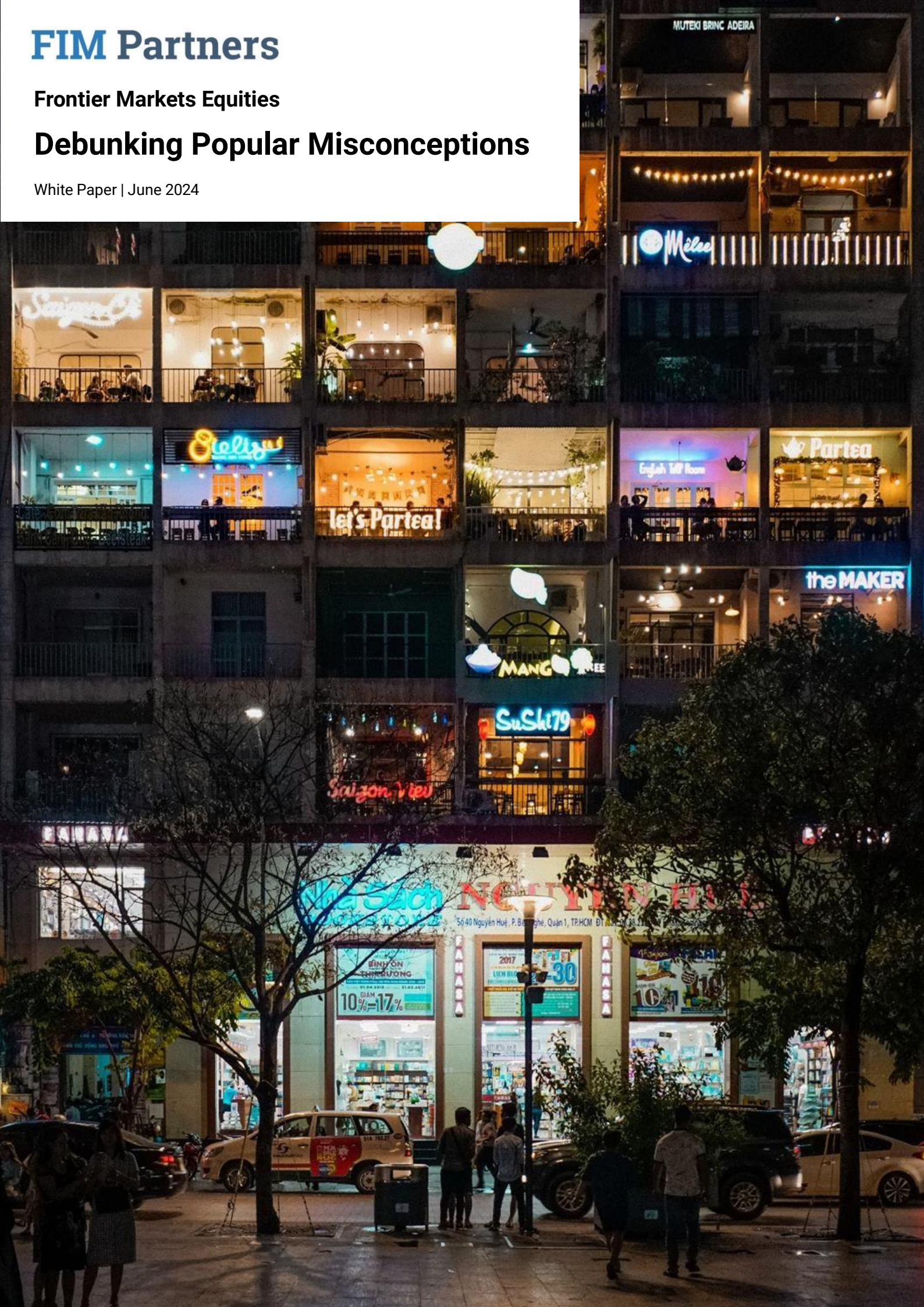


# FIM Partners

Frontier Markets Equities

## Debunking Popular Misconceptions

White Paper | June 2024





## Introduction

Over the last decade, our engagements with global allocators on Frontier Markets (“FM”) equities depict a high level of scepticism stemming from perceived limitations in size, liquidity, and pedestrian returns versus Emerging Markets (“EM”). The culmination of these concerns leads to the majority outright dismissing the asset class or remaining content with their EM manager’s purported FM exposure.

