

Russell Research

By: Mat Lystra, Senior Research Analyst

JUNE 2011

The United Arab Emirates and Colombia:

Why they belong in emerging markets indexes

Russell's classification of the United Arab Emirates as an Emerging Market differs from the current Frontier Market designation given by MSCI and S&P. This represents the largest difference by weight between the comparable Russell and MSCI Frontier and Emerging index offerings, and the second largest difference between Russell and S&P behind Colombia, which S&P also classifies as a Frontier Market. The UAE was the first Gulf Cooperation Council (GCC) country to graduate from Frontier to Emerging Market status within the Russell Global Index series. In this paper we examine the UAE and Colombia relative to the rest of the countries represented in the Russell Emerging Markets (REM) Index and median indicators from the Russell Frontier Index (RFI). Using elements of Russell's country classification rules, along with some common measures of market size, we find evidence that these two countries – Colombia and the UAE – are more appropriately classified as Emerging rather than Frontier.¹

The Russell Indexes country classification methodology seeks to identify the relative risk of investing in a country by evaluating both macro-level and market-level factors. Specifically, for this research we utilize:

- Two key macro level measures used by Russell Indexes – the EIU country risk score and the World Bank Income Category;
- Market accessibility and operational risk across factors – foreign ownership limits, participation requirements, liquidity, existence of delivery vs. payment, and settlement period; and
- Additional market size and investability measures – GDP, GDP per capita, market capitalization, market capitalization/GDP, and market value (float adjusted)/market capitalization.

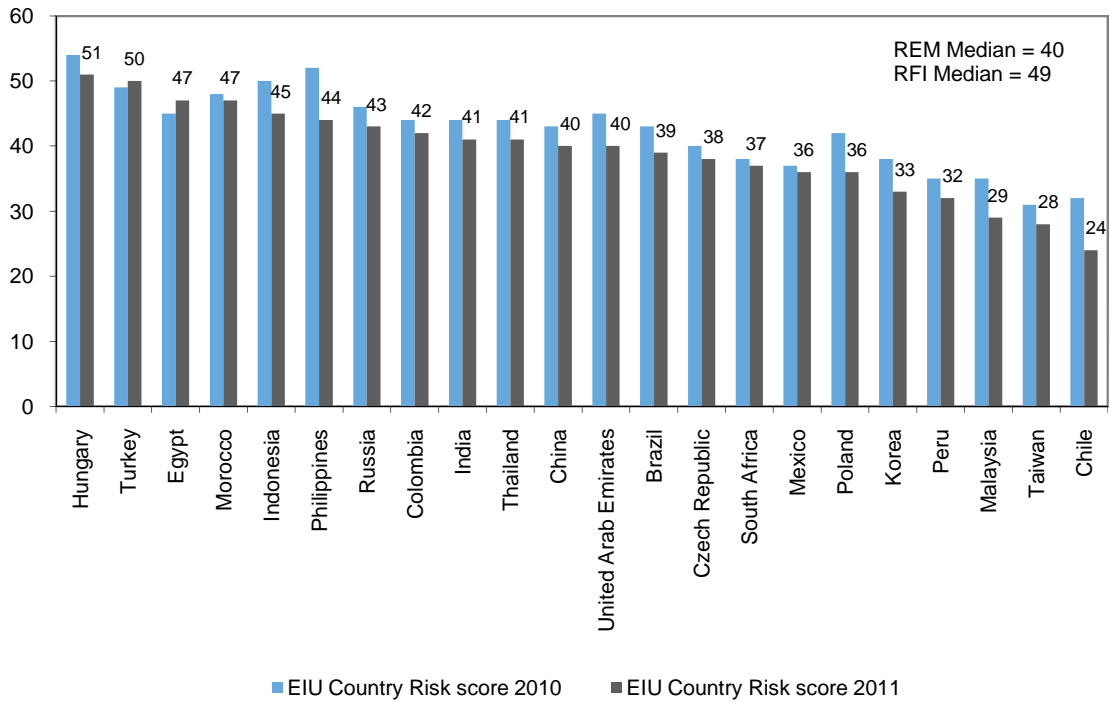
Our analysis across these factors demonstrates that both the UAE and Colombia should be included in the emerging markets opportunity set.

¹ The author thanks Sarah Orzell, Mary Fjelstad, Andrew Pittman, Tricia O'Connell and Lori Stoner for their assistance in the research and production of this paper.

