ABSTRACT

In this document we examine the rationale behind investments in emerging markets, discuss whether such investments have intrinsic value, and review the various investment vehicles available to institutional investors.

BACKGROUND

Before 1990, institutional investment in emerging markets was virtually non-existent. However, since then, hundreds of billions of dollars have been allocated to this asset class. Though there is a large number of emerging markets, only approximately fifty of these are "investable," as some are closed to foreign investors and many others are too small or illiquid to be practical to institutional investors. These fifty emerging markets account for roughly 20% of global economic output and 80% of the world's population. However, the publicly traded stocks of these emerging markets represent less than 9% of the world's total market capitalization.[1]

Do investors continue to allocate capital to emerging markets based on extensive analysis of the quantitative and qualitative risks, of the economic environment, and of potential returns? Or is it simply the siren-like allure of potentially high growth and inefficient markets?

THE EMERGING MARKETS THESIS

The rationale behind investing in emerging markets is simple: growth. Proponents of emerging markets support the thesis that the most rapid economic growth in the coming decades will occur in less developed nations. This is a logical assumption for two reasons. First, these economies begin from a very low base and, therefore, even modest improvements result in large percentage increases. Second, much of the developed world appears willing to supply large amounts of capital to developing markets.

In an economic context, ideal growth in emerging markets would be symbolized by large scale investment in multiple industries, new technologies, small businesses, and infrastructure projects with the goal of improving productivity, increasing real wages, and efficiently allocating public and private resources. In addition, ideal growth would encompass the establishment and development of financial and banking systems able to effectively price risk and allocate resources. Model growth also requires the establishment and protection of property rights, which is widely regarded as the single most important factor in the long-term health of a free market system. In addition, the government must create a strong legal, fiscal, and financial infrastructure.

[1] Source: IFC, World Bank.

In the worse cases, however, capital is directed toward the creation of large, unproductive industries, banks, and other companies that are owned by the state. Here, growth may appear attractive in the short-term, but it is likely to eventually subside.

Phrases such as "new paradigm" or "this time it's different" are used frequently when referring to investment opportunities in which there does not exist strong fundamentals or a historical precedent to support the investment thesis. Whether the shallow economic strength of the Asian economies in the mid 1990s or the lofty heights of the NASDAQ index at the turn of the century, the markets have corrected themselves despite fervent belief by investors that this time was indeed different. So, despite all the headlines about China, India, and globalization, why should investors believe in an asset class that, on a calendar-year basis, has barely exhibited more performance gains than losses? Emerging markets have delivered spectacular returns over short periods, but subsequently have taken hard tumbles. In short, the answer lies in the approach to investing in emerging markets, and understanding what changes have actually taken place and the corresponding effect on the investment opportunity.

The main cause of the various capital market crises in emerging markets has been the inability of the investor base to differentiate strong fundamental economic expansion, supported by strong local government, legal, and financial institutions, from short-term run-ups based on temporary increases in export or commodity prices. Moreover, the local markets, from a liquidity, financial infrastructure, and economic context, are generally not equipped to deal with large shifts in foreign cash flows. Over the past few years, many emerging market economies have built up large foreign exchange reserves, primarily due to exports to a rather voracious U.S. consumer. In addition, large increases in commodity prices have added to government coffers. Contrary to historical trends, these governments have been using the capital to pay down debt, to encourage consumer demand, and to shore up their financial systems. In addition, numerous emerging markets have opened up to foreign ownership in what were formerly seen as "key industries," such as banks and manufacturing. Finally, the effects of globalization can be overstated, but not ignored. International economies are slowly becoming more intertwined, while advances in technology and financial product innovation is increasing liquidity and decreasing risk.

An emerging markets equity strategy based on diversification, thorough due diligence, and oversight, should reduce the number of negative surprises and help produce consistent value at the portfolio level.

DEFINING AN EMERGING MARKET

Clearly defining what makes a market "emerging" is difficult. Is it possible for the capital markets to be emerging, but the economy to be developed? What if the debt and equity markets of the same country are at significantly different stages of sophistication and development? Are equities to be considered emerging if the companies are based in countries not included in the MSCI World universe[2]? Several managers only categorize fixed income securities as emerging if they are issued by a corporate or government entity based in a country with a sovereign rating below investment grade. Today, such an approach would consider Mexican and Russian equities as emerging, but fixed income securities from these countries as already emerged.

The International Finance Corporation ("IFC"), the investment arm of the World Bank, classifies emerging markets as those economies with a Gross Domestic Product ("GDP") per capita of less than approximately $10,000, or what the World Bank categorizes as a low or middle-income country. As a reference point, the U.S. had a GDP per capita of approximately $44,000 in 2006. In addition, the size of the country's investable stock market relative to its GDP is taken into account. To adjust for currency fluctuations and volatility, Standard and Poor's will only allow a market to "graduate" out of its emerging status if its GDP per capita ranks above the low and middle income threshold for three consecutive years, and if the size of the investable market relative to GDP is greater than or equal to the average of the same indicator for developed markets.

