

Capturing emerging markets' dynamism with lower volatility

Are emerging markets still all about high risk and high return? It is true that financial assets have been volatile in the recent market cycle, but we think there is more to emerging markets investing than meets the eye. Many investors now recognise that emerging economies have become stronger and more stable in the decade since the 1997 Asian financial crisis. They have implemented a wide range of reforms and are exhibiting a greater commitment to free markets, orthodox monetary policies, fiscal discipline and open trade. A multitude of world-class companies has emerged during this period, producing goods and services of greater variety and quality. As a result, our conviction in emerging markets has grown substantially.

What is ETOP?

Emerging Markets Total Opportunities (ETOP) is a strategy that invests in the broadest opportunity set within the emerging markets to take advantage of their inherent diversity. Drawing on our extensive company and security analysis as well as our macroeconomic research on countries and industries, our investment professionals are able to select from the entire universe of traded emerging markets securities. We construct portfolios based on fundamental research and rigorous quantitative analysis, investing in stocks, dollar sovereign bonds, local currency sovereign bonds, corporate bonds, convertibles and inflation-linked securities, with the aim of generating equity-like returns with lower volatility than an equity-only portfolio. Our objective is to achieve a return of 10% per annum with a volatility target of 12% over a full business cycle.

ETOP allows us to execute macro themes efficiently and invest in the most attractively valued securities based on our research. At the same time, careful portfolio construction with close attention to correlations at all levels — market, sector and security — allows us to mitigate political, country and currency risk. The result is a strategy that potentially allows investors to gain access to some of the most dynamic areas of the capital markets, with greater consistency of returns. We have been managing money for clients in this strategy since October 2007.

Capital's Emerging Markets Total Opportunities strategy

- Can invest in the entire traded emerging markets universe
- Aims to produce equity-like returns with lower volatility
- Combines investments in stocks, bonds, convertibles and other instruments in a single mandate
- Benefits from the diversity inherent in the emerging markets
- Complements most existing emerging markets investment programmes because of its different risk-return profile
- Provides an efficient tradeoff between return and volatility

Where does it fit?

ETOP is not easily categorised — but then, strategies that fit into neatly defined boxes have not necessarily worked in recent turbulent markets. In our experience, investment approaches that promise a return above Libor or another floating rate while investing in markets with varying amounts of equity beta create an inherent mismatch between the invested assets and expected returns.

In contrast, ETOP taps the entire opportunity set of emerging markets. By aiming to achieve a good balance between expected return and volatility, ETOP makes emerging markets more accessible and palatable to a much broader group of investors. It also makes possible a larger allocation to emerging markets as the strategy's risk-return profile is different from a dedicated emerging markets debt or equity mandate.

How do we invest in this strategy?

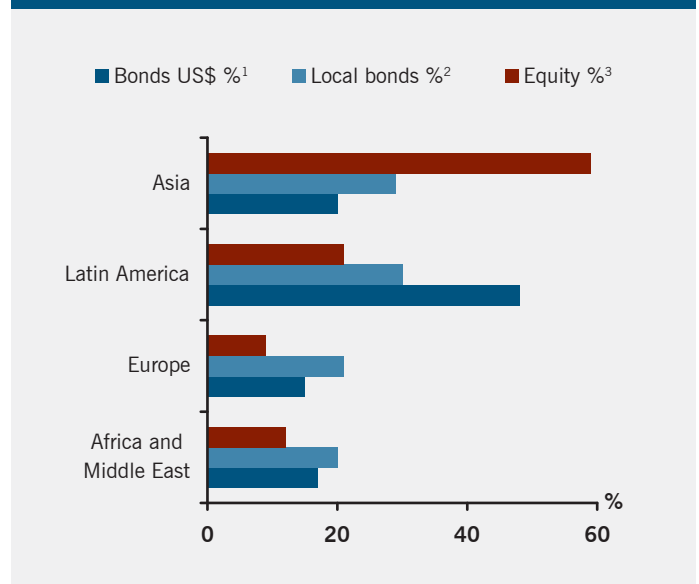
We take a multipronged approach to managing assets in ETOP:

- Invest in all tradeable emerging markets
- Efficiently implement macro themes
- Understand volatility and tradeoffs in generating returns

