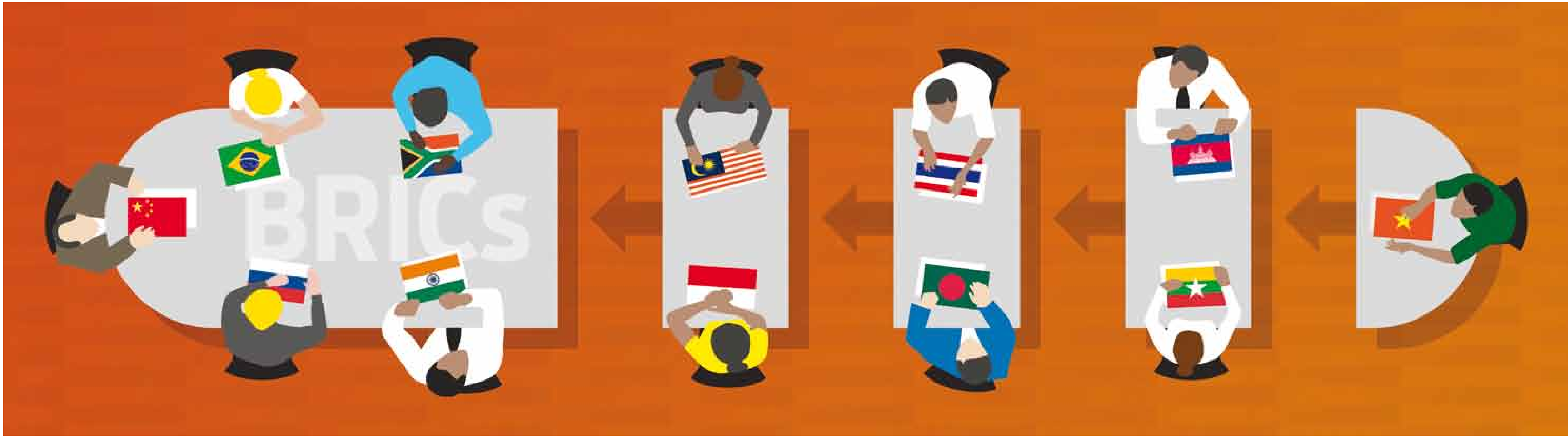


Focus builds on emerging market benchmarks

Asian investors' awareness of the benefits of alternative methods of benchmarking and weighting assets is growing – and emerging and frontier markets look set to benefit.

By Bee Ong

Investment benchmarks form a significant part of Wylie Tollette's work at US fund house Franklin Templeton, where he heads global investment risk and performance. Over the last decade, his team has used benchmarks in increasingly granular ways to identify where risks have been taken in an effort to beat the benchmark. For this purpose, Tollette thinks the best benchmarks reflect the underlying economic growth of its constituents, among other attributes.

Such emphasis on economic growth has become increasingly prevalent among active fund managers and institutional investors, and has boosted the importance of emerging markets in both fixed income and equity indices and spawned frontier market indices.

The widely followed MSCI Emerging Markets Index has evolved from comprising 10 countries representing 1% of global equity market capitalisation in 1988 to 21 countries and 13% of global market cap today. Even within shorter periods, EM shows an increase.

Investors' interest in emerging markets has been strong: of the $1.5 trillion invested into equity exchange-traded products (ETPs) worldwide, 15% was allocated to emerging markets in July 2013, up from 6.7% in December 2005, according to ETFGI, a London-based ETF research firm. Fixed income ETFs' and ETPs' EM allocations have risen even more significantly, from just 0.8% in December 2005 to 5.2% in July 2013.

While EM equity ETFs have suffered big outflows in recent months, this sector retains the second largest market share after North America's 56.8%.

Indeed, interest has also been rising in more specific EM regions. For example, FTSE has been receiving a growing number of requests for Association of Southeast Asian Nations (Asean) equity indices, says Jessie Pak, the firm's managing director for Asia. High-growth economies such as Indonesia, the Philippines and Thailand are starting to attract the kind of attention formerly paid to the Bric (Brazil, Russia, India and China) countries.

Illustration Infomen

A similar trend is being reflected in the use of exchange-traded funds. Deborah Fuhr, the founder of and a partner at ETFGI, says: "Institutional investors are using emerging-market ETFs in more and more precise ways to target parts of markets that can benefit from structural or economic changes such as China, Korea and Russia. As they gain knowledge about these markets, they will move from large cap to mid- and small-caps and so on."