EIU Country Risk and Economic Freedom

The UAE is ranked the 12th-riskiest country in the Russell Emerging Markets Index by the Economist Intelligence Unit (EIU), with a score of 40, which is also the median EIU score for REM countries (Figure 1). Colombia is considered slightly more risky by the EIU, with an above-median score of 42. Within the Russell Global Indexes methodology, a risk score of 40 or less is an indicator of a stable country.

Figure 1 / EIU Country Risk scores, January 2010 & January 2011.

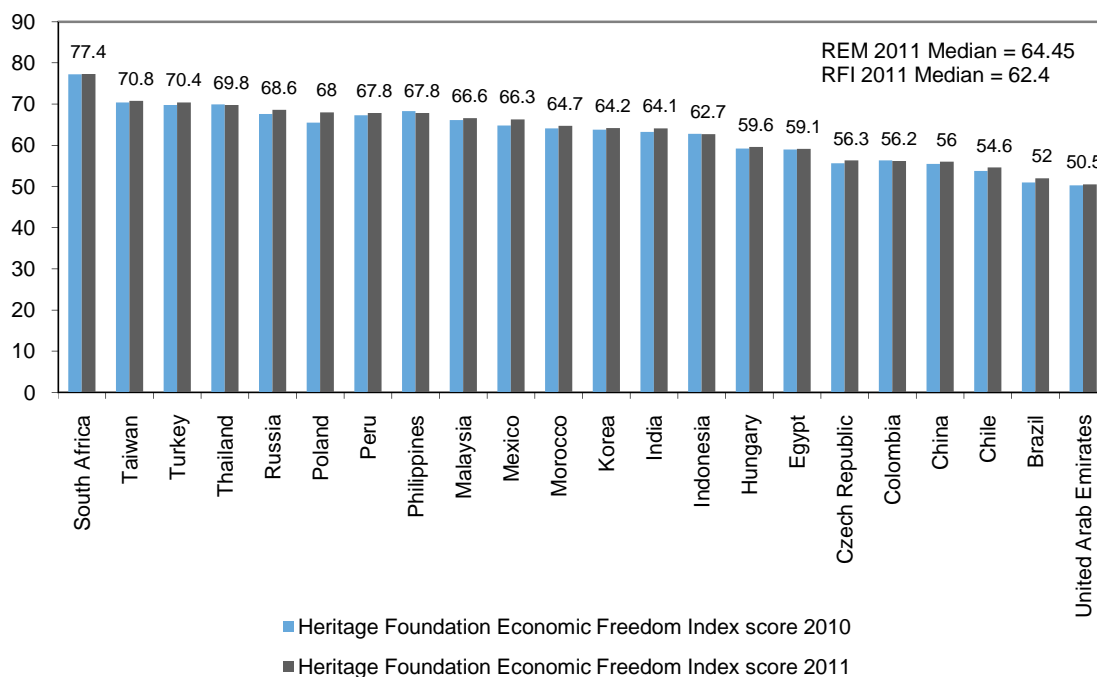


Source: Economist Intelligence Unit.

However, the Heritage Foundation ranks the UAE last among emerging market countries for economic freedom (Figure 2). It is worth noting that China and Brazil – both leading emerging market economies – rank near the bottom in scores for economic freedom. But Colombia, with a score of 56.2, is seen as more economically free than China, Chile, Brazil and the UAE.

The Russell Frontier Index has a median risk score of 49, which Russell would consider moderate to risky. Russell allows for higher risk within the Frontier Index, but the UAE and Colombia are currently viewed as stable, and their scores fall within the distribution of emerging countries. Both countries scored beneath the frontier market median score for economic freedom.

Figure 2 / Economic Freedom Index scores.



