

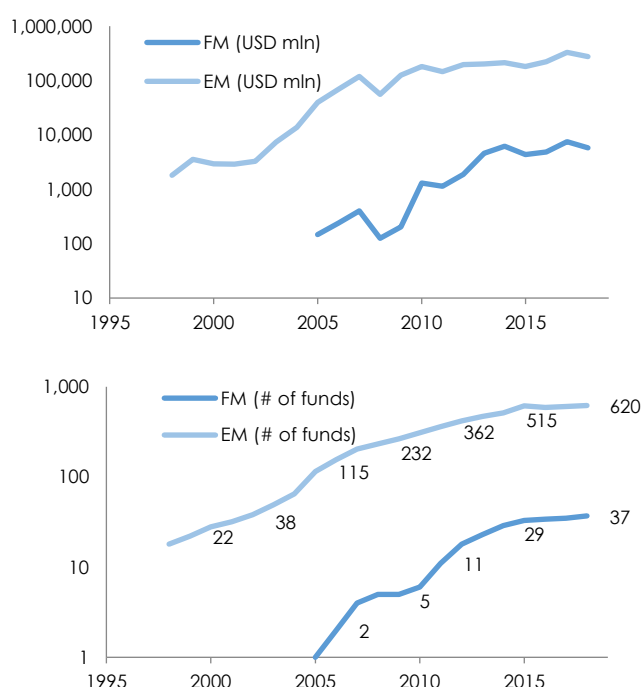
Frontier Markets – A Unique Asset Class

November 2018

On 30th November 2007 MSCI published an index tracking the performance of the smaller and less accessible but still “investable” countries: Frontier Markets¹. In early 2008 Deutsche Bank launched the first Frontier Markets exchange-traded fund, listed on the London Stock Exchange. A decade later, we analysed the evolution of Frontier Markets and why they have to be considered as a distinct asset class not only from a macroeconomic point of view, but also as an essential investment opportunity to capture economic growth premium.

Data regarding the evolution and level – in terms of managed assets and number – of specialised European mutual funds, suggest that the development of this new asset class is today where the Emerging Markets' industry was a couple of decades ago.

Exhibit 1: AUM and number of European Equity mutual funds on Frontier (FM) and Emerging (EM) Markets

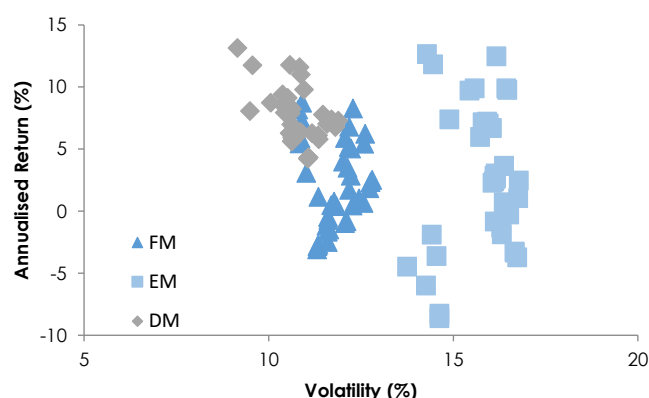


As highlighted in the Exhibit 1, in the last few years Frontier markets have experienced increasing investment flows, therefore it makes sense to examine their main characteristics within portfolio analysis.

Risk and return analysis

Exhibit 2 shows risk and return over 3-year rolling periods for Developed, Emerging and Frontiers Markets, it is clear that Frontiers Markets have their own differentiated pattern of return and volatility when compared to Developed and Emerging markets. Notably, Frontiers Markets offer a return profile similar to Emerging Markets, but with a risk profile comparable to Developed Markets.

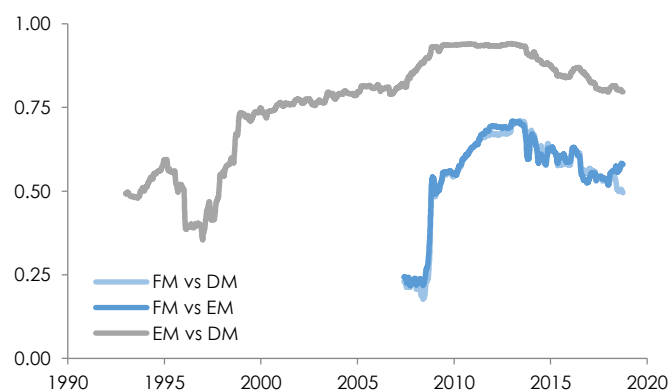
Exhibit 2: Rolling 3-Year Risk and Returns for the MSCI Frontier Markets (FM), MSCI World (DM) and the MSCI Emerging Markets (EM) Indices for the period 2015 to 2018



Correlation analysis

Frontier Markets have low correlation with both Emerging and Developed markets because of their low level of integration as local factors tend to be more influential than the global economy.