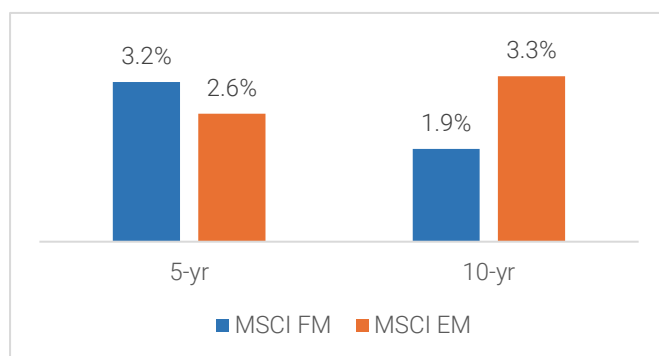
We aim to refute these misconceptions and advocate for dedicated FM equities exposure to complement existing EM allocations in terms of enhancing overall returns and diversification, especially as allocators reevaluate the extent of Chinese exposure.

## The Key Misconceptions

The primary objections to FM equities allocations revolve around their perceived insignificant size and liquidity, coupled with lacklustre relative returns to EM over the last decade. A rudimentary comparison of the asset class size and returns utilizing their respective MSCI indices seemingly confirms these apprehensions.

Returns have been a mixed bag with a slight outperformance versus EM over the last 5 years but a meaningful underperformance over the last decade. But the bigger concern is the relative size and liquidity as FM are a mere 2% of EM in terms of market capitalization and offer less than 1% of their liquidity. Closing the FM chapter on these data points alone appears justified.

**Figure 1: Comparative Annualized Returns (US\$)<sup>1</sup>**



Source: MSCI, Bloomberg

However, a critical aspect overlooked by this cursory approach is the significant off-benchmark (“OB”) exposure of FM funds. Our proprietary analysis of the largest active FM funds top 10 country holdings, representing 80% of AUM, reveals over 50% of their holdings are in OB countries that are primarily part of the MSCI EM index (Figure 2, with OB countries highlighted in orange).

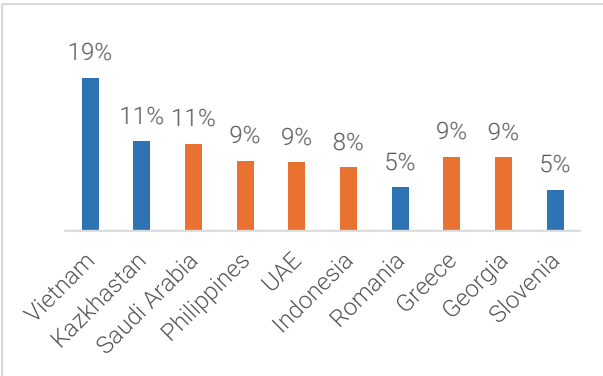
**Table 1: MSCI FM vs. MSCI EM**

	MSCI FM	MSCI EM
Mkt Cap (US\$ tn)	0.4	20.6
ADTV (US\$ bn)	0.3	66.1

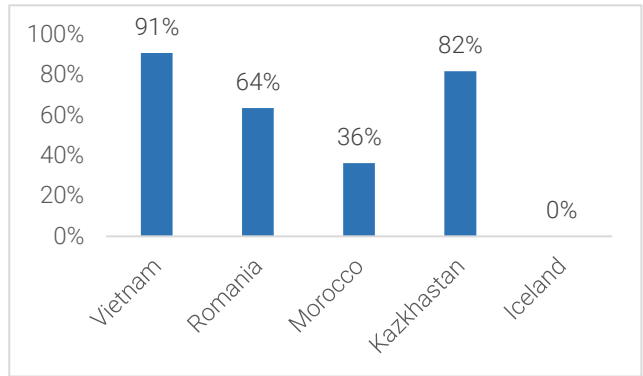
(2023)