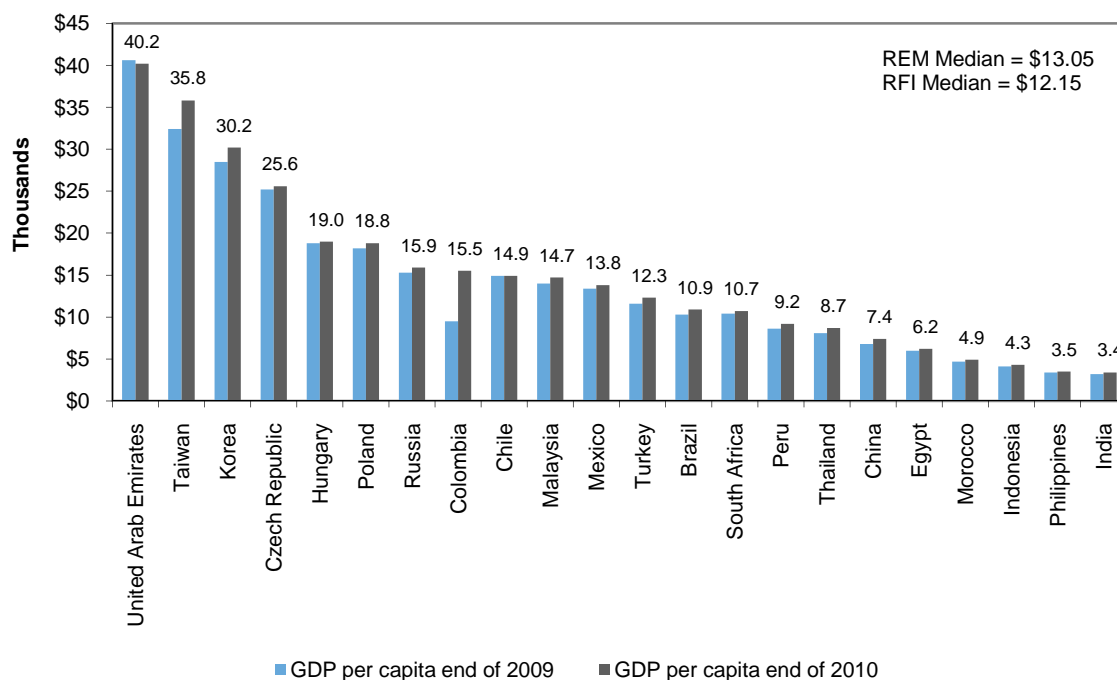
Source: Heritage Foundation, 2011.

World Bank Income (GNP ranked) and GDP per capita

Investment managers often use GDP per capita as part of their own market classification process. Russell Indexes uses a similar measure – the World Bank Gross National Income (GNI) designation – to gauge the relative size and wealth of a country. The UAE has the highest GDP per capita of any emerging market country (Figure 3), and is categorized as a “high income” country by the World Bank (Table 1). Colombia, at \$15,500, is comfortably above the median GDP per capita of \$13,050 for emerging countries, and is categorized as an “upper middle income” country by the World Bank.

The Russell Frontier Index has a median GDP of \$12,050 USD, about \$1,000 less than the REM. However, this number falls to \$10,250 when the GCC countries are removed – the average falls more dramatically. A majority of frontier countries are categorized as “lower middle” and “low income” by the World Bank, with the GCC countries again distinguishing themselves from the rest of frontier by falling into the “high income” grouping. Both the UAE (a member of the GCC) and Colombia are far above the RFI median.

Figure 3 / GDP per capita (000's USD).



Sources: CIA World Factbook, World Bank.

Table 1 / World Bank Income Designation (based on GNI).

High income	Upper middle income	Lower middle income
Czech Republic	Brazil	China
Hungary	Chile	Egypt
Korea	Colombia	India
Poland	Malaysia	Indonesia
United Arab Emirates	Mexico	Morocco
	Peru	Philippines
	Russia	Thailand
	Turkey	
	South Africa	

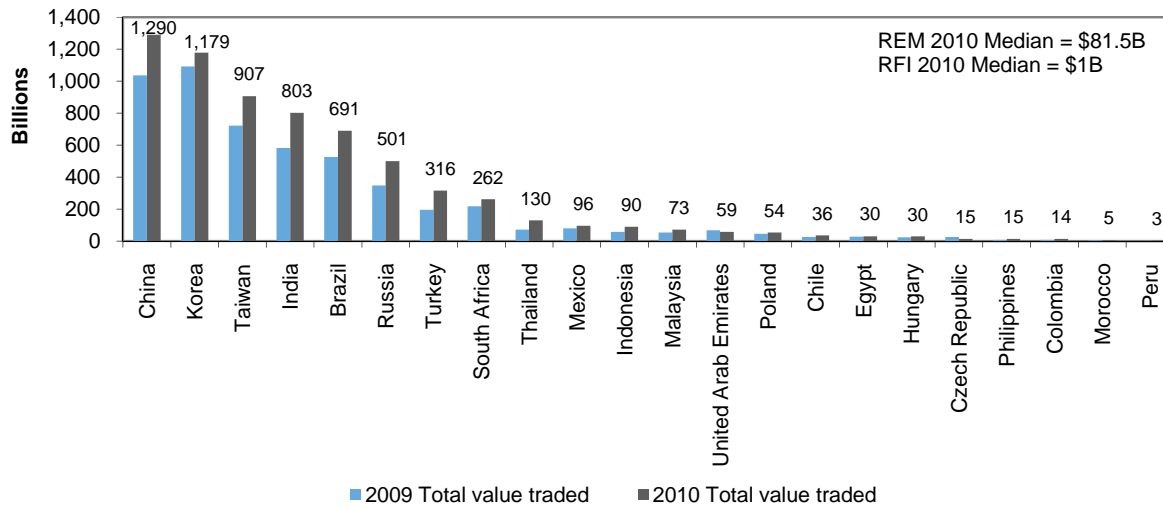
*Taiwan not ranked. Source: World Bank Group, 2011.

