



Thoughts from the president of 1995's best emerging market fund

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The long, dark shadow of the Mexican Peso crisis cast itself over the emerging market universe in 1995 like some sinister ghoul, frightening away investors and sending many of the dedicated managers scurrying into the distant, unfamiliar corners of the investment world: Africa, the Middle East and Russia.

For some, however, the crisis in Mexico was an unexpected boost. Just ask Steve H. Hanke, Professor of Applied Economics at Johns Hopkins University, *Forbes* columnist, advisor to Argentina's Minister of Economy and President of the best performing Emerging Market fund of 1995 (Toronto Trust Mutual Fund Argentina), which was up a stunning 79.25%.

"Mexico was the best thing that happened", asserts Professor Hanke.

The investment policy for Toronto Trust Argentina was laid out in Hanke's *Forbes* column back in December 1994, just prior to the Mexico crisis. Hanke identified that understanding a country's monetary policies is crucial to getting one's timing right in Emerging Markets investing. Key to this is understanding a country's exchange rate system.

There are three types of exchange rates - floating, fixed and pegged. The floating exchange rate, which is used in the US and by most major currencies, is not

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Overall 3rd quarter country flows

The total value of holdings in international dedicated emerging market funds fell by US\$4.5 billion during the 3rd quarter, to just under US\$109 billion. This compares with 2nd quarter growth of US\$15.5 billion for this universe of funds.

Net buying and selling activity was much quieter than in the 2nd quarter. Based on our estimates, only about US\$0.5 billion (net) flowed into emerging stock markets from international emerging market funds during the 3rd quarter. (see table on page 4) This was down sharply from the estimated US\$2.9 billion and US\$3.2 billion of net buying in the 1st and 2nd quarters respectively.

Year to date then (to the end of the 3rd quarter), total flows into emerging stock markets from international emerging market funds was US\$6.6 billion.

Korea and Russia are Popular

On a regional basis, about US\$0.8 billion flowed into Europe/Middle East/Africa ("EMEA"), with US\$0.3 billion of that total being channeled to Russia and the Commonwealth of Independent States ("the CIS"). In fact Russia and the CIS attracted more money than any other emerging market except South Korea in the 3rd quarter. Year to date, about

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used in Emerging Markets, but both the fixed and the pegged are, with the latter being prevalent. Fixed and floating systems are free-market mechanisms, limiting a governments control over the currency, whilst a pegged rate is an interventionist tool, decreeing that the central bank must manage the exchange rate, liquidity and the capital account. Hanke cites this as a near impossible task, and warns investors to pay the most careful and anxious attention to pegged exchange rate systems.

The fixed exchange rate is used only in a small minority of countries: Argentina, Lithuania, Estonia and Hong Kong. Professor Hanke was involved in the creation of the currency-board systems in Lithuania (April 1994), Estonia (June 1992), and most notably in Argentina (April 1991). As a result, the Argentinean peso, fully backed by US\$ denominated assets, is freely convertible into US Dollars at the fixed rate of one peso to one dollar, and Argentina is now part of the unified US Dollar area.

The markets considered Argentina's currency-board as high risk, even before the crisis in Mexico. For the Toronto-based Friedberg Mercantile Group, where Hanke is vice-chairman, the picture was somewhat different. Hanke's thorough understanding of the system, gained from within, suggested a different scenario. Whilst the rest of the market thought Hanke and Friedberg to be not entirely serious and ultra-optimistic, the Canadian-based company, which manages Toronto Trust Argentina, started to make its investments.

Friedberg's basic premise is this - once the exchange rate is absolutely fixed, interest and inflation rates in a currency board country will start to converge towards those in the anchor country currency. Inflation in Argentina was indeed falling, ending 1994 only just above the US rate. Interest rates, however, were well above those in the US. Peso-denominated T-bills were yielding around 10% and 7 year paper yielded 16.75%. Comparable rates in the US at the time were just over 5% and 8% respectively. The differences can occur for a number of reasons - for international investors, the total cost of investing in Argentinean paper is higher than for US bonds, and perhaps more importantly, Argentina's credibility as a debtor is somewhat below that of the US. However, Hanke and Friedberg considered that the differences in yields between the US and Argentina were unjustified and, that Argentinean debt securities were, hence, a very interesting prospect.

Then the Mexican Peso was devalued, and most of the rest of the world sought to liquidate Argentinean peso holdings. By March last year, panic selling was nearing a peak and yields were as high as 46% on some paper. The world, and its dog it seemed, was selling while Friedberg was buying. Whilst the world saw collapse and disaster, Hanke saw greater opportunity - "the rest of the market got it wrong".