<sup>1</sup> As of March 2024

**Fig 2: Active FM Top 10 Country Exposures<sup>2</sup>**

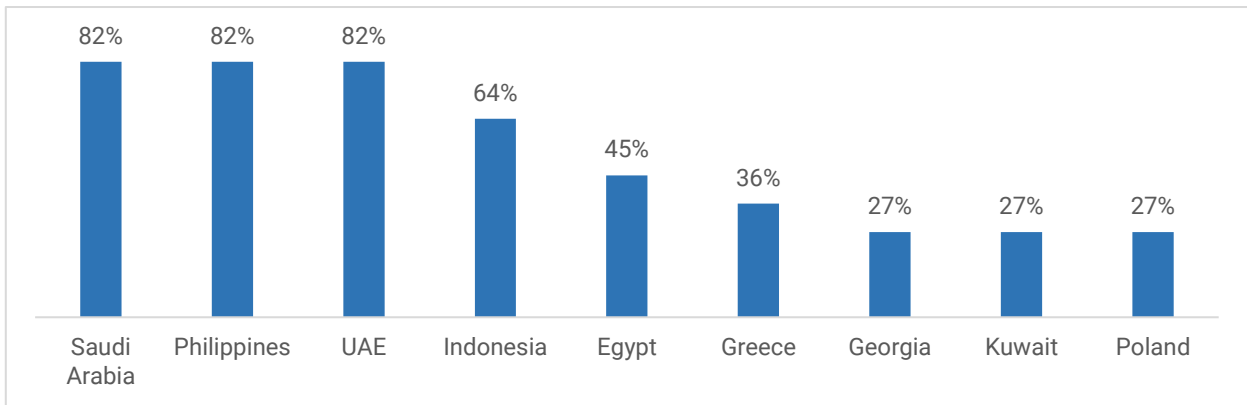


**Fig. 3: % of Funds Invested in MSCI FM Top 5<sup>3</sup>**



Source: Fund factsheets, FIM Analysis. Figure 2 is in order of aggregate exposure of all funds. Figure 3 is in order of top 5 country weights of MSCI FM Index.

**Figure 4: Percentage of FM Funds Investing in Off Benchmark Countries (%)**



Source: Fund factsheets, FIM Analysis

This benchmark deviation primarily stems from questionable country classification methodologies that let Iceland occupy a top 5 country weight in FM index whilst allowing Egypt and Philippines to share EM status with Taiwan and South Korea. Interestingly, none of the FM funds had top 10 country exposure to Iceland (Figure 3).

**Table 2: Top Country Weights**

MSCI FM		MSCI EM	
2013	2023	2013	2023
Kuwait	Vietnam	South Korea	China
UAE	Romania	China	India
Qatar	Morocco	Taiwan	Taiwan
Nigeria	Iceland	Brazil	South Korea
Argentina	Kazakhstan	South Africa	Brazil

Furthermore, the constant carousel of country status changes in the FM index over the last decade (Table 2) makes returns comparisons inaccurate but more importantly is counterintuitive to long term investing. Consequently, FM managers have expanded their investment remit outside the narrow index constraints which is contrary to the benchmark mirroring country allocations of EM funds, as discussed in detail later.

Understanding these intricacies is integral to addressing popular misconceptions surrounding the asset class.