Invest in the broadest opportunity set. While adhering to our core philosophy of investing in the best companies and sovereign credits, we believe the broadest possible opportunity set available in this strategy allows for the greatest diversification within the portfolio. The emerging markets bond and equity universes are somewhat complementary. Asia has a higher representation in stock market indices, while the largest and most liquid bond markets are in Latin America. The factors that drive stocks are demographics, economic growth, rising corporate profitability and greater productivity, while bond investors tend to pay closer attention to macroeconomic and geopolitical risks, balance of payments and current accounts. These elements enable us to build a highly diversified portfolio. To ensure that we do not unintentionally create an excessive concentration in a single market through our combined stock, bond and currency exposure, a maximum of 25% of the portfolio's total assets may be invested in a single country. Within bonds, the portfolio can be invested in local currency debt, money market instruments, corporate bonds, inflation-linked bonds and GDP-linked warrants.

We also view currency as a separate exposure that needs to be managed as well as a potential source of return. With the substantial market reforms in the aftermath of the Asian currency crisis a decade ago, emerging markets currencies have become liquid and tradeable; most are no longer pegged to the US dollar and increasingly reflect the macroeconomic fundamentals of their economies.

Figure 1: BONDS AND STOCKS MAKE UP SOMEWHAT COMPLEMENTARY UNIVERSES IN EMERGING MARKETS



As of 30 June 2009

¹ As represented in the JPMorgan Emerging Markets Bond Index Global

² As represented in the JPMorgan GBI-EM Global Diversified

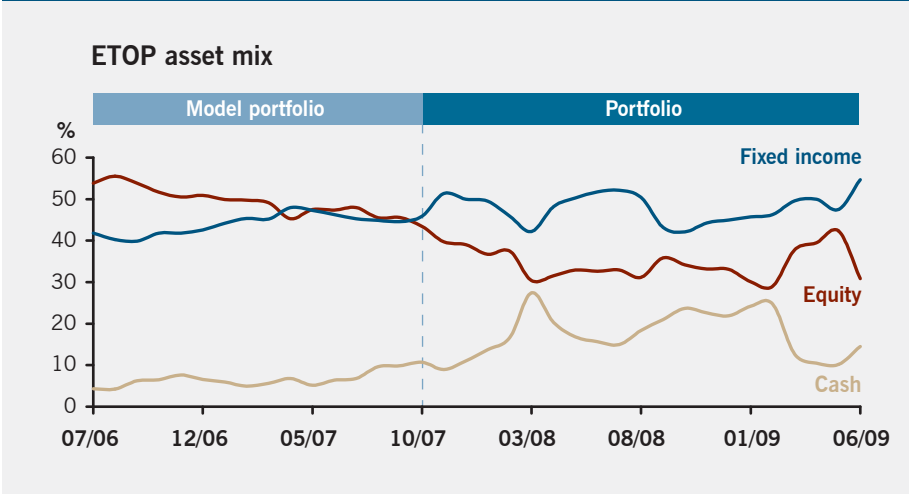
³ As represented in the MSCI Emerging Markets Investable Market Index

All indices are unmanaged.

Sources: RIMES and JPMorgan Chase

Efficient implementation of macro themes. The ability to invest across the entire traded emerging markets universe allows us to execute broad investment themes with ease and efficiency. For instance, when we see inflation rising, we can invest in inflation-linked bonds, as we did in 2007. In periods when we anticipate adverse movements from currency volatility or depreciation, we may shift out of local currency bonds into dollar assets or hedge our currency exposure; in periods when we expect interest rates to decline, we may shift to longer duration bonds.

Figure 2: INVESTING FOR POSITIVE RETURNS IN VARYING MARKET CONDITIONS



Source: Capital/CGII

The seamless combination of stocks, bonds and convertibles also allows us to move across a company's capital structure. We may like a company on a fundamental basis, but given market conditions and relative valuations we may invest in the company's dollar bonds, convertibles or common or preferred equity. At times, we may make investments across several layers of a company's capital structure. We believe that shifting between investment instruments, sectors and countries within the emerging markets universe based on our macro and company-level research can both add substantial value in a portfolio and enable us to better understand and manage risk.

Understanding and managing volatility.

