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Investing in frontier markets with investment trusts

How investment trusts provide exposure to the dynamic economies in frontier markets...

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BlackRock

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The balance of power is changing. Emerging markets will overtake the US to account for more than a third of global market capitalisation by 2030, according to Goldman Sachs, rising to 55% by 2075. The sector has already established a mainstream position in portfolio allocations as an economic and demographic powerhouse, accounting for 45% of global GDP and 55% of population.

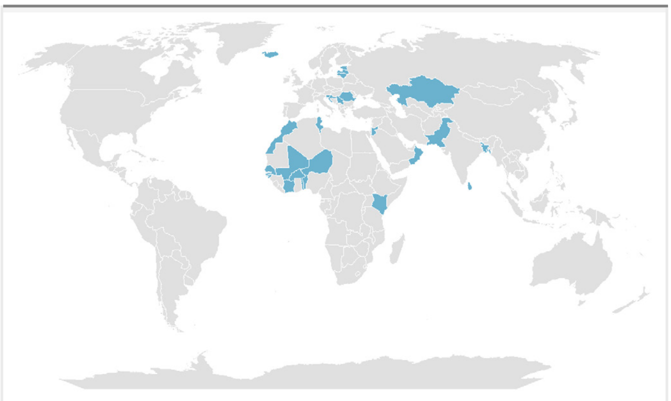
That said, the focus is slowly shifting to frontier markets as the next major growth story. These share many of the attractive characteristics of emerging markets, including strong economic and demographic growth, urbanisation, relatively cheap labour and a burgeoning consumer class.

However, this asset class remains relatively untapped by institutional and private investors, representing less than 1% of global market capitalisation. We take a closer look at the investment case for frontier markets as a dynamic and growing portion of the global investment universe.

What are frontier markets?

The term was coined in the 1990s by the International Finance Corporation (IFC) to describe smaller, less liquid markets that are typically at an earlier stage of economic and financial development than emerging markets. However, some developed countries, such as Iceland and Bahrain, are included due to their smaller size and/or trading restrictions.

Fig.1: Frontier Markets Across Asia, Africa And Europe



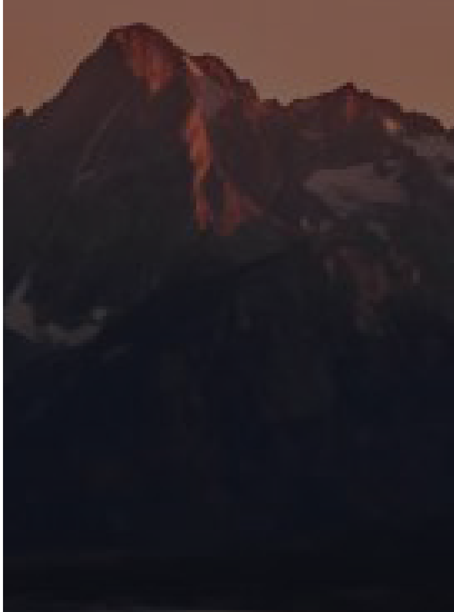
Source: MSCI

Classification systems vary but the MSCI considers all equity markets not included in the MSCI Emerging Markets Index that demonstrate openness and accessibility for foreign investors, excluding countries from the developed market universe and countries with extreme economic or political instability.

This leaves a universe of 28 countries in the MSCI Frontier Markets Index (as shown in the map below), although some funds will include 'off-benchmark' geographies from smaller emerging markets with similar characteristics.

Why invest in frontier markets?

Investing in frontier markets has typically been driven by investors looking for a mix of growth opportunities and equity exposure uncorrelated to their core investments. We look at the individual factors in more detail below:



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Growth opportunities

A key attraction of frontier markets is the exposure to smaller, faster-growing economies, which have a longer runway for growth.

According to the IMF, average annual GDP growth for frontier markets over the next five years is forecast to be more than 4%, compared to 1% and 2% respectively for the Euro area and North America. Within this group, Vietnam, Niger, Senegal, Côte d'Ivoire, Benin and Bangladesh have forecast GDP growth in excess of 6% per annum over the next five years.