Slow to evolve

However, even widely used indices have not evolved as quickly as the investment approaches of active managers and increasingly yield-hungry asset owners. That's mainly because these indices are capitalisation-weighted, meaning they are driven by trading momentum rather than a country's economic prospects. For example, big fixed-income investors often use the Barclays Global Aggregate Index and end up getting significant exposure to countries issuing the most debt instead of exposure to economic growth.

However, banks and index providers recognise this and have, in some cases, been responding. In 2009, Barclays developed the family of GDP Weighted Bond Indices, which use GDP instead of market cap to weight country blocs. The GDP-weighted benchmarks usually have higher weights in EM. The traditional Barclays Global Aggregate has a 5.35% allocation to EM in mid-August 2013, whereas the Barclays Global Aggregate GDP Weighted Index has a 14.32% allocation.

And JP Morgan is revising how it defines emerging markets, in a move that will affect the calculation of its widely used EM bond indices, say sources. The US bank aims to make the benchmarks better reflect the development of EM bond markets by incorporating more than just a simple income measure.

Moreover, index provider MSCI has developed benchmarks based on constituents' economic activity, called the MSCI Economic Exposure Indices. For example, if a London-listed company's revenues are derived mainly from Indonesia, the stock is considered an EM component. The first family of indices in this series, launched in March last year, is the MSCI Indices with EM exposure, including the MSCI World with EM Exposure Index, the MSCI EAFE with EM Exposure Index and three others.

Yet large asset owners still tend to use broad-based, frequently referenced and publicly available benchmarks. In April, the Government of Singapore Investment Corporation adopted a reference portfolio of 65% MSCI All Country World Equity Index and 35% Barclays Global Aggregate Fixed Income Index. This is starting to change – albeit very gradually and on the margins – with some more sophisticated investors experimenting with or asking about alternative weightings.

Certainly, large institutional asset owners should take a different approach to using indices, argue Thomas Higgins, global macro strategist, and Michael Faloon, managing director of quantitative analysis at bond fund house Standish Mellon.

"We believe this greater representation of EM components [in the GDP-weighted index] better reflects the macro realities of our rebalancing global economy and provides greater alpha opportunities for global bond investors," they argue. They expect EM allocation in the Barclays' GDP-weighted index to increase to 27% by 2016, based on the International Monetary Fund's projections of GDP growth, according to a paper last year.

New breed

A growing number of fund executives, including Tollette, are considering the newer breed of indices for several reasons.

For one thing, some indices have implicit concentrations that asset managers aren't comfortable with. Thomas Hugger, CEO of Asia Frontier Capital and manager of the AFC Asia Frontier Fund, says the MSCI Frontier Index is too skewed to energy assets, because Kuwait, Qatar and the United Arab Emirates and other oil-producing countries are constituents.

"Qatar and the UAE are among the wealthiest countries in the world," he notes. "Why are they in a frontier index?" Incidentally, MSCI will include the two markets in its EM index from November 2014.

That said, Hugger does use the MSCI Frontier index as a benchmark for his fund's performance and to draw the line between 'frontier' and 'emerging' market. For example, if MSCI removes Sri Lanka from the frontier index, Hugger figures he might have to exclude it from his frontier fund.

Too broad – or too narrow?

Meanwhile, some investors find indices to be too broad, especially where less developed markets are concerned. Hugger's fund only invests in four of the 25 markets in the MSCI Frontier Markets Index. Most of the 13 markets in the fund's universe, such as Mongolia, aren't in the index.

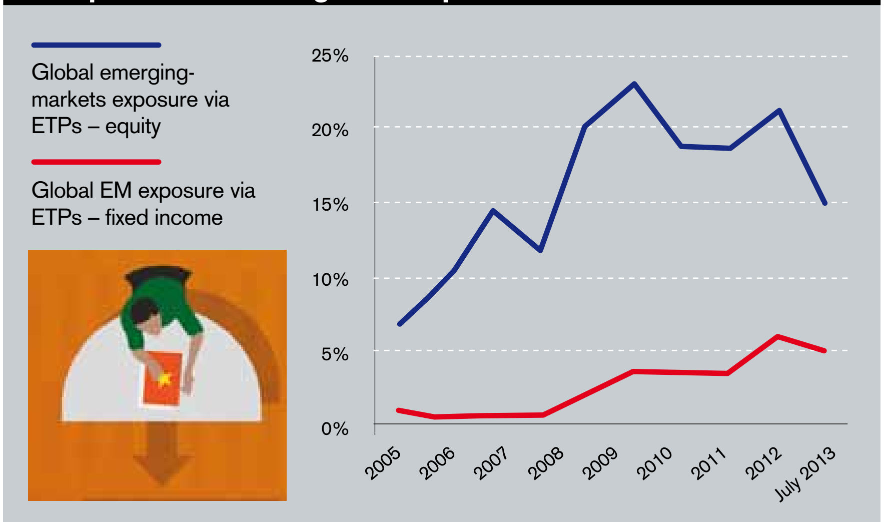
Norway's sovereign wealth fund, the $757 billion Government Pension Fund Global (GPFG), uses the FTSE Global Equity Index Series All Cap as a benchmark. But it prefers to hold a smaller number of securities than are in its benchmarks, to reduce complexity and cost: "The diversification gain from holding all stocks and bonds included in broad benchmark indices is limited."