These determinants serve as a logical starting point for country inclusion in the emerging market benchmarks, and many investment managers utilize similar methodology to define their universe. Other factors include: political systems, corruption levels, capital markets depth and sophistication, and the existence and strengths of judicial and enforcement institutions.

The IFC has further divided the emerging world into developing markets and frontier markets. Frontier markets represent the least developed economic, political, and social environments and, therefore, the riskiest destinations for investment capital. As we do not consider frontier markets to be part of the current investable universe, Meketa Investment Group will exclude these markets from this discussion.

[2] The MSCI World Index℠ is a free float-adjusted market capitalization index that is designed to measure global developed market equity performance. As of March 2007, the MSCI World Index consisted of the following twenty-three developed market country indices: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States.

EMERGING EQUITY MARKET RETURNS

Since the inception of the Morgan Stanley Capital International Emerging Markets ("MSCI EM") index in January 1988, emerging market equities have generated strong results. Through the end of 2006, emerging market equities had outperformed U.S. public equities and fixed income, and the equities of non-U.S. developed economies. However, emerging market equities have exhibited considerably higher volatility. Since inception, the annualized standard deviation of the MSCI EM index is 22.8%, significantly higher than U.S. and non-U.S. developed market indices (see chart below).

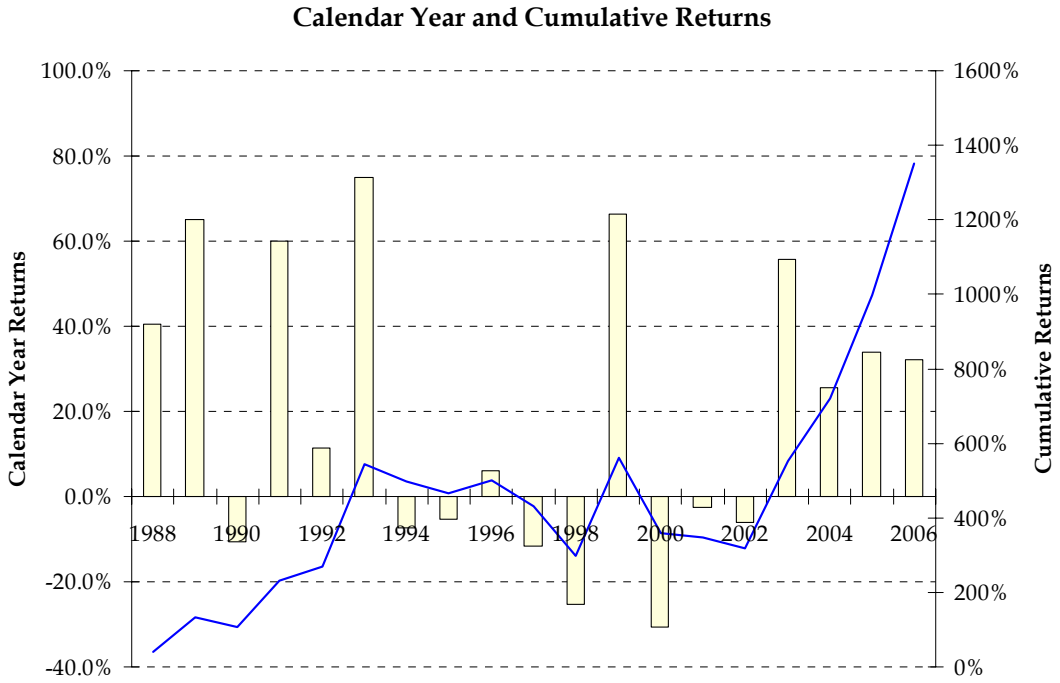
Performance Characteristics
January 1988 - December 2006

	Annualized Returns	Annualized Standard Deviation	Correlation with MSCI EM
MSCI EM	15.1%	22.8%	N/A
Lehman Aggregate	7.6%	4.0%	-0.05
Russell 3000	12.3%	13.8%	0.62
MSCI EAFE	7.3%	16.1%	0.58

However, as with any asset class, the starting point and the end point used to measure emerging market equities can have a considerable impact on returns.[3] For example, the annualized return of the MSCI EM index between 1990 and 2006 drops to 11.4% from 15.1%. Over that same period, the Russell 3000 index returned 11.0%, resulting in annualized underperformance of only 40 basis points versus underperformance of 280 basis points. Fluctuations of this volume are to be expected of such a highly volatile asset class.

