

A Case For... Regional Emerging Markets

The decision to introduce emerging market equities into a portfolio is typically driven by three factors: the desire for potential return enhancement, greater diversification, and access to a wider set of investment opportunities. Over the past ten years, emerging market equities have dramatically outperformed developed market equities, albeit with greater volatility. Emerging market correlations have increased relative to US and other developed equities, but still offer diversification benefits. Lastly, emerging markets offer investors access to a wide range of leading global companies.

WHAT ARE EMERGING MARKETS REGIONS?

Indexes like the MSCI Emerging MarketsSM and the S&P[®] Emerging BMI Index are frequently used by investors as broad benchmarks and as a proxy for the emerging market asset class. For example, the BMI Emerging Markets Index comprises approximately 2,433 companies covering 19 of the world's emerging markets. This Index is a reasonable proxy given that companies excluded from the benchmark have capitalizations under \$100 million and, thus, are difficult to invest in due to poor liquidity. The Index classifies EM economies into four regions:

- Asia Pacific
- Europe
- Latin America
- Middle East & Africa¹

WHY EMERGING MARKETS REGIONS NOW?

Emerging market countries' share of global GDP increased from 17% in the 1960s to nearly 40% in 2008–2009. Based on higher expected growth rates, emerging markets' share of global GDP should continue to grow and could exceed 50% of world GDP in the next ten years. Many emerging market countries came out of the 2008 global financial crisis and recession in better condition than their developed market counterparts. Currently, emerging market equities represent approximately 14% of total world equity capitalization.

EMERGING MARKETS DEFINED

The terms 'emerging markets' and 'developing countries' are sometimes used interchangeably. Generally defined, emerging markets are countries that are experiencing rapid economic growth and financial and economic liberalization, prompted by policy reforms. Typically, they have immature capital markets and only partially developed institutions. Frequently, these countries are undergoing rapid economic, political and social transformation.

Generally, the per capita incomes and gross national income (GNI) of emerging markets are just a fraction of those of developed world economies. The World Bank classifies countries into four income categories. A majority of emerging countries fall within the bottom three categories and have a GNI per capita income of below \$12,196. By comparison, the United States 2009 GNI per capita was approximately \$46,360.¹

Several countries, Czech Republic, Hungary and Poland for example, fall within the high income category; but from an investor's perspective, they may be considered to be 'emerging' due to specific structural and political issues.

FIGURE 1: COUNTRIES CLASSIFIED AS "EMERGING REGIONS" AND CORRESPONDING WEIGHTING IN THE S&P EMERGING BMI INDEX

EM ASIA PACIFIC	% WEIGHT	EM EUROPE	% WEIGHT	EM LATIN AMERICA	% WEIGHT	EM MIDDLE EAST AND AFRICA	% WEIGHT
CHINA	19.99	RUSSIA	8.53	BRAZIL	17.05	SOUTH AFRICA	7.98
TAIWAN	14.51	TURKEY	2.00	MEXICO	4.79	EGYPT	0.48
INDIA	9.87	POLAND	1.72	CHILE	2.40	MOROCCO	0.39
MALAYSIA	3.03	HUNGARY	0.45	PERU	0.77		
INDONESIA	2.73	CZECH REPUBLIC	0.40				
THAILAND	2.02						
PHILIPPINES	0.88						

Source: S&P FactSet, SSgA Global ETF Strategy & Research, as of 3/31/2011.

¹South Korea is considered a developed market by S&P.

As much as emerging markets are treated as a single asset class, there is actually significant variation among the countries and regions within the emerging markets. Brazil, Russia, India, and China—the BRIC nations—are the clear leaders, representing nearly half of the market capitalization. However, other nations such as Taiwan, Poland, Turkey, South Africa, Israel, and Mexico play leadership roles in specific sectors. One way to approach emerging market investing is from a regional standpoint. Rather than treating emerging markets as a monolithic bloc, some investors prefer to take a more tactical approach.

