Frontier Markets – A Rising Reality

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In our first two papers[1] we showed how Frontier Markets differ from both Emerging and Developed Markets in terms of risk, return and correlation, and how efficient would be their inclusion in a global equity portfolio to definitely improve its risk-return profile. The purpose of this latest work is to highlight the differences between Frontier Markets and more developed countries at both macro and micro levels and observe how these have shaped institutional investors' interest over the last decade.

Sample Data

Annual data on GDP and GNI per capita are from the World Bank and IMF database, going from 1995 to 2017. Daily and weekly equity data for the ten most weighted Equities within the five most weighted Countries listed in MSCI Frontier Markets, MSCI Emerging Markets and MSCI World Indices, are taken from Bloomberg Terminal. The analised period goes from January 2009 to March 2019.

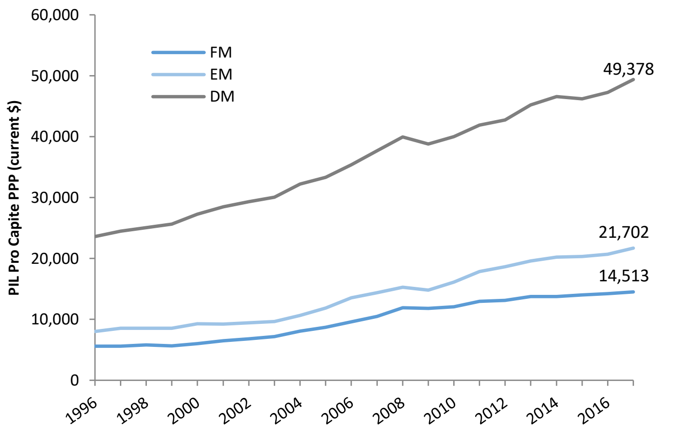
Macro Environment Analysis

One of the first features long-term investors should look at when making investment choice in a specific market is how big it is and how fast it is growing.

Frontier, Emerging and Developed Markets are on a completely different scale in terms of market size. Nonetheless, the economic growth of a country depends not only on strict economic conditions, but also on the development of a middle class capable of supporting it over time. Empirical academic studies (Brueckner, 2018; Kharas, 2017; Uner and Gungordu, 2016; Kravets and Sandikci, 2014) are increasingly supporting that a strong middle class is in fact the real source of economic growth, since it provides a stable consumer base that drives productive investments. It is not only a motor of consumption and domestic demand, but has also an equally important social role. In fact, a solid middle class is a key factor in encouraging fundamental national and social conditions that lead to growth and represents a prerequisite for robust entrepreneurship and innovation. Moreover, it stimulates social interactions and reduces transaction costs through increasing volumes of business: a pillar of civic engagement that helps to create a better governance and a favourable environment for long-term investments.

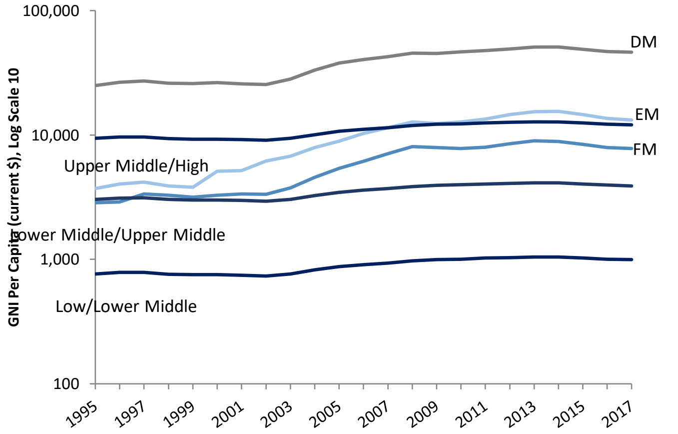
[1]"Frontier Markets – A Unique Asset Class", (2018), "Frontier Markets – A Source of Diversification", (2019).