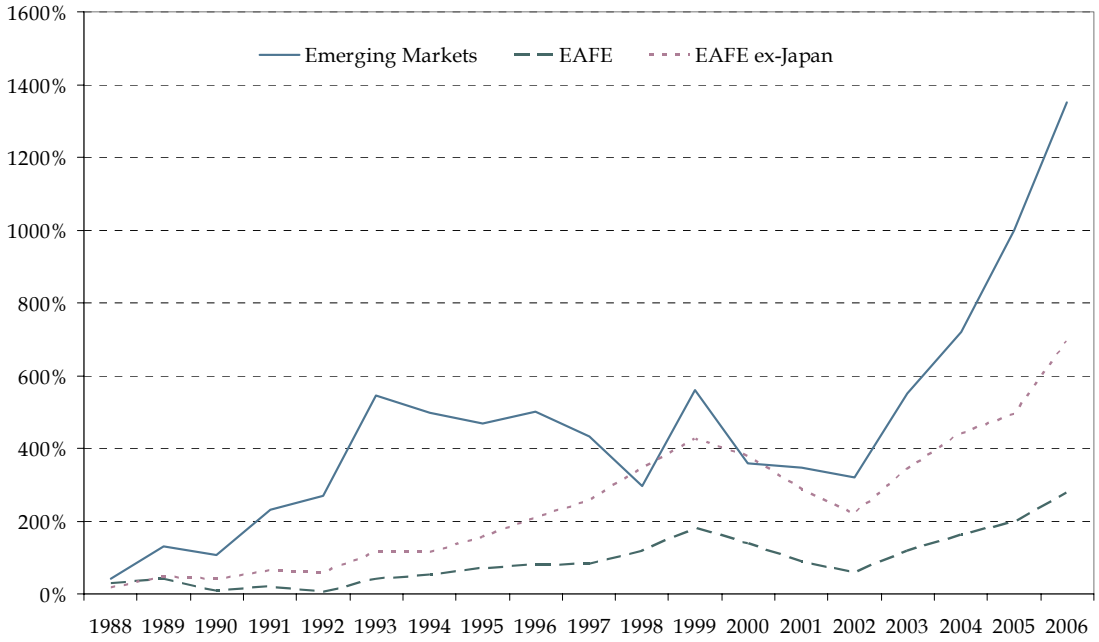
The following chart demonstrates the year-over-year volatility in returns. The average period of consecutive positive or negative annual returns is only 2.1 years. In the nineteen years since inception, eight have been negative. Indeed, after the first six years of performance, the index lost money in seven out of the next thirteen years, although it managed an aggregate gain over the same period. One final, telling statistic is that the average upside calendar year return since inception through 2006 is 42.9% versus an average loss of -12.4% during negative return years. This may be the primary factor in explaining why emerging markets remain an attractive target for generating high returns.

[3] See Alan Spatrick's paper, "Endpoint Bias and the Generation of Expected Returns" for further insight on this topic, available at http://www.meketagroup.com/research.php.



Another argument in favor of U.S.-based plan sponsors investing in the less developed world is that emerging market equities have historically exhibited stronger returns than the equities of the developed foreign markets, namely Western Europe and Japan. Although the MSCI EM index significantly outperformed the MSCI EAFE index from 1988 to 2006, the EAFE index's performance has been negatively affected by the large weight of Japan, a country whose equities have performed poorly since 1988. However, as evidenced by the following chart, while removing Japan from the equation does improve the performance of developed international equities, on a cumulative basis, the MSCI EM index still comes out ahead. Indeed, for only two brief periods did the cumulative return of the MSCI EM index dip below that of the MSCI EAFE ex-Japan index.

Cumulative Returns



Hence, the case for investing in emerging market equities is strong when comparing their returns to those of developed foreign markets over the past seventeen years. However, the results are decidedly mixed when evaluating returns versus the U.S. markets. Emerging market equities have demonstrated an ability to produce significantly superior returns in a given calendar year, but the return set has failed to sustain such returns over an extended period and performance declines can be severe. If a plan sponsor believes that historical returns for an asset class are indicative of future performance, then the case can be made that emerging market equities can boost the returns of institutional portfolios. We next investigate if a similar beneficial case can be made from a diversification standpoint.

