What Are Frontier Markets and Why Invest in Them?

By Livia Yap and Constantine Courcoulas July 8, 2020, 6:23 AM EDT

If emerging markets are the wild child of the investment family, offering potentially higher rewards in return for greater risk, then what about their smaller sibling, frontier markets? These include countries such as Sri Lanka, Kazakhstan and Nigeria where stock exchanges and currency markets are too small or underdeveloped to be classified as emerging markets. While frontier markets may bring investors more exotic thrills, and spills, they also somewhat counterintuitively can be a safe haven when markets are rocky.

1. What are frontier markets?

In the investing hierarchy, they are the bottom rung of three. At the top are developed markets (such as the U.S. and U.K.), in the middle are emerging markets (such as China and Russia). The denomination is not so much a judgment on a country's wealth or stage of development as about its markets. Depending on who's doing the classifying, there are around 30 frontier markets, mostly in the Middle East, Asia, Africa and Eastern Europe.

2. How are they determined?

According to the world's biggest index compiler, frontier markets need to meet subjective criteria, including "at least some" openness to foreign ownership and "at least partial" ease of capital flows. Objective requirements include having at least two companies worth $700 million each.

3. How are they different from emerging markets?

Everything's on a smaller scale. Frontier markets have a combined market value of about $510 billion; emerging-market stocks are worth around $20 trillion. Trading volumes are relatively minuscule as are the number of listed companies; while Vietnam has more than 1,500, Burkina Faso counts just three and Benin one. Foreign participation tends to be much lower than in emerging markets and there are tighter restrictions on who can own shares.

4. Who invests in them and why?

Mainly local and state investors. Among the overseas crowd, it's mostly active funds; passive investments such as exchange-traded funds make up just 10% of estimated foreign flows. One of the main investor attractions is getting into a market before the crowds arrive. That can lead to outsized growth as an economy prospers and financial infrastructure develops. Pakistan's main stock index grew at an annual clip of more than 25% in U.S. dollar terms in the eight years through end-2016, shortly before it got promoted to an emerging-market status.

5. How have they performed?

Some markets have rewarded long-term investors handsomely. Vietnam's benchmark index rose by an annual average 9.8% in the decade through 2018 in local-currency terms -- including a 48% jump in 2017 and a 27% drop in 2011. That underlines the idiosyncratic nature of frontier markets and their increased sensitivity to local matters. Sri Lanka's main stock index fell 10% as a political crisis in October 2018 was followed by deadly terrorist attacks in April last year. As a group, the picture has not been especially rosy. Frontier markets underperformed their emerging counterparts in all but two years since 2012.

6. How are they safe havens?

Their relatively limited financial links to the outside world make frontier markets less correlated with global markets than their more developed counterparts. Their geographic diversity also means they are less intertwined with each other. Individual frontier nations may be prone to particular risks such as hyperinflation or investments becoming locked up either because of a debt default, currency meltdown or capital controls. But the poor correlation with one another makes a basket of frontier stocks gyrate less. Like emerging markets, they can bear the brunt of global sell-offs; both classes lost about 50% of their value in 2008.

7. Is emerging-market status every frontier market's dream?

Not necessarily. Being upgraded to an emerging market can attract heaps more foreign investment and boost a country's efforts to open up its financial sector. On the other hand, frontier markets that were once a big fish in a small pond can become lost in the emerging-market ocean. Pakistan's market, for example, failed to attract sizable investment flows after its elevation to an emerging market in 2017 and experienced the worst foreign sell-off since the 2008 financial crisis.

8. Can countries be demoted to frontier markets?

Yes, and it may happen to Turkey and Argentina. MSCI warned of possible demotion for Turkey if the "already deteriorating accessibility level" of the equity market were to worsen. Authorities imposed lengthy bans on short-selling and limited foreigners' access to the local currency. In Argentina, capital controls imposed in 2019 have made it "impossible" for international investors to access the country's equities and may cost the stock market its emerging-market status, according to the index compiler.

9. Are frontier markets disappearing?

The frontier market class has been shrinking, as more countries graduate to become emerging markets. In the past six years, some giants of the asset class have stepped up, including Qatar, the United Arab Emirates and Pakistan. Kuwait, which accounts for about a third of the MSCI Frontier Markets Index, is due for an upgrade in November. These frontier heavyweights have been replaced by smaller territories that cannot make up for the decline in market value. Although the frontier-market universe has lost some of its bulk, the smallest countries benefit as funds are forced to diversify their allocations.