

Frontier Markets

An Alternative to Emerging Markets?

While emerging markets are a common term for most investors, frontier markets often move in the shadow of their bigger brother. But how do these categories differ? Citywire looks at an often-overlooked sector.



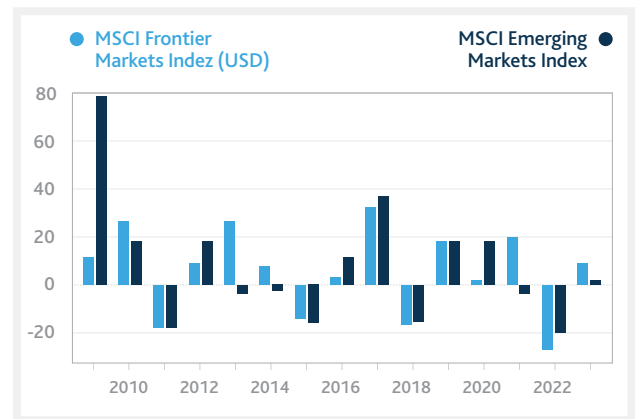
Stefan Böttcher
Fund Manager,
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Frontier markets are a distinct category of countries that fall after developed and emerging markets. To define them more precisely, MSCI uses a helpful definition that considers not only economic data but also the size and liquidity of the market itself. Countries can move between categories based on their economic development and market conditions. For example, Pakistan lost its emerging market status and became a frontier market in 2021, while Greece slipped from developed to emerging market status in 2013. However, countries can also move up in categories. Frontier markets can become emerging markets, while emerging markets can eventually become industrialized countries.

Frontier Markets With Good Performance

Over the past decade, Frontier Markets have performed slightly better than the Emerging Markets. The MSCI Frontier Markets index, which includes countries like Vietnam, Romania, Morocco, Kazakhstan and Iceland, has generated an annualized return of 2.61% in US dollars up to the end of September. In comparison, the MSCI Emerging Markets index has returned 2.07% over the same period. Furthermore, the Frontier Index currently offers a higher dividend yield of 4.3% than the Emerging Markets Index, which is just below 3.1%.

Annual USD returns (%)



Source: MSCI as at 29.09.2023

Frontier markets offer a \$1.2 trillion investment opportunity, according to Stefan Böttcher who co-manages Fiera Capital's €500 million Magna New Frontiers fund. These markets are an attractive niche that many investors overlook. Compared to the classic emerging markets, they are under-researched, under-analysed, and have lower foreign investor participation. This results in greater market inefficiencies that are reflected in share prices, which in turn create exciting investment opportunities.

In addition, the large emerging countries are much more susceptible to developments on global markets and to macroeconomic changes. In Frontier Markets, domestically driven economic growth plays a dominant role in companies' profit growth. That's why, according to Böttcher, the fastest-growing countries can be found within the Frontier Markets category. However, the manager's investment style is benchmark independent.

Looking at the country weighting of his portfolio at the end of August shows that countries such as Vietnam (31%), Saudi Arabia (14%), Greece (10%), Kazakhstan (10%) and the United Arab Emirates (8%) account for a large part of the portfolio. An overweight in the classic sectors of finance (33%), energy (18%) and cyclical consumer goods (11%) fits with the basic idea that investors can benefit from the rising domestic demand in such countries.



Reforms as a Return Driver

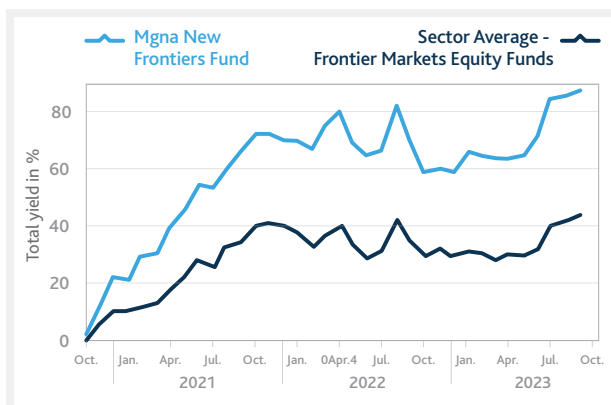
When considering potential investments, the expert pays attention to specific criteria. The first criterion is to look for countries that are implementing positive reforms and driving economic growth. The second is to look for companies that can benefit from these reforms and growth.

The investment process starts with a macroeconomic assessment of countries. Stefan excludes countries with high inflation, capital controls, parallel foreign exchange markets, and other factors that pose risks of not getting the invested capital back in hard currency.

In the remaining investable universe, he analyses the reform trajectories of the countries to determine if they are on track to generate strong GDP growth. He then uses his experience with local contacts and research trips to find companies with strong management, attractive business models, sustainable overall growth, and alignment with shareholder interests.

The Magna New Frontiers fund leads the ranking in the Equities – Frontier Markets category, with a performance of 87.8% over the last three years, compared to the industry average of 43.8%.

Fund performance vs peers



Source: MSCI as at 29.09.2023

According to Stefan, frontier markets could benefit from the current loss of confidence in Chinese investments. Multinational companies are looking to establish new manufacturing hubs and reduce their dependence on China. Vietnam is a prime example of this trend, with companies like Samsung and Lego already present in the country. It is important to note that while China remains a significant player in the global economy, the countries we invest in have low correlation to the global macro picture.

Trend Reversal in Inflows and Outflows

The relatively strong performance of frontier markets is now having an impact on investor interest, as shown by the inflows and outflows of corresponding funds. It is expected that 2023 will be an important year for Frontier Markets. Currently, there are 20 equity funds included in the Morningstar Frontier Markets Equity category. Looking at the inflows and outflows in this category since 2020, it is evident that the sector has been particularly popular with investors since the middle of this year. Although there were outflows of almost a billion euros from January 2021 to December 2022, the trend reversed this year. From January to the end of September, there were inflows of €547 million. At the end of the third quarter, the pure net inflows of funds already corresponded to a quarter of the sector volume at the beginning of the year.

In terms of numbers, the fund volume in the Frontier Markets sector was €2.2 billion at the start of 2023. However, due to the inflow of funds and price increases, the volume rose to €2.7 billion by the end of September. On the other hand, the emerging market equity funds had almost opposite behaviour. The much larger and more liquid Morningstar Global Emerging Markets Equity category saw slight inflows of €4.3 billion since the beginning of the year but had significant outflows since August. Despite the poor performance, the increase in funds by the end of September was still 1.6% compared to the total volume at the beginning of the year. Fund assets under management fell from €250 billion to just under €225 billion.



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