Exhibit 1: Median GDP Per Capita (Current US$) for Frontier, Emerging and Developed Markets as MSCI definition, for the period 1996 to 2017 (annual data)



Fonte: WorldBank, IMF

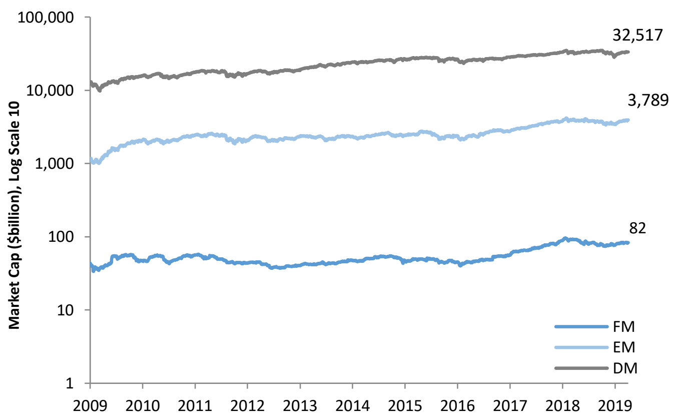
Exhibit 2: Median GNI Per Capita (Current US$), for Frontier, Emerging and Developed Markets as MSCI definition, for the period 1995 to 2017 (annual data)



Source: WorldBank, IMF

Since 1995 GDP and GNI per capita in Frontier Markets have constantly risen (Exhibits 1 and 2). While GDP per capita measures the standard of living in a country, GNI per capita reflects the average income of a country's citizens. Exhibit 2 includes also the thresholds that, according to the World Bank, classify a country as High, Middle, or Low Income. Frontier markets have long since become Middle Income countries (early 2000s), and are now on the verge to reach the Upper Middle/High end. However, while these results suggest a constant expansion of the middle class in Frontier Markets, which, as we said above, is a main factor for supporting a country's economic success, they highlight how the gap with Emerging and Developed Markets continues to be rather considerable: Frontier Markets are now at the same level where their "big brothers", the Emerging Markets, where almost 15 years ago.

Exhibit 3: Market Cap Sum of the five most weighted countries within Frontier, Emerging and Developed MSCI Indices for the period 2010 to 2019 (daily data)



Source: Bloomberg

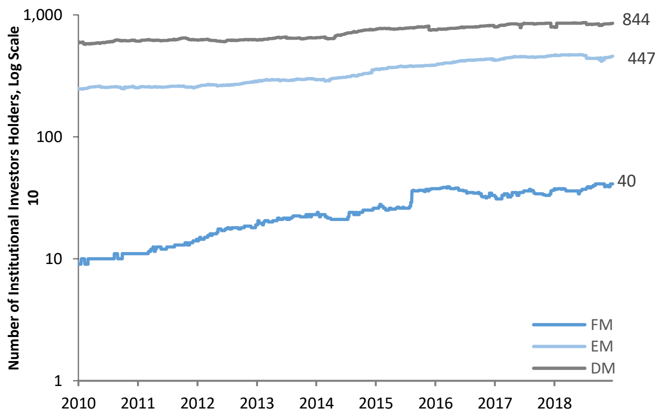
Exhibit 3 gives us an idea of the disparity in stock market's size between Frontier, Emerging and Developed Markets. The market capitalisation of Frontier Markets is in fact on a total different scale in terms of number compared to Emerging and Developed Markets. The sum of the market value of the five main Frontier Markets (Kuwait, Argentina, Vietnam, Morocco and Nigeria) is only 82.17 billion USD, and, while it has had a considerable growth over the last few years, it still is way below the level where Emerging (China, South Korea, Taiwan, India and Brazil) and Developed Markets (U.S., Japan, U.K., France, Canada) currently stand, which is, 3.8 and 32.5 trillion USD respectively.

Equity Markets Participation Analysis

It is also worth noting how different are these markets in terms of presence and investments made by institutional investors.