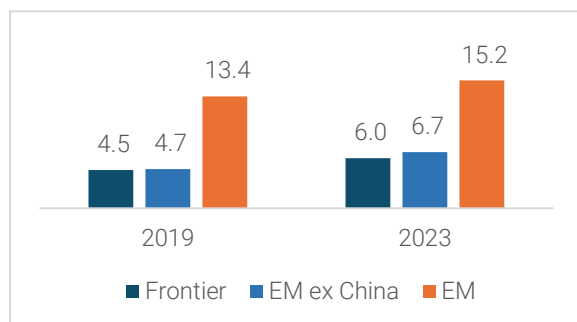
<sup>2</sup> Compiled using the aggregate top 10 country exposures of the sample funds and then the average portfolio weight of funds invested in the country.

<sup>3</sup> Based on Top 10 country holdings

## Myth 1: Frontier Markets Lack Size and Liquidity

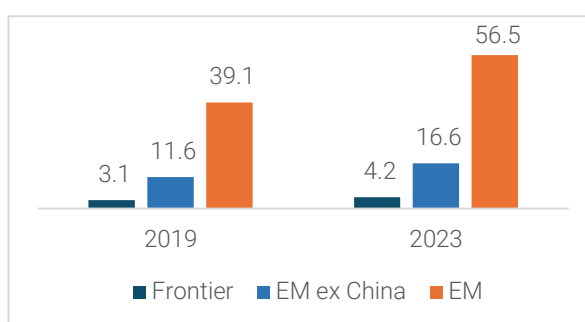
Unsurprisingly, the size and liquidity of the actual FM universe is substantially larger than perceived (Figures 5 & 6), with liquidity equivalent to 25% of the EM ex-China<sup>4</sup> universe. Although less than 10% of EM, this isn't as detrimental given rising concerns around China which dominates EM liquidity. Our recent allocator interactions depict a notable sentiment shift with decisions ranging from reducing Chinese exposure to outright exclusion, which is partially reflected in the rising appetite for EM ex-China strategies (Figure 7).

**Figure 5: Market Capitalization (US\$ trillion)**

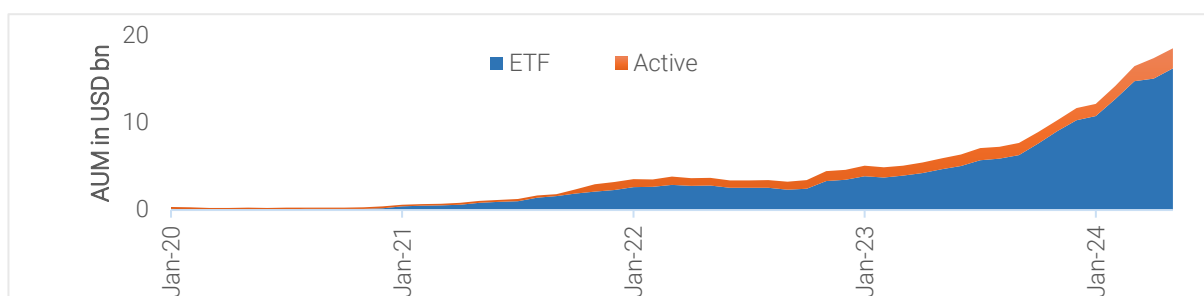


Sources: Bloomberg, MSCI

**Figure 6: Avg. Daily Traded Val (US\$ billion)**



**Figure 7: EM ex-China AUMs (US\$ billions)**



Source: HSBC Research

To demonstrate the FM universe depth, we filtered it for stocks with a minimum market capitalization of USD 1 billion and an average daily liquidity of at least USD 1 million. The attributes of the resulting 489 stocks are detailed in Table 3. With the S&P 500 Index widely regarded as the platinum standard for global equity market returns over the past decade, we analysed how many FM stocks could achieve US\$ returns at par with the S&P 500 over 5- and 10-year periods. Our analysis shows that 30% of eligible stocks with a 5-year trading history and 19% with a 10-year trading history matched the S&P 500 returns.