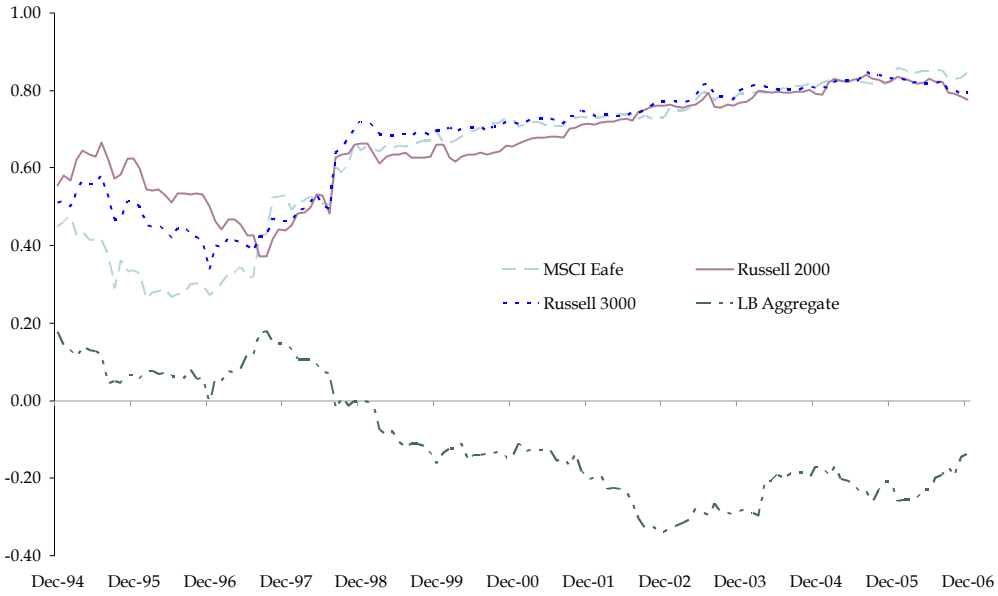
RISK DIVERSIFICATION BENEFITS

Theoretically, the greater the risk offered by a particular investment opportunity, the greater the reward to be sought by the investor. Emerging markets have arguably rewarded investors for the numerous risks they present. However, plan sponsors should also consider whether an allocation to emerging markets would benefit an institutional portfolio from a diversification perspective. The following table shows that emerging market equities have exhibited a low r-squared (correlation) statistic versus the MSCI EAFE, Russell 3000, and Lehman Brothers Aggregate indices, suggesting that only a small portion of emerging market equity returns can be explained by the returns of these other major asset classes.

	R-Squared with MSCI EM Index 1988 - 2006
MSCI EAFE	0.34
Russell 3000	0.38
LB Aggregate	0.00

Historically, the correlation between the returns of emerging market equities and other major asset classes has been volatile. However, as shown in the following chart, since January 1995, the rolling five-year quarterly correlations between the equity asset classes have been steadily rising. Just the opposite has been true of emerging market equity and U.S. fixed income returns. Unfortunately, since the emerging market equity universe does not possess a lengthy and robust return data set, it is difficult to extrapolate with certainty how the correlations among emerging markets and other major assets classes will behave in the future.

Rolling Five-Year Correlations Between Emerging Markets and Other Asset Classes



Using five-year rolling correlation figures helps smooth the volatility to reveal any trends. The most important question the chart raises is whether the historically low correlation between emerging market equities and other equity asset classes is gone. Since the Asian Financial Crisis, correlations have been rising steadily, although they appear to have plateaued in the past two years just above 0.80.

The MSCI EM index has shown a less-than-perfect, although growing, correlation with U.S. and developed market international equities, and maintains a negative correlation with

bonds. Assuming that the correlation between emerging and developed market equities remains relatively high, the case for investing in emerging market equities for risk diversification is not as strong as it had been historically.

RETURN EXPECTATIONS

Meketa Investment Group believes that emerging market equities should command a long term risk premium over developed markets, both domestic and overseas. Using projected return, risk, and correlation assumptions, we constructed several hypothetical investment portfolios using mean-variance optimization software to assess the effect of an emerging market allocation.

	Base	Similar Return	Similar Risk	Similar Return
Investment Grade Bonds	20%	25%	23%	23%
High Yield Bonds	5%	5%	5%	5%
Real Estate	10%	10%	10%	10%
US Equity	50%	35%	37%	42%
Foreign Developed Equity	10%	10%	10%	10%
Private Equity	5%	5%	5%	5%
Emerging Markets Equity	**0%**	**10%**	**10%**	**5%**
Expected Return	*8.13%*	*8.13%*	*8.22%*	*8.13%*
Standard Deviation	*12.36%*	*11.97%*	*12.36%*	*12.14%*

As the table above shows, the addition of emerging market equities allows for more efficient portfolios. By adding an allocation to emerging markets at the expense of domestic equities, while adjusting the bond allocation as necessary, a plan sponsor can construct a portfolio that either has a higher expected return for the same level of risk, or a lower level of risk for the same expected return.

In fact, for any portfolio that invests at least 40% of its assets in equities, the optimizer calls for an allocation of at least 10% in emerging markets. Only when the total equity allocation falls to 20% does the suggested allocation to emerging markets decline to 5%. Hence, *emerging market equities appear to offer meaningful diversification benefits.*

After examining the risk and reward characteristics of the asset class, we will next survey the strategies and investment vehicles available to institutional investors, including a review of the pitfalls in attempting to benchmark an emerging market portfolio.

