

## **BRIC Markets: Investment Rationale, Risks and Access Options**

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- ❑ There are economic and investing rationales for considering dedicated allocations to Brazil, Russia, India and China (BRIC).
- ❑ The economic rationale is straightforward and centers on size and growth of these economies. A combination of large human capital, less mature economies and access to natural resources have contributed to estimates that predict BRICs eclipsing most developed economies in size and importance in a few decades.
- ❑ The investing rationale is based on the structure of most emerging market investment vehicles that do not make a distinction between traditional emerging markets (represented by BRIC markets) and more advanced emerging markets. Advanced emerging markets have nearly half of the weight of emerging market funds while their share of world GDP is less than a fifth of BRIC markets. This dissonance between economic footprint and stock allocation has led evolution of dedicated BRIC funds.
- ❑ While the investment rationale for BRIC investments are attractive, these markets remain prone to shocks associated with political upheavals and commodity price cycles. Further, like most investment themes, BRIC investing is prone to corrections following reversals in investor sentiments.
- ❑ BRIC indices fall into two categories – broad market benchmarks and investable indices. Broad market benchmarks are a useful gauge for measuring overall market performance. However, they are not fully replicable by passive managers and need discretionary optimization. They may also have higher frictional costs. Investable indices are narrower, fully replicable and based on accessibility to foreign investors.
- ❑ The S&P BRIC 40 is an investable index that has emerged as the most popular index for passive BRIC products because of its full replicability and focus on liquidity and market access. About half of index-linked BRIC products are tied to the S&P BRIC 40.

## Investing In BRIC Markets – The Rationale

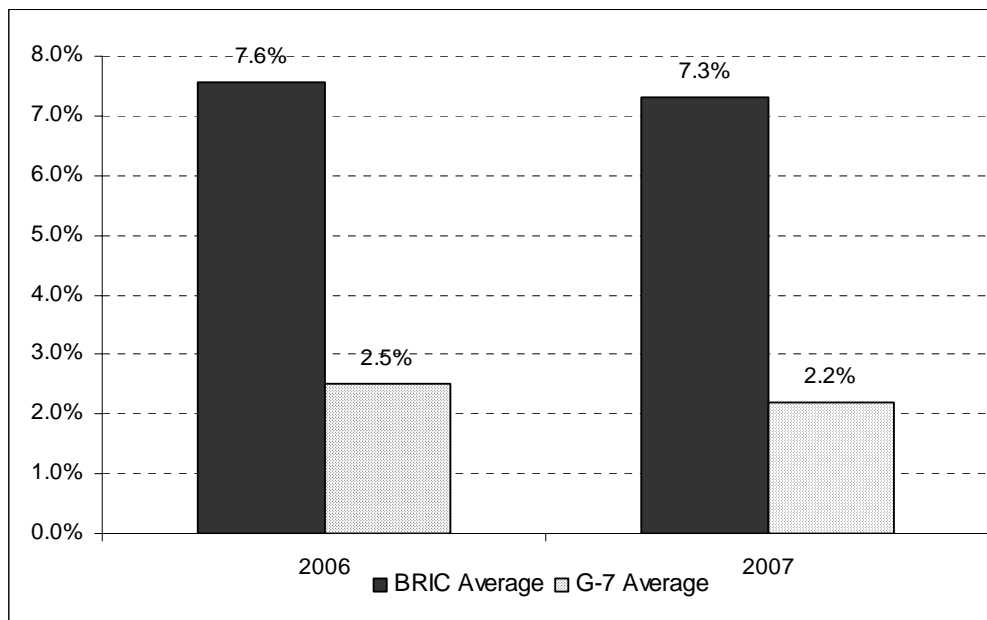
There are two distinct rationales for investing in BRIC markets. The first rationale centers on size and growth of these economies. The second is more investing specific, based on more granular analysis of typical investment positions.