**Table 3: FM Universe Attributes**

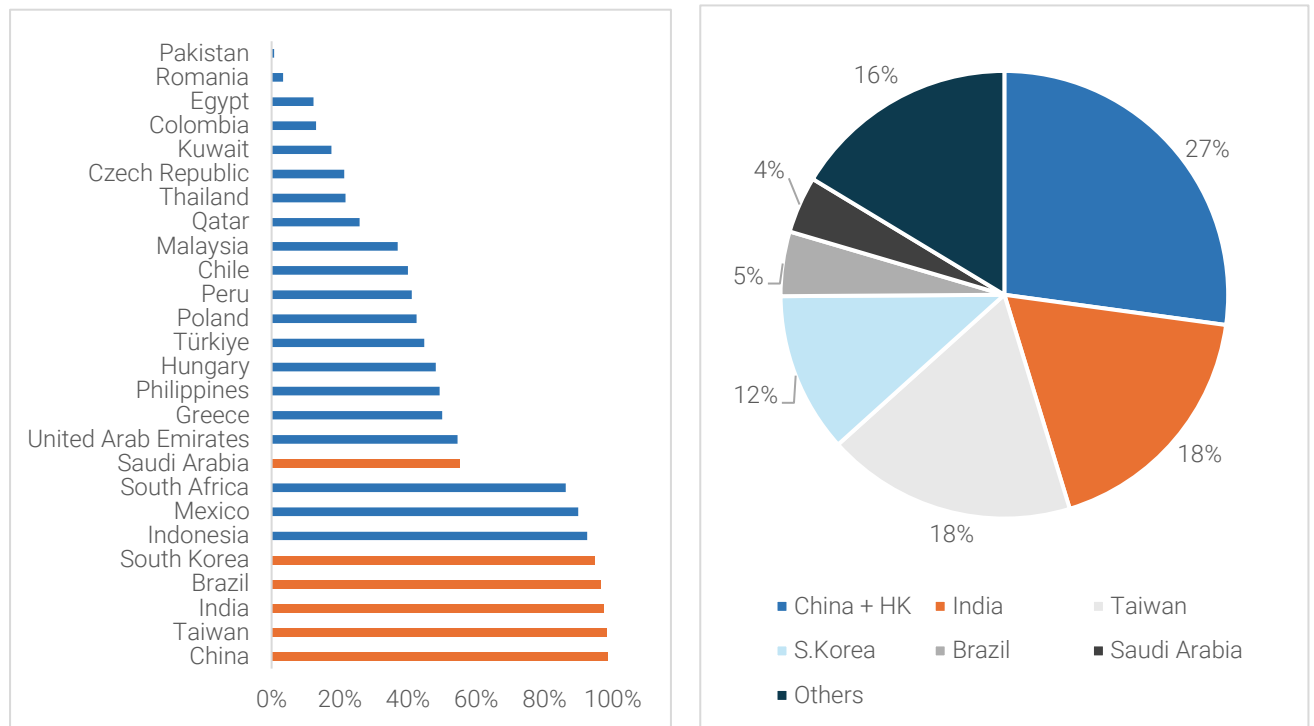
Market Cap		Liquidity	
USD 1-5bn	317	USD 1 -5mn	238
USD 5- 10bn	89	USD 5 - 10mn	109
> USD 10bn	83	> USD 10mn	142
<b>Total</b>	<b>489</b>		<b>489</b>
S&P 500 Annualized Returns		5-yr	10-yr
		15.2%	13.0%
Number of companies		489	489
Eligible Companies		405	337
Companies > Return Target		122	63
<b>% of Eligible Companies</b>		<b>30%</b>	<b>19%</b>
Avg Mkt Cap (US\$ bn)		9.1	12.8
ADTV (US\$ mn)		11.1	16.0

<sup>4</sup> For EM, we utilize the daily liquidity of the respective MSCI country indices for China, Taiwan, South Korea, India, Brazil, and South Africa. For EM ex-China, we have removed China from our EM calculation. The FM universe comprises of the ASEAN (Indonesia, Philippines, Vietnam, Thailand, and Malaysia) and MENA (Saudi Arabia and UAE) regions.

