Developed, Emerging, or Frontier – Thinking Outside the Index

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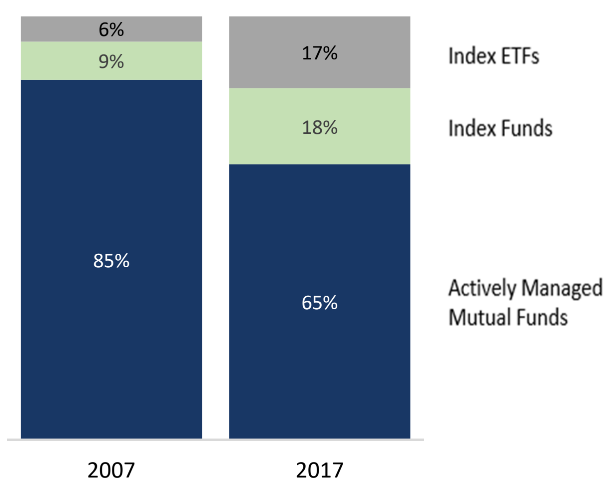
In the world of developing market equities, investment opportunities caused by market inefficiency and investor bias are being created and enhanced through the allied forces of passive investing and index construction practices.

The prominence of global passive investing (Exhibit 1) guarantees that changes in country membership of the most widely followed equity indexes exert a sizable technical impact on market performance due to general market size and the flows associated with changes in index constituents. In this way, index providers command considerable influence over investment flows around the world, triggering large transaction volumes that have little-to-no connection to investment fundamentals.

Exhibit 1: The Rise of Passive Investing



Note: ETF category excludes non–1940 Act ETFs. Mutual fund category excludes money market funds.

Source: ICI Investment Company Fact Book 2018

The major global equity index provider is MSCI, but FTSE also serves as an important player, and then there also is S&P, still mainly a US proxy, but also working to build share in global indexing. The process for making index changes generally involves consultation with index customers and others with vested interests. Though on the surface index changes appear quantitatively driven, there are typically nuances due to the collaborative process, especially when large index changes are made, such as the inclusion of MSCI's China A shares and the determination of whether South Korea is an MSCI developed or emerging market (you be the judge).

For emerging and frontier investors, index construction is increasingly dominated by a selection of large markets, with a tail of smaller markets that are often orphaned due to liquidity and analytical bandwidth. Recent changes have exacerbated this issue, with Pakistan's elevation to emerging market status where it subsequently collapsed to .04% of the MSCI EM Index. At the same time, China has become more than 30% of the MSCI EM Index and could approach ~45% with 100% inclusion of A shares. Even Colombia, Peru and Egypt are less than .50% of the MSCI EM Index.

For a country to be classified as developed within the MSCI system it must show per capita income that is 25% above the high-income threshold of ~$12,500. But being classified as developed doesn't automatically provide a country with entrée into developed market indexes. To be included in the MSCI's EAFE or ACWI Indexes a country must also provide high levels of liquidity as well as meet strict accessibility criteria for foreign investor access. (Exhibit 2) Per capita income is not a factor in the frontier or emerging market categorization. As a result, small and less liquid Slovenia, with $22,000 GNI per capita in 2017, is clearly a developed economy but it resides in the MSCI Frontier Markets Index along with Bangladesh, which at $1K of 2017 GNI per capita is still clearly developing. Lack of foreign investor access explains why the GCC state of Kuwait is categorized by MSCI as frontier, despite being wealthier than Spain. FTSE takes a more rational approach to the wealth factor.

Exhibit 2: MSCI Index Criteria

	Frontier	Emerging	Developed
Economic Development 1. Sustainability of economic development	No requirement	No requirement	GNI per capita 25% above World Bank high income threshold* 3 consecutive yrs.
Size and Liquidity Requirements			
1. No. companies meeting standard index criteria	2	3	5
Company size (full market cap)**	USD 797 mm	USD 1,594 mm	USD 3,187 mm
Security size (float market cap)**	USD 71 mm	USD 797 mm	USD 1,594 mm
Security liquidity	2.5% ATVR	15% ATVR	20% ATVR
Market Accessibility Criteria			
1. Openness to foreign ownership	At least some	Significant	Very high
2. Ease of capital inflows	At least partial	Significant	Very high
3. Efficiency of operational framework	Modest	Good and tested	Very high
4. Competitive landscape	High	High	Unrestricted
5. Stability of the institutional framework	Modest	Modest	Very high

* High income threshold for 2017: GNI per capital of USD 12,235 (World Bank, Atlas method)
** Minimum in use for the May 2018 Semi-Annual Index Review, updated on a semi-annual basis

Source: MSCI

In the FTSE system (Exhibit 3), Kuwait was never considered a frontier market. It was recently added to the FTSE Emerging Markets Index from being unclassified. In FTSE, South Korea has been an advanced market since 2009, while in the MSCI system it remains classified as emerging due to some limitations on foreign exchange trading. Some smaller frontier markets end up nowhere depending on the Index. MSCI FM currently includes 23 countries, FTSE EM 20, while the S&P FM Index has 33.