### **The Economic Rationale**

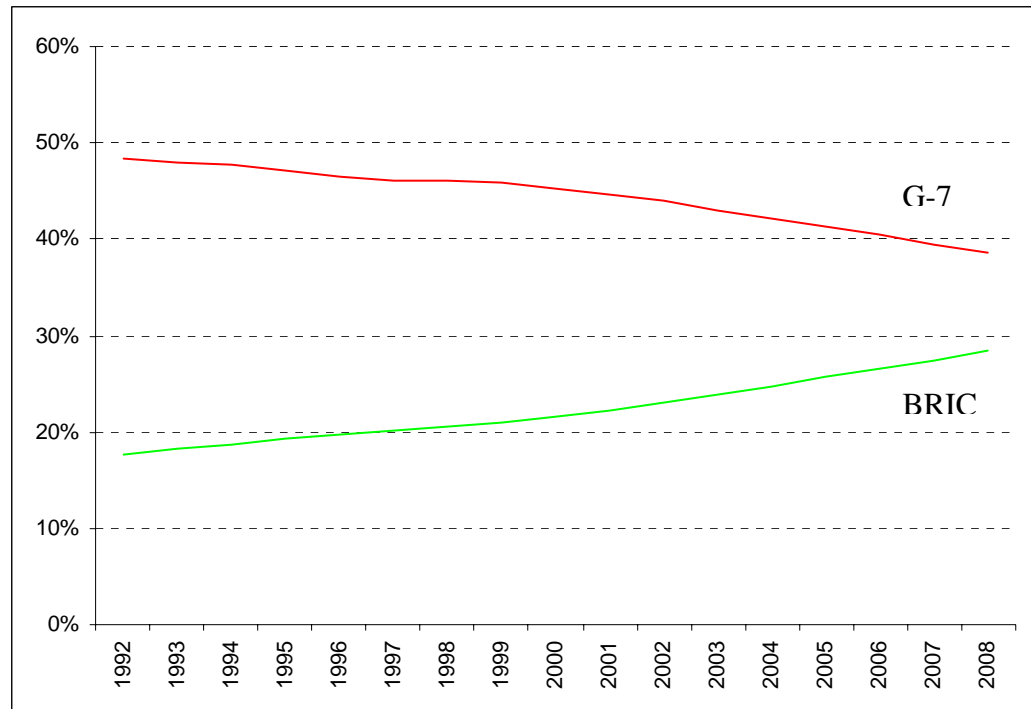
The economic rationale for investing in BRIC markets has been highlighted in the popular press since economists at Goldman Sachs coined the term “BRIC”. A combination of large human capital, less than mature economies and access to natural resources have contributed to estimates that predict BRICs eclipsing most developed economies in size and importance in a matter of few decades.

Exhibit 1 shows the World Bank estimates for economic growth of BRICs compared to developed countries represented by the G-7 countries (Canada, France, Germany, Italy, Japan, U.S. and U.K.). Exhibit 2 shows a different perspective, tracking the percent of global economic output represented by BRICs as compared to G-7.

**Exhibit 1: GDP Growth of BRICs Versus Developed Markets**



Source: Standard & Poor’s calculations from April 2007 World Economic Outlook Report of IMF.

**Exhibit 2: Share of World Economic Output**

Source: Standard & Poor's calculations based on April 2007 World Economic Outlook Report of IMF.