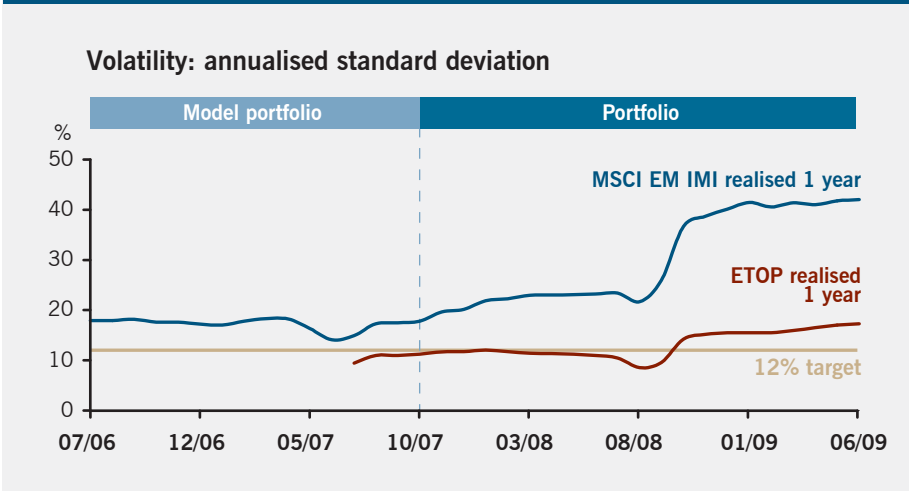
We take a multidimensional view of volatility — modeling it, analysing it and understanding its sources at all levels, whether country, sector, security or instrument type. We accept greater volatility when we think we are being rewarded for it and reduce it when we are not. We try to identify investment opportunities that appear to be mis-priced in terms of both volatility and expected return. For instance, amid the market dislocations of last year, we thought convertibles presented such an opportunity: they had lower volatility than stocks and a high yield, leading us

to double-digit return expectations over a one- to two-year time frame. It turned out that the investment thesis played out more quickly than we expected. We aim to invest in areas of markets and securities where we understand the downside protection and find greater upside. When we invested in Brazilian iron ore producer Vale do Rio Doce, which we liked on a fundamental basis but which at one point represented 10% of the volatility of the portfolio, we questioned what return assumption was called for. Would the price double over the next year, or triple in three years?

Our quantitative analyst provides the three portfolio managers — Shaw Wagener, Laurentius Harrer and Luis

Oliveira — with volatility analyses for their individual portfolios as well as the overall mandate. In addition, the analyst and the managers examine both the quantitative and qualitative risks in the portfolio and frequently adjust investments as a result of their discussions. It is a dynamic group that discusses sources of both market and portfolio volatility, including shifting macroeconomic conditions and the specifics of portfolio construction. Managers also recognise that at times they should take on additional volatility. Several emerging markets sectors and companies are highly leveraged to turns in the economic and business cycles, and actively trading directional volatility can provide good risk-adjusted returns.

Figure 3: MANAGING VOLATILITY IN VARYING MARKET CONDITIONS



As of 30 June 2009

The MSCI Emerging Markets IMI is based on the MSCI Emerging Markets Index with net dividends reinvested through 30 November 2007 and the MSCI Emerging Markets Investable Market Index with net dividends reinvested thereafter. Standard deviation is based on 252 daily observations. All indices are unmanaged.

Source: Capital/CGII

Following are some examples of various issues in the ETOP portfolio construction process and how we have addressed them:

Security-specific risk. In late 2008, several portfolio managers were invested in Brazilian iron ore producer Vale do Rio Doce. Fundamental research showed this to be an attractive investment based on its valuation relative to growth prospects, especially given our expectation that several commodities and commodity-producing companies would rebound once the global economy started to recover. Vale is also a well-managed company that we have researched and invested in for many years. While the company's stock was attractive at those prices, it could also be volatile based on sharp movements in commodity prices. Our analysis showed that Vale represented about 2% of the portfolio's assets but accounted for about 10% of the portfolio's volatility. As a result of this information, one manager reduced his investment in Vale while another manager retained his holding but offset it with investments in Asian companies that have strong long-term fundamentals but also have historically shown a negative correlation to Vale.