## Myth 2: EM Allocation Captures Frontier Markets

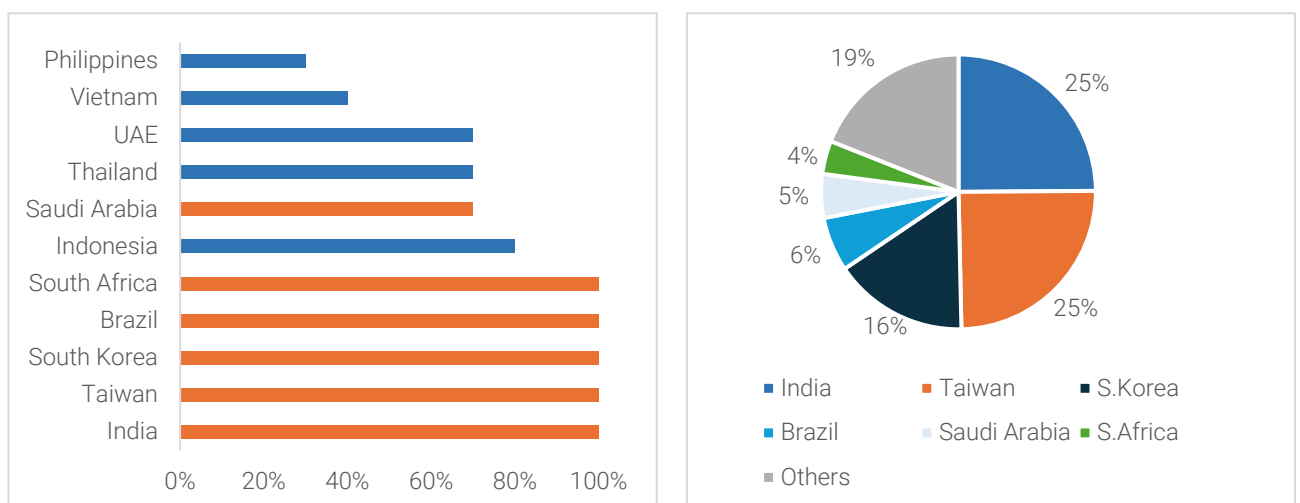
Allocators assume their EM allocation adequately captures FM exposure, relying on the assortment of smaller emerging/frontier markets in the respective EM indices. However, our analysis of active EM and EM-China funds country exposures (Figure 8 & 9) versus their respective benchmarks portrays a contrary picture.

**Figure 8: Active Funds (% of Funds Invested) & MSCI EM Index<sup>5</sup>**



Source: Copley Research, HSBC Research & MSCI (Orange indicates top index weights in the chart on the left)

**Figure 9: Active Funds (% of Funds Invested) & MSCI EM ex- China Index<sup>6</sup>**



Source: Bloomberg, Fund Factsheets & MSCI (Orange indicates top index weights in the chart on the left)