Liquidity

Liquidity within a market is important to global investors who expect to be able to buy and sell shares efficiently. Emerging markets liquidity is dominated by the BRICs, Korea and Taiwan; these countries accounted for 81% of the total value traded in 2010 (USD). The UAE represented about 1% of the REM volume, trading almost \$60B, making its market the 13th most liquid (Figure 4). Colombia suffers from a less liquid market, of only \$14B traded in 2010, perhaps due to the restrictions on foreign investment we discuss in the following section. Evaluating average daily trading value (ADTV) does not change the rank of any country relative to total yearly value traded (Figure 5).

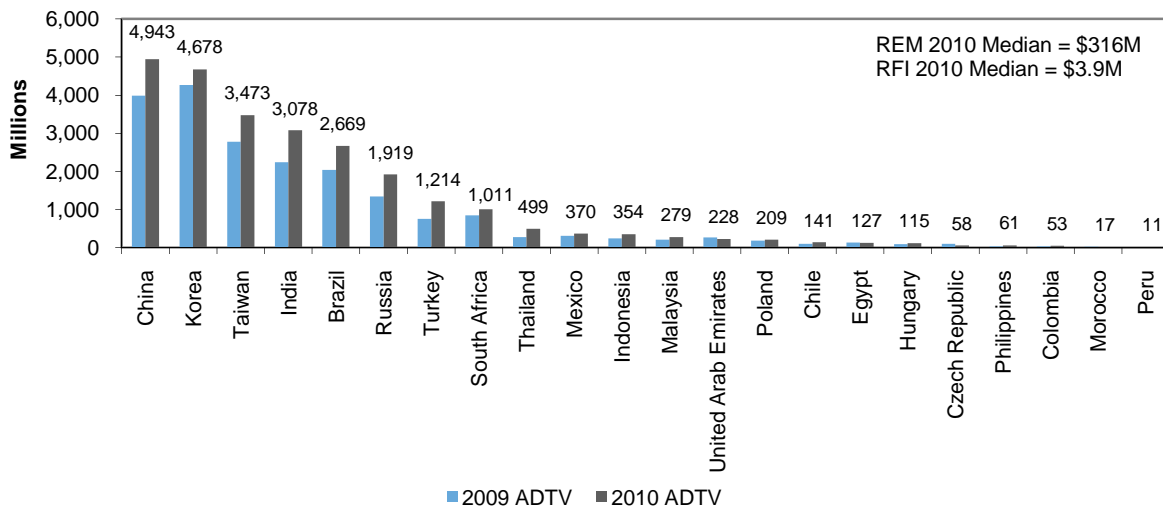
The difference in liquidity between frontier and emerging markets is noteworthy. The median value traded for the REM in 2010 was \$81.5B, as compared to just over \$1B for the RFI. ADTV similarly shows a stark contrast in liquidity between the two asset classes. Both the UAE and Colombia distinguish themselves as having highly liquid markets as compared to the frontier medians.

Figure 4 / Total value traded (USD).



Source: Russell Indexes.

Figure 5 / 2009–2010 ADTV (USD).

