

# International (Non-U.S.) Equity

## review and outlook — fourth quarter 2009

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### Market review

Stocks rose slightly against the backdrop of a nascent global economic recovery and low interest rates. The MSCI EAFE Index gained 2.2%. Stocks rallied from March through June; the pace of gains then slowed amid doubts about whether economic growth could be sustained after the withdrawal of fiscal and monetary stimulus. Commodity-related markets made the steepest gains, while heavily indebted countries such as Japan and Greece fell in U.S. dollar terms. The euro declined against the dollar, as did the yen after reaching a 14-year high.

Materials led, helped by robust demand for base metals in China and India. Gold stocks rose as the precious metal hit an all-time high in November, boosted by central bank buying and demand from ETFs tied to commodities. Consumer staples gained amid a takeover battle for Cadbury and improved profits from some beverage and beauty products companies. Rising oil prices buoyed energy stocks, and health care companies benefited from progress on industry reform in the U.S. In contrast, technology stocks declined.

Several banks reported profits and broke free from government control by repaying bailout funds. But overall financials fell amid concerns about European banks' exposure to Dubai World as it attempted to restructure its debt. Royal Bank of Scotland, Standard Chartered and HSBC all came under scrutiny. Greek banks plunged as a credit rating downgrade raised the risk they might be denied access to central bank loans. In Japan, several banks announced share offerings, causing worries about stock dilution. Mitsubishi UFJ planned to raise \$12 billion, the most ever by a Japanese bank.

The euro zone and Japan resumed economic growth; however, GDP in the U.K. contracted and Australia's was weaker than expected, casting doubt on further rate increases after its central bank became the first to tighten monetary policy since the global financial crisis. Elsewhere, interest rates remained at historic lows amid tame inflation data. Deflation re-emerged in Japan, where the government said it would increase economic stimulus and sell more bonds to cover an expected tax shortfall, further inflating Japan's national debt — already the highest in the developed world.

### Portfolio review

The portfolio's gains outpaced the broader market. Our cautious stance on the financials sector proved beneficial as it saw the largest decline, with stock selection further contributing to returns. Among the top contributors were banks with ties to fast-growing emerging markets, including Industrial and Commercial Bank of China and Singapore banking group DBS. Avoiding several large European and Japanese banks also helped. In general, our focus in the sector has been on companies likely to benefit from reduced competition in certain areas of the credit market and on those best placed to meet the demands of more stringent capital requirements.

The large investment in consumer staples added to returns, with French companies L'Oréal and Pernod Ricard among the biggest contributors as they stand to benefit from strong demand in emerging markets. We prefer L'Oréal due to its superior growth prospects and worry that Pernod Ricard's high leverage could make it more vulnerable to disappointing cash flows. We also added to our holdings in French food

products company Danone as we believe it shows encouraging growth prospects and has a portfolio of leading brands in healthy food categories.

Selection among information technology and telecommunication services stocks helped the portfolio. SoftBank, the official carrier of the iPhone in Japan, gained on positive second-quarter results as it continues to dominate new mobile subscriptions there. In the energy sector, Seadrill was the top overall contributor as shares rose after its third-quarter profit jumped, benefiting from a focus on oil rigs for deep water, where most discoveries are being made.

While the significant investment in the materials sector was beneficial as it posted double-digit gains, some investments in the sector were a negative factor. Shares of European building materials firms CRH and LaFarge fell in the wake of disappointing U.S. housing data. The selection of industrials and utilities also detracted, including Mitsui OSK Lines, which fell following recent downward revisions to earnings guidance, and Veolia Environnement, which declined as investors grew concerned over management changes. We continue to have large investments in both Veolia and Mitsui OSK, which should benefit from its business of shipping iron ore to China.

### **Outlook and strategy**

Most developed economies have returned to growth after the sharpest global recession since World War II, brought back to life in part by massive fiscal and monetary stimulus. While areas of stress remain in Europe, France and Germany have begun expanding, as has Japan. Other Asian-Pacific economies are showing more robust growth, led by domestic demand and a surge in commodities. Corporations that kept lean inventories, cut costs and used the rally in credit markets to strengthen their balance sheets are well positioned to grow earnings as economies resume even modest growth.

Our largest areas of investment relative to the market continue to be information technology and telecommunication services. Several technology stocks should benefit from the onset of a new upgrade cycle. We are also increasing investments in stocks with high yields and growing dividends, including a number of telecom holdings but also in health care and utilities — especially in Europe — as well as some insurance firms. We remain more cautious on other financials, particularly certain European banks due to the uncertain regulatory landscape and lack of growth opportunities. In Japan, we think companies with strong ties to China will continue to do well. Within energy we prefer some of the oil services firms with strong project pipelines. We have also found opportunities among materials stocks whose growth prospects are closely tied to emerging markets. ■

# Emerging Markets Equity

## review and outlook — fourth quarter 2009

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### Market review

Emerging markets equities climbed further amid robust corporate earnings, improved exports, vigorous intra-Asian trade and sustained economic recovery. The MSCI Emerging Markets Investable Market Index rose 9%, taking year-to-date gains to more than 80%. A brief pause in October, followed by jitters surrounding Dubai World's attempted debt renegotiation in November tempered the rally. But brisk economic growth in China helped support economies and stock market gains, especially commodity-heavy markets in Brazil, Russia and South Africa.

