Whitepaper

Growth Markets: Playbook for Success

September 2011

“The West has been trying to sell to China since we arrived there in 1820. People think: ‘One billion people – if we can sell each person one pair of shoes, we’ll be rich.’ “

Large global manager. May 2011

Table of Contents

Introduction

With slowing GDP growth and competitive home markets, Western asset managers are increasingly lured by emerging markets. When thinking about growth markets, the sheer size of the population and growth potential has always mesmerised Western investors: they imagine that even a small penetration of these markets can result in a huge creation of wealth. The reality is, of course, very different, with China as a great case in point; throughout history, many have tried and failed to enter the Middle Kingdom market successfully. In this white paper, we argue that, despite their undeniable allure, emerging markets are fraught with pitfalls. However, with the right approach, we believe that investment managers can navigate these challenges and build a successful global business.

Executive summary

The fact that emerging and frontier markets have great potential is undeniable. Yet, these markets can be quite volatile and illiquid, and foreign investors may have limited access. Accounting conventions and political instability also pose significant risk.

There is no straightforward recipe for distribution success. Assuming open architecture even exists, distribution can be quite concentrated and unwelcoming to new foreign entrants. Joint ventures can help overcome lack of brand recognition and provide a local partner on the ground, yet such partners may have competing goals and must be chosen wisely.

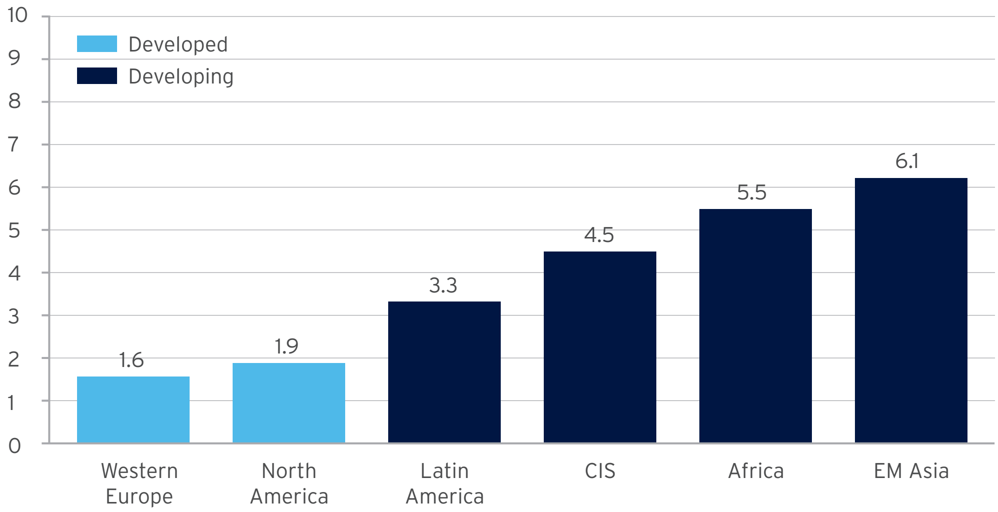
While there are no guarantees for success, we believe that five key principles should be recognised as preconditions for success. Asset managers should choose a clear strategy, think locally, plan for the long haul, recognise that distribution is king, and stay true to their philosophy.

Beyond these five guiding principles, managers may wish to embrace forward-thinking ideas in their plans for future growth. These include thinking at a city, rather than a country or regional, level; considering large institutions as "virtual countries"; and better utilising service providers to facilitate low-cost entry.

Growth is real but so are the challenges

The growth potential of emerging markets is unquestionable. For example, since its inception in March 2005 through September 2011, the Vanguard Emerging Markets ETF has compounded over 51%, versus a -4% return for the S&P 500 index. But this is not just a backward-looking story: owing to young populations (providing cheap labour and lower healthcare costs), developing infrastructure and a rapidly emerging middle class, many emerging economies continue to outpace developing markets and are expected to do so going forward. For instance, we project that real GDP per capita will grow at 6.1% in emerging Asia and 5.5% in Africa versus just 1.9% in North America and only 1.6% in Western Europe annualised through 2030.

Real GDP per capita growth, 2010-2030 (%)



Source: Citigroup Global Markets, June 2011.

Critical mass, volatility and governance pose challenges

As studies have shown, GDP growth is not necessarily correlated with stock market performance. And even when there is strong the stock market growth, this doesn't always translate to a big opportunity for investment managers – especially foreign managers.