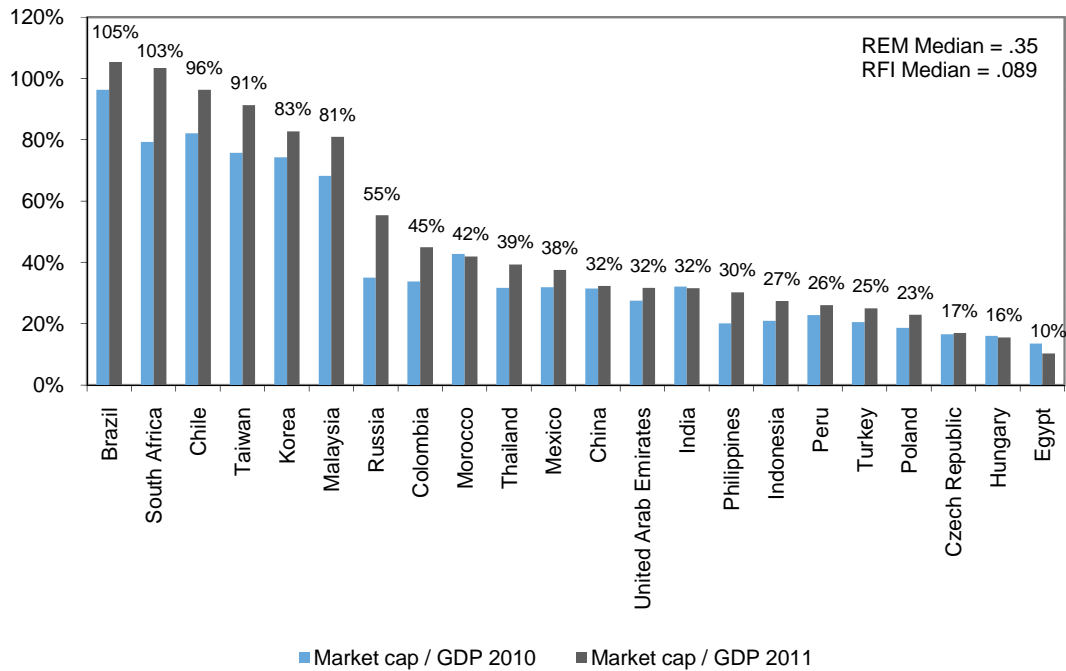


Source: Russell Indexes.

Market Cap/GDP and Market Value/Market Cap

The total equity market capitalization of a country in proportion to its GDP is a gauge of capital market development relative to the country's overall economic output. The capitalization/GDP of the UAE market falls just below the 35% median for the REM, at 32%, suggesting that there is upside potential in the market relative to the UAE's economic footprint (Figure 6). Colombia's capitalization is 45%, above the median but with room to grow relative to countries like Brazil and South Africa, whose markets are greater than 100% capitalized relative to their GDPs. By this measure, both the UAE and Colombia fall within the distribution of emerging countries rather than frontier, where the RFI median is 8.9%.

Figure 6 / Market capitalization / GDP.