***The Investing Rationale***

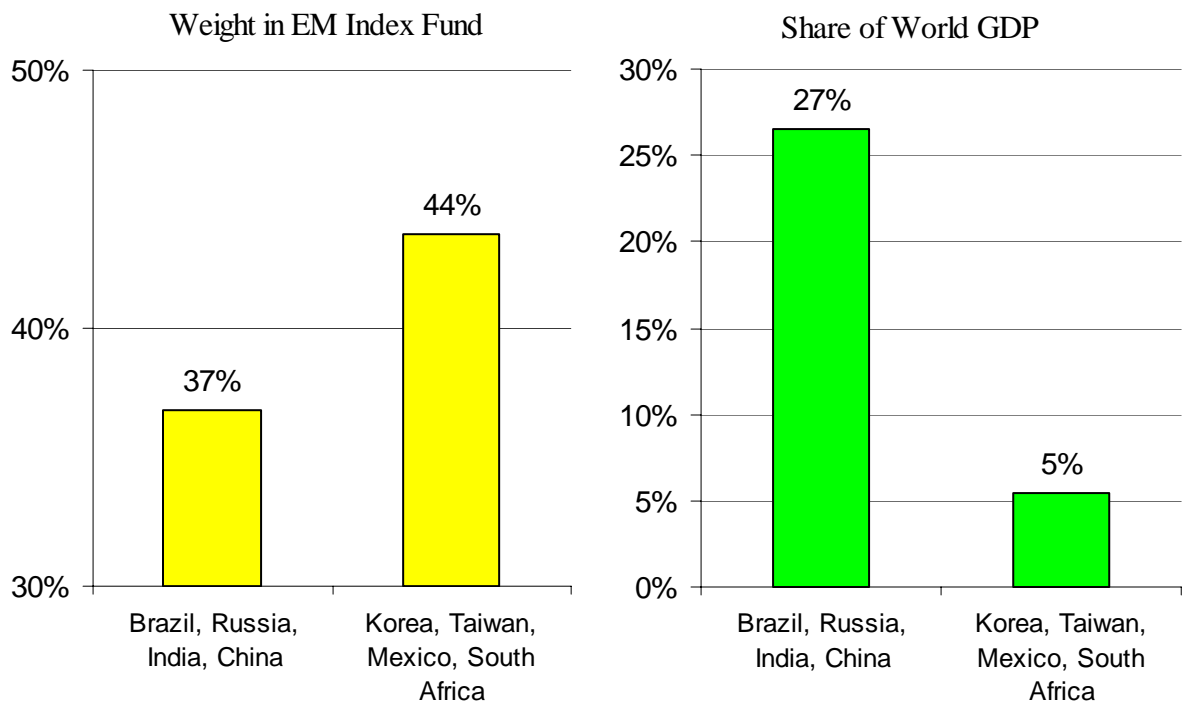
The investing rationale is based on the structure of most emerging market investments. Most emerging market investors already have access to BRIC markets through their existing funds. This begs the question – why a separate allocation to BRICs?

The answer lies in the definition of emerging markets, and its impact on emerging market investment portfolios. Emerging markets are defined by benchmark providers through a combination of quantitative economic criteria and qualitative survey of local market depth and investor opinion. This results in a rather heterogeneous group of countries. While countries like Brazil, Russia, India and China are perhaps fit the definition of “traditional emerging markets”, countries like South Korea, South Africa, Taiwan and Mexico are perhaps best categorized as “advanced emerging markets.” Advanced emerging markets have higher market capitalization to gross national output ratios and are more closely intertwined with the economic cycles of developed markets. Traditional emerging markets have smaller stock market capitalization compared to

their economic size, and have more idiosyncratic risk because of the greater size of their domestic market.

Unfortunately, emerging market investments and benchmarks do not make this distinction. Exhibit 3 shows the discrepancy between economic footprints of these two blocks. Clearly, advanced emerging markets have nearly half of the weight of an emerging market index fund while their share of world GDP is less than a fifth of BRIC markets. This dissonance between economic footprint and stock allocation has led to consideration of dedicated BRIC market investments.

**Exhibit 3: Economic Footprint Versus Stock Allocation**



Source: Standard & Poor's. Share of World GDP calculated from April 2007 World Economic Outlook Report of IMF and are 2006 estimates based on purchasing power parity. Weight in EM Index Fund from iShares MSCI Emerging Market Index Fund Factsheet for March 31, 2007.

## Obtaining Exposure to BRIC Markets

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### ***Market Benchmarks Versus Investable Indices***

The popularity of BRIC investing has led to the evolution of several BRIC benchmarks. They fall into two distinct categories:

**Market Benchmarks:** These are broad benchmarks that cover 80% to 90% of gross market capitalization of BRIC markets. They are based on a combination of individual country indices in each index provider's data product. Typical examples include MSCI or S&P/IFCI country indices. They are a useful gauge for measuring broad market performance, but are not fully replicable by passive managers.

**Investable Indices:** These are narrower indices that cover 60% to 70% of gross market capitalization of BRIC markets. These indices are designed for full replicability and are based on access to foreign investors. Typical examples are S&P BRIC 40, FTSE BRIC 50 and DaxGlobal BRIC indices.