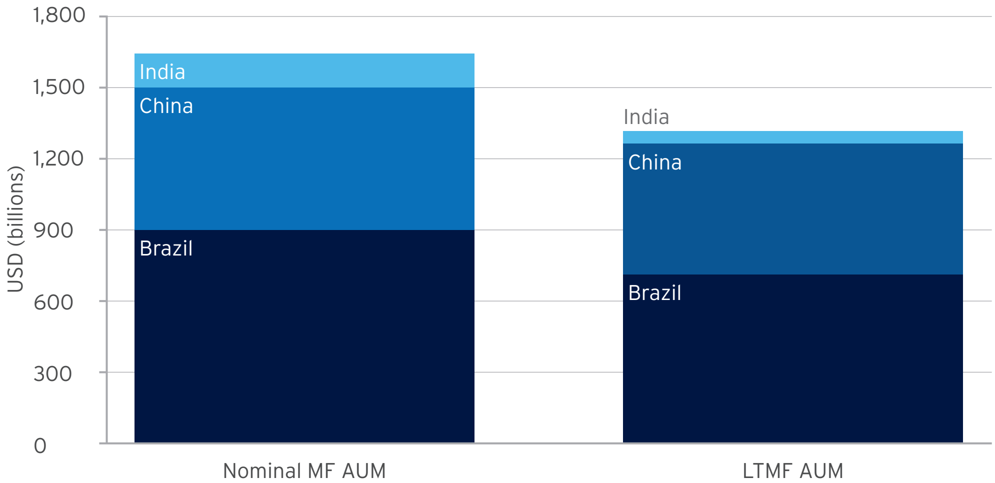
For those looking to build an asset management business in emerging markets, it is important to understand that the current addressable market size is relatively small. After stripping out money markets and other short-term vehicles, BRIC countries (Brazil, Russia, China and India), the largest of the globe's emerging markets, are cumulatively just north of USD 1 trillion in collective fund assets. By comparison, North America alone is close to USD 30 trillion in managed assets.

At the same time, these markets are much more volatile, gauged by quantitative or qualitative measures. For instance, Russia's three-year beta to the MSCI All-Country World Index was 1.67 through May, while the Brazilian market exhibited a beta of 1.39.

Shareholder rights are another issue for asset managers and their clients, since Western accounting standards or bankruptcy rules do not apply. Even where some investor protections do exist, foreign investors may not be on an equal footing with local players.

Political risk is also a major consideration, particularly in the Middle East and the Korean peninsula, but also elsewhere. The lack of free press, untested property rights and other democratic institutions belies a strong state and suggests that intervention is always a moment away. Memories of the Tiananmen Square demonstrations are quite fresh in China; more recently, treatment of Russian entrepreneurs who don't play by unwritten rules is evidence that economic and political freedoms are ephemeral.

Nominal versus addressable market ($)



Source: Cerulli Associates, Citi SFS, June 2011.

Accounting scandals, other headlines highlight risks

Recent headlines also illustrate some of the perils of emerging market investing.

According to Transparency International, Brazil – while rich in population and resources – ranked 69th (with 1st equating to best) out of 178 countries in terms of perceived corruption.

Investors in Vietnam have encountered trouble with Vinashin, and frustration over the state-run shipbuilder's failure to repay loans is intensifying, particularly given an earlier-implied government guarantee.

And a 27-fold rise in the Shanghai index since 1990 has led to opportunistic malfeasance at dozens of companies. Several local and US-listed Chinese companies have suffered a series of high-profile accounting scandals, including Sinoforest and Rino International, the latter's shares frozen at 40 cents.

Many well regarded investment managers have fallen prey to these and other scandals.

No straightforward recipe for success

Whether building or buying, unfortunately, there is no magic bullet for entering growth markets.

Joint ventures (JVs) are often thought of as a way to clear local hurdles, be they distribution or regulation. But JVs can often cause major disagreements in critical junctures of the JV. Moreover, JVs in emerging markets come with limited control: in China, for example, foreign managers may control no more than 49% of the combined entity. A majority stake, combined with superior knowledge of local regulations and distribution, generally give the local partner the upper hand in the relationship. Moreover, partnerships can sometimes run into snags if one of the local players is government owned, and thus has a different set of objectives.

On the other hand, entering independently using your own Western brand has its own issues.

The first consideration is whether or not foreign entry is even allowed. In markets such as India or China, application and subsequent approval for a qualified institutional investor licence are prerequisites to owning local shares; similar approvals are required to distribute funds sold to local investors.