STRATEGIES AND INVESTMENT VEHICLES

Passive and Active Management

At present, emerging equity markets provide significant opportunities to add value through active management. While passive management provides diversification benefits, active management can control risks and improve performance. Skilled investors have opportunities to add value by allocating holdings between markets and within markets. The limited research coverage, intrinsic inefficiencies, and inherent volatility of emerging markets create an opportunity for the savvy manager to produce added value. In addition, while individual stock returns range widely in any market, the range of returns within individual emerging markets is far greater. Therefore, stock picking is even more important in emerging markets.

The historical record appears to confirm that active management has shown the ability to outperform the passive benchmark. For example, for the five-year period ended March 31, 2007, the median emerging market equity manager returned 26.64% per year, versus 24.5% for the benchmark.[4] Furthermore, out of the sample size of ninety-nine, 80% of the active managers outperformed the MSCI EM index. This compares to only 58% of active managers outperforming the MSCI EAFE index over the past five years. The data sample for ten-year returns as of March 31, 2007 provides further evidence. Over 95% of the sixty-two managers beat the MSCI EM index return of 8.6%. It is important to note that the sample may have a significant upward bias as poorly performing investment products may have been liquidated or simply stopped reporting. Indeed, the Asian Financial Crisis and the Russian Default represented significant negative shocks to global emerging equity markets. The true effect of survivorship bias is difficult to assess, as the historical return set of active emerging market management is not robust and highly incomplete.

Investment Vehicles

A common mechanism for making an allocation to emerging markets is to permit an international equity manager to allocate a portion of their portfolio to emerging markets. Typically, the manager is limited to holding 10% to 20% of the portfolio in emerging markets, while the balance remains in developed markets. This may, however, result in a sub-optimal amount of overall assets allocated to emerging markets. There is also the risk that the manager has limited expertise in emerging market investing.

On the other hand, some investors hire a manager to oversee a dedicated portfolio of emerging market equities through a separate account or a commingled fund. Total operating costs are smaller for a commingled account, which can be many times the size of a large separate account. Further, commingling smaller accounts also lowers transaction costs, as the netting of inflows and outflows from different mandates reduces the volume of stocks that need to be traded.

[4] Source: EvestmentAlliance emerging market equity and large cap international universes as of March 31, 2007.

According to MSCI and Bernstein, unless a separate account is at least $100 million dollars, it would be more cost-efficient to invest in a commingled investment vehicle[5]. Based on this figure, if a plan sponsor were to allocate 5% of its assets to emerging market equities, it would necessitate at least $2 billion in total assets to warrant a separate account. Therefore, for most plan sponsors that seek exposure to emerging market equities, a commingled account should be the preferred choice. This practice is confirmed by data from Intersec Research, which shows that 74% of emerging markets equities held by U.S. pension funds are invested in some type of pooled vehicle.

INVESTMENT COSTS

The costs of investing in emerging markets are higher than investing in foreign developed markets, and much more expensive than investing domestically. First, emerging markets are relatively illiquid, which increases the bid/ask spread for any transaction. Second, the custody and accounting work required to maintain the investments is more complex and more expensive, and significant currency hedging costs may be incurred. Third, foreign governments sometimes levy withholding taxes on dividends or other gains, thus increasing costs and reducing returns. Finally, portfolio management fees are relatively high, reflecting the higher cost of gathering useful information.

Although the exact cost of investing in emerging market equities is unknown, estimates place it between 200 to 500 basis points annually[6]. Alliance Bernstein estimates investment management fees ranging from 0.8% to 1.5%, operating costs (custody, legal, accounting, and pricing fees) ranging from 0.2% to 0.3%, and transaction-related costs (commissions, taxes, and bid-ask spreads) ranging from 1.1% to 4.0%. Transaction-related costs, which represent the largest factor of the total cost of investing in emerging market equities, are not easily observable (i.e., they are hidden within the returns of the account). Therefore, when selecting an emerging market equity manager, strategies that minimize transaction costs are preferable.

Still, the total increase in costs incurred by investing in emerging markets is relatively small compared to the potential benefits of increased diversification and enhance returns. Furthermore, as markets become more "globalized," costs should decline.

BENCHMARKING

There are two primary index providers for measuring the performance of emerging market equities: Morgan Stanley Capital International (MSCI) and S&P/International Finance Corporation (IFC). The IFC is the private investment arm of the World Bank and began publishing the emerging market benchmark in 1988. It sought to incorporate investment

[5] Masters, Seth J. "Emerging Markets – Managing the Impact of High Costs" Institutional Investor, Spring 2002.
[6] Masters, Seth J. "Emerging Markets – Managing the Impact of High Costs" Institutional Investor, Spring 2002.

restrictions faced by foreign investors such as closed markets, highly illiquid securities, or tax issues. In January 2000, Standard and Poor's purchased the emerging market index from the IFC.

