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Investors Chart New Course as Index Stars Graduate

ByJavier Espinoza

Downtown Lagos. Nigeria's weight in the key frontier markets index has grown considerably with the upgrade to emerging market status of Qatar and United Arab Emirates.

Reuters

This week, the UAE and Qatar, which until the end of May together made up more than one-third of the MSCI Frontier Markets Index, officially graduated to the MSCI's Emerging Market Index. As members of the emerging markets index, the two countries will be minnows alongside whales such as China and Brazil.

Together, they represent just over 1% of the value of the EM index.

Their new status as small fish in a much larger pond is a far cry from their position in the frontiers index. Because they counted for such a significant portion of the index, their removal has triggered a meaningful reconfiguration of the frontier index.

The rebalancing leaves FM-index-based investors heavily exposed to Kuwait, which now makes up roughly 27% of the index, and Nigeria, with a roughly 20% weighting in the new configuration.

What does this mean for frontier-market investors?

For those in index-tracking funds it could lead to a significant change in performance. Not only did Qatar and the UAE make up a major chunk of the value of the index, they had been star performers, particularly over the past year after MSCI announced its plan to upgrade the two nations.

In the 12 months to the end of May this year, Qatar's stock market was up almost 50%. The UAE, which has two stock markets, saw even stronger gains. While Abu Dhabi's market was up 46% on the year, the Dubai index more than doubled, posting gains of 115%.

Without the two powerhouses in the FM index, investors are concerned that its growth, which topped 29% for the year to the end of May 2014, could falter. Kemal Ahmed, portfolio manager of South Africa-based fund manager Investec's Horizon Markets Fund, says the recent strong rise in the FM index has been dominated by returns from the Gulf Cooperation Council (GCC) countries. "Now the UAE and Qatar have graduated it is unclear what the frontier market index's prospects are going to be for the second half of 2014," he says.

Corin Frost manages $1.7 billion in frontier market assets as global head of Index Strategy at BlackRock in San Francisco. He believes investors can still find good valuations in the frontier index following the exit of these two countries.

In Mr. Frost's view, the new frontier index is a better representation of that segment of the global investing pie. "The areas that we find exciting from a diversification perspective would be sub-Saharan Africa, countries such as Nigeria and Ghana. Those really do represent in investors' minds the true frontier markets," he says.

Others agree that the new configuration of the frontier index will give investors exposure to "truer" frontier markets. "The presence of the UAE and Qatar was skewing the frontier index toward countries that were not really frontier," says Andrey Kutuzov, associate portfolio manager with Wasatch Advisors in Salt Lake City, Utah. Wasatch's Frontier Emerging Small Countries Fund holds some $1.3 billion in assets. "Removing those countries is a net positive for the frontier index because the index will become more truly representative of the frontier universe. Investors will get exposure to countries at an earlier stage of the economic development than emerging markets."

Not everyone is happy with the new distribution of countries in the frontier index, however. David

Wickham, director of global emerging markets and frontier markets equity at HSBC Global Asset Management, doesn't think the new configuration gives investors the desired frontier market exposure. "The skews in the index have become more profound," with Kuwait and Nigeria taking a more prominent chunk of the frontier index, says Mr. Wickham.

However, even though this is the first time MSCI has upgraded countries from frontier to emerging status, it might not be the last. Argentina, which was downgraded from emerging to frontier in May 2009, has been mooted as a potential candidate to move up the ladder again.

Asha Mehta, portfolio manager of the $320 million Acadian Frontier Markets Equity Fund, sees these upgrades as catalysts that help investors generate returns. Ms. Mehta believes Pakistan might be upgraded in the future. "The institutional standards are quite strong, in line with emerging markets," she adds.

These changes aren't likely to happen overnight and they will take place depending not only on fundamentals but also on investors' opinions. So what should those looking to benefit from any of these likely moves do to cash in?

Anticipate events and actively manage their portfolio, says Ms. Mehta. "Investors need to know how to anticipate these events, even if they are two years early," she says. "They also need to have a very active stock selection."

Additional reporting by Dan Keeler.