By market capitalization, Asia makes up the largest percentage of the emerging markets. However, each emerging market region has significantly different investment characteristics. The Asian region is dominated by China and trade with China. Energy and materials stocks play a much smaller role in Asia, unlike in the Europe and Latin America regions. An investor who wishes to emphasize commodity-related investing might prefer to overweight EM Europe and EM Latin America relative to Asia. Let's consider the characteristics of each regional Index.

FIGURE 2: REGIONAL EMERGING MARKET INDEX COUNTRY WEIGHTS

COUNTRY	WEIGHT
S&P ASIA PACIFIC EMERGING BMI INDEX	
CHINA	37.69
TAIWAN	27.36
INDIA	18.61
MALAYSIA	5.72
INDONESIA	5.14
THAILAND	3.81
PHILIPPINES	1.67
S&P EUROPEAN EMERGING BMI CAPPED INDEX	
RUSSIA	65.09
TURKEY	15.29
POLAND	13.12
HUNGARY	3.42
CZECH REPUBLIC	3.09
S&P LATIN AMERICA BMI INDEX	
BRAZIL	68.19
MEXICO	19.14
CHILE	9.58
PERU	3.09
S&P MID-EAST AND AFRICA BMI INDEX	
SOUTH AFRICA	90.19
EGYPT	5.37
MOROCCO	4.44

Source: S&P, FactSet, SSgA Global ETF Strategy & Research, as of 3/31/2011.

EMERGING MARKETS ASIA

The S&P Emerging Asia Pacific BMI Index, which represents 53% of the emerging markets by market capitalization, is a much more diversified Index. The top ten holdings collectively represent only 19% of the Index by market capitalization. More than 47% of the Index is in financial and technology stocks. From a country standpoint the Asia Index is also more diversified, with China and Taiwan representing nearly 65% of the Index and another 18% split in India.

EMERGING MARKETS EUROPE

The S&P European Emerging BMI Index represents 13% of the emerging markets by market capitalization. EM Europe is the most concentrated Index—75% of the Index is in energy, financials and materials stocks, with more than 38% in energy. The energy concentration is dominated by one name—Gazprom—and the top ten holdings collectively represent 45% of the Index by market capitalization. From a country standpoint, 65% of the Index is in Russian stocks, followed by Turkey with 15%.

EMERGING MARKETS LATIN AMERICA

The S&P Emerging Latin America Index represents 25% of the emerging markets by market capitalization. Latin America is more concentrated than Asia, with the top ten holdings collectively representing 40% of the Index by market capitalization. From a country standpoint, 68% of the Index is in Brazilian stocks, followed by Mexico with nearly 19%. Latin America is a resource-rich region, with materials representing 22% of the Index and energy another 15%. Financials are 20% of the Index.

EMERGING MARKETS MIDDLE EAST AND AFRICA

The S&P Mid-East and Africa BMI Index represents 9% of the emerging markets by market capitalization. EM Middle East and Africa is highly concentrated by country, with nearly 90% in South African stocks. The Index has the lowest weight in energy stocks, at 7%, and the highest in consumer discretionary at 13%.

FIGURE 3: REGIONAL EMERGING MARKET INDEX SECTOR WEIGHTS

SECTOR	S&P ASIA PACIFIC EMERGING BMI INDEX WEIGHT (%)	S&P EUROPEAN EMERGING BMI CAPPED INDEX WEIGHT (%)	S&P LATIN AMERICA BMI INDEX WEIGHT (%)	S&P MID-EAST AND AFRICA BMI INDEX WEIGHT (%)
FINANCIALS	25.65	22.65	20.59	26.91
INFORMATION TECHNOLOGY	22.01	0.49	1.29	0.33
ENERGY	11.34	38.05	15.04	7.42
MATERIALS	9.66	14.33	22.20	24.80
INDUSTRIALS	8.77	3.38	6.84	6.45
CONSUMER DISCRETIONARY	6.68	2.03	6.79	13.98
TELECOMMUNICATION SERVICES	5.81	7.63	8.32	9.28
CONSUMER STAPLES	5.63	3.61	11.90	7.36
UTILITIES	2.61	6.76	6.09	0.00
HEALTH CARE	1.83	1.07	0.93	3.46

Source: S&P, FactSet, SSgA Global ETF Strategy & Research, as of 3/31/2011.