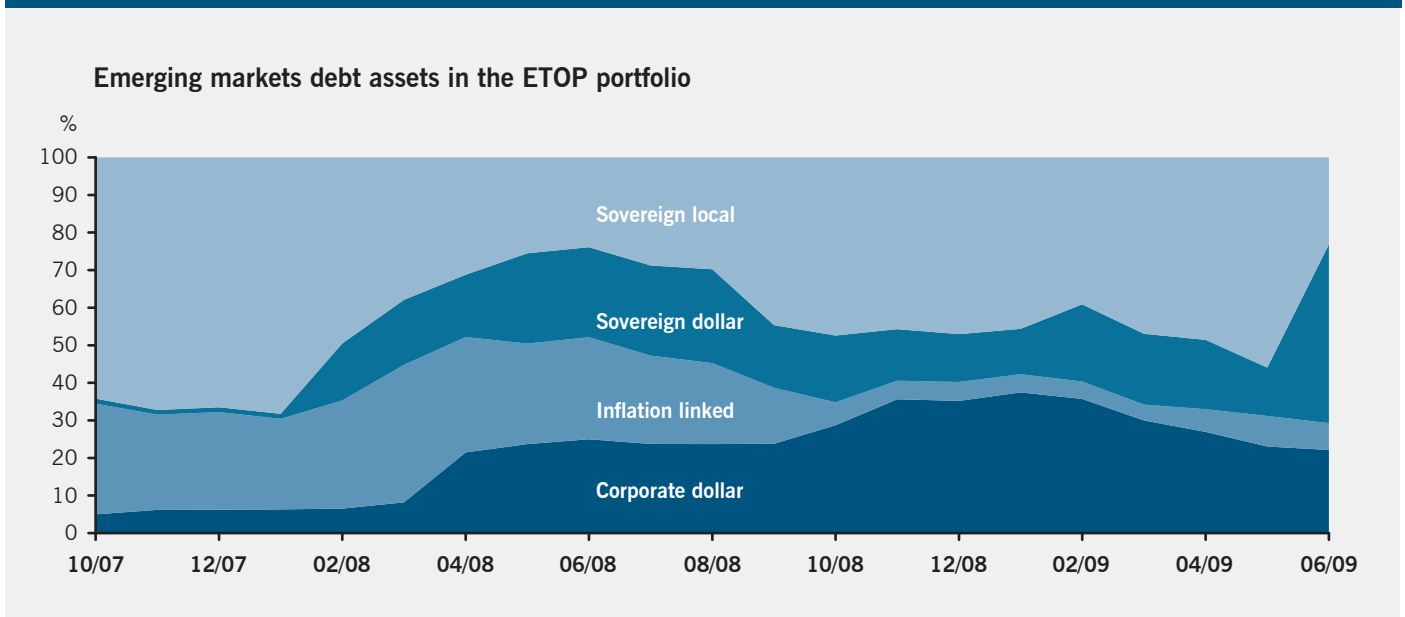
Similarly, in late 2007, all three portfolio managers invested in Samsung Electronics based on our fundamental research and their views of the stock's valuation. However, quantitative analysis showed that Samsung was also the source of disproportionate risk in the portfolio, namely the additional volatility that is generated with a 1% increase in that holding. Samsung's volatility was partly the result of a lag in Korea's

monetary policy amid a slowing economy and declining exports, which increased the volatility of all Korean assets at the time. In response, portfolio managers either reduced the investment in Samsung or hedged their exposure to the won currency, or both. One manager chose to instead invest in Taiwan Semiconductor Manufacturing, a company with equally attractive prospects from a fundamental perspective but with a different home currency and risk-return profile.

Relative value across the capital structure: Gazprom shares or bonds? There are times when, after doing the fundamental research on a company, we will switch among its stocks, bonds and convertibles. For instance, we became more cautious on equity investments in Russian oil producer Gazprom in mid-2008 amid declining oil prices as well as rising political uncertainty and slowing economic activity in the country. However, we increased our investment in Gazprom bonds on the view that the company enjoys quasi-government status, is the dominant gas producer in Russia and offered a double-digit yield. The switch also allowed us to reduce our rouble exposure and invest in dollar-denominated bonds that offered a high yield. While both Gazprom stocks and bonds fell in the second half of 2008, the bonds held up much better than stocks and subsequently rebounded in 2009.