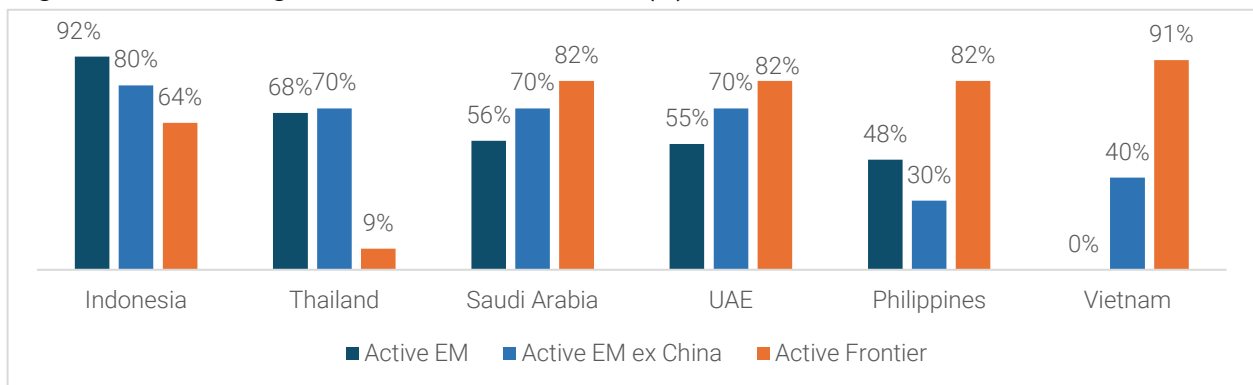
<sup>5</sup> Representing 304 active EM funds with USD 530bn in AUM as of May 2024. Country index weights (May 2024)

<sup>6</sup> Representing 10 active EM ex-China funds with USD 1.1bn in AUM. Country index weights (May 2024)

It appears both active EM styles are focused on their respective top country weights with allocation levels tapering off for smaller countries. A notable standout is Saudi Arabia, which despite having a top 6 country weight in both indices, has only garnered investments from 55% and 70% of the respective active funds.

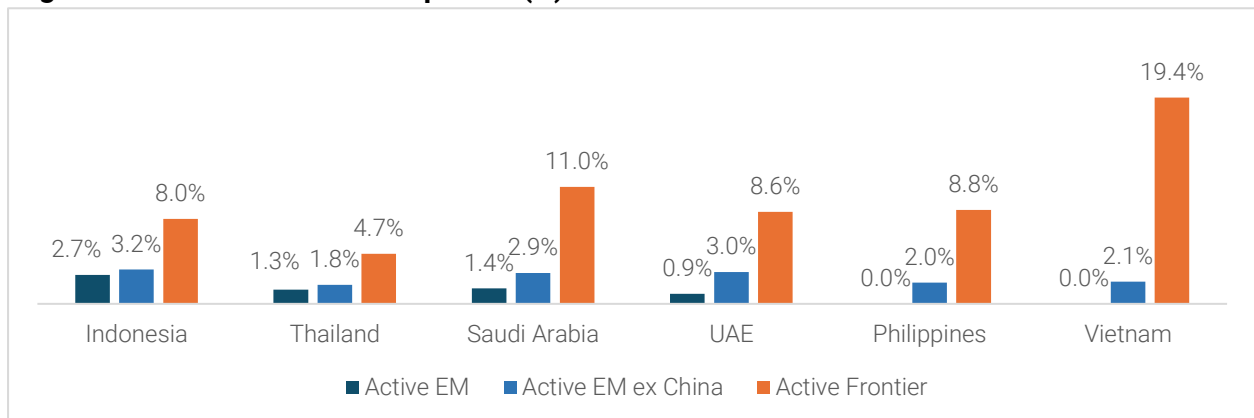
On the other hand, FM funds have a greater probability of exposure to these underinvested markets whilst allocating a relatively higher percentage of their portfolios (Figures 10 & 11). The low active FM exposure to Thailand is testament to their high conviction approach given Thailand has been amongst the worst performing ASEAN markets since the end of 2019 with a -4.7% annualized US\$ return. Unlike EM and EM ex-China funds that might take exposure to remain aligned with their benchmarks, FM managers face no such compulsion.