Exhibit 3: FTSE Index Criteria

Criteria	Developed	Advanced Emerging	Secondary Emerging	Frontier
World Bank GNI Per Capita Rating				
Credit Worthiness **Market and Regulatory Environment**				
Formal stock market regulatory authorities actively monitor market (e.g., SEC, FSA, SFC)	X	X	X	X
Fair and non-prejudicial treatment of minority shareholders	X	X		
No or selective incidence of foreign ownership restrictions	X	X		
No objection to or significant restrictions or penalties applied to the investment of capital or the repatriation of capital and income	X	X	X	X
Free and well-developed equity market	X	X		
Free and well-developed foreign exchange market	X	X		
No or simple registration process for foreign investors	X	X		
Custody and Settlement				
Settlement - Rare incidence of failed trades	X	X	X	X
Custody-Sufficient competition to ensure high quality custodian services	X	X	X	
Clearing & settlement - T+2 / T+3	X	X	X	X
Settlement - Free delivery available	X			
Custody - Omnibus and segregated account facilities available to international investors	X	X		
Dealing Landscape				
Brokerage - Sufficient competition to ensure high quality broker services	X	X	X	
Liquidity - Sufficient broad market liquidity to support sizeable global investment	X	X	X	
Transaction costs - implicit and explicit costs to be reasonable and competitive	X	X	X	
Stock Lending is permitted	X			
Short sales permitted	X			
Off-exchange transactions permitted	X			
Efficient trading mechanism	X			
Transparency - market depth information/visibility and timely trade reporting process	X	X	X	X
Derivatives				
Developed Derivatives Market	X			
				Source: FTSE Russell

The promotion (and sometimes demotion – hello, Greece and Morocco) of countries has created a quasi-cottage industry devoted to index watching and technical recommendations aimed at capitalizing on fund flows. This on top of the already massive index ETF industry.

The buzz in frontier market equities right now is the pending elevation of Argentina (2019) and Kuwait (2020) to emerging market status and the subsequent impact on passive net investment flows (Exhibits 4,5).

Frontier favorite, Vietnam, might soon follow. For the pragmatic active EM and FM manager, investment decisions should be based on fundamentals and expected long term results, not passive arbitrage. (Even if you wanted to be a frontier market "index watcher", it can be tricky to manage around index changes, given liquidity constraints and transaction costs.) This inevitably creates a challenge in managing the investment universe and presenting relative performance to investors.

Exhibit 4: Frontier Market Indexes Proforma Country Allocations

	MSCI FM			FTSE FM	
Country	Actual	Estimated		Actual	Estimated
	Dec 2018	May 2019 Ex Argentina	May 2020 Ex Kuwait	Dec 2018	Dec 2018 Ex Argentina
Kuwait	23.0	27.5	--	--	--
Argentina	16.5	--	--	16.3	--
Vietnam	15.4	18.5	25.5	19.0	22.7
Morocco	8.2	9.8	13.5	10.5	12.5
Nigeria	7.1	8.5	11.7	11.8	14.1
Kenya	4.7	5.6	7.7	6.0	7.1
Bahrain	4.1	4.9	6.7	--	--
Romania	3.9	4.7	6.5	5.9	7.0
Bangladesh	2.8	3.3	4.6	13.2	15.8
Lebanon	2.6	3.2	4.4	--	--
Slovenia	1.8	2.1	2.9	2.6	3.1
Mauritius	1.7	2.1	2.8	2.0	2.4
Croatia	1.7	2.0	2.8	0.6	0.7
Oman	1.6	1.9	2.7	3.7	4.4
Jordan	1.1	1.3	1.8	1.4	1.7
Kazakhstan	0.8	1.0	1.4	1.1	1.3
Sri Lanka	0.8	1.0	1.3	2.3	2.8
Tunisia	0.7	0.8	1.1	1.4	1.7
Senegal	0.6	0.8	1.0	--	--
Estonia	0.4	0.5	0.7	0.3	0.4
Serbia	0.2	0.3	0.4	--	--
Lithuania	0.2	0.3	0.4	0.2	0.3
Ivory Coast	0.1	0.1	0.2	0.8	1.0
Palestine	--	--	--	0.7	0.8
Bulgaria	--	--	--	0.2	0.2