Bond-like equity investments: LG Telecom stock vs. Korean bonds. During periods of monetary and fiscal uncertainty, we are often biased toward companies whose businesses we like at

Figure 4: EMERGING MARKETS DEBT OFFERS DIVERSE SOURCES OF RISK AND RETURN



Source: Capital/CGII

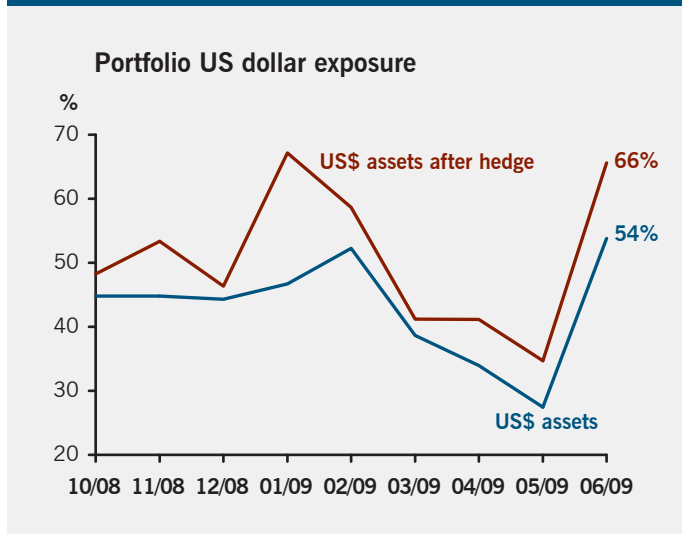
a fundamental level but which also generate a high level of income through dividend payments. For example, we invested in several telecommunications companies such as Taiwan Mobile, LG Telecom and Philippines Long Distance Telephone in 2008, preferring the equity over local currency bonds amid volatility in the currency markets. Given the companies' cash flow dynamics and commitment to paying dividends, we treated these investments as bond proxies. Many telecoms are good long-term investments in the emerging markets, where they still enjoy strong subscriber growth. In addition, these lower beta stocks also tend to be great diversifiers as they take us to markets in which we would normally have very few investments, such as the Philippines, the Czech Republic and Croatia.

Diversifying with uncorrelated sectors or clusters of companies: hedging commodity exposure with Turkish lira bonds. We found value in shares of several commodity and oil companies in the market slide of 2008 and early 2009. The broad market decline indiscriminately depressed share prices of most companies, industries and markets, and commodities and materials fell the hardest. Some managers particularly liked the valuations and longer term outlook for oil producers Petrobras and Rosneft and coal companies China Shenhua Energy and Banpu. However, our quantitative analyst told managers that a large part of the equity risk in the portfolio was emanating from commodity stocks. Rather than sell what managers saw as undervalued energy stocks, they hedged the exposure to a potential decline in oil prices by investing in Turkish lira bonds. Turkey is a net importer of oil and thus its securities have a negative correlation to oil stocks. Moreover, managers liked the high yield and valuation of the lira bonds on the view that markets were overestimating the economic and fiscal challenges facing Turkey. We rarely invest in an asset purely as a hedge if we are not convinced by its underlying fundamentals.

Taking large positions. Although we aim to manage volatility within a target, we do not think of ETOP as a defensive strategy, and at times we make large, concentrated investments. For example, in 2008, we had a large investment in Brazilian local bonds while hedging the exposure to the real currency. We anticipated that yields would decline sharply as the central bank began a monetary easing cycle. At the same time we also expected the currency to be pressured by declining commodity prices and greater demand for the US dollar because of its safe haven status amid the financial market turmoil. As a result, we had a partial hedge against the Brazilian currency. The investment turned out to be a large contributor to returns for the year.

As these examples show, ETOP is an active strategy that combines bottom-up company research with macro views through careful portfolio construction and investment in a broad range of securities. This approach has generated returns that have held value relative to the broad market in periods of decline.

Figure 5: EMERGING MARKETS CURRENCIES ARE LIQUID, PROVIDING ANOTHER SOURCE OF RETURN



Representative portfolio as of 30 June 2009

Source: Capital/CGII

Why invest in ETOP?

