The pitfalls of correlation

Why frontier markets offer a unique blend of diversification and growth opportunities...

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The late American investor David Swensen shared the following words of wisdom: “Diversification is about more than spreading your investments, it also means choosing investment vehicles with low correlation.”

It would be fair to say that the 60:40 equity-to-bond portfolio has traditionally been the go-to choice for investors seeking diversified and (relatively) uncorrelated returns. However, correlation dynamics have also shifted substantially in recent years, with the negative bond-to-equity correlation swinging sharply positive for the first time in decades in 2022 as global bond markets suffered their worst rout on record.

Within equity allocations, global trackers may continue to curry favour with UK investors as a portfolio diversifier, but the ever-increasing concentration of the Magnificent Seven has undoubtedly reduced their effectiveness. Neither is it easy to find effective portfolio diversifiers outside the US given the high correlation between US indices and their UK and European counterparts, as well as the rising correlation between emerging and developed markets over the past decade.

As a result, advocates of a correlated-focused diversification strategy may wish to look further afield for investment ideas. One such option is frontier markets, which not only offer a lower correlation to developed markets but also very low correlation to each other in many cases, balancing out the volatility of individual economies.

Frontier equities also offer exposure to a wide range of exciting and uncorrelated growth drivers across four continents and often trade at attractive valuations due to the relative lack of attention and research coverage.

Refining the universes

Frontier markets offer a rich spectrum of opportunities across Eastern Europe, Africa and the Middle East. While China, India, South Korea, and Taiwan heavily dominate the MSCI Emerging Markets index, the 28 countries within the MSCI Frontier Markets index remain largely under-represented.

Frontier markets also remain at a significant valuation discount to emerging markets and global indices, despite many companies delivering strong earnings growth and attractive dividend yields.

However, the economic and political landscapes of frontier countries can vary significantly, necessitating a granular approach to identify the most compelling investment opportunities. A lack of reliable company and country-level data, along with limited equity research, also remains a barrier for investors.

As a result, this is a region where active management offers clear advantages. Co-managers of **BlackRock Frontiers (BRFI)**, Sam Vecht, Emily Fletcher and Sudaif Niaz, together have more than 50 years’ experience at BlackRock, complemented by the extensive on-the-ground resources of the BlackRock emerging markets team to help identify the best opportunities in a large investable universe.

Regular field trips to these regions allow the managers to understand the macroeconomic and political ecosystems, as well as sector-specific competitive and supply landscapes. Although time-intensive, these form an essential part of the managers' due diligence process prior to investing.

A unique blend

The idiosyncratic drivers inherent in frontier markets offer exposure to a range of high-growth, uncorrelated themes, creating a solid foundation for alpha generation.

Macroeconomic tailwinds

While developed markets have struggled to tame inflation, the easing of inflation in some frontier and smaller emerging markets has allowed central banks in Latin America and emerging Europe to cut rates well ahead of the US and Europe, providing a more supportive domestic backdrop for equities. Argentina has been a particularly strong performer in the last financial year, thanks to economic reforms, falling inflation and rising commodity prices.

The improving macroeconomic environment should also drive cyclical growth in domestically-focused economies. As a result, the trust has increased its exposure to some of the smaller countries such as Bangladesh, Kenya, Egypt and Pakistan.

By way of example, the managers initiated a holding in BRAC Bank in Bangladesh, due to a more positive macro outlook after the change in government, alongside a new position in Lucky Cement, one of Pakistan's largest conglomerates.

Similarly, the managers have recently increased their exposure to the Philippines, which offers a more attractive risk-reward ratio thanks to an improving macroeconomic backdrop combined with low investor sentiment towards equities.

Geopolitical angles

Another idiosyncratic driver of growth in frontier markets is geopolitics, with many frontier and smaller emerging countries choosing to remain neutral to capitalise on the growing tensions between Russia, China and the US. Indonesia is one such example of a country that has demonstrated its ability to build strong relationships with both the East and West.

The move towards friendshoring has seen multinationals relocating their manufacturing operations away from China to improve the resilience of supply chains. Frontier and smaller emerging countries have eased regulatory and trade barriers to attract investment under this 'China plus one' strategy, which has seen the likes of Apple, Nike and Samsung scaling up manufacturing operations in Vietnam, and H&M and Zara in Bangladesh.

BRFI also invests in a number of ASEAN-member countries, which provides a single area market for intra-bloc trade as well as negotiating trade deals with China, Japan and Australia.

Commodity production

Frontier markets also offer exposure to commodities, which provide diversification beyond the traditional asset classes of equities and bonds. Middle Eastern countries are substantial exporters of oil, with higher historic oil prices driving an increase in current account surpluses and helping to finance government investment programmes.

As a result, BRFI has been investing in the real estate, consumer and healthcare sectors which are well-positioned to benefit from this public investment. In Dubai, the property sector has boomed in the last few years, helped by its rising prominence as a regional hub for global financial services. Emaar Properties, a Dubai-headquartered residential and commercial property developer, is a top-10 holding for the fund and also offers exposure to India, Turkey and Pakistan.

However, frontier markets provide wider exposure to commodities beyond oil. BRFI's largest weighting is currently Indonesia, which is the largest global producer of nickel and the second-largest producer of cobalt. Demand for these critical minerals is forecast to soar in the transition from fossil fuels to green energy and Indonesia is already a primary supplier of commodities to the Chinese electric vehicle industry.

Local versus global

Another advantage of frontier markets is a blend of local and global drivers of growth. The larger international companies may be highly correlated to the global economy, but the fortunes of smaller companies are often more closely tied to the domestic economy.

Indonesia is South-East Asia's largest economy and the fourth most populous country globally, with a growing middle-class consumer base. Around 80% of the population are unbanked or underbanked, according to research by Fulcrum, which provides an attractive potential market for financial services providers, with BRFI holding investments in Bank Central Asia and PT Bank Negara Indonesia.

BRFI offers a strong track record against its peer group, achieving a five-year NAV total return of 63%, significantly above the 24% weighted-average return for the AIC Global Emerging Markets sector. Companies in frontier markets are also often cash generative and, with fewer investment options, choose to return cash to shareholders via dividends, with BRFI currently trading on an attractive dividend yield of 4.8%.

In conclusion, the idiosyncratic drivers of growth in frontier markets, together with their lower correlation to developed markets, may provide a real diversification opportunity for advocates of the Swensen approach.

All data as at 16/12/2024 unless otherwise specified.

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