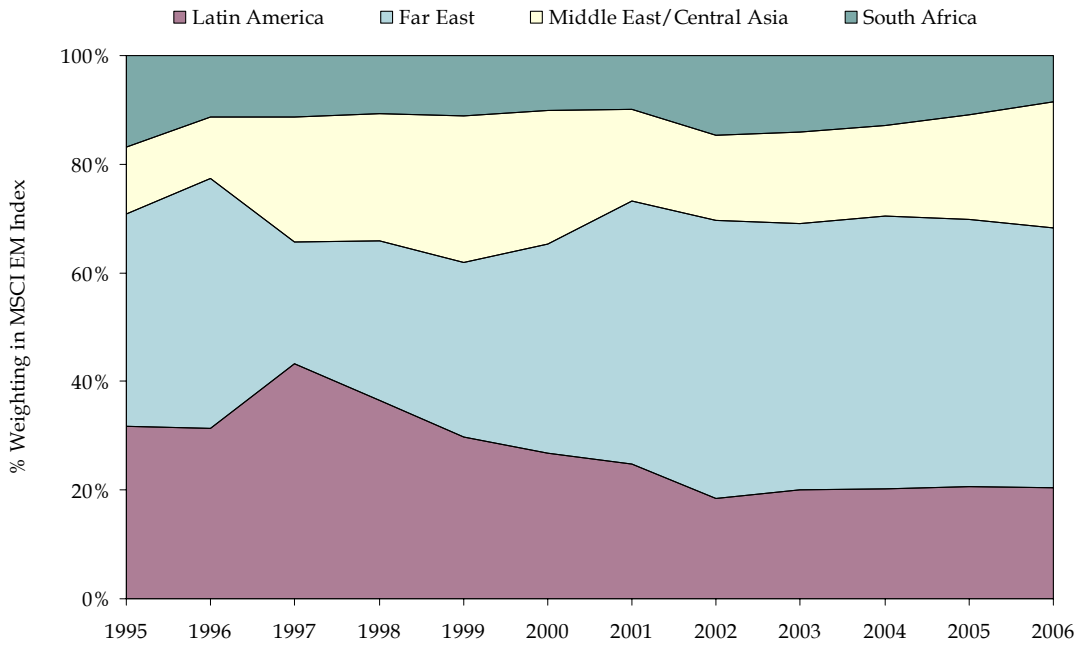
MSCI developed its index in the fourth quarter of 1987, the MSCI Emerging Markets Free index, or MSCI EMF. In 2004, MSCI dropped "Free" from the name. Similar to the IFC index, MSCI uses a capitalization-weighted approach to constructing its benchmark. However, MSCI frequently will adjust the weightings of individual country markets in the index based on the assumption that active managers would not be as country/regionally concentrated as the index frequently is, and that an index in which over 50% was comprised of only three markets was not a practical indicator of emerging market performance.

Despite the different construction methodologies, the returns of each index are nearly perfectly correlated. Since 1989, the lowest quarterly, three-year rolling correlation between the two indices is 0.91, and the average is 0.99. The MSCI EM index is the most widely used emerging markets benchmark in the money management industry.

There are several major issues with emerging equity benchmarks. The first, as touched on above, is the high concentration of certain markets or regions in each index. Perhaps the best explanation of this is the notion that foreign investment in emerging markets is highly cyclical on a regional and country basis. Emerging countries usually find the attention of foreign investors (and their capital) when the government attempts to privatize, or open for foreign investment, certain industries or individual companies. These companies, many of which were previously state owned, are attractive due to monopolistic advantages they enjoy in their home markets. Foreign investors logically increase their investment in these markets, including speculative investments, which, in turn, leads to larger market capitalizations.

Due to the various levels of economic, political, and social development in each emerging market, emerging market countries evolve at different paces. Therefore, different countries and regions will dominate at different times. The Asian Financial Crisis is a good example. Throughout the first half of 1996, emerging Asian countries began to open various industries to foreign investment. During this period, Far East countries dominated the index. In 1996, emerging Far East markets accounted for 44% of the MSCI EM index, based on market capitalization. Two years after the Far East crisis, these countries comprised only 28% of the index. By the end of 2002, Far East countries again dominated the index, comprising 49% of the country constituents. The following chart provides an example of the changing allocations represented by individual/regional markets. It also highlights the opportunity for active management to generate returns that significantly deviate from the benchmark.