ETOP's objective is to achieve equity-like returns with lower volatility over the long term. While the strategy does not easily fit into traditional asset allocation categories, it offers many advantages:

- Makes emerging markets more investable with an efficient tradeoff between return and volatility
- Maximises use of a client's limited risk budget
- Provides the broadest possible exposure to emerging markets within a single mandate by investing in both fixed-income and equity securities
- Complements an existing emerging markets equity programme because of its different risk-return pattern

Why Capital Guardian for ETOP

The Emerging Markets Total Opportunities strategy is a natural evolution of Capital's substantial investment experience in emerging markets equity, debt and private equity. We have one of the largest dedicated emerging markets research efforts in the investment management business. Moreover, the equity, fixed-income and private equity research teams work closely together and benefit from the cross-pollination of investment ideas.

Capital International and its affiliate Capital Guardian have been pioneers in emerging markets investing, making their first investments in those markets in the 1970s. We launched a dedicated emerging markets equity fund in 1986 in cooperation with the International Finance Corporation, the private financing arm of the World Bank. Our first dedicated emerging markets fixed-income account was established in 1990 and private equity investments began in 1992. Anticipating investor needs, we launched the Emerging Markets Total Opportunities strategy in 2007.

All three managers for the ETOP mandate — Shaw Wagener, Luis Oliveira and Laurentius Harrer — have worked together for more than a decade and have invested in emerging markets equities and bonds for two decades. They take a top-down view of stocks, bonds and currencies to implement macro themes, and a bottom-up view for stock and security selection. Their varied backgrounds foster healthy debate and different investment styles, resulting in a diversified portfolio. In addition to their experience as bond and equity investors, Shaw has experience trading emerging markets equity, debt and currencies, Laurentius has been a currency trader, and Luis has worked as a bank analyst and banker focusing on bond and money markets. Iris Rivera, the quantitative analyst, adds depth and richness to the discussion. She challenges conventional views and unintended biases or risks in the individual manager portfolios as well as the overall mandate.

The portfolio managers are supported by a large and experienced team of investment professionals dedicated to the emerging markets, including equity and bond analysts as well as economists. The emerging markets group is part of a team of analysts that covers all sectors and all markets around the globe.

The wealth of resources that the Capital organisation puts into research at the macro and micro level allows managers to combine informed qualitative judgments with the quantitative information specific to this strategy. We believe this makes Capital uniquely positioned to manage the Emerging Markets Total Opportunities strategy. ■

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The Capital Group Companies

Capital International

Capital Guardian

Capital Research and Management

Capital Bank and Trust

American Funds

INVESTMENT RESULTS

CGTC Emerging Markets Total Opportunities composite

Results

	As of 30 June 2009				
	Q109	Q209	YTD	1 year	Lifetime
	%	%	%	%	%
Composite					
– gross of management fees	5.5	18.6	25.1	-2.3	-0.6
MSCI Emerging Markets IMI with net dividends reinvested	1.2	36.5	38.1	-26.9	-21.0
Emerging Markets Equity-Debt Index	0.2	24.4	24.6	-14.1	-9.2

Standard deviation

	As of 30 June 2009				
	Q109	Q209	YTD	1 year	Lifetime
	%	%	%	%	%
Composite	11.6	13.0	12.4	17.2	14.2
MSCI Emerging Markets IMI with net dividends reinvested	33.3	27.4	30.7	42.0	35.0
Emerging Markets Equity-Debt Index	21.7	17.4	19.8	28.0	22.8

Preliminary

Composite lifetime: 30 September 2007–30 June 2009

Results are in US dollars. Periods greater than one year are annualised. Standard deviations are based on daily returns. Results reflect the reinvestment of dividends, interest and other earnings. Composite results are net of withholding taxes on dividends, interest and capital gains. Withholding tax rates apply primarily to US institutional investors.

The investment results shown above supplement the required or recommended presentation and disclosure provisions of the GIPS standards, which are available upon request.

The composite's primary investment objective is to seek equity-like returns with significantly lower volatility and preservation of capital. The objective is 10% annual return and 12% volatility over a business cycle.

The MSCI Emerging Markets IMI with net dividends reinvested is based on the MSCI Emerging Markets Index with net dividends reinvested through 30 November 2007 and the MSCI Emerging Markets Investable Market Index with net dividends reinvested thereafter.

The Emerging Markets Equity-Debt Index represents 50% MSCI EM IMI Index/25% JPMorgan GBI-EM Global Index/25% JPMorgan EMBI Global Index.

Returns are rebalanced monthly.

All indices are unmanaged.