Materials and consumer stocks led the markets. Technology also made further headway, advancing more than 115% in 2009 amid a sharp rebound in prices for semiconductor chips and flat television screens after a prolonged slump. Telecommunications trailed.

Asia continued to lead the global economic recovery. China's GDP grew at an 8.9% annualized rate in the third quarter, supported by manufacturing and exports. Meanwhile, third-quarter Indian GDP expanded by a greater-than-expected 7.9%, though a dry monsoon season raised concerns about decreased crop production and rising inflation. Chinese and Indian equities rose 11% and 8%, respectively.

Chinese demand for electronics and auto parts boosted Taiwanese and South Korean exports, bolstering economic growth in both countries. Taiwanese stocks jumped 10%, while Korean shares edged up 2%. Indonesia took a breather from its breakneck gains for the year, rising 3% for the quarter and 125% in 2009 against a backdrop of impressive economic growth.

Resource-related stocks lifted markets in Brazil, Russia and Chile. Brazil jumped 14%, ending the year up 135% to become one of the world's best-performing markets. Domestic demand in Brazil also remained strong amid increased consumer lending. Mexican shares rose 14% after struggling earlier in the year, buoyed by the approval of President Felipe Calderón's 2010 budget and signs the nation's economy had begun to emerge from its slump.

Russia gained 11%. Eastern European economies showed some improvement, with Poland's third-quarter GDP growing at a better-than-expected 1.7% annualized rate. Polish stocks rose 11%, while Czech and Hungarian equities lagged.

### Portfolio review

The portfolio posted strong returns over the quarter but slightly trailed the benchmark. Several commodities producers, especially coal miners, boosted results as did industrials stocks. The portfolio's investments in China further supported results, particularly containerboard producer Nine Dragons Paper and consumer companies including GOME Electrical, China Mengniu Dairy and herbal shampoo maker BaWang.

Coal producers China Shenhua Energy and Thailand's Banpu were major contributors to portfolio returns, with shares of both companies rising as Asian demand picked up. Banpu's third-quarter profits beat

estimates, supported by sales from Indonesian mines.

Several infrastructure-related companies powered ahead in the industrials sector. Shares of China's Weichai Power climbed as the producer of heavy duty diesel engines reported higher third-quarter profits amid more widespread use of commercial vehicles. Rio de Janeiro's successful bid to host the 2016 Olympic Games also lifted Brazilian toll road operator Companhia de Concessões Rodoviárias (CCR).

Consumer staples stocks registered steep gains across several markets, contributing to portfolio returns. Shares of India's major beverage producer United Spirits rose more than 40%. Brazilian household and beauty products manufacturer Hypermarcas and food processor Marfrig gained nearly 20%, while brewer Ambev jumped almost 25%. Mexican brewing company Fomento Económico Mexicano (FEMSA) climbed on speculation of a merger with Heineken or SABMiller. Russian supermarket chain Magnit also registered strong gains.

On the other hand, some investments in information technology hampered results. South Korea's Samsung Electronics announced that earnings had tripled from a year ago to more than \$3 billion, boosted by higher chip and LCD panel prices, but its share price lagged for the quarter. Shares of Chinese Internet companies Netease and PerfectWorld also slackened after sharp run-ups.

Several telecommunications stocks also declined, holding back results. Indian wireless provider Bharti Airtel — a top holding in the portfolio — was a large detractor as increased competition weighed on the company's share price over the quarter; a large percentage of Bharti's new customers have also come from lower-paying rural areas, putting pressure on profit margins. South Korea's SK Telecom also slid, though third-quarter profits jumped on increased subscriber rates amid successful cost-cutting measures.

## **Outlook and strategy**

Emerging markets earnings multiples are no longer low following this year's sharp rally. Yet, the developing world is likely to sustain substantially higher growth rates than developed nations, especially in the wake of the recent financial crisis. We consequently expect emerging markets stocks to be supported by higher revenue and earnings growth rates. Exports remain a significant factor in several economies, but nonetheless represent a lower percentage of overall growth than in the past, while domestic demand has expanded at a rapid pace.

Against this backdrop, we continue to focus on commodities producers and a number of domestically oriented consumer companies. We have investments in several coal, oil, iron ore and cement companies as infrastructure development has proven to be an enduring theme throughout the developing world. We also have diverse investments in the consumer areas, ranging from sportswear to cosmetic firms that have developed strong local brands. Technology has helped drive the world's stock market recovery this year; we are attracted to global industry leaders with a high level of exposure to the Asian consumer, as well as select Internet companies. Although subscriber rates have risen rapidly for many telecommunications companies, we continue to invest in those that still have room to expand their customer bases, and in some cases, fixed-line providers that offer stable returns and impressive dividends. ■