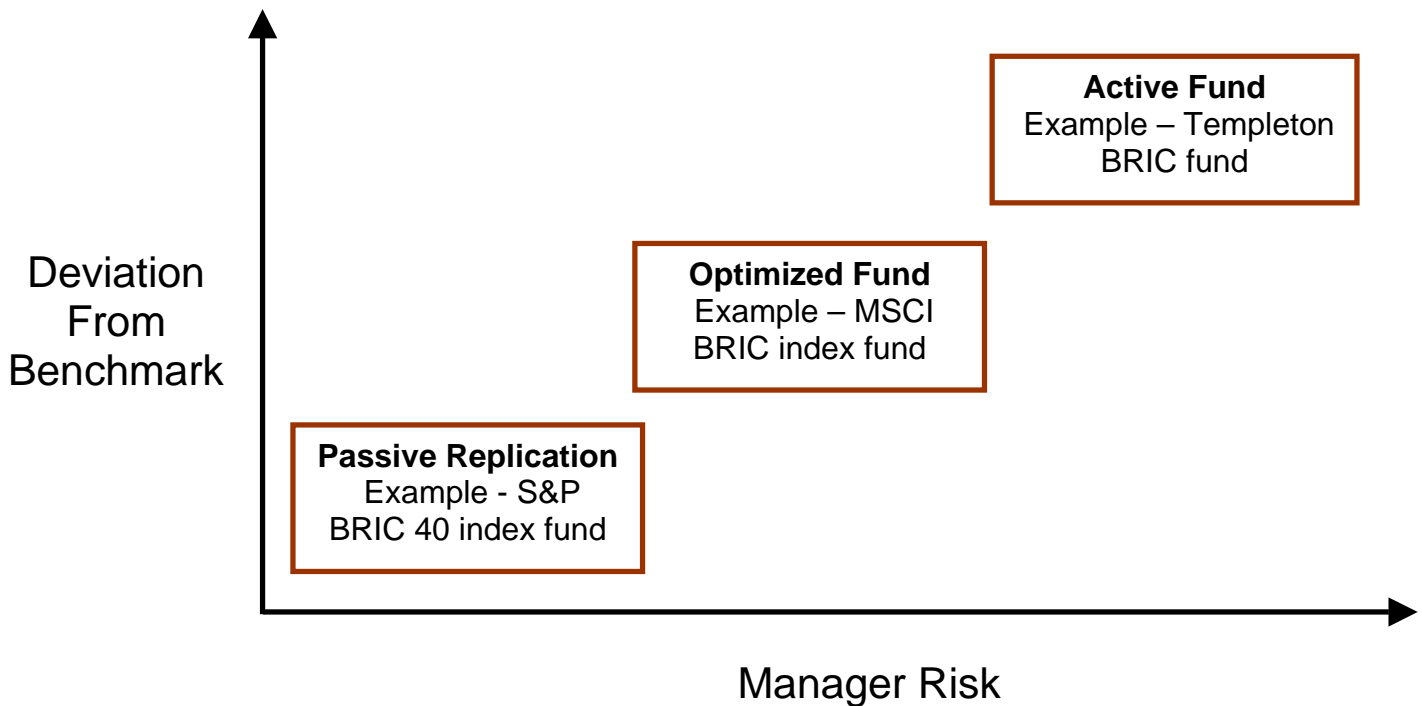
Exhibit 4 highlights access issues associated with each of the four BRIC markets and shows the differences in constituent selection for market benchmarks and investable indices. Due to structural issues discussed in the exhibit, most passive products are linked to investable indices. Any index fund linked to a broader market benchmark has to be optimized. Sampling, or optimization, is different from passive index replication. It is a stock selection technique through which stocks are chosen by a discretionary algorithm employed by a fund manager to minimize deviation from a benchmark. Therefore, optimized funds are not as passive as fully replicated index funds. Exhibit 5 highlights the differences between optimized and replicated products. Furthermore, less broader benchmarks may have higher frictional costs of investing that will get indirectly passed on to investors in terms of higher fees, taxes, commissions and market impact costs.