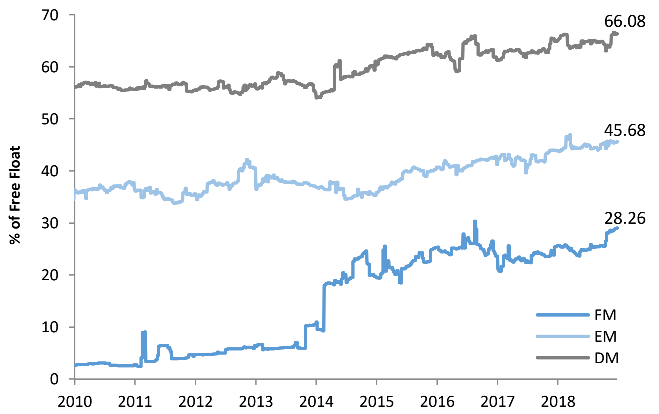
The number of Institutional Investors (Exhibit 4) holding Frontier Markets' equities has significantly grown over the last few years (40), confirming that for financial institutions Frontier Markets are becoming an increasingly essential component in a long-term portfolio investment perspective This phenomenon tells us that institutional investors have grown more interest in holding large chunks of Frontier companies, recognizing their differentiated characteristics from Emerging and Developed Markets, and so their benefits in terms of diversification and potential returns. Despite being increased, these numbers once again demonstrate that in absolute terms the level of market participation and investment flows of institutional investors in Frontier Markets is far lower when compared to Emerging and Developed Markets. The median number of institutional investors holding Frontier equities is more than 10 times smaller compared to Emerging (40 vs 447), and 21 times compared to Developed (40 vs 844).

Exhibit 4: Median Number of Institutional Investors Holders (weekly data)



Source: Bloomberg

Exhibit 5: Average Percentage of Free Float Held by Institutional Investors for Frontier, Emerging and Developed Markets for the period 2010 to 2019 (weekly data)

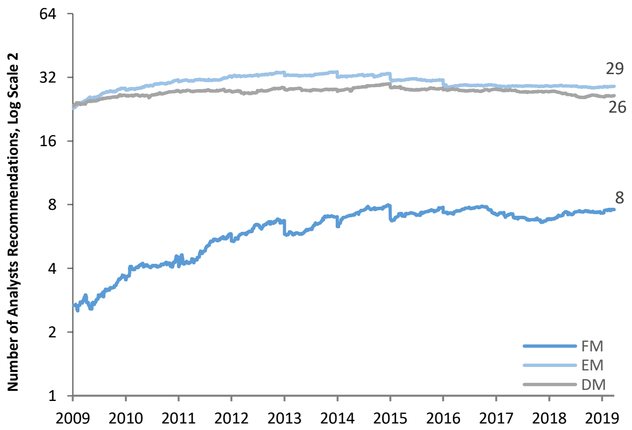


Source: Bloomberg

This is also supported by looking at Exhibit 5, which shows the percentage of free float held by institutional investors in Frontier, Emerging and Developed Markets. Again, even though the growth for Frontier Markets is clear (especially since 2014), being now at 28.26%, this level is considerably lower than Emerging and

Developed Markets, which are 45.68% and 66.08%, respectively.

Exhibit 6: Average number of Analysts Recommendations for Developed, Emerging and Frontier Markets (weekly data)



Source: Bloomberg

The demand of analysts with a specific approach for these new class of countries is constantly growing. The number of analysts following Frontier companies has almost tripled (8) on average since 2009 (Exhibit 6). Yet, their total number remains rather limited compared to Developed Countries (26), and especially to Emerging Markets (29).

Conclusion

Frontier Markets' economy has steadily evolved over the last few years, being now at a stage where Emerging Markets were almost 15 years ago. This growth has been supported not only by improved economic and political conditions, but also by the expansion of a rising middle class, demonstrating its sustainability going forwards.

As a consequence of this economic and social development, the interest of institutional and foreign investors in Frontier Markets has increased over the last decade. However, despite this positive trend, Frontier Market are still on a totally different scale – both at macro and micro level - when compared to Developed, but especially to Emerging Markets, to which they are too often wrongly associated. This suggests that Frontier Markets have to be considered as a new and distinct asset class from Emerging and Developed Markets, and that adequate professionals with a deep knowledge of them are needed when it comes to design the right investment approach.