Exhibit 3: 3-Year Rolling Correlation of MSCI Emerging Markets (EM), MSCI Developed Markets (DM) and MSCI Frontier Markets (FM) Indices



¹ The term Frontier Markets was coined by International Finance Corporation's Farida Khambata in 1992 when the IFC Emerging Markets Database began publishing data on smaller markets

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The low correlations are even more obvious when looking at single country level. In fact, the main Frontier Markets countries present low correlation not only with the main Developed and Emerging countries, but also due to their locally driven economies, to the other Frontier countries.

Exhibit 4: Correlation Matrix of Main MSCI Emerging, Developed and Frontiers Countries Indices (Based on 3-Year Monthly Returns)

	US	JP	UK	CN	KR	TW	KW	VT	AR
US		0.72	0.65	0.79	0.75	0.64	0.26	0.36	(0.04)
Japan-JP	0.72		0.67	0.74	0.71	0.59	0.25	0.50	0.19
UK	0.65	0.67		0.65	0.67	0.38	0.23	0.29	0.31
China-CN	0.72	0.74	0.65		0.77	0.69	0.26	0.42	0.22
Korea-KR	0.65	0.71	0.67	0.77		0.75	0.13	0.42	0.34
Taiwan-TW	0.63	0.59	0.38	0.69	0.75		0.24	0.34	0.29
Kuwait-KW	0.26	0.25	0.23	0.26	0.13	0.24		0.02	0.22
Vietnam-VT	0.36	0.50	0.29	0.42	0.42	0.34	0.02		0.26
Argentina-AR	(0.04)	0.19	0.31	0.22	0.34	0.29	0.22	0.26	

Frontiers Markets offer a specific low-risk, high return and low correlated investment opportunity. Due to their unique characteristics, when building a portfolio, they have to be considered as a separate and differentiated asset class, therefore a dedicated investment strategy has to be specifically designed for these particular countries. The approach has to be very different to those adopted in Developed and Emerging Markets: dedicated asset managers with specific knowledge and understanding of early-stage financial markets will focus on selecting the best opportunities to capture Frontier Markets unique edge, caring less about global economic cycles than global portfolio managers.

Asset Allocation

From an asset allocation perspective, Frontier Markets are following the same pattern experienced by their "big brother" Emerging Markets. The aim of investing in Frontier Markets is focusing on taking exposure to an uncorrelated source of equity growth premium, often seen as an allocation outside the core portfolio as was for Emerging Markets a few decades ago².

Today Emerging Markets have changed their role in the global equity portfolio construction. In fact investors across the globe are increasingly adopting the New Classic equity allocation framework³ as the basis for global equity allocation. Under this framework, the starting point for a

global equity allocation is one that includes large, mid and small cap securities from both Developed and Emerging markets.

As shown by the development of their weight in the MSCI ACWI the Emerging Markets are now an essential part of a global equity portfolio. This leaves room for uncorrelated source of equity growth premium to Frontier Markets, which today have a weight of 0.3% in the MSCI ACWI + FM as the Emerging Markets before 1988.

Exhibit 5: Weights for Emerging (EM) and Developed (DM) Markets in MSCI ACWI

	1987	1992	1997	2002	2007	2012	2017
DM	99.1%	95.4%	93.2%	96.0%	88.7%	87.4%	89.1%
EM	0.9%	4.6%	6.8%	4.0%	11.3%	12.6%	10.9%

Conclusion

Given the specific features of Frontier Markets in term of risk, return and correlation compared to Developed and Emerging Markets, these group of countries have to be considered as a new asset class. Frontier Markets' investment role has enhanced in recent years as they represent a unique opportunity of investing within a global equity portfolio. Investing in this new asset class is a new way to diversify.

As the new uncorrelated source of equity growth premium, Frontier Markets request a specific investment approach which has to be very different from those adopted when looking at Emerging and Developed Markets. Any investment strategy focused on Frontier Markets has to be designed to fit the specific characteristics of the early-stage financial markets.

² MSCI "Built to Last - Two Decades of Wisdom on Emerging Markets Allocations" Juliana Bambaci, Chin-Ping Chia and Billy Ho, October 2012

³ Kang, Nielsen and Fachinotti, 2010