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## — MANAGEMENT DISCUSSION SECTION

### Unidentified Company Speaker

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Welcome to Financial Research Perspectives for FactSet. Today on our podcast, I am joined by Frank Nielsen, Executive Director and Head of Core Equity Research for the Americas at MSCI Barra. Frank is responsible for managing and developing emerging market equity entities for the Americas region.

Frank recently joined us for a webcast in which he discussed the risk profile of emerging market nations and the best and worst performers among the developing nations. Today we are going to follow-up with that conversation.

**QUESTION AND ANSWER SECTION**

<Q>: Hi Frank. Thank you so much for joining us.

<A – Frank Nielsen>: Thank you.

<Q>: So Frank, emerging markets are recovering more rapidly than developed markets currently. What is this recovery most originating from? And what causes do you think are the least cause of this disparity in performance?

<A – Frank Nielsen>: Right. And yeah, so what we've observed over the last year is significant differences between emerging and developed markets and in particular some areas to highlight emerging market small cap have clearly outperformed the larger cap and mid cap segments in emerging markets and have, with the rest of emerging markets, clearly outperformed developed markets. So clearly a very strong small cap story for emerging markets in 2009 and very strong recovery and also – they also lost a little bit more than mid cap and large cap in 2008. So that is clearly one segment to highlight.

The other interesting areas that really – did much stronger – performed much stronger in 2009 were a couple of countries in particular Brazil, India, Indonesia had great runs in 2009, but then on the other hand India and Brazil also were one of the worst performing ones in 2008. So what we observed in 2009 is a strong rebound of countries that have suffered more in 2008 but then there are also a couple of other countries that may not recover as quickly even though they had a pretty terrible 2008.

And then thirdly, also when one looks at the sector performance, we see very strong differences between emerging markets and developed markets. So to be more specific, in emerging markets in 2008, energy and industrials and financials were the worst performing sectors and they also were pretty much the strongest ones in 2009 having very strong rebound. Whereas in developed markets, financials as everybody knows performed terribly in 2008 and have not recovered as much at the end of July as in emerging markets again, highlighting the continuous uncertainty of some of the biggest financial institutions.

Another example is information technology, which didn't really significantly show up in emerging markets as a terrible performer in 2008 but was -- the second or worst performer in developed markets and had a pretty strong rebound in 2009.

So again, highlighting what we see here is that emerging markets and developed markets responded very differently at a more detailed level to the financial crisis. Countries behaved very differently and rebounded strongly in emerging markets much more so and small caps in emerging markets also in particular outperformed the rest of emerging markets and of course developed markets.

<Q>: Would you venture a guess as to whether the small cap over performance will continue – would you venture a guess as to whether you think that kind of performance will continue for longer or is it probably a brief trend given to the recovery period?

<A – Frank Nielsen>: Yeah, unfortunately I can't make any predictions or venture out into forecasting what may or may not happen. But historically, small caps have – in the long run have outperformed mid and large cap securities. And in the short run have performed quite differently. And there are periods where they perform very similarly, but there are also periods where you see a wide dispersion between small caps and large and mid caps.

And this certainly is such a period where small caps have heavily outperformed the rest of the market. And if it will continue or how long it will continue is certainly a different question.

<Q>: What would you say are the biggest surprises to the emerging markets in terms of how they responded to the recession and were there – what would you say are the biggest surprises among country performance and sector performance?

<A – Frank Nielsen>: Right. So clearly in emerging markets, we had Russia, India, Brazil as one of the worst performing ones in 2008 and they are clearly very different in terms of their economies, their political systems and also the implications that the global crisis had.

India certainly is not very much integrated into the global system and therefore, it's a little bit surprising that they have been affected so much. And with Russia again, they have been mostly hit by the global decrease in energy – in demand for energy. It's a very different reason, but I think what these countries were surprised by is the really global effect on all the different sectors. And even though these three countries have not too much in common, were affected very similarly through different reasons, but nevertheless we're impacted extremely by this crisis.

And then a similar story on the rebound, where people may have realized that Brazil and India are really not as integrated into the global economy, not as affected by the financial crisis and, therefore, people have realized that it may have been an overreaction in 2008 on the downside and responded accordingly and, therefore led to this very strong upside in 2009 so far.

Again on the sector side, I can add to that, the energy sector in emerging markets was hit the hardest and financials as well, and one that may also be surprising energy surprising so far as the global demand has come down in the second half of 2008, but maybe not to a degree that was reflected in the underperformance of the emerging markets energy sector relative to the rest of emerging markets. And again that was potentially reflected by the rebound in 2009. So people realized that that again may have been an overreaction.

And the same with financials, not many emerging market financial companies were heavily impacted directly by the financial crisis, but were hit very hard when it happened [inaudible] and then, therefore, again we may have experienced this very strong rebound because people realized that there was a strong overreaction.