Source: FGP, MSCI, FactSet, Exotix

Exhibit 5: Emerging Market Indexes Proforma Country Allocations

Country	MSCI EM Actual Dec 2018	MSCI EM Estimated May 2019*	FTSE EM Actual Dec 2018	FTSE EM Estimated Dec 2020*
China	30.4	32.3	32.7	35.5
Korea	14.2	13.2	--	--
Taiwan	11.6	10.8	12.9	11.8
India	8.7	8.1	12.1	11.1
Brazil	7.8	7.1	9.2	8.4
South Africa	6.1	5.7	7.7	7.1
Russia	3.9	3.6	4.2	3.9
Mexico	2.8	2.6	3.4	3.1
Thailand	2.5	2.3	3.6	3.3
Malaysia	2.4	2.3	3.3	3.0
Indonesia	2.1	1.9	2.5	2.3
Poland	1.2	1.1	--	--
Qatar	1.1	1.0	1.3	1.2
Chile	1.1	1.0	1.3	1.2
Philippines	1.0	0.9	1.3	1.2
UAE	0.8	0.7	1.0	0.9
Turkey	0.6	0.6	0.8	0.7
Peru	0.4	0.4	0.4	0.4
Colombia	0.4	0.4	0.4	0.4
Hungary	0.3	0.3	0.4	0.4
Greece	0.2	0.2	0.3	0.3
Czech Republic	0.2	0.2	0.2	0.2
Egypt	0.1	0.1	0.2	0.2
Pakistan	0.0	0.0	0.0	0.0
Saudi Arabia	--	2.5	--	2.7
Kuwait	--	0.3	0.6	0.5
Argentina	--	0.4	--	--

* Argentina, Saudi Arabia, Kuwait, China A 20%

Source: FGP, MSCI, FactSet, Exotix

Index providers have attempted to diffuse index construction flaws by developing adjunct products that group smaller markets together, such as the MSCI Frontier Emerging and Horizon indexes. Similarly, FTSE segregates the emerging market countries into Advanced Emerging and Secondary Emerging categories. Though they are not yet widely adopted, investors may pay closer attention to secondary benchmarks in the future due to the growing size of China and the shrinking of the frontier.

Regardless of the index chosen, the main question is how investors should approach developing markets given the size of China when including A-shares, the ongoing decline in countries categorized as "frontier", and the de minimis size of many emerging markets within the broader indexes. Trends indicate that investors are going with the flow, so to speak, by following the indexes and often adopting passive approaches. That is a shame. It eliminates an area of immense opportunity, which will become even more interesting the further marginalized frontier and smaller emerging markets become with upcoming index changes.

We encourage investors to:

- Think outside the index. Large swaths of the developing universe have been pushed to the edges by common country categorizations. Lack of interest often creates compelling price inefficiencies in frontier and smaller emerging market equities.
- Stay active even when passive is important to your plan's economics. Active managers can move around the smaller developing markets, looking for companies that are often not owned by foreign investors and are rarely covered by global sell side firms. Active strategies that target these markets can be an excellent complement to passive investing.
- Be flexible when measuring performance against a passive index. The complexity of frontier and small emerging markets make routine benchmarking ineffective. Often it might be helpful to look at more than one index given the shortcomings of popular index construction methodologies.
- Take a very long-term view on frontier and smaller emerging markets. Illiquidity can be an advantage, not a drawback. Many companies in smaller markets, particularly in the frontier space, exhibit "listed private equity" characteristics. We believe that patience will be rewarded with future liquidity expansion.

As long-standing frontier market investors, we are well aware of index shortcomings and do not make decisions based on their construction. Our portfolios tend to have high active share and often invest in markets outside popular FM indexes, including some of the smaller emerging markets. We encourage investors to do the same. The investment world that exists beyond commonly followed frontier and emerging indexes is filled with opportunity.

About Frontier Global Partners

Frontier Global Partners manages a focused set of investment solutions covering international, global and frontier market equities, asset allocation and alternative investments. Under the direction of managing partners Lawrence Speidell, CIO, and Horacio Valeiras, CEO, the organization sustains a dynamic investment culture rooted in behavioral finance. The firm's investment strategies reflect a shared commitment to investing in high-quality securities at prices that represent good value and to managing portfolios that exhibit low turnover. Born of twin organizations that covered separate and distinct global market segments with common approaches, the firm manages concentrated equity portfolios drawn from the breadth of the world's markets. Frontier Global Partners is an independent, employee-owned organization with offices in La Jolla, California and Boston, with the majority of the firm owned by its minority partners.

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