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WHAT DEFINES AN EMERGING MARKET?

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We are commonly asked what defines an emerging market and which countries fall within emerging market mandates. There are many organizations that provide differing definitions for emerging markets. Most of the organizations that attempt to define emerging markets are large non-governmental organizations such as the Organization for Economic Cooperation and Development, the International Monetary Fund and the World Bank. However, for equity investment purposes, the task of classifying markets according to their state of development largely falls to index providers.

MSCI, one of the world's major index providers, launched the first comprehensive emerging markets index in 1988. It is widely used by both passive and active fund managers to construct portfolios and benchmark performance. For the sake of simplicity and since MSCI's non-U.S. indices are the best-known, we will focus our discussion of the definition of emerging markets on the MSCI Emerging Markets index and the rules MSCI uses to classify country markets.

The MSCI Emerging Markets index has evolved considerably since its inception in terms of size, as well as the countries and companies included. In 1988, China, India, Korea and Taiwan – 45% of the index today – were not part of the index. China and India were added to the index in 1996 and 1994, respectively. Argentina and Jordan are categorized as Frontier Markets today while Greece is part of the Developed Markets Index. The largest company in the emerging markets index today is Samsung Electric, valued at $132.7 billion, which is 3.5 times larger than the value of the entire index in 1988. Below is a comparison of the index today versus its composition in 1988 when the index first was launched.

Emerging Markets Index: Composition at launch vs. today

	January 1988	September 2012	
Percent of Global Equity Market Cap	1%	14%	
Market Cap (USD)	$38.4 billion	$3.6 trillion	
# of companies included	269	818	
# of countries included	10	21	
Countries			
Americas	Argentina Brazil Chile Mexico	Brazil Chile Colombia	Mexico Peru
Asia	Malaysia Philippines Thailand	China India Indonesia Korea	Malaysia Philippines Taiwan Thailand
Europe, Middle East & Africa	Greece Jordan Portugal	Czech Republic Egypt Hungary Morocco	Poland Russia South Africa Turkey

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Firms like MSCI, as well as other index providers such as FTSE and Russell, construct their indices based on a series of rules. MSCI's criteria consist of three components: economic development within the country, size and liquidity requirements, and market accessibility. Specifics within each category are as follows:

MSCI Market Classification Criteria

Criteria	Frontier	Emerging	Developed
Economic Development	No requirement	No requirement	Country GNI per capita 25% above the World Bank high income threshold[1] for three consecutive years
Size and Liquidity Requirements			
Number of companies meeting the standard index criteria[2]	2	3	5
- Company size (full market cap)[3]	USD 449 mm	USD 898 mm	USD 1796 mm
- Security size (float market cap)[3]	USD 33 mm	USD 449 mm	USD 898 mm
- Security liquidity[4]	2.5% ATVR	15% ATVR	20% ATVR
Market Accessibility Criteria			
- Openness to foreign ownership	At least some	Significant	Very high
- Ease of capital inflows/outflows	At least partial	Significant	Very high
- Efficiency of the operational framework	Modest	Good and tested	Very high
- Stability of the institutional framework	Modest	Modest	Very high

The economic development criteria affect only the classification of the developed markets. The standard to be classified as high income requires a GNI per capita of USD 12,276 as of 2010.

[1] High income threshold for 2010: GNI per capita of USD 12,276 (World Bank, Atlas Method)
[2] The number of companies that must match all the criteria in order for a country market to be added to the index.
[3] Minimum in use for May 2012 Semi-Annual Index Review, updated on a semi-annual basis.
[4] ATVR or the annualized traded value ratio, is the sum of the monthly median traded values. Depository receipts are included in the trading volume for the security.

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A comparison of the GNI per capita of some of the key countries is shown in the table below. While Brazil, China and India, have a number of large, globally competitive companies listed on their stock exchanges and thereby may meet the size and liquidity criteria for developed markets, they do not yet meet the economic development criteria. Korea, however, which is still classified as an emerging market, does meet the economic development criteria.

Each of these main classification categories has sub criteria. The market accessibility criteria are largely qualitative and particularly extensive. The market accessibility criteria include such factors as: foreign ownership limits; equal economic and voting rights for foreign investors; restriction on capital inflows/outflows; a developed foreign exchange market; an advanced legal and regulatory framework governing the financial markets, a stock exchange and various entities involved in the financial markets; lack of ambiguity; prompt enforcement of laws and regulations; well functioning clearing and settlement systems based on international standards; competition among custodian banks and global custodian bank presence; a well functioning registry/depository; practical framework for short selling; availability of information in English; and others.

GNI per Capita

Country Name	2010
World	9,067
Argentina	8,620
Australia	46,200
Brazil	9,540
China	4,240
Colombia	5,520
France	42,190
Germany	42,970
Greece	26,890
Hong Kong, SAR, China	32,780
Israel	27,270
Italy	35,530
Japan	42,050
Korea, Rep	19,720
Morocco	2,850
Spain	31,460
Thailand	4,150
UAE	39,640
UK	38,140
US	47,350

During its annual market classification review, MSCI analyzes and seeks feedback on those markets it has placed under review for potential reclassification. Every June, MSCI communicates its conclusions from the discussions with the investment community on the list of countries under review and announces the new list of countries, if any, that may be reclassified in the upcoming cycle. MSCI will consider markets for reclassification only if the classification status can be viewed as irreversible.

MSCI's practice of only reclassifying a country if the country's new status is thought to be permanent is an important one that limits potential market disruptions that could result in more frequent classification changes. For example, the two countries currently under review for potential reclassification to Developed Markets as part of the 2013 annual market classification review are Korea and Taiwan. Both countries have been under review for several years. They represent 15.5% and 11.1%, respectively, of the Emerging Markets Index at September 30, 2012. Moving these countries to the developed markets index would significantly alter the composition of the Emerging Markets Index.

The list of country indices currently under review for potential reclassification to Emerging Markets are Greece, Qatar, and UAE. Greece is currently part of the developed markets index, with a weighting of less than 0.1%. Qatar (26.5% weight) and UAE (10.7% weight) are part of the Frontier Markets Index. The largest stocks from Qatar and UAE are financials – National Bank of Kuwait and Qatar National Bank.

Additionally, under consideration for potential reclassification to Frontier Markets is Morocco. Morocco is 0.1% of the

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Emerging Markets Index. Reclassification of this country would have little impact on the emerging markets index.

MSCI will communicate its final conclusions on these potential market reclassifications in June 2013.

In January 2013, the MSCI Emerging Markets index will be 25 years old. The emerging markets index has evolved considerably since its launch, encompassing many more countries and companies, and representing a significant share (14%) of the global equity opportunity set. As the oldest and best-known investment index for emerging markets, the MSCI Emerging Markets index likely will continue to hold considerable sway over the commonly accepted definitions of emerging markets for the foreseeable future.

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