Regional Weighting of MSCI EM Index



The second major issue is that of individual security weights within each market and within the index as a whole. The top ten companies in the S&P 500 index accounted for approximately 20% of the overall market capitalization of that index as of December 31, 2006. Although this may seem high, it compares favorably to many country-specific emerging market indices, in which the top ten holdings account for up to 80% of the overall index capitalization. The table below demonstrates how concentrated local markets may be, and how widely that concentration varies. For example, Teva Pharmaceuticals dominates the Israeli public equity landscape, while 71% of Brazil's country index can be accounted for in the issues of only ten companies. Of the 815 companies in the MSCI EM index, the top four companies account for 10% of the overall market cap.

% of Overall Country Index Capitalization
As of December 31, 2006

Country	Top 1	Top 3	Top 5	Top 10
Brazil	15%	36%	51%	71%
China	15	33	45	66
India	14	34	43	58
Israel	40	56	68	80
South Africa	11	27	39	57
Taiwan	14	28	35	48

The benchmarks are constructed to best represent the overall investable universe of emerging markets, and are comprised of the most liquid stocks in the most liquid emerging markets. Therefore, Korea dominates the index precisely because Korea offers not only the greatest investable market for foreign investors, but also the largest market capitalization.

Despite concerns surrounding the effectiveness of emerging market benchmarks as true representatives of emerging market performance, they do offer a useful indicator of whether an active manager can add value through country and industry allocation, as well as security selection. It is prudent, however, to incorporate individual country and industry indices into the performance analysis used to assess a manager's skill.

CURRENCY HEDGING

The effect of currency movements can be mitigated or even eliminated by purchasing the appropriate hedging instruments, such as future contracts, forward contracts, or options. The following table demonstrates the effects of local currency movements. The decline of the dollar over the past five years has increased the return for U.S. dollar-based investors. However, the longer-term strength of the dollar has diminished returns.

MSCI EM Returns[7]
As of December 31, 2006

Return FX	1 Year	3 Year	5 Year	10 Year
In Local Currency	28.9%	26.8%	22.7%	12.8%
In U.S. Dollar	32.2	30.5	26.6	9.2

While currency hedges eliminate the currency portion of a foreign stock's return volatility, the cost of even partially hedging exposure to a particular currency can significantly diminish the investment's return. In addition, hedging eliminates a portion of the diversification benefit of international investing.

Because the cost of a full hedge outweighs the short-term benefits, we do not believe that fully hedged portfolios are appropriate for most plans with a long-term investment horizon. We do recommend, however, that active managers be allowed to hedge currency exposure opportunistically and in limited circumstances. If the manager believes that a particular stock is very attractive, but that the underlying currency is weak, then the manager should be allowed to buy the stock and hedge, or eliminate, the currency risk. We also do not believe that currency speculation is an appropriate strategy for most funds. We recommend that managers be specifically forbidden to speculate in foreign currencies as this is often not their area of expertise and it could add unwanted volatility to a portfolio.

[7] Returns are gross of taxes and fees.

EVENT RISK

The harsh reality of the investment environment surrounding emerging market assets advanced to the forefront of investors' minds in 1997 and 1998 with the arrival of the Asian Financial Crisis, along with subsequent crises involving a huge default by Russia on its sovereign debt, and the devaluation of Brazil's currency. Events such as these led to massive investment losses, the virtual economic collapse of several developing economies, and lost hope on the part of many that emerging markets could ever fulfill the expectation of generating consistently high returns. Yet, emerging markets have demonstrated a tendency to rebound quickly, and significantly, after major, negative events.

POLITICAL RISKS

When assets are invested outside developed markets, civil insurrection, repudiation of debts, and the state seizure of private assets are possibilities that must be considered. Even in a less extreme context, new legislation may alter tax laws, place limits on foreign ownership of domestic assets, or introduce regulatory or accounting costs to businesses. These represent political risks that are separate from ordinary market risks.

While political risks have rarely been a long-term, damaging factor in developed markets during the last fifty years, political risks often affect investments in emerging markets. For example, in 2004 the arrest of Mikhail Khodorovsky, former CEO of Yukos, by the Russian government, and the subsequent seizure of Yukos assets under the charge of delinquent tax bills, demonstrates the significant political risk of government intervention. History may show that Yukos, under the leaderships of Mr. Khodorovsky, did indeed evade taxes. However, foreign investors in Yukos stock lost their money. Yukos' assets were subsequently sold in a state run auction, derided by many as a sham, to a Russian government-owned energy company. Additional examples of political risk are the civil unrest and government actions (such as voiding contracts of foreign businesses) by President Hugo Chavez in Venezuela and the ongoing tensions between China and Taiwan.

Political risks, whether realized or not, are captured in the return data, and therefore act as a negative force on returns. Active managers may be more effective in navigating and negotiating these types of risks versus a passive portfolio.

An important point is that detrimental political events do occur in developed countries, but the strong legal and legislative infrastructure in place in many of these countries, especially the U.S., translates to greater transparency, a solution based primarily on laws (not men), and an orderly, if not desirable, outcome.