<Q>: So can you tell me a little bit more about the riskiness level of the emerging market countries? So I wanted to talk a little bit about how the risk levels have changed in the emerging market countries today versus at the start of the crisis in 2007 and even throughout 2008?

<A – Frank Nielsen>: Yes, so at the aggregate level for emerging market, the risk has more than doubled, which in itself is very similar to developed markets. So it's not that emerging markets have proportionately more increase in risk, both developed and emerging markets have increase by almost a factor of two since 2007. And within emerging markets then the biggest increase of risk comes from the increase in country risk.

So the increase is on the one hand side driven by the overall capital markets have become much more volatile, but secondly, second most important cause of this increase in risk is country specific and here in particular we see that Asian countries have become much more risky, particular China, Taiwan, Korea, but China to a much larger extent have really increased in risk very, very significantly during this crisis.

<Q>: So you mentioned China as an emerging market country with a lot of potential but also obviously they were hit very hard. Can you elaborate on China as a particular case study for an

emerging market country and maybe discuss a little bit about the differences and similarities between China and the other emerging market countries?

**<A – Frank Nielsen>**: Yes. So the biggest difference right now is that the domestic China market is pretty much closed for foreign investors. And if one just looks at the market capitalization of that domestic China market in relation to the emerging markets indices globally it would have the weight of 14% in the global emerging market index, if it were investable for foreign investors. So there is a huge potential for emerging market investors to invest in more companies if the domestic market would open up to foreign investors. So that is one area where China, the Chinese capital markets could gain a lot of foreign investments.

On the other hand the other interesting observation which is partly driven by the fact that it's not investable for foreigners, is that the domestic market is clearly driven by retail investors and that's one of the reasons why it's extremely volatile that retail investors in China seem to be very short term oriented and going in and out of the markets very rapidly and quickly. And that in itself leads to very high volatility. And that then again is reflected to some degree in the China market that is investable for foreign investors where we also see there is much higher volatility.

So on China, the interesting potential is that this domestic market has opened up a little bit to foreign investors, but certainly only to a very small degree. And if that opening continues then a large number of very interesting companies that [inaudible] to an emerging markets portfolio will be available to foreign investors. If that indeed happens, that opens up opportunities. If it does not happen then we will continue to see a very different performance behavior of the domestic China market relative to the internationally available China market.

**<Q>**: Okay. So I wanted to ask you Frank, if you had anything else that you would like to add today before we wrap up?

**<A – Frank Nielsen>**: Yeah, I think what is really interesting about [audio gap] evolution over the 20 years is that it's a very dynamic segment where we have seen countries moving in and out of the emerging markets sector. The latest one is Israel, that will now upgrade to developed market status next year in May by the MSCI indices classification

We have Argentina, which was downgraded to frontier market status and that leads to the other area, frontier markets, which has seen some money inflows over the last few years. And frontier market is basically a segment of markets that are not as efficient, whether it may be not as good regulatory environment, maybe more restrictions on foreign investments, and they sort of look like emerging markets 20 years ago and for sure some of these frontier markets will evolve into strong emerging markets and maybe even developed markets over time; others will probably not evolve much or maybe even retract from the current development level.

But this frontier market segment certainly has seen some interest, certainly not offset by the crisis. They are not very liquid, but we see that as yet another frontier of global investing that will play a bigger role going forward, similar to the development of emerging markets, which in 1988 started out with less than 1% market capitalization weight in the index and today is at more than 12%.

**<Q>**: So, Frank, you were mentioning that the frontier markets, there's some countries there that maybe have the potential to be sort of upgraded to emerging market status. Is there any right now that that we sort of know will gain that status soon, or is that sort of yet to be seen?

**<A – Frank Nielsen>**: Yeah, that clearly is yet to be seen. There are a couple of countries in the Middle East that certainly have more mature capital markets and significant market capitalization already. And one of the major drawbacks there is that it's relatively difficult still for foreign investors to invest in these markets or they have just relatively recently opened up for foreign investors.

So they have to prove that the changes and accessibility to foreign investors is sustainable and that they're planning to continue to make information available and continue to have efficient infrastructure that makes it easy for foreign investor to invest in these markets. But on the other hand, they are certainly certain criteria like GDP and liquidity. Number of companies would certainly qualify them for emerging markets and so that certainly is one area where we monitor very closely. Thank you very much.

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**Unidentified Company Speaker**

You're welcome, Frank. Have a nice day.

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**Frank Nielsen, Executive Director and Head of Applied Research for the Americas at MSCI Barra**

Thank you. You too. Bye-bye.

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**Unidentified Company Speaker**

Bye-bye.

Operator: If you're interested in learning more about MSCI Barra research on emerging markets, you can receive their full research report titled, "Emerging markets: a 20 year perspective." To receive the report, simply email [podcasts@factset.com](mailto:podcasts@factset.com). That's P-O-D-C-A-S-T-S at [factset.com](http://factset.com). You can also check our podcast notes to see this email in more detail about the report. Again, thank you for listening.

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