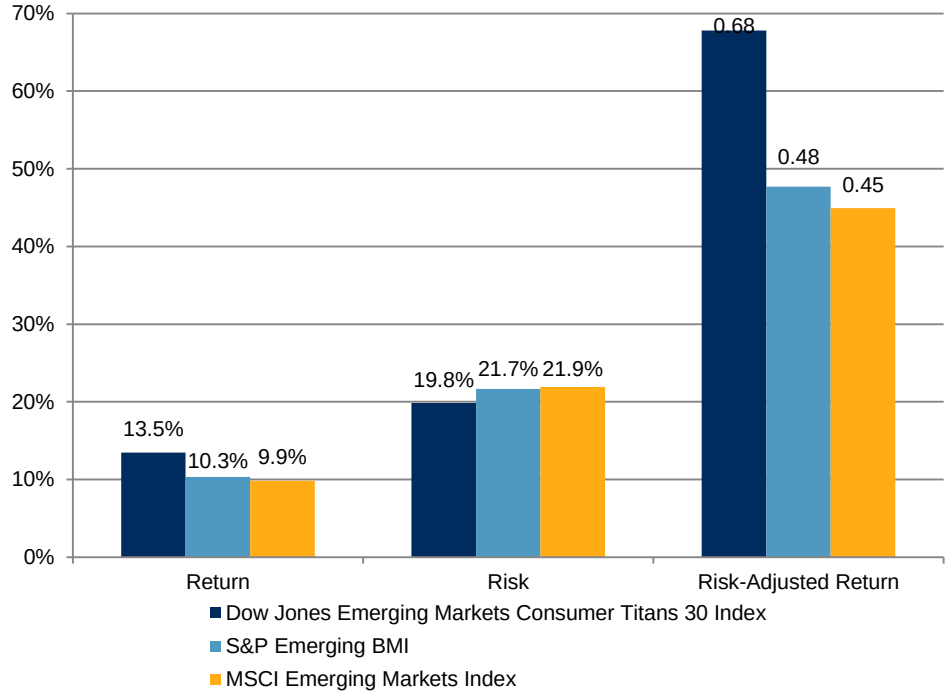


Source: S&P Dow Jones Indices LLC. Data as of March 31, 2017. Chart is provided for illustrative purposes.

Over the long term, the index has demonstrated attractive risk/return characteristics when compared with traditional broad emerging market benchmarks. As illustrated in Exhibit 10, the index significantly outperformed the S&P Emerging BMI and MSCI Emerging Markets Index with lower volatility over the 15-year period ending March 31, 2017, which includes back-tested data prior to the index launch in January 2010.

The significant growth and development of emerging markets has expanded the opportunity set available to market participants.

Exhibit 10: Dow Jones Emerging Markets Consumer Titans 30 Index – 15-Year Comparative Risk/Return Metrics



Source: S&P Dow Jones Indices LLC. Data as of March 31, 2017. Past performance is no guarantee of future results. Chart is provided for illustrative purposes and reflects hypothetical historical performance. Please see the Performance Disclosure at the end of this document for more information regarding the inherent limitations associated with back-tested performance.

CONCLUSION

The significant growth and development of emerging markets has expanded the opportunity set available to market participants. Although index innovation and associated product development have encouraged some members of the investment community to look deeper at opportunities within the emerging markets, the vast majority of assets remain linked directly to index-based products tracking traditional benchmarks (see Appendix). Evidence indicates that taking a more discerning approach to emerging markets investing has the potential to add value.