THE EMERGING MARKETS DECISION: REGIONAL VERSUS COUNTRY

As we've seen, each of the emerging market regions is dominated by specific countries—Brazil, Russia, China and South Africa. Many investors seeking exposure to those countries will consider a single country investment, seeking the most targeted exposure. However, from a risk/return perspective, regional exposure can often provide a more attractive risk-return relationship, providing much of the potential upside with lower volatility. For example, a weighting to an ETF that invests only in Brazilian stocks would have proven to be significantly more volatile than an investment in the Latin American region. As you can see in Figure 4, the S&P Brazil Index provided a higher return but with much higher risk than the S&P Latin America BMI Index. An investment in the S&P South Africa Index provided only slightly higher return with greater volatility than an investment in the S&P Mid-East and Africa BMI Index.

In addition, many emerging market countries participate in regional trading blocks. For example, the APAC nations have a highly developed trade dynamic largely driven by trade in and around China. Trade within emerging market economies has increased as well—growing from approximately 20% of total emerging market trade in the 1980s to nearly 35% from 2000–2008.

FIGURE 4: RISK-RETURN: SINGLE COUNTRY VERSUS REGIONAL EMERGING MARKET INVESTING (APRIL 2001 - MARCH 2011)

DESCRIPTION	ANNUALIZED RETURN	ANNUALIZED STD DEV	SHARPE RATIO
S&P EMERGING ASIA PACIFIC BMI INDEX	13.57	24.71	0.46
S&P CHINA BMI INDEX	19.97	28.09	0.64
S&P EUROPEAN EMERGING BMI CAPPED INDEX	23.19	31.23	0.67
S&P RUSSIA BMI INDEX	26.66	34.76	0.71
S&P LATIN AMERICA BMI INDEX	22.91	27.77	0.75
S&P BRAZIL BMI INDEX	25.51	37.00	0.63
S&P MID-EAST AND AFRICA BMI INDEX	18.25	22.62	0.71
S&P SOUTH AFRICA BMI INDEX	19.62	27.39	0.64

Source: S&P, FactSet, SSgA Global ETF Strategy & Research, as of 3/31/2011.

PORTFOLIO UTILIZATION: TACTICAL OR STRATEGIC

Investing in EMs can be beneficial to suitable individual and institutional investors from a long-term investment perspective (or strategic asset allocation) and for sophisticated investors, short-term investment perspectives (or tactical asset allocation). To best assess the use of comprehensive, regional or country-specific EM funds, let us first think about them in terms of their application as strategic and tactical investment vehicles.

THE STRATEGIC CASE

Investment in broad EM funds may impart diversification characteristics to the portfolio. With a historically low correlation relative to US equities, an allocation to EMs in the context of a well diversified portfolio may help investors create more efficient, less volatile portfolios. For example, from April 2001 to March 2011, the S&P Europe BMI Index and S&P 500® Indices had a correlation of 0.90. The S&P Emerging Market BMI Index had a 0.79 correlation to the S&P 500 and a 0.85 correlation to the S&P Europe BMI Index.

Regional emerging markets can impart even greater diversification benefits. The S&P Emerging Asia Pacific BMI Index is the most correlated to broader emerging markets, closely followed by Latin America, and the S&P Emerging European BMI Capped Index is the least correlated. The S&P Emerging European BMI Capped Index actually had a lower correlation to developed Europe, as measured by the S&P Europe BMI Index, than it did to the S&P Emerging Markets BMI Index—0.75 versus 0.85.

THE TACTICAL CASE

For the tactically-oriented, a means to exploit existing opportunities and/or inefficiencies in EMs is provided. Valuations vary considerably among the regions, so investors who view one region as overvalued might choose to focus on one of the other regions. The sector exposures also vary considerably region to region. Investors who have a favorable view on energy and materials, for example, might choose to overweight the Latin America and Europe regions versus Asia.