**Exhibit 4: Market Access & Component Choices in BRIC Markets**

<b>Market</b>	<b>Local Market Access</b>	<b>Market Benchmarks</b>	<b>Investable Indices</b>
Brazil	<ul style="list-style-type: none"> <li>• Most large stocks have liquid NYSE listed ADRs.</li> <li>• Average transaction cost is 0.42% locally compared to 0.16% at NYSE.</li> </ul>	Local market listings are included	NYSE ADRs are included.
China	<ul style="list-style-type: none"> <li>• Four distinct types of shares exist. These are A shares at Shanghai and Shenzhen (in Renminbi), B shares at Shanghai (in US\$) or Shenzhen (in HK\$), H shares in Hong Kong (in HK\$) or N shares in New York (in US\$).</li> <li>• A shares are available only to qualified foreign investors. B shares are available to foreign investors but have limited liquidity.</li> </ul>	H-Shares, N-Shares, and B-Shares included.	Only H-Shares and N-Shares included.
India	<ul style="list-style-type: none"> <li>• Majority of foreign portfolio investment is routed through Singapore or Mauritius based entities to avoid unfavorable tax treatment.</li> <li>• Free-of-payment delivery not allowed.</li> <li>• 0.125% tax on all local exchange trades.</li> </ul>	Local market listings are included.	NYSE ADRs or London GDRs are included.
Russia	<ul style="list-style-type: none"> <li>• Local markets trade primarily over-the-counter via RTS, a screen based trading system.</li> <li>• Local market has limited breadth. Custody and settlement are challenges.</li> <li>• Most institutional investors trade in London listed GDRs, which are very liquid.</li> </ul>	Local market listings are included. (Except when none exists.)	NYSE ADRs or London GDRs are included.

Source: Standard & Poor's. Transaction cost data is from Elkins McSherry as reported in 2006 edition of Standard & Poor's Global Stock Markets Factbook. Custody and settlement related information is from State Street's 2007 edition of The Guide to Custody in World Markets.