APPENDIX

Exhibit 11: Investment Products Linked to S&P Emerging Equity Indices

UNDERLYING INDEX	PRODUCT NAME	TICKER
Dow Jones Emerging Markets Consumer Titans 30	Columbia Emerging Markets Consumer ETF	ECON
S&P Emerging BMI	SPDR S&P Emerging Markets ETF	GMM
S&P Asia Pacific Emerging BMI	SPDR S&P Emerging Asia Pacific ETF	GMF
S&P China BMI	SPDR S&P China ETF	GXC
S&P Emerging < $2bn	SPDR S&P Emerging Markets Small Cap ETF	EWX
S&P China 500	CBCCS WisdomTree S&P China 500 UCITS ETF	CHIN
S&P New China Sectors	CSOP S&P New China Sectors ETF	3167
Dow Jones Russia GDR	Direxion Daily Russia Bull 3x Shares ETF	RUSL
S&P Emerging Asia Consumer Index	Horizons S&P Emerging Asia Consumer ETF	3054
S&P BSE Midcap Select	ICICI Prudential Midcap Select iWIN ETF	539980
S&P BSE SENSEX	ICICI Prudential Sensex iWIN ETF	555555
S&P BSE SENSEX	IDFC Sensex ETF	540154
Dow Jones China Offshore 50	iShares Dow Jones China Offshore 50 UCITS ETF (DE)	EXXU
S&P Emerging Markets Infrastructure	iShares EM Infrastructure UCITS ETF	DEIN
Dow Jones Emerging Market Select Dividend	iShares Emerging Markets Dividend	DVYE
S&P Emerging Markets Infrastructure	iShares Emerging Markets Infrastructure ETF	EMIF
Dow Jones Russia GDR	Lyxor PEA Russia (Dow Jones Russia GDR) UCITS ETF	PRUS
Dow Jones Turkey Titans 20	Lyxor PEA Turkey (DJ Turkey Titans 20) UCITS ETF	ETUR
Dow Jones Russia GDR	Lyxor Russia (Dow Jones Russia GDR) UCITS ETF	RUS
Dow Jones Russia GDR	Lyxor Russia (Dow Jones Russia GDR) UCITS ETF	JC7
Dow Jones Turkey Titans 20	Lyxor Turkey (DJ Turkey Titans 20) UCITS ETF	TUR
S&P BMI Emerging Markets Low Volatility	PowerShares S&P Emerging Markets Low Volatility Portfolio ETF	EELV
S&P Momentum Emerging Plus LargeMidCap	PowerShares S&P Emerging Markets Momentum Portfolio ETF	EEMO
S&P Emerging Markets Dividend Opportunities	SPDR® S&P Emerging Markets Dividend ETF	EDIV
Dow Jones Turkey Large-Cap Banks	Turkey Large-Cap Banks ETF	BNKTR

Source: S&P Dow Jones Indices LLC. Table is provided for illustrative purposes. S&P Dow Jones Indices does not sponsor, promote, or endorse any investment product linked to any of our indices. The above is a complete list of all products that were linked to the indices discussed in this report as of March 31, 2017.

PERFORMANCE DISCLOSURE

The Dow Jones Emerging Markets Consumer Titans 30 Index was launched on January 8, 2010. All information presented prior to an index's Launch Date is hypothetical (back-tested), not actual performance. The back-test calculations are based on the same methodology that was in effect on the index Launch Date. Complete index methodology details are available at www.spdji.com.

S&P Dow Jones Indices defines various dates to assist our clients in providing transparency. The First Value Date is the first day for which there is a calculated value (either live or back-tested) for a given index. The Base Date is the date at which the Index is set at a fixed value for calculation purposes. The Launch Date designates the date upon which the values of an index are first considered live: index values provided for any date or time period prior to the index's Launch Date are considered back-tested. S&P Dow Jones Indices defines the Launch Date as the date by which the values of an index are known to have been released to the public, for example via the company's public website or its datafeed to external parties. For Dow Jones-branded indices introduced prior to May 31, 2013, the Launch Date (which prior to May 31, 2013, was termed "Date of introduction") is set at a date upon which no further changes were permitted to be made to the index methodology, but that may have been prior to the Index's public release date.

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Another limitation of using back-tested information is that the back-tested calculation is generally prepared with the benefit of hindsight. Back-tested information reflects the application of the index methodology and selection of index constituents in hindsight. No hypothetical record can completely account for the impact of financial risk in actual trading. For example, there are numerous factors related to the equities, fixed income, or commodities markets in general which cannot be, and have not been accounted for in the preparation of the index information set forth, all of which can affect actual performance.

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