Not surprisingly, however, passive investment specialists argue the benefits of broad benchmarks. Greg Davis, Asia-Pacific chief investment officer at Vanguard, prefers geographically broad-based indices. As CIO of the some of the region's biggest passive index funds, Davis does not see emerging markets in the same light as active managers.

"A broad-based benchmark delivers the efficient frontier," he says. "About 90% of investment returns are determined by asset allocation; broad-based and low-cost is the best way to go, because most investors have home bias so they need global exposure, ideally market-cap weighted."

Australia's superannuation funds and investment advisers represent the bulk of Vanguard's Asia-Pacific-based investors. Even though Vanguard's assets under management are largely related to pensions, which tend to be averse to emerging- and frontier-market risks, Davis is not concerned about such markets' rising weight in broad indices, as long as they are geographically diversified. With regard to frontier markets, he argues, a 0.5% allocation is "too small to matter".

EM exposure via exchange-traded products



Source: ETFGI

But there is also the ongoing issue, as seen with Qatar and the UAE, of perceived misclassification of markets. Many investors view Korea and Taiwan as developed markets because of their economic cycles and structures. However, both countries are emerging markets in MSCI's indices, while FTSE classes Taiwan as emerging, though it promoted Korea to developed status in 2009.

Tollette and Hugger both view Korea as similar to a developed market. Franklin Templeton has long treated some Korean companies like Samsung as similar to a DM stock because of its revenue sources, company structure, governance and other characteristics.

Whether Greece is still truly a developed market is another point of debate. Franklin Templeton started treating parts of the country's economy as similar to those of an emerging market several years ago, but MSCI will only downgrade Greece to emerging status from November. FTSE will re-evaluate Greece during its country classification review in September.

Certainly, reclassification can have significant repercussions. When Vanguard switched its benchmark for six international stock index funds from MSCI to FTSE, it meant Korea would exit Vanguard's EM portfolios and enter its DM portfolios. The market was concerned that this change would cause a sudden sell-off of Korean equities. To ease the conversion, FTSE developed a transition index for Vanguard, which gradually increased Korean allocations in the DM index over six months.

Mongolia is another market with debatable status. Risk-tolerant investors such as Temasek Holdings and Hugger have been investing in Mongolian companies or those with significant revenues from Mongolian operations for several years. However, Mongolia has yet to appear in MSCI's and FTSE's frontier indices. Pak says it is on FTSE's watchlist and institutional investors have shown increasing interest.

Future candidates may include countries like natural-resource rich Papua New Guinea. But Mongolia, with 301 listed equities – far more than the 18 on Papua New Guinea's Port Moresby Stock Exchange – is still the most likely next EM candidate among frontier markets.

In the meantime, the continued debate over how specific countries should be classified underlines the importance of tailored portfolios – and indices. ■

FTSE EM index weightings 2008–2013

Country	2008	2009	2010	2011	2012	2013
China	10.76	17.97	16.27	17.31	18.24	19.89
India	9.83	11.78	11.48	9.21	8.63	8.88
Indonesia	1.48	2.04	2.42	3.52	3.12	3.46
Malaysia	4.00	3.81	4.09	4.94	4.78	5.08
Pakistan	0.13	0.13	0.12	0.12	0.12	0.16
Philippines	0.40	0.42	0.47	0.70	1.06	1.56
Thailand	1.35	1.53	1.73	2.17	2.72	3.26
Taiwan	12.06	12.68	13.01	12.84	12.80	13.56
UAE	-	-	0.27	0.27	0.35	0.47

Source: FTSE