Another driver is the 'demographic dividend' of a young and growing population, with almost one billion people located in frontier markets, in contrast to the shrinking (and ageing) populations of some of their developed peers. Rising disposable income is also fuelling the growth of a burgeoning consumer class, providing a domestic market to complement export-led economic growth.

Some frontier markets have benefitted from the China Plus One strategy whereby multinationals are looking to 'friend-shore' supply chains to reduce their dependence on China in the midst of geopolitical tensions. Foreign investment has been further stimulated by the easing of regulatory and trade barriers. By way of example, Apple, Samsung and Nike have scaled up manufacturing operations in Vietnam, and Bangladesh has become a key textiles exporter thanks to the likes of H&M and Zara.

In many ways, Vietnam is the epitome of a frontier market, with a fast-growing economy and a stock market that currently accounts for a quarter of the MSCI Frontier Markets Index. The country offers a deep and liquid market, boasting nearly 1,700 listed companies and daily trade volumes in excess of $1bn.

Alpha generation from pricing inefficiencies

Companies in frontier markets often receive little to no analyst coverage and publicly available information can be limited. This can result in pricing inefficiencies if a company's valuation does not reflect its growth potential.

Active fund managers may uncover these hidden gems by carrying out their own due diligence, creating a potential source of significant alpha generation for investors. Similarly, early bird investors may reap the rewards when markets attract a higher allocation by retail and institutional investors as they mature.

Portfolio diversification

Frontier markets also offer investors a useful source of diversification. The internal dynamics of domestic markets may play a more significant role than global drivers, enabling them to develop independently of the wider global economy. Listed companies are also less sensitive to global active and passive fund flows due to the lower institutional exposure to frontier markets than developed and emerging markets.

As a result, frontier markets tend to display a low correlation with both emerging and developed markets, which can help to improve diversification. As shown in the chart below, frontier markets have the lowest correlation to leading US, UK and world indices (with zero representing no correlation and one representing a perfect positive correlation).

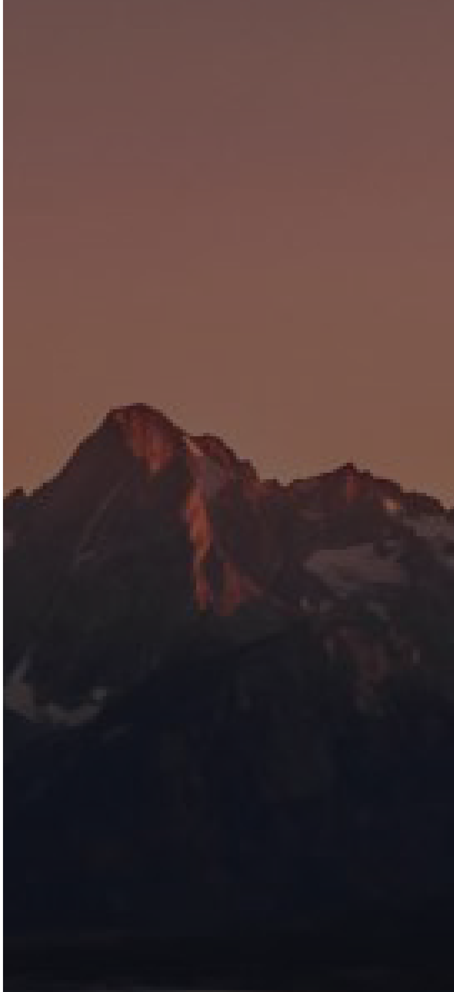
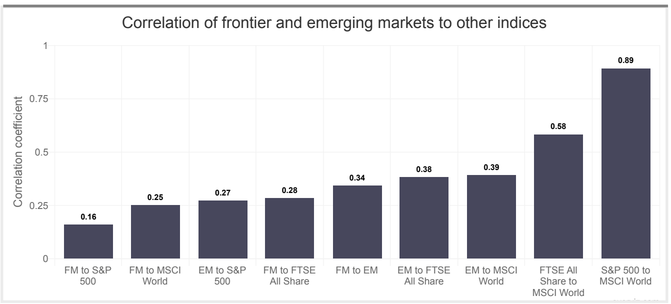


Fig.2: Frontier Markets Show Low Correlations



Source: Bloomberg (as at 08/10/2024). Based on five-year average correlations for the MSCI Frontier (FM), Emerging Markets (EM) and World indices and the S&P 500 and FTSE All Share indices (in US dollars).