Even when approval is granted, it may be based on a quota system; in China, these allotments average between USD 100 million and USD 200 million, barely enough to run a profitable strategy. In many cases, a Western brand is not a meaningful currency for distribution in emerging markets. Global firms with a sterling reputation elsewhere may find that their brand does not resonate with local investors. If, in fact, open architecture exists at all, homegrown players are likely to have the edge. Moreover, partnerships with distributors might be highly influenced by transactional relationships, requiring the asset manager or its affiliates to trade through or place deposits with the local bank or broker-dealer.

In many cases, a Western brand is not a meaningful currency for distribution in emerging markets

Finally, it is critical to grasp how to operate within the legal and political infrastructure of these markets.

IKEA, the Swedish furniture maker, which has managed to build a global operating model with offices in almost 30 countries, may have underestimated these factors in Russia. Anticipating corruption, the firm refused to pay bribes, only to find the local utility had cut its power. Even after taking preventative measures, such as hiring an outside contractor to provide power generators, IKEA found that these relationships, too, were also corrupt, and eventually, the firm experienced massive delays in acquiring licences for new stores. While IKEA has not pulled up stakes yet, they are now re-examining a multibillion-dollar investment there, and freezing plans to add new stores.

Overcoming challenges: five guiding principles for success

And so the challenges are there, but there is money to be made. From our experience with clients and markets, we believe that there are five guiding principles that an asset manager should follow when entering a growth market. These will not guarantee success, but are necessary conditions for success:

- Choose a clear strategy.
- Think local.
- Plan for the long haul.
- Distribution is king.
- Stay true to your philosophy.

Successful entry starts with a clear strategy

Expansion into emerging markets is obviously an external strategy, yet it should begin with some introspection. Managers should ask themselves, "What are we selling, and to whom?" We see four main approaches for tapping into emerging markets:

- Selling local investment solutions to local investors.
- Selling global investment solutions to local investors.
- Selling local investment solutions to investors around the globe.
- And finally a niche play: focusing on a few large institutions in emerging markets with tailored mandates.

The first of these approaches we might call "local-to-local," and it seems the most simple. Local-to-local is an onshore strategy using local vehicles designed for local tastes. On paper, it seems like the simplest approach – utilise the local collective fund format, and offer a strategy that is in demand. Yet these two necessary steps assume that a foreign manager can both navigate the local regulatory landscape and accurately gauge local investor tastes.

Though these are challenging tasks, a few foreign managers have achieved these goals. Pictet, the Swiss fund manager, is a great case in point. Pictet studied the Japanese market before entering, seeing a conservative, aging society with a need for income. The Swiss firm took note of one of the most successful funds, a yield-oriented bond fund, and emulated the product, adding a blue-chip equity income component and offering attractive dividends in a market known for a chronic yield shortage. Pictet also decided to develop relationships not just with the top five banks, but with secondary banks and securities firms. Despite being a relatively small player on the global stage, Pictet has parlayed its thoughtful approach to product development and distribution into a slot among the top 10 fund houses in Japan.

A second approach for managers wishing to expand into emerging markets is one we might call "global-to-local".

Rather than focus on local solutions in the markets in which it distributes, Korea-based Mirae Asset's approach is to offer nearly universal products – such as its Global Emerging Markets Great Consumer fund – and offer them in the local regulatory structure. Importantly, for Mirae Asset, global-to-local also means that global mandates should also be underpinned by a local investment management presence. This means having portfolio managers, analysts and traders on the ground in markets such as Brazil, as opposed to investing in those securities from the home office.

A third approach is called "local-to-global". This strategy is the least complicated of the four, as it involves taking an existing strategy, possibly in an existing vehicle, and attempting to export it to investors in emerging markets.

Perhaps the most common example is the use of UCITS, the European fund passport, for sales into Asia and Latin America.

Highly regarded for its investor protections, and without the tax trappings of US-based fund solutions, UCITS funds have become welcomed in Asian offshore centres (such as Hong Kong and Singapore) and Latin America (where it is embraced by HNW investors and Chilean pension funds alike).

Yet if UCITS offers simplicity for its suppliers, the vehicle has its limitations: with over 5,200 such vehicles already being sold in Asia, competition is fierce. Moreover, as local wealth management increasingly moves onshore to address mass market investors, the appeal for European-created vehicles is on the wane.

The fourth approach that managers take into emerging markets is a niche solution. In this approach, managers offer highly customised mandates, tailoring portfolio construction and other features (e.g. fee structure) to meet the needs of local clients.