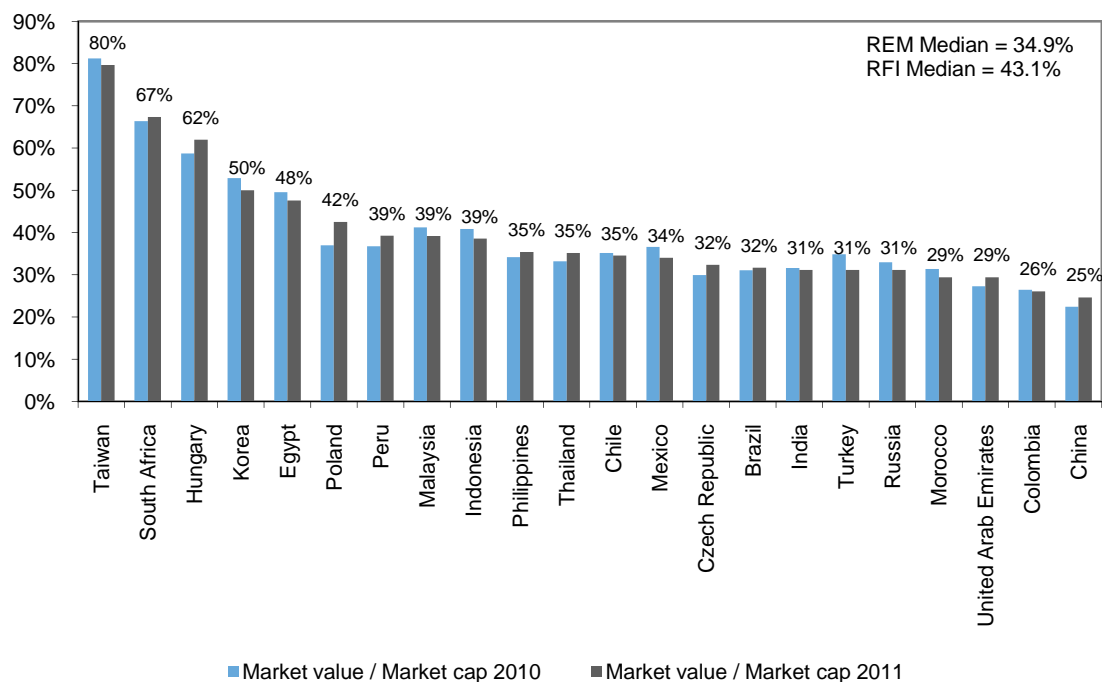


Sources: Russell Indexes, CIA World Fact book.

Market availability of the UAE, as measured by market value (float adjusted)/market cap, is below the 35% median for the REM, at 29%, suggesting a tightly held market with greater foreign ownership restrictions and government holdings in companies (Figure 7). The Colombian market has an even lower accessibility ratio, at 20% market availability.

Frontier market countries in general have much lower market cap-to-GDP ratios than emerging market countries. Frontier capital markets tend to be underdeveloped relative to their economic output. The UAE and Colombia both exhibit strong capital market developments compared to most countries in frontier. However, their markets, as noted above, lack sufficient accessibility. The lack of accessibility is problematic in markets throughout the emerging and frontier countries and is not, in our view, a central reason to preclude an emerging designation for the UAE and Colombia. It is interesting to note that in Figure 8 the REM median is much lower than the median for frontier markets: 17 of the 22 emerging markets countries come in lower than the RFI median.

Figure 7 / Market availability.



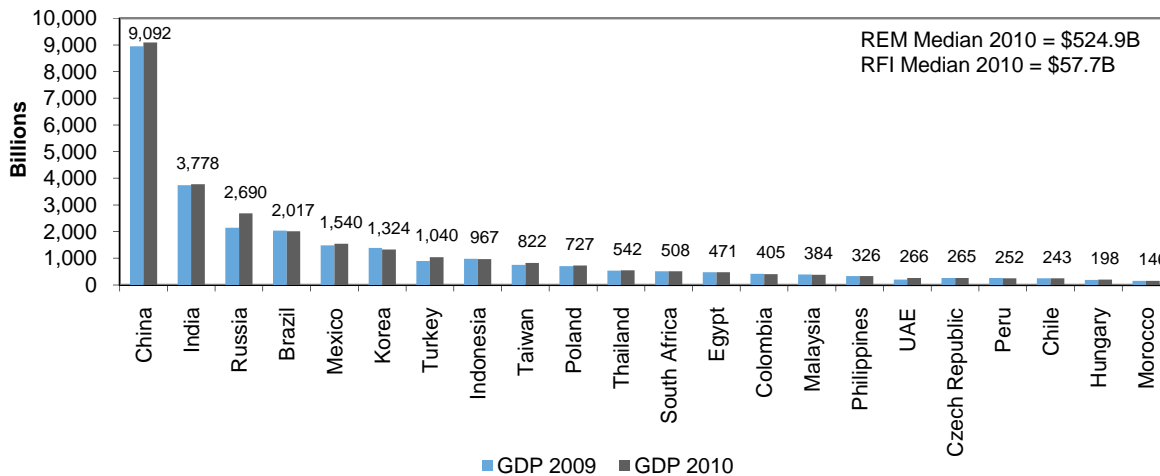
Source: Russell Indexes.

Aggregate GDP and market capitalization

As we observed in the evaluation of liquidity, the BRICs, Taiwan and Korea dominate the GDP and market capitalization in the emerging markets. These six countries represent 70% of aggregate GDP and 76% of total market capitalization. Using these pure market size indicators, the UAE is in the bottom third of the REM Index, with roughly 50% less GDP than the median of \$525B USD (Figures 8 & 9). Although these measures are best adjusted for the relative size of a country's resources, we find the UAE's pure economic footprint within the emerging markets sufficient at slightly less than 1% of GDP and market cap. Colombia's footprint is more robust, at 7.3% of GDP and 1.2% of market cap.