Past performance is not a reliable indicator of future results.

Frontier markets have a correlation of just 0.16 to the S&P 500, compared to 0.27 for emerging markets, which have been exhibiting a higher level of convergence to developed markets in recent years. As with emerging markets, there is also high heterogeneity within frontier markets, which provides further diversification.

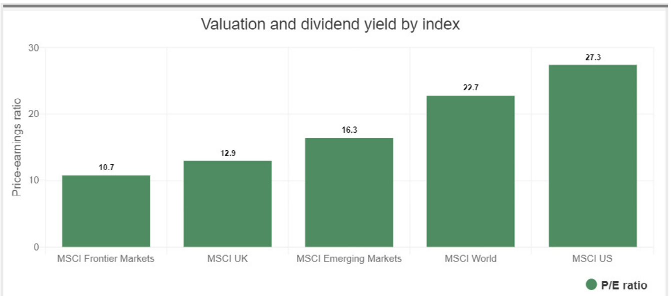
In addition, there is a low correlation between frontier and emerging markets, partly due to minimal passive allocations to frontier markets. This means that frontier markets are one step removed from global investment flows and often less susceptible to risk-on/off sentiment, although they aren't always immune to major global sell-offs.

There is often a misconception that frontier markets are more volatile but the MSCI Frontier Markets Index has exhibited lower volatility over the last three, five and ten years than the MSCI Emerging Markets, US and World indices (as at 30/09/2024). Combined with the low correlation, this means that an allocation to frontier markets in a broad-based global portfolio can help to lower overall portfolio volatility.

Attractive valuations

Frontier markets are currently trading at a significant discount to their emerging and developed market peers, as shown in the chart below:

Fig.3: Frontier Markets Offer Attractive Valuations And Dividend Yields



Source: MSCI factsheets (as at 30/09/2024, based on historic trailing 12-month data).

Given the strong secular growth drivers, we think there could be the potential for a re-rating in valuation as frontier markets mature. The sector also offers an attractive dividend yield of more than 4%, in excess of the MSCI UK Index, which is often a popular choice for income-seekers, although dividend policies may not be as stable as their developed market counterparts.

How difficult is it to invest in frontier markets?

Frontier markets can be challenging for investors to access due to constraints on foreign ownership of companies, currency controls and lower liquidity. This makes it difficult for investors to buy equities in frontier markets and none of the three major retail investment platforms currently offer access to these equity markets.

In addition to limited market access, it can be hard to evaluate investment opportunities in frontier markets due to a lack of public information. Companies may have little third-party coverage in the media, reports that are not available in English and no analyst coverage. A strong understanding of the country-specific political and economic environment is also a prerequisite for investment.

Private investors looking to invest in frontier markets will therefore face significant hurdles in terms of market access and evaluating potential investments with limited information.

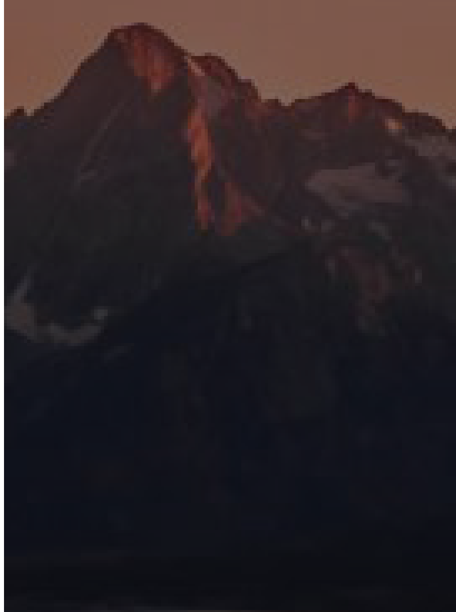
Investing in frontier markets using investment trusts

Investment trusts are a type of fund that enables investors to gain broad exposure to frontier markets, while managing the risks mentioned above. Investors can buy and sell shares in trusts listed on the London Stock Exchange, providing a ready-made diversified portfolio of companies.