By their nature, tactical considerations are heavily influenced by liquidity with the need to get in and out of positions quickly. For some professional investors, the potential to easily invest in specific regional emerging markets may wield tremendous trading power and efficiency.

FIGURE 5: CORRELATION MATRIX (APRIL 2001 – MARCH 2011)

DESCRIPTION	S&P EMERGING MARKETS BMI INDEX	S&P EMERGING ASIA PACIFIC BMI INDEX	S&P EUROPEAN EMERGING BMI CAPPED INDEX	S&P MID-EAST AND AFRICA BMI INDEX	S&P LATIN AMERICA BMI INDEX	S&P EUROPE BMI INDEX	S&P 500 INDEX	MSCI EAFE INDEX	MSCI EMERGING MARKETS INDEX	MSCI ALL COUNTRY WORLD INDEX
S&P EMERGING MARKETS BMI INDEX	1.00	0.95	0.85	0.86	0.92	0.85	0.79	0.87	0.99	0.89
S&P EMERGING ASIA PACIFIC BMI INDEX	0.95	1.00	0.71	0.73	0.78	0.75	0.70	0.77	0.93	0.79
S&P EUROPEAN EMERGING BMI CAPPED INDEX	0.85	0.71	1.00	0.76	0.79	0.74	0.66	0.77	0.85	0.76
S&P MID-EAST AND AFRICA BMI INDEX	0.86	0.73	0.76	1.00	0.80	0.80	0.75	0.85	0.87	0.84
S&P LATIN AMERICA BMI INDEX	0.92	0.78	0.79	0.80	1.00	0.83	0.78	0.84	0.92	0.86
S&P EUROPE BMI INDEX	0.85	0.75	0.75	0.81	0.83	1.00	0.90	0.99	0.87	0.97
S&P 500 INDEX	0.79	0.70	0.66	0.75	0.78	0.90	1.00	0.89	0.81	0.96
MSCI EAFE INDEX	0.87	0.77	0.77	0.85	0.84	0.98	0.89	1.00	0.89	0.97
MSCI EMERGING MARKETS INDEX	0.99	0.93	0.85	0.87	0.92	0.86	0.81	0.89	1.00	0.90
MSCI ALL COUNTRY WORLD INDEX	0.89	0.79	0.76	0.84	0.86	0.97	0.96	0.97	0.90	1.00

Source: S&P, MSCI, FactSet, SSgA Global ETF Strategy & Research, as of 3/31/2011.

The correlation coefficient measures the degree to which the movements of two variables are related. For example, a correlation of 1.00 (or 100%) would indicate that the two asset classes monthly returns move in the same direction (positive or negative) for the stated time period. In contrast, a correlation coefficient of -1.00 would mean that the two indices move in opposite direction. A correlation of zero indicates that the two exhibit no discernible relationship.

VALUATION

Historically, one of the appeals of emerging markets has been attractive valuations relative to developed market stocks, particularly given the higher historical growth rates for emerging markets. Within the emerging markets, valuations can vary significantly. Historically, EM Europe has offered the lowest valuations, driven by the high weighting in Russian and Polish stocks. Asia has typically had the highest valuations, however Latin America’s valuations exceeded Asia’s in 2004 and again from 2009–2010. An investor seeking to take advantage of lower valuations within the Index might overweight EM Europe relative to EM Asia and EM Latin America.

FIGURE 6: REGIONAL EMERGING MARKET PRICE/EARNING RATIOS



Source: S&P, FactSet, SSgA Global ETF Strategy & Research as of 3/31/2011.

A WORD ABOUT RISKS

As already alluded to, EMs do present unique risks. Like all asset classes, they carry market risk. However, they are also predisposed to three risk elements which do not raise concerns for traditional domestic investors.

- A lack of information standards within the country and/or region
- The risk that the currency of the stock exchange where the investment is located may depreciate against the US dollar
- Political risk long considered by many to be the dark side of emerging markets may prove cumbersome because the impact of political events on investments is extremely difficult to measure.
- These risks are reflected in the higher volatility in EMs, as well as the increased risk of loss.