So why was there this almost unanimous misconception? How could experienced traders and managers from the rest of

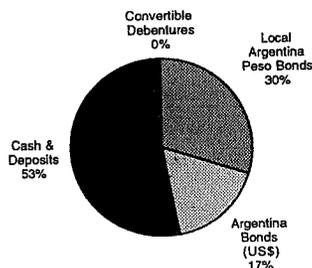
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"Mexico was the best thing that happened"

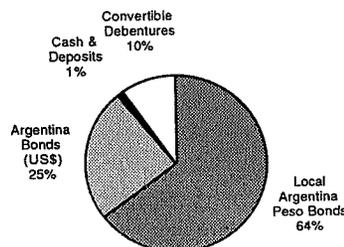
"the rest of the market got it wrong"

Toronto Trust Mutual Fund Argentina

Asset Allocation Dec. 94



Asset Allocation Dec. 95



"People don't always pay attention"

the world miss such an opportunity? Hanke cites his and Friedberg's experience as currency traders as a core reason. "This gives us a better understanding of the market than many other players. Half way through 1995, nobody foresaw that an Argentinean fund would be top of the pile at the year end, but this 'anomaly' was predictable", argues Hanke, "it just requires knowledge of the system".

Indeed, on January 17 last year, Argentinean finance minister Cavallo re-recruited Hanke as an official advisor, to explain to the world how the currency-board worked. "But", asks the Professor, tugging on his pipe, "was anybody really listening?". It seemed to Hanke, that the international players took his optimism with a large grain of salt. "People who I spoke with, and who obviously thought I was a bit off-the-wall, would later ring me back and say 'you were right all along', but they still would do nothing about it!"

Emerging Markets, more than developed ones, are rife with rumors and hearsay. I've known Menem [Argentinean President] since 1989", comments the Professor, "and I knew that the rumors that Cavallo was going to be sacked, or resign, were nonsense". To reinforce this, Hanke and his wife Liliane interviewed Menem for Forbes magazine in September. It ended with Menem's assertion that Cavallo would stay with the government 'until 1999'. Obviously, fund managers do not believe everything they read in the press.

"People don't always seem to pay attention", he continues. "The market's perception was completely out of line with reality. A fantasy land". Hanke is also a little critical of some of the less experienced players, predominantly from London and New York. "They are too much influenced by the Argentines, who, given Argentina's propensity to shoot itself in the foot, have become rather pessimistic". Friedberg's, because of their own knowledge of the market, did not succumb to this negative local

bias. Coupled with a rather superficial understanding of currency markets, especially the fixed-rate currency board system, it was the influence of this local pessimism that kept most of the big foreign players out of the Argentinean debt market.

Hanke notes that "more people are realizing the strengths of Argentina now". This does, to some extent, reinforce Hanke's view that the competition in 1995 were "too hesitant, too slow and too reactive. Our knowledge of the system helped us to anticipate developments, and get our timing right".

With interest rates in Argentina now falling, liquidity rapidly increasing, and the economy likely to grow by 5% in real terms (Hanke considers it may do even better) and profits returning, Friedberg's are now looking seriously at equity investment. Already, they hold 10% of the fund's portfolio in convertible debentures, and the first straight equity investments will probably follow shortly.

Professor Hanke re-iterates the advantages of knowing the currency markets. "If you don't understand the currency situation, you can get clobbered. You will therefore get your buy/sell timing wrong, and you will only react, not anticipate. We succeeded in 1995 because we anticipated the situation. Mexico just made things better".

Friedberg's are, according to the Professor, currency specialists first, country pickers and portfolio allocators second. "If you get the country right, and you know how much to allocate to bonds and equities, individual stock selections are not always vital. Obviously, if you just pick the dogs, you won't get anywhere. But, if you get the currency right, then the stock selection will be less important.

"Ultimately", Professor Hanke muses, quoting the Duke of Wellington, "victory is often not being overwhelmed by the opposition".

EMF

"... fund managers do not believe everything they read in the press"