Typically, these solutions will be offered to institutional clients, on whose behalf managers can run bespoke, non-collective portfolios, thus avoiding most local regulatory requirements. Managers such as PIMCO, renown for its fixed income prowess, have taken this approach in expanding into new markets.

Think local: Asia is not homogenous

	CURRENT SIZE	GROWTH POTENTIAL	BEST OPPORTUNITY	EQUITY OWNERSHIP	MARKET ACCESS
CHINA	Medium	High	Institutional	Low	Low
INDIA	Small	High	Retail	Low	Moderate
JAPAN	High	Low	Institutional	Moderate	Moderate
AUSTRALIA	Medium	Moderate	Institutional	High	High

Source: Citi SFS, June 2011.

Think local: Asia is not homogenous

A second pitfall to avoid is crafting a regional strategy rather than a country-based one.

For example, 'Asia' is not one homogenous region, but a mosaic of countries that differ substantially when it comes to all the factors managers should consider when entering a market – be it size and growth or the leading investing sectors (retail versus institutional).

The same is true in Latin America, where Brazil is the largest market, yet Chilean pension funds may be more accessible.

In addition, to borrow a basketball term, there are no "layups" – there is no one country that ticks all the boxes.

Hong Kong, for example, may offer ease of entry via UCITS , yet the offshore market is relatively small and not growing as rapidly as mainland China, which, in turn, remains largely inaccessible.

Any pan-regional strategy would have to incorporate different product preferences, different regulatory structures, require a multilingual salesforce and understand important cultural differences and distribution dynamics.

In short, going after an entire region is very difficult, and very expensive; economies of scale on a regional basis are scarce. Therefore, a smarter strategy is to start small, identifying one or two initial target markets; only after success there should managers attempt a broader regional strategy.

Plan for the long haul, wait for an inflection point

A third principle that managers should consider is to plan for the long haul. As we have already discussed, obtaining regulatory approvals alone could take years; identifying JV or distribution partners can take even longer. Patience is not just a virtue but essential for any emerging market expansion strategy.

Plan for the long haul, wait for an inflection point

Source: Citi SFS, June 2011.

Many local managers believe that European and American entrants are likely to pull out early if their expansion plans do not bear immediate fruit. This is not just mudslinging: a few representatives from Western managers confided that they question their own firms' willingness to stick to the plan when things get rocky.

Given the need to differentiate certain markets we just discussed, timing your entry point becomes critical as managers consider the "readiness" of the country for a functioning asset management industry.

Though it has become fashionable to assume that frontier markets will offer even greater rewards than emerging economies, markets such as Nigeria are still a very long way from developing an asset management industry. It may not payoff to be early here: spending heavily now will likely result in a low NPV, even if eventually the market becomes attractive.

Conversely, Hong Kong and Singapore are well developed, but they are already quite saturated.

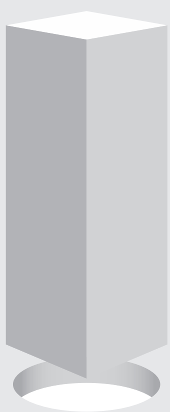
Managers should be on the lookout for "sweet-spot" markets with a well functioning exchange and asset management industry but relatively low penetration by foreign managers.

> Managers should be on the lookout for "sweet-spot" markets with a well functioning exhange and asset management industry but relatively low penetration by foreign managers

South Africa is an example of a country often overlooked, based on where it stands in the development cycle. This market offers the emerging middle class typical of high-growth economies, a large retail and institutional asset management industry and an Anglo-based legal system. Moreover, it is one of the only fund markets to have posted positive net inflows in each of the past five years.

Distribution is king

WESTERN MODEL DOES NOT FIT	SUGGESTED ADJUSTMENTS
Banks continue to dominate distribution.	Partner with gatekeepers and sponsor local events.
Getting shelf space is difficult.	Sales could be contingent on trading, deposits, etc.
IFA channel virtually non-existent.	Recognise unique local channels (ex: door-to-door).
Global brand irrelevant.	May need to co-brand or build brand from scratch.



Source: Citi SFS, June 2011.

Distribution is king

Once an asset manager decides on a strategy and homes in on the right market, the next big challenge to execution is distribution.

If the three biggest words in real estate are "location, location, location," then perhaps in asset management, they are "distribution, distribution, distribution.

Bringing Western distribution models to emerging markets is like putting a square peg in a round hole.