CONCLUSION

The emerging markets opportunities of today are not the same as those of ten years ago. While volatility will always be a part of EM investing, we believe that the risk in the asset class should continue to decline.

As a tactical investment tool, the presence of regional EMs exposure may help investors enhance returns while mitigating overall risk. For the long term-oriented who have shown an interest in this asset class, the potential advantages of EM regions bears earnest consideration as an investment which can help investors achieve their strategic asset allocation objectives with more precision than comprehensive vehicles.

In summary, investing in EM regions can potentially capture excess return and diversify traditional, developed market portfolios, and may increase portfolio efficiency and improve overall performance, however, investment in EM regions also brings a greater risk of loss.

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DEFINITIONS

ALPHA

A measure of performance on a risk-adjusted basis. Alpha takes the volatility (price risk) of a mutual fund and compares its risk-adjusted performance to a benchmark index. The excess return of the fund relative to the return of the benchmark index is a fund's alpha.

BETA

A measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole.

INDEX DEFINITIONS

MSCI ACWI (ALL COUNTRY WORLD INDEX) INDEX

The MSCI ACWI (All Country World Index) Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 45 country indices comprising 24 developed and 21 emerging market country indices. The developed market country indices included are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and the United States. The emerging market country indices included are: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.*

MSCI EAFE INDEX (EUROPE, AUSTRALASIA, FAR EAST)

The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI EAFE Index consists of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.*

MSCI EMERGING MARKETS INDEX

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.*

S&P 500® INDEX

The S&P 500 Index is composed of 500 selected stocks, all of which are listed on the Exchange, the NYSE or NASDAQ, and spans over 24 separate industry groups. Since 1968, the S&P 500 Index has been a component of the US Commerce Department's list of Leading Indicators that track key sectors of the US economy. Current information regarding the market value of the S&P 500 Index is available from market information services. The S&P 500 Index is determined, comprised and calculated without regard to the Trust.

S&P ASIA PACIFIC EMERGING BMI INDEX

The S&P Asia Pacific Emerging BMI Index is a market capitalization weighted float-adjusted index that defines and measures the investable universe of publicly traded companies domiciled in the emerging Asia Pacific region.

S&P BRAZIL BMI INDEX

The S&P Brazil BMI Index is a market capitalization weighted float-adjusted index that defines and measures the investable universe of publicly traded companies domiciled in Brazil.

S&P CHINA BMI INDEX

The S&P China BMI Index is a float-adjusted, market capitalization-weighted index that defines and measures the investable universe of those publicly traded companies domiciled in China that are legally available to foreign investors.

S&P EMERGING BMI INDEX

The S&P Emerging BMI Index is a float-adjusted, market capitalization-weighted index that defines and measures the investable universe of publicly traded companies domiciled within global emerging markets.

S&P EUROPE BMI INDEX

The S&P Europe BMI Index is a market capitalization weighted float-adjusted index that defines and measures the investable universe of publicly traded companies domiciled in Europe.

S&P EUROPEAN EMERGING BMI CAPPED INDEX

The S&P European Emerging BMI Capped Index is a market capitalization weighted float-adjusted index that defines and measures the investable universe of publicly traded companies domiciled in emerging Europe.

S&P LATIN AMERICA BMI INDEX

The S&P Latin America BMI Index is a market capitalization weighted float-adjusted index that defines and measures the investable universe of publicly traded companies domiciled in Latin America.

S&P MID-EAST & AFRICA BMI INDEX

The S&P Mid-East & Africa BMI Index is a market capitalization weighted float-adjusted index that defines and measures the investable universe of publicly traded companies domiciled in the Middle East and Africa.

S&P RUSSIA BMI INDEX

The S&P Russia BMI Index is a market capitalization weighted float-adjusted index that defines and measures the investable universe of publicly traded companies domiciled in Russia.

S&P SOUTH AFRICA BMI INDEX

The S&P South Africa BMI Index is a market capitalization weighted float-adjusted index that defines and measures the investable universe of publicly traded companies domiciled in South Africa.

*As of May 30, 2011.



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