Within *Focus* we comment on extraordinary market events and analyse capital market related special topics.

## Frontier market investments make strategic sense[1]

Frontier market (FM) exposures to equities, and especially bonds, are strategically sound components of multi-asset portfolios. They offer diversification advantages, higher performance potential, and relatively low volatility compared with traditional investment alternatives. Looking back at 2018, the strength of the USD and home-made problems in individual countries weighed on the development of many frontier markets, in both equities and bonds. For bonds, risk premiums versus government bonds from developed countries have risen significantly. Funds specialising in such bonds currently yield around 13% with a shorter maturity than emerging market (EM) bonds and thus a lower interest rate risk. Hence, the timing for entering the FM segment, especially bonds, seems favourable.

*Frontier markets offer diversification advantages and higher return potentials with comparatively low volatiliy*

FMs are countries like Namibia or Uruguay, which are not as politically, economically and financially developed as EMs - they could become the "EMs of tomorrow". In many ways, today's frontier markets resemble the EMs of the early 1990s. Back then, EM investments were regarded as “fancy”. Today they are no longer particularly exotic and offer only limited diversification advantages. So, what are the strategic advantages of investments in FMs?

*FMs are less correlated with global markets than eg EMs and DMs*

1. **FMs have lower correlations to investments in developed markets (DMs) than EM markets and therefore offer diversification potential.** First, the dominance of local investors and, thus, the lower proportion of international investors make investments in FMs less susceptible to changes in global investors' risk appetite and capital flows, despite less developed and liquid financial markets. Next, the stronger domestic orientation of the economy as well as of the sector structure implies that the development is less dependent on the global growth cycle - country-specific developments are the most important drivers of FMs. This no longer applies to EMs, where current account balances have expanded considerably over the past decade. FMs are therefore less affected by the current trade disputes than EMs. In addition, FM currencies with their low correlation to the G10 currencies offer additional diversification potential.

*Different FM assets are often not strongly correlated with each other, reducing volatility in a FM portfolio*

2. **FM assets normally have a lower volatility than EM assets.** On the one hand, the lower proportion of international investors reduces volatility in periods of stress. Compared with EMs, FMs have fewer capital outflows and inflows in the same direction across all countries. On the other hand, the dominance of country-specific risks reduces the volatility of a portfolio of FM investments. The reason is that the correlations between FMs are significantly lower than correlations between EMs. For example, Brazil's growth is heavily dependent on its main trading partner, China, while with FMs, these interrelationships do not (yet) exist. Lastly, FMs generally have a less developed institutional framework than EMs, for example regarding government institutions and central banks. This means that in FMs it is extremely important who is currently in government, as this will significantly

[1] This article is based on a guest commentary published in the Börsen-Zeitung on 19 January 2019.

influence the development of the country. However, this political risk can also lead to losses for investors due to investment restrictions or indirectly due to downgrades by rating agencies as a result of poorer economic and financial prospects.

*Higher performance potential through possible convergence with EMs*

3. **FM equities, bonds and currencies promise better performance in the medium to long term than corresponding investments in DMs and EMs.** In general, FM economies offer higher growth than DM and EM countries, because they have convergence potential towards the economic, political and financial stage that the EM countries have reached. At the same time, the public debt of FMs is generally lower relative to EMs and DMs, because FM countries have only just begun to raise capital in international financial markets. Consequently, convergence towards EM status should attract capital flows and investors can benefit from potentially converging risk premiums. Inclusion in EM indices could further trigger additional capital inflows and positive reactions, as passive investments that track EM indices have gained importance.

## Table 1: FMs offer additional diversification benefits

| Correlations and annualised volatilities of weekly returns over the last 10 years | DM Equities | EM Equities | FM Equities | DM Bonds | EM hard currency | EM local currency | JPM Next Gen. |
|---|---|---|---|---|---|---|---|
| Annualised Volatility (%) | 16 | 19 | 13 | 3 | 6 | 11 | 7 |
| Equities Developed Markets | 100 | | | | | | |
| Equities Emerging Markets | 82 | 100 | | | | | |
| Equities Frontier Markets | 48 | 49 | 100 | | | | |
| Bonds Developed Markets | -29 | -16 | -10 | 100 | | | |
| Emerging Markets hard currency | 50 | 64 | 37 | 21 | 100 | | |
| Emerging Markets local currency | 61 | 76 | 35 | 8 | 74 | 100 | |
| JPM Next Generation Markets | 48 | 58 | 42 | 0 | 84 | 58 | 100 |

Source: Bloomberg, J.P. Morgan Indices, MSCI Indices, Berenberg

The capital markets in FMs are typically relatively small and illiquid. These characteristics have so far hampered the potential for foreign and institutional participation. For investors, the illiquidity risk can range from higher bid/ask spreads to the extreme case that individual positions cannot be traded at all for some time. However, the risk as well as the evolution of the market regarding size and liquidity for equities and bonds often varies across countries: those with relatively sound equity market structures and sizes do not necessarily have equally well developed bond markets, and vice versa. This means that some countries may be considered FMs for one of the two asset classes, but may already be classified as EMs for the other.

There exist various benchmark indices for FM equities, but the classification criteria are largely index-independent. For example, MSCI uses three criteria to distinguish DMs, Ems and FMs: economic performance, size and liquidity requirements, and market access. The sustainability of economic development is not a prerequisite for either EM or FM shares.

Unlike FM equities, there is only one benchmark index for FM bonds, the J.P. Morgan "Next Generation Markets Index". However, this index is defined as a subcategory of EM hard currency bonds (J.P. Morgan EMBI Global Diversified), ie bonds of issuers with "low liquidity". Hard currency bonds are EM bonds that are not denominated in local currency, but instead in USD or EUR, for example. Thus, this index represents more of an exposure to EM hard currency bonds with a high beta. This is a significant difference compared with FM equity indices, because there is no overlap between FM and EM equity indices. In addition, the index includes only hard currency bonds and only countries already included in the index for EM foreign-currency bonds. Thus, the J.P. Morgan Next Generation Markets Index does not offer all the advantages one would expect from the addition of FM bonds to a portfolio. For example, there are no positive effects from future index inclusion or greater independence from the global risk appetite of investors.

*Especially for FM bonds, active funds are preferable to passive investments*

Investors who are interested in the diversification benefits and convergence prospects of FM bonds should therefore not limit themselves to the universe of the above-mentioned tracker, but should also consider local currency bonds and in particular bonds from countries not included in the index. Compared with EM bonds, these also have a lower or only indirect dependence on the US yield curve and the USD. Active funds focused on FM bonds are therefore preferable to passive investments in this segment. Conversely, investors should avoid investing in individual bonds due to high idiosyncratic risk, ie the specific risks of an individual issuer, and low diversification.

# PUBLISHING INFORMATION

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