Fund managers can overcome the hurdles of investing in frontier markets, such as navigating the bureaucracy of buying and selling shares and managing factors such as liquidity and currency risk that would be cumbersome and expensive for private investors.

They are also able to access a deeper pool of resources to analyse the large equity universe in frontier markets, including in-depth screening of the macroeconomic, regulatory and political factors. This is supplemented by on-the-ground resources, with managers often conducting regular visits to meet with companies, competitors, suppliers and local officials.

There are currently nine trusts in the AIC Global Emerging Markets category. The majority focus on emerging markets with limited exposure to frontier markets, although three specifically include frontier markets in their investment objectives. The scope varies by trust, with some trusts investing in a more concentrated portfolio of companies while others take a broader approach.



Case Study

BlackRock Frontiers (BRFI)

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BlackRock

Launched: 2010

Investment manager: BlackRock Fund Managers

Managers: Sam Vecht, Emily Fletcher and Sudaif Niaz

Dividend policy: Aims to pay a dividend semi-annually

Benchmark: MSCI Emerging ex Selected Countries + Frontier Markets + Saudi Arabia Index (net total return, USD)

BlackRock Frontiers (BRFI) is currently one of the few investment trusts listed on the London Stock Exchange that provides investors with dedicated exposure to frontier markets and smaller emerging markets. There is also no open-ended fund that invests in the same markets.

The trust was launched just over a decade ago in 2010 and is managed by Emily Fletcher, Sam Vecht and Sudaif Niaz, with a combined experience of more than 50 years.

BRFI invests in a bespoke investment universe of the MSCI Emerging Markets and MSCI Frontier Markets indices, minus the eight largest countries by market capitalisation (being Brazil, China, India, Korea, Mexico, Russia, South Africa and Taiwan). Saudi Arabia is also in the investable universe, although it does not currently fit under either classification.

The trust provides investors with a diversified portfolio that has a low correlation to developed markets, combined with superior growth potential.

What is the trust's goal?

BRFI aims to achieve long-term capital growth by investing in companies that are listed in, or that derive the bulk of their revenue from, less developed countries.

What kind of stocks do the managers invest in?

The managers invest in companies that have strong balance sheets and can translate top-line revenue growth into strong free cash flow.

Are investments driven by a particular style?

BRFI's investments aim to take advantage of the growth potential that frontier markets offer. Nonetheless, their focus on cash-generative businesses also means they have a long track record of paying a dividend.

Frontier markets tend to be more subject to macro-risk compared to developed markets. As a result, the managers combine both top-down and bottom-up analysis in their decision making.

With regard to the former, the managers use a proprietary dashboard to monitor factors like liquidity, currency and political risk. If these factors pose significant risks, the managers will not invest, regardless of how attractive a company's fundamentals might be.

How many companies does the trust normally hold?

The trust typically has exposure to 35-65 holdings diversified across regions and sectors, aided by the lack of correlation within frontier markets.

What is the trust's dividend policy?

The trust does not have a specific dividend target but pays a semi-annual dividend. The dividend yield was 4.5% as at 07/10/2024.

What are the trust's ongoing charges?

The trust's ongoing charges are 1.38% (ex-performance fee).

Does the trust have a performance fee?

The trust has a performance fee equal to 10% of any NAV outperformance relative to the cumulative benchmark returns since inception. This fee is capped at 2.5% of gross assets if absolute returns are positive (or 1% if not).

How much attention do the managers pay to their benchmark, and to what extent are absolute returns important?

BRFI uses a bespoke benchmark index, which it deviates from markedly on both a sectoral and country allocation basis. Although the managers can (and do) use derivatives to take short positions in the market, this is not an absolute returns strategy. The maximum permissible exposure to short positions is 10% of net assets.

Does the trust use gearing? Is it structural or opportunity-led?

BRFI uses opportunity-led gearing, which is typically achieved by buying or selling contracts for difference (CFDs). The managers take both short and long positions in the market using derivatives.

View the latest research note here

Click here to add BRFI to your watchlist

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