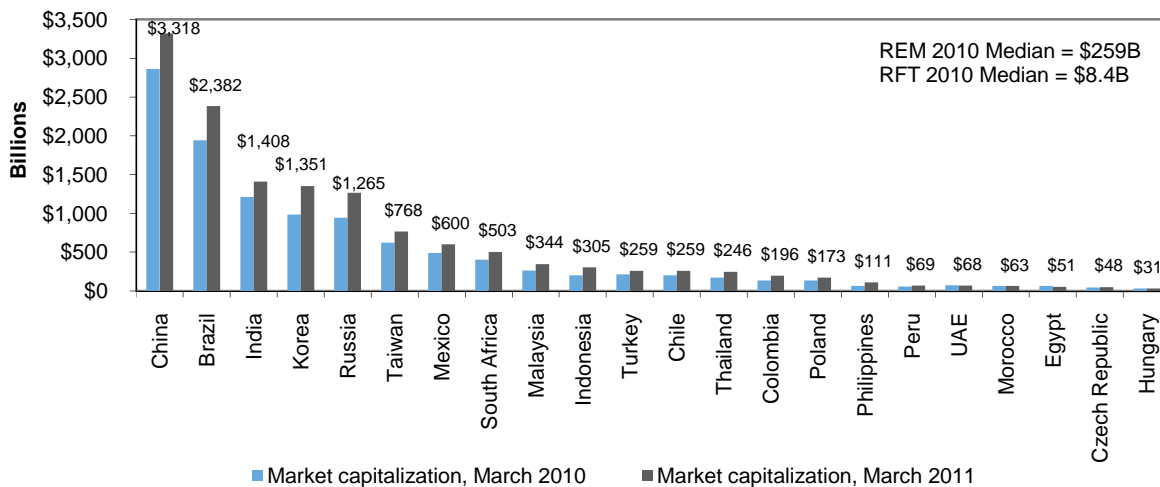
Again, we see that Colombia and the UAE have values that by both measures align better with emerging countries than with frontier (RFI median). Russell frontier markets have markedly lower median GDP and market cap than emerging markets. Market size and liquidity may be the two best differentiators of frontier and emerging markets, given the spread between their medians. The UAE and Colombia each have an economic output at least \$200B greater than the frontier median (Figure 9). The two countries exceed the frontier total market cap median by \$60B (UAE) and \$188B (Colombia); including both in the Russell Frontier Index would consume 43.5% of the total cap of the index.

Figure 8 / 2009 – 2010 GDP.



Source: CIA World Factbook.

Figure 9 / Total market capitalization. Source: Russell Indexes.



Source: Russell Indexes.

Operational risk factors

The UAE recently announced its intent to move to a delivery vs. payment (DvP) trading system, a capability standard among most of the other emerging markets countries, by June 2011. With DvP in place, and fewer currency-related restrictions, the UAE will have a better operational risk profile than many emerging countries. Colombia's operational risk profile is similar to those of most other emerging countries. Russia, notably, still lacks both a central depository and DvP, among its other operational obstacles for global investors – perhaps these are the reasons why it has lagged its BRIC counterparts in market size.

Frontier markets naturally have fewer operational efficiencies than emerging markets. Acknowledging this, the Russell methodology relaxes requirements for frontier markets. Some examples of exceptions in the frontier space are: settlement should be t+3 or better for an emerging market, but may be longer in a frontier market; central depository and DvP are widely available, but not necessarily standard; and availability of custody may be limited. Neither Colombia nor UAE suffers from the sort of heightened operational risk profile that would typically be expected in a frontier market.

Table 2 / Operational Risks.

Country	Delivery vs. payment	Depository	Settlement	FX restrictions	Available custody
Brazil	Yes	Yes	T+2	Yes	Yes
Chile	Yes	Yes	T+2	Yes	Yes
China	Yes	Yes	T+3	Yes	Yes
Colombia	Yes	Yes	T+3	Yes	Yes
Czech Republic	Yes	Yes	T+3	No	Yes
Egypt	Yes	Yes	T+2	Yes	Yes
Hungary	No	Yes	T+1	No	Yes
Indonesia	Yes	Yes	T+3	Yes	Yes
India	Yes	Yes	T+2	Yes	Yes
Korea	Yes	Yes	T+2	Yes	Yes
Morocco	Yes	Yes	T+3	Yes	Yes
Mexico	Yes	Yes	T+2	No	Yes
Malaysia	Yes	Yes	T+3	Yes	Yes
Peru	Yes	Yes	T+3	No	Yes
Philippines	Yes	Yes	T+3	Yes	Yes
Poland	Yes	Yes	T+3	Yes	Yes
Russia	No	No	T+1	Yes	Yes
Thailand	Yes	Yes	T+3	No	Yes
Turkey	Yes	Yes	T+2	No	Yes
Taiwan	Yes	Yes	T+2	Yes	Yes
South Africa	Yes	Yes	T+3	No	Yes
United Arab Emirates	Pending	Yes	T+2	No	Yes

Sources: State Street, The Bank of New York Mellon, Auerbach Grayson, local exchanges.