THE CHINA FACTOR

Stellar economic growth and the impact of its labor force on the world economy have made China the focal point of the emerging market universe. China has influenced energy prices, manufacturing practices, labor, and investment portfolios on a global basis, especially in the Pacific Rim.

In the context of public equity investments, direct investment in issues listed on the Shanghai and Shenzen stock exchanges is a risky proposition for foreign investors. As of 2005, nine-tenths of all listings on the exchanges are state-owned enterprises (SOE's), and approximately 60% of the aggregate shares outstanding are owned by the government, rendering shareholder activism virtually impossible. In other words, foreign investors hold little power to control risk or influence management through the election of board members. This dynamic is reflected by China's modest 11.8% weighting in the MSCI EM index despite its enormous economic clout. In addition, there is a significant lack of transparency and disclosure required by these exchanges. However, many Chinese companies list on foreign exchanges such as Taiwan and Hong Kong, and a growing number of Chinese companies list ADRs on the NYSE.

An alternative approach for capitalizing on the China opportunity is to invest in U.S. or non-Chinese foreign public companies that have significant manufacturing or revenue-generating operations in China. In this fashion, plan sponsors can gain (and may already have) some China "exposure" even without a dedicated allocation to emerging markets.

It is impossible to understate the growing importance of China on the world economic stage. China is currently the third largest economy, the second largest consumer of energy behind the United States, and the third largest trading partner for the U.S. The role of China in the Asia Pacific region is even more pronounced. In the context of public equities, there are two primary ways to participate in China's economic and financial emergence: purchase securities of China-based companies listed on foreign exchanges that have more stringent listing requirements than Chinese exchanges, or purchase the securities of emerging market companies that derive a large part of their revenue from China or that utilize China for a more efficient cost structure. On the whole, this latter approach is most common among emerging market equity managers, as they too recognize the perils of investing in companies listed only on Chinese exchanges.

RECOMMENDATION

The prospects for emerging markets remain unclear. They may grow rapidly, or stagnate for years. Much will depend on the patterns of growth in the developed world. However, by their very nature, emerging market investments will continue to be very volatile and somewhat speculative.

Individual emerging markets have the ability to deliver spectacular returns over a one or two year period. However, finding consistently strong returns has remained an elusive goal for almost the entire universe of managers. Indeed, the following table provides a stark contrast of substantial short-term gains versus significant and sometimes long-term losses. Note that an 80% decline requires a subsequent 400% gain to offset that loss.

Cumulative Returns of MSCI Country Markets

	Substantial Gains		Significant Draw Downs	
Argentina	1993	336%	1992-2001	-72%
Russia	1990-1991	431%	1998	-83%
Thailand	1996-1997	454%	1995-2001	-89%
Indonesia	1993-1994	102%	1994-2002	-85%

Source: Julius Baer (MSCI)

Meketa Investment Group recommends the use of active management in emerging markets. Only managers with solid experience in emerging markets should be considered for any assignment. Qualified managers should be able to demonstrate the in-depth analytic expertise necessary to track rapidly changing events in these potentially chaotic markets. In addition, and perhaps more importantly, any analysis should focus on a manager's ability to control downside risk. The key to generating consistent returns in emerging markets is to control the downside risk effectively and over extended periods. In addition, the custodian bank used by the manager or plan sponsor must have the capability to settle, reconcile, and measure emerging markets trades accurately.

Meketa Investment Group believes that emerging markets investing is appropriate for long-term portfolios as a tool for enhancing returns and reducing overall portfolio volatility.

APPENDIX A

2006 ECONOMIC STATISTICS

	Population (millions)	Approximate GDP Growth	GDP ($U.S. billions)	GDP/Capita	Inflation	Foreign Currency Reserves (billions)	Current Account Balance
Argentina	40	8.5%	$210	$5,211	10.0%	$30	$5.8
Brazil	190	2.8	944	4,966	3.0	87	13.5
China	1,322	10.5	2,512	1,900	1.5	1,034	179.0
India	1,130	8.5	796	705	5.3	165	(26.4)
Israel	6	4.5	140	21,831	-0.1	28	1.5
Korea	49	4.8	897	18,298	2.2	239	2.0
Mexico	109	4.5	742	6,821	3.4	85	(0.4)
Poland	39	5.3	337	8,749	1.3	50	(4.5)
Russia	141	6.6	733	5,185	9.8	315	105.3
South Africa	44	4.5	201	4,557	5.0	24	(12.7)
Thailand	65	4.8	197	3,021	5.1	59	(0.9)
United States	301	3.4%	$13,220	$43,900	2.5%	$69	(862.0)

Source: Bloomberg, the Economist, CLSA, Goldman Sachs, Morgan Stanley, CIA World Factbook