Overall Leaders

Top 10 - 3 Months		%	Top 10 - 1 Year		%
1	Vista Fixed Balanced Sub-Fund (Brazil debt)	37.99	→ Toronto Trust Argentina		79.25
2	Vista Equity Sub-Fund (Brazil equities)	37.93	Spes Bona Investment Co.		59.88
3	Intrust (South Africa equities)	25.97	GMO Emerging Country Debt Fund		44.72
4	Toronto Trust Argentina	23.27	Consulta Emerging Markets Debt		43.36
5	Paribas EM Index Alloc Argentina Portfolio	22.56	Alliance World Dollar Government Fund, Inc.		41.70
6	Spes Bona Investment Co. (South Africa equities)	22.25	Toronto Trust Latin American Securities		39.91
7	Toronto Trust Latin American Securities	22.08	Nigeria Emerging Market Fund		37.97
8	Vista High Yield Sub-Fund (Brazil debt)	21.82	Old Mutual South Africa		36.91
9	Paribas EM Index Alloc Chile Portfolio	20.48	Emerging Markets Income Fund II, Inc.		36.70
10	NatWest/IFC LAIF Argentina Index	18.89	Intrust		36.24
Top 10 - 3 Years		%	Top 10 - 4 Years		%
1	Vertice (Brazil equities)	461.25	Vertice (Brazil equities)		516.33
2	Patrimonio New Fund Equity (Brazil equities)	418.64	JF Thailand Trust		259.49
3	East Europe Development Ltd.	279.74	East Europe Development Ltd.		246.66
4	Lexington Strategic Investments (SAfrica gold mining)	257.05	Old Mutual Thailand Trust		236.09
5	Lippo Indonesian Growth	200.57	Intrust		235.02
6	Brazilian Investments SA	197.84	Thornton NTS Philippines		232.41
7	Intrust	192.26	JF Eastern Smaller Companies Trust		226.11
8	Pioneer First Polish Trust	179.77	Aetna ASEAN Development Trust		223.47
9	UBS Equity Invest South Africa	176.22	Fidelity Funds Thailand		221.19
10	Explorer Fund LP	174.73	Thornton NTS Thailand		211.08
Top 10 - 5 Years		%	Top 10 - 7 Years		%
1	Genesis Chile Fund (fully diluted)	475.47	Toronto Trust Chile Fund		782.32
2	Equity Fund of Brazil	455.38	Thailand Fund		538.57
3	Brazilian Investments SA	403.39	Thai-Euro Fund (undiluted)		439.70
4	Chile Fund, Inc.	335.82	Templeton Emerging Markets Fund, Inc.		402.38
5	GT Chile Growth Fund	332.11	Emerging Markets Growth Fund		398.41
6	Schroder Latin American Fund	320.10	Sub Thawee Two Fund (Thailand equities)		397.15
7	JF Thailand Trust	315.20	Thai Fund, Inc.		374.68
8	Brazil Fund, Inc.	307.92	Aetna Asia Trust		372.48
9	Fidelity Funds Hong Kong & China	306.03	JF Eastern Trust		356.65
10	Deltec Latin American Fund	303.24	Siam Fund (Cayman) Ltd.		356.47

Overall Laggards

Bottom 10 - 3 Months		%	Bottom 10 - 1 Year		%
1	Emerald Equity Fund (Brazil equities)	-27.62	Chescor Indian ICL Smaller Companies		-52.42
2	Brazilian Investments SA	-27.06	Thornton NTS Sri Lanka		-50.50
3	Brazil Fund, Inc.	-22.59	JF Pakistan Trust		-50.06
4	Brazilian Smaller Cos Investment Trust (undiluted)	-20.81	CL Pakistan Growth		-48.16
5	Nomura SF China	-20.48	Second India Investment Fund		-48.00
6	CL Pakistan Growth	-20.13	JF India Trust		-47.65
7	Alpha Asia Hedge	-20.08	Core Pacific Pioneer Fund		-45.58
8	Brazvest Fund Ltd.	-19.98	Schroder Indian Communications		-44.86
9	Turkish Growth Fund	-19.28	20/20 India Fund		-44.65
10	Pakistan Investment Fund, Inc.	-19.14	Brazilian Investments SA		-44.62
Bottom 10 - 3 Years		%	Bottom 10 - 4 Years		%
1	Emerging Mexico Fund	-45.43	CL Pakistan Growth		-40.18
2	Bankinvest Afd 10 Mexico	-41.97	Turkish Investment Fund		-37.72
3	Mexican Investment Company	-41.77	Creditanstalt Central Europe		-34.98
4	Mexico Fund, Inc.	-37.90	Argentinian Investment Company		-34.15
5	ML Mexican Income Peso Portfolio B	-33.18	Emerging Mexico Fund		-33.18
6	ML Mexican Income Peso Portfolio A	-32.65	Pakistan Fund		-32.39
7	Creditanstalt Central Europe	-31.30	Bankinvest Afd 10 Mexico		-30.23
8	Barclays ASF China (PRC)	-27.57	Mexican Investment Company		-29.89
9	Korea Small Companies Trust	-26.66	Korea Small Companies Trust		-27.81
10	Pakistan Special Situations	-26.64	ASA Limited		-27.56

US\$ % returns, NAV to NAV, gross income reinvested. Periods ending Dec. 31, 95. (Singapore, H Kong, Cyprus and Israel funds not included in above rankings)