**Exhibit 5: Degree of Active Risk in BRIC Products**

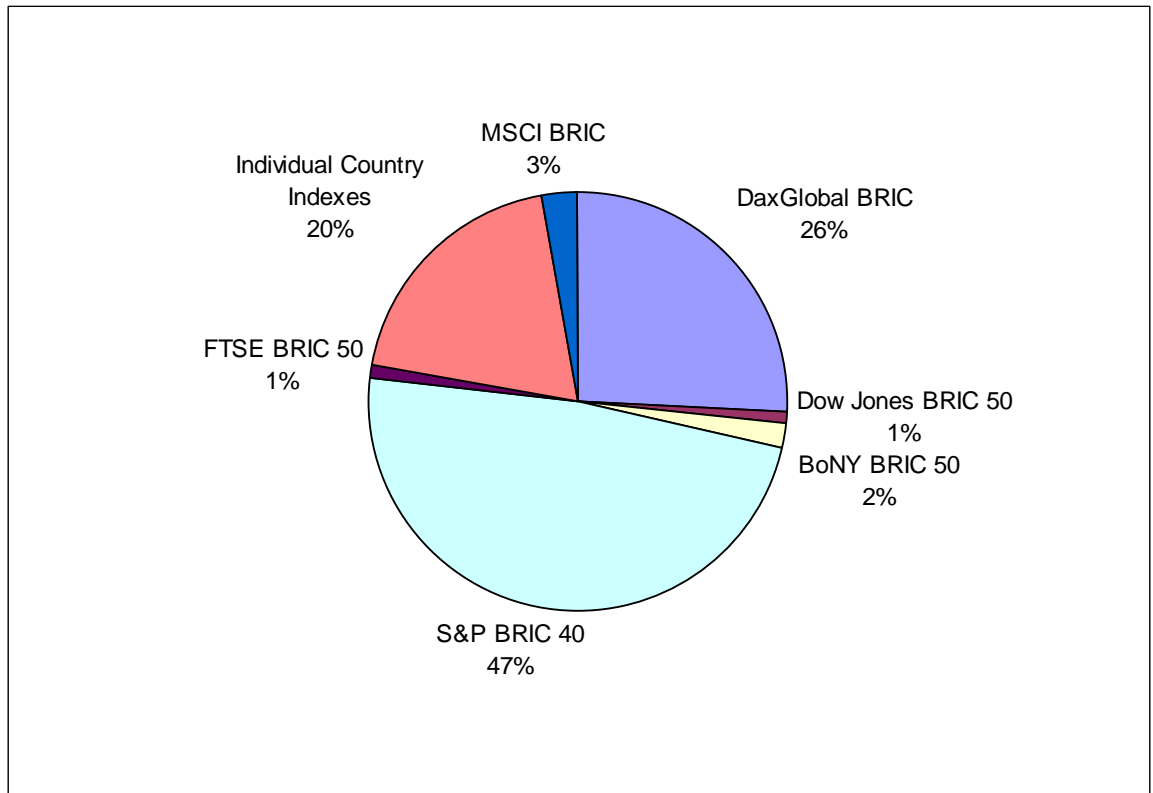


Source: Standard & Poor's

***The S&P BRIC 40 Index***

The S&P BRIC 40 index is the most commonly used BRIC index for equity index based investment products. Exhibit 6 shows roughly 1 in 2 BRIC index based products are linked to S&P BRIC 40. The reasons for the popularity of the index are fairly straightforward – it provides exposure to leading companies from the BRIC markets while being completely replicable and extremely liquid. All constituents trade in developed market exchanges (Hong Kong Stock Exchange, London Stock Exchange, NASDAQ, and NYSE).

**Exhibit 6: Market Share of BRIC Indices Among BRIC Index Products**



Source: Standard & Poor's calculations based on (a) structured product data for all equity index linked BRIC products with a launch date in [www.structuredetailproducts.com](http://www.structuredetailproducts.com) and (b) ETF filings. Individual country index products are based on combination of single market indices such as S&P CNX 50, Bovespa, FTSE/Xinhua 25, RTS etc.

**Universe:** All stocks in the S&P BRIC 40 index are constituents of the S&P/IFC Investable (S&P/IFCI) index series, a family of emerging market indices that measure the return of stocks that are legally and practically available for foreign investment.

S&P BRIC 40 uses data from the S&P Emerging Markets Database (EMDB), which contains the oldest, and deepest data history of emerging markets equities. Acquired by Standard & Poor's in 2000, this database has been maintained since 1975.

**Membership:** The membership is arrived at as follows:

- Listing. Stocks in the universe that do not have a developed market listing are removed.

- **Public Float.** All stocks with a float adjusted market cap less than the “Market Cap Threshold” and/or average three-month daily value traded less than the “Liquidity Threshold” are removed. Currently, the Market Cap Threshold is US\$ 1 billion and the Liquidity Threshold is US\$ 5 million.
- **Multiple Share Classes.** If a stock has multiple share classes, the share class with lower liquidity is removed.
- **Final Index Membership.** Remaining stocks are sorted in decreasing order of their market cap. The top forty become index members.

**Calculation and Rebalancing:** The index uses a modified market capitalization weighting scheme and is rebalanced once a year after the close of the third Friday in December with a mid-year review in May that may result in a mid-year rebalancing. The mid-year rebalancing to be effective after the close of the third Friday in June would only occur if three of the biggest 30 stocks from the eligible universe are not in the index. At rebalancing, the starting weight of each stock is proportional to its available market capitalization, which accounts for available float and investment restrictions for foreign investors. Modifications are made to this weight, if required to ensure the following:

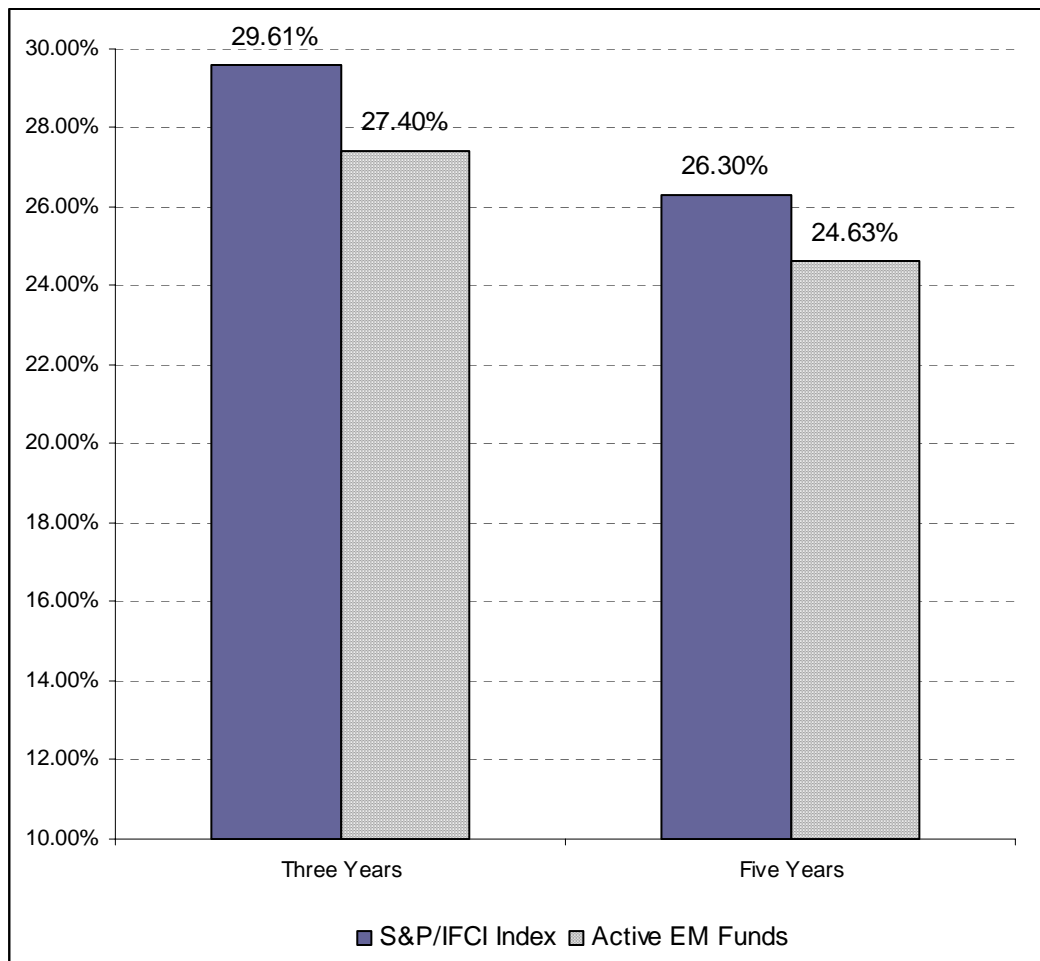
- No single stock has a weight in index greater than the “Maximum Weight,” which is currently at 10%.
- The maximum portfolio size that can be turned over in a single day based on historical volumes is greater than the “Basket Liquidity,” which is currently at US\$ 600 million.

### ***Active BRIC Funds or Passive BRIC Index Funds?***

While BRIC investing is new, the question of active versus passive is quite old. Any allocation to BRICs must first consider the active versus passive choice. Unfortunately, only a handful of actively managed US-based BRIC funds exist (and all of them have history of less than 4 years), so it is difficult to establish good active versus passive comparisons for this category. However, similar results for the broader category of emerging market funds are instructive. Emerging markets are supposed to be inefficient, providing a much higher opportunity for active managers to generate out performance.

However, Standard & Poor’s SPIVA scorecard, which corrects for survivorship and multiple share classes, shows that actively managed emerging market funds have underperformed benchmarks by 150 to 200 basis points (before accounting for loads) on average over the last three to five years. This is shown in Exhibit 7. Clearly, the added frictional costs of active funds have not helped in beating benchmarks, and this lesson may prove instructive in choice of BRIC funds.

**Exhibit 7: Performance of Actively Managed Emerging Market Funds**



Source: [www.spiva.standardandpoors.com](http://www.spiva.standardandpoors.com). Equal weighted fund returns after expenses and before loads. All returns are as of March 31, 2007.

## Caveats

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While the investment theses for BRIC investments seem attractive, it is important to consider several risk factors.

- As is normal with emerging market investments, these markets remain prone to shocks associated with political upheavals and commodity price cycles.
- BRIC investing falls in the realm of thematic investing. Investment themes are prone to sharp corrections following reversals in investor sentiments.
- A BRIC investment will not offer complete global and emerging market exposure. Therefore, it should be considered in conjunction with a broad, global equity allocation plan.
- The impact of economic growth may take years to reflect in the stock market. Therefore, any BRIC investment must be long-term by nature.

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