Is it time to venture off-piste?

Why it may be an opportune time to look beyond mainstream equity markets...

Update
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Stability has been in short supply for investors in recent months. After a stellar run, the S&P 500 ground into reverse amid mounting concerns over the waning of American exceptionalism. This sell-off deepened after the geopolitical aftershocks of 'Liberation Day' reverberated through global stock markets, further rattling investor confidence.

American neuroscientist John Lilly once observed, "Our only security is our ability to change" and the recent market turbulence may serve as a timely reminder for investors to take a fresh look at portfolio allocations.

While diversification remains a popular strategy, finding uncorrelated equity returns is becoming ever harder. The Magnificent Seven not only dominate global indices but also shape the fortunes of tech-driven sectors in major emerging markets such as the semiconductor industries in South Korea and Taiwan.

Against this backdrop of heightened uncertainty and shifting global dynamics, might it be a good time to improve diversification by venturing off-piste into less correlated equity markets? If so, frontier markets could just fit the bill, offering access to attractively-valued companies with strong domestic growth drivers, alongside compelling income yields.

Harnessing the middle ground

As geopolitical rivalries deepen, smaller emerging and frontier economies are benefitting from the growing polarisation between East and West. Whilst the evolving geopolitical environment signifies a period of potential market volatility, it also presents unique opportunities across a variety of sectors, industries and geographies in BRFI's investment universe.

These structural shifts are creating a fertile hunting ground for active managers. In a recent webinar, Emily Fletcher, co-manager of **BlackRock Frontiers (BRFI)**, highlighted the benefits of maintaining political neutrality, dubbing the UAE as the "Switzerland of the Middle East". The last few years have seen global businesses setting up regional hubs in the region, which also enjoys a burgeoning domestic market in finance and real estate.

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Although tariffs remain a potential headwind, co-manager Sam Vecht believes much of this risk is reflected in valuations. However, the outlook remains very uncertain until there is more clarity on the likely tariffs after the current 90-day pause. Sam also sees opportunities arising from shifting trade dynamics, with the potential for Southeast Asian and emerging European companies to become the unexpected beneficiaries of US trade barriers with China in particular.

Growth meets yield

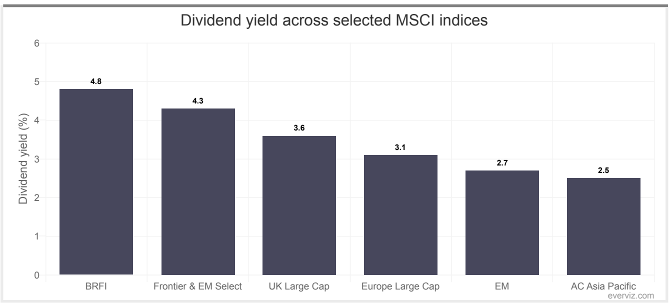
Smaller emerging and frontier markets offer exposure to some of the world's fastest-growing economies. The IMF is forecasting real GDP growth of over 5% in Vietnam, Georgia and the Philippines in 2025, compared to 1% for the G7 economies.

This is also a diverse and underexplored universe which offers a broad range of both local and global growth drivers. These include demographic tailwinds, a growing consumer class and financial inclusion on the domestic front and export-led opportunities in megatrends such as clean energy and friendshoring.

The size and breadth of the universe also plays to the strengths of active managers. By way of example, BRFI has exposure to a diverse range of markets including Pakistan, Kenya and Bangladesh where economic reforms and IMF support are driving a more positive outlook.

Beyond growth, these markets also offer an attractive but often overlooked income stream. As illustrated in the graph below, the MSCI Frontier and Emerging Markets Select Index currently yields almost 5%, comfortably above traditional equity income sectors such as UK and European large caps.

Fig.1: Frontier Markets Offer A Compelling Yield



Source: MSCI factsheets (as at 31/03/2025) and BRFI factsheet (as at 28/02/2025). Indices include MSCI Frontier and Emerging Market Select and MSCI Emerging Markets indices

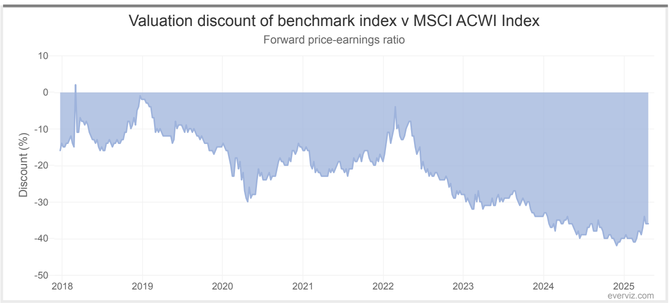
BRFI also currently offers a dividend yield of just under 5%. While the trust doesn't follow a progressive dividend policy, portfolio companies typically exhibit discipline in capital expenditure and maintain consistent dividend payout ratios, meaning that earnings growth has generally translated into rising dividend income.

Unlocking valuation opportunities

Valuations in smaller emerging and frontier markets remain appealing. The MSCI Frontier + Emerging Markets ex Selected Countries Index (the "Benchmark Index") is currently trading on a forward price earnings ratio of 11 times, well below the 17 times for the MSCI ACWI Index.

As shown in the graph below, this discount has widened in recent years, as valuations have increased in developed markets but remained largely flat in frontier and smaller emerging markets. This growing divergence in valuations presents a compelling opportunity for active managers to uncover undervalued companies with overlooked growth potential.

Fig.2: Valuations Remain At A Significant Discount



Source: Bloomberg (as at 21/04/2025). Based on forward price-earnings ratio for MSCI ACWI and MSCI Frontier + Emerging Markets ex Selected Countries indices

Finding an active edge

Frontier and smaller emerging markets remain inefficient and under-researched. Passive strategies are scarce (due to illiquidity and high tracking costs) while most active emerging markets funds concentrate on a handful of large economies such as China, India and Brazil, leaving much of the investable universe untouched.

This creates a genuine edge for experienced managers such as Sam and Emily. Backed by the substantial resources of BlackRock, they combine top-down macro overlays with in-depth, bottom-up company research.

Currency risk is considered as part of the asset allocation process and liquidity is another important factor for the managers. While BRFI has the ability to hold 15% of the portfolio in one single company, an individual position will typically not exceed 5% and it will usually not invest in a name trading below US$1-10 million a day.

Crucially, Sam and Emily conduct extensive on-the-ground due diligence prior to investing, meeting not only company management but also suppliers, customers, politicians and even trade unions to get a holistic view of the entire ecosystem. Corporate governance considerations are also important, and all portfolio companies will have fully audited accounts (often conducted by Big Four firms).

BRFI's performance is testament to the stock-picking skills of its managers. The trust has achieved a share price total return of almost 90% over the last five years (to 28/02/2025, in GBP) compared to 32% for the benchmark index. It also offers a relatively low correlation to mainstream US and global equities, as well as lower volatility than the S&P 500 and MSCI World indices over the last year.

Looking ahead, venturing off-piste into smaller emerging and frontier markets may serve as a valuable diversifier at a time when market volatility looks likely to continue and mainstream equities are increasingly correlated. While the investment universe does carry inherent political and macroeconomic risk, it also offers a unique entry point for active managers to tap into under-researched, high-growth companies at compelling valuations.

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