**Figure 10: Percentage of Active Funds Invested (%)**



Source: Fund factsheets, Bloomberg, FIM Analysis

**Figure 11: Relative Portfolio Exposure (%)<sup>7</sup>**



Sources: Copley Research, HSBC Research, Fund factsheets, Bloomberg, FIM Analysis

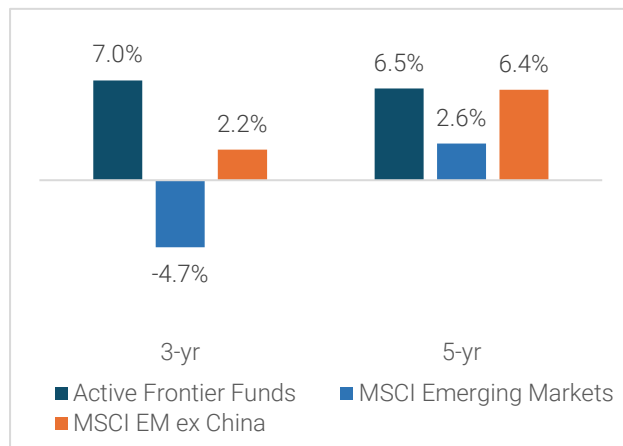
But the lower exposure of active EM and EM-China funds to these markets on its own is inconsequential. Rather, it is whether the opportunity cost of doing so is detrimental to potential overall EM returns?

<sup>7</sup> Represents the average portfolio weight of funds invested in the country.

## Myth 3: Returns Have Lagged Emerging Markets

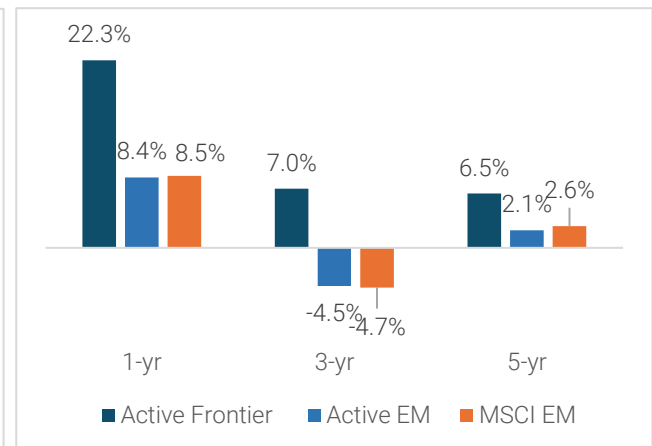
To create an accurate comparison, we compiled the average returns of 25 active FM funds representing at least 90% of AUMs and compared their returns to (i) the EM indices (Figure 12) and (ii) active EM funds representing 1,094 funds and USD 785 billion of AUM (Figure 13). (Note – We have excluded active EM ex-China funds from this analysis as the majority have less than a 3-year track record).

**Figure 12: Active FM vs EM Indices (US\$)<sup>8</sup>**



Source: Bloomberg, MSCI

**Figure 13: Active FM vs. EM Returns (US\$)<sup>9</sup>**



Source: Bloomberg, MSCI, HSBC Research

The results highlight that under-investment in smaller emerging/frontier markets has been detrimental to potential overall EM returns. Furthermore, the removal of China from the EM index does not alleviate the legacy top heavy concentration concerns of active EM strategies as the void has largely been distributed amongst the top 6 countries in the EM ex-China index, leaving minimal incentive for active managers to dedicate significant resources outside their realm. On the contrary, FM managers remain relatively unconstrained and in doing so, inadvertently complement an EM allocation in terms of diversification and returns.

## Allocator Checklist Suggestions

Our findings support a viable scenario for supplementing overall EM exposure with a dedicated FM allocation. Rather than dismissing FM as a niche asset class, it should be viewed as bridging the geographical exposure gap of EM strategies compensated by higher overall returns in the process. We recommend the following FM evaluation suggestions for the allocator checklist:

- The investment universe remit and associated liquidity
- Universe overlap and country allocation versus existing EM managers
- Relative returns to their existing EM allocation
- Overall portfolio diversification by adding a FM allocation

We hope to have assuaged some of the common apprehensions surrounding FM and left you with a strong case for revisiting the structure of your existing EM allocation.

<sup>8</sup> Annualized returns as of March 2024

<sup>9</sup> Annualized returns except 1-yr as of March 2024

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