Channels that feature prominently in a manager's home market (e.g. IFAs) will likely not exist in emerging markets. Worse still, the distribution challenge is unique by country, not just by region.

For example, some fund sales in Taiwan are made door-to-door; in China, banks control distribution but branch managers – not the home office –often decide what to put on the shelf. To gain significant market share, asset managers and their affiliates might be asked to place their deposits at the bank and funnel trades through it.

Stay true to your core beliefs

If our message so far has stressed the importance of adapting to local markets, asset managers should not make the opposite mistake. It is imperative for firms not to dilute their culture and investment beliefs.

MFS is a great example of a company that is doing just that, opting on some occasions to forgo certain markets with growth potential in favour of maintaining a consistent strategy and business model. A key guideline for MFS is that if the firm does not want to invest there, then it probably does not want to distribute there either.

Distribution, distribution, distribution

Equally important, MFS prefers to control its own destiny, avoiding JVs as a rule. The Boston-based manager also will not stray far from its key competencies. Although willing to tweak a strategy slightly, especially for institutional clients, MFS will not build a new capability to chase a hot fad.

This is not to say that every manager need follow MFS in lock-step, but this does illustrate that long-term success that can be generated by "sticking to your guns."

New distribution ideas

Although we believe the five key principles outlined above will be helpful for managers targeting emerging markets, we do not claim that these approaches have reinvented the wheel. In the section that follows, however, we propose some additional considerations to help managers push the envelope as they consider their plans for future growth.

Footprint: think city rather than country or region?

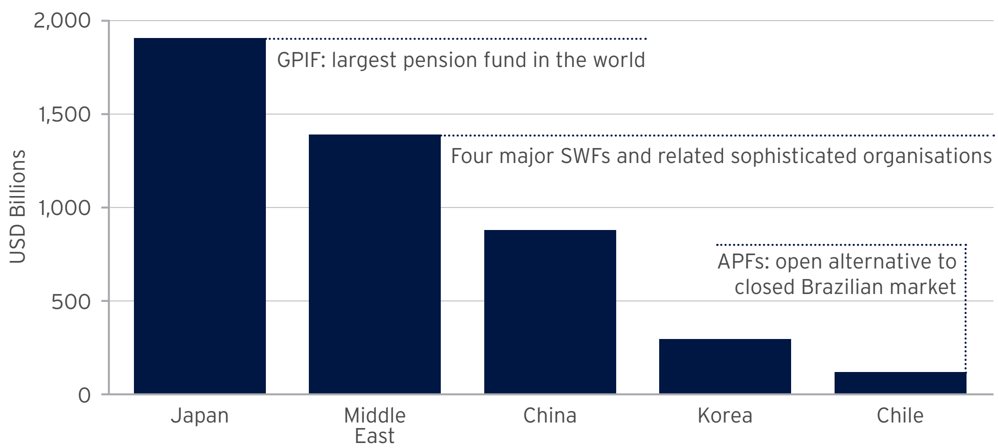
We have just seen that regions are not homogenous, and we have seen that countries themselves are in different stages in the lifecycle and diverge in their appeal. Instead of thinking about the country denominator when considering expansion to growth markets, a fair question to ponder is: can we think of large cities as investment denominators? According to The Endless City, for the first time in history, more than 50% the earth's population lives in cities – by 2050 it will be 75%. Furthermore, 17 of the 20 largest cities in the world are in emerging markets. Cities are the main drivers of growth in emerging countries, and, interestingly, large cities across these countries may have much more in common than we see within individual countries themselves. In fact, these megacities are more likely to look and feel like their developed market peers. Can managers find a way to bet and capitalise on a city's growth rather than dilute this thesis by investing in the entire country? One investment strategy to consider is to develop portfolios focused on the development of urban areas – perhaps even an individual city. Whether the strategy is actively or passively(ETF) managed, it could seek to profit from the concentration of consumption and the necessary infrastructure development (transportation, utilities, etc.) required to support megacities. Such a strategy could also provide an alternative to the traditional means to exploit concentrated growth – namely, direct property investments, as the latter is highly illiquid and perhaps underdiversified.

Large institutions as "virtual countries"?