Scorecard

In order to organize and score each of the countries in the REM based on its rank for each factor, we have devised a basic scorecard. Each country was given a "score" based on its rank for each factor. The highest score = 21 and the lowest = 0. We then totaled the scores for each country; all scores are displayed in Table 3. Of the 22 countries in the REM, based on total score, the UAE ranked 13th and Colombia 18th. Taiwan and Korea, both of which are among the strongest candidates to graduate to developed nation status in the near term, had equal high scores of 127. Egypt, Hungary and Morocco had the lowest scores among the REM countries; each struggles with risk, liquidity and market size.

Table 3/ Aggregate Scorecard.

Country	EIU country risk	Economic Freedom Index	GDP per capita	WB income	Shares traded	Value traded	GDP	MC	Operations	Total
Taiwan	20	20	20	3*	17	17	13	16	4	127
Korea	17	10	19	3	20	20	16	18	4	127
Russia	6	17	15	2	16	16	19	17	2	110
China	10	3	5	1	21	21	21	21	4	107
South Africa	14	21	8	2	15	15	10	14	5	104
Brazil	12	1	9	2	18	18	18	20	4	102
Mexico	8	9	0	1	19	19	20	19	4	99
India	15	12	11	2	10	10	17	15	5	97
Turkey	1	19	10	2	14	14	15	11	5	91
Poland	16	16	16	3	7	7	12	7	4	88
Malaysia	19	13	12	2	9	9	7	13	4	88
Thailand	9	18	6	1	12	12	11	9	5	83
United Arab Emirates	11	0	21	3	13	13	5	4	5	75
Indonesia	4	8	2	1	11	11	14	12	4	67
Chile	21	2	13	2	5	5	2	10	4	64
Czech Republic	13	5	18	3	6	6	4	1	5	61
Peru	18	15	7	2	0	0	3	5	5	55
Colombia	7	4	14	2	1	1	8	8	4	49
Philippines	2	6	4	1	8	8	9	2	4	44
Egypt	5	14	1	1	2	2	6	6	4	41
Hungary	0	7	17	3	4	4	1	0	3	39
Morocco	3	11	3	1	3	3	0	3	4	31

"High" income status = 3 pts, "Upper middle" income = 2 pts, "Lower middle" income = 1 pt.

*Using actual GNI data, Taiwan would be classified as "High income".

Conclusion

We have examined two markets – the UAE and Colombia – across a variety of factors to determine the merits of their classification as emerging vs. frontier countries. Their relative size and liquidity profiles are significant compared to the Russell Frontier Index. Although economic freedoms in each country are low – as is market availability – the country risk profiles for both more closely align with the REM. The operational infrastructures in both the UAE and Colombia are better in most areas than is typically the case in frontier markets. Both countries score competitively when cumulatively ranked across factors and compared to the rest of the REM cohort. The Russell Global Indexes methodology has accurately classified the UAE and Colombia as emerging markets.

**For more information about Russell Indexes call us or visit www.russell.com/indexes.
Americas: +1-877-503-6437; APAC: +65-6880-5003; EMEA: +44-0-20-7024-6600**

Disclosures

Russell Investments is a Washington, USA Corporation, which operates through subsidiaries worldwide and is a subsidiary of The Northwestern Mutual Life Insurance Company.

Russell Investments is the owner of the trademarks, service marks and copyrights related to its respective indexes.

Indexes are unmanaged and cannot be invested in directly.

This material is proprietary and may not be reproduced, transferred or distributed in any form without prior written permission from Russell Investments. It is delivered on an "as is" basis without warranty.

Nothing contained in this material is intended to constitute legal, tax, securities, or investment advice, nor an opinion regarding the appropriateness of any investment, nor a solicitation of any type. The general information contained in this publication should not be acted upon without obtaining specific legal, tax and investment advice from a licensed professional.

This is not an offer, solicitation or recommendation to purchase any security or the services of any organization.

Copyright © Russell Investments 2011. All rights reserved.

First use: June 2011.

CORP-6767