A second novel approach to emerging markets is to think of large institutions as virtual countries. Given the expensive proposition of pursuing complex markets, managers need to find ways to leverage their investment dollars better. For example, managers should question if they really want to

Thinking of large institutions as "virtual countries"

Selected EM pension and sovereign funds, 2010



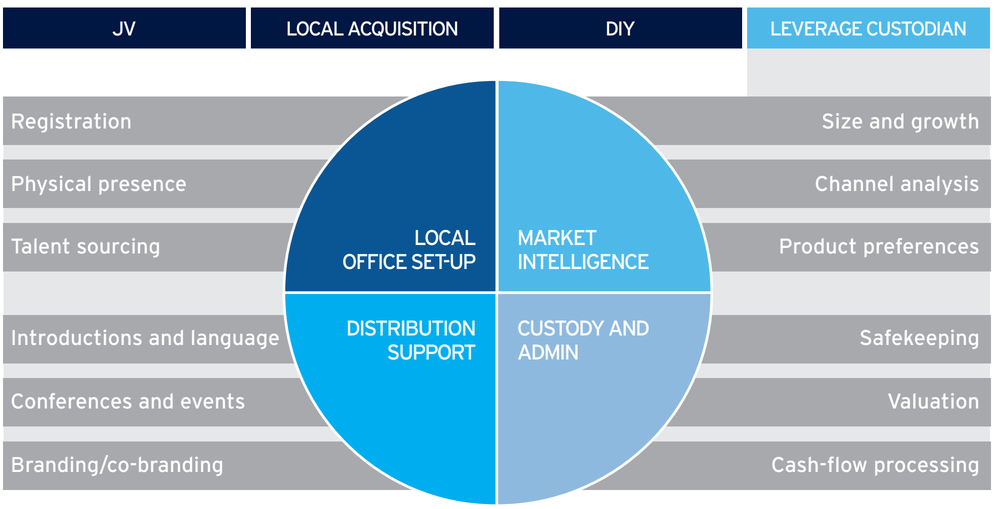
Source: Citi SFS, June 2011.

pursue the USD 160 billion Indian fund market – a complicated market at that – when a single pension or sovereign fund in the region might be larger than the whole country's fund market. The ambition of Western asset managers to succeed in emerging markets is certainly admirable, but needs a dose of realism. Those aspiring to build a 5% market share up from 0% in a few years' time should realise that they might have a much better chance of winning a single institutional mandate of comparable size. To be sure, dealing with pensions and sovereign funds also requires some patience, but there are likely to be greater similarities globally than there are with regulated retail schemes across developed and emerging markets. We also urge asset managers thinking about targeting institutions to avoid following the crowd. For example, one of our colleagues questioned why a recent RFP from the China Investment Council received 60 responses, while a similar RFP from Petro China received only 15 responses. As an asset manager, you need to be more visionary and not pursue the usual suspects. Failing to do so might not only mean fighting with numerous competitors, but also result in lower fees, as target institutions play managers off each other.

Can partners facilitate effective low-cost entry?

Finally, we believe that managers wishing to expand into emerging markets should leverage partners to facilitate effective, low-cost entry. Here, we delineate between partnerships with distributors, consultants and other service providers, and fellow investment managers. In the case of the latter, JVs often lead to the types of friction outlined above, as the two players have competing goals. For the foreign manager, the chief goal is local distribution; for the local manager, the key objective is technology transfer (e.g. best practices in portfolio management and structuring of investment personnel). The right partner can not only provide access and plumbing but educate the asset manager on important considerations for doing business locally – be they regulatory, product preferences or cultural considerations. Global custodians can be leveraged in many ways beyond the obvious ones, from setting up low-cost virtual offices (providing a physical address and operating infrastructure and translating key investor documents into local language), to providing distribution support and connecting managers directly to major outlets.

Partners can facilitate effective low-cost entry



Source: Citi SFS, June 2011.

Conquering new worlds: lessons from the Persian Empire

As asset managers continue their quest to expand into new regions, we think they can draw lessons from the Persian Empire (ca. 550-330 BCE) which, at its peak, covered almost half of the known world and had one of the most stable governments and political infrastructures of all ancient empires.

While the Empire had by and large a common platform and belief system, the ancient Persians were also able to govern a diverse population effectively by recognising the differences of every state in the Empire, drawing on local centres of power to enable trade and leaving enough autonomy for local leaders to make decisions and drive prosperity.

Managers who embrace this ideology – thinking locally, recognising the importance of distribution and having a clear strategy, while staying true to themselves and focusing on the long haul – are much more likely to succeed.

For more information, please contact:

Benjamin Poor
Manager of Market Intelligence
Global Transaction Services, Citi
benajmin.poor@citi.com

Global Transaction Services
www.transactionservices.citi.com

GRA22233 10/11