The Situation:

Despite high historic volatility, we feel emerging markets (EM) will continue to play a vital role in fulfilling investors’ desire to enhance returns. However, emerging markets are no longer an “undiscovered” asset class, and as a result, their correlation with more developed markets has increased. Investors requiring higher returns may need to be more strategic in their approach to the asset class by considering frontier markets.
Russell’s View:

- We believe one way to enhance the emerging markets asset class is to pair it with its lesser-known cousin, frontier markets (FM). Frontier markets are at the stage emerging markets were three decades ago. They can be thought of as the “emerging” emerging markets.

- Many countries classified within frontier markets are located in the Gulf region, as well as other less-developed Asian and African nations. Examples include Qatar, Kuwait, Nigeria, Vietnam and Bangladesh. Needless to say, this is an asset class with even more financial market and geopolitical risks than its more senior EM cousin. However, the history of strong returns from EM should not dissuade investors from considering frontier markets as a longer-term strategic holding.

- Lower correlation has always been one of the reasons for justifying EM within a balanced portfolio. However, while the longer term correlation average of 0.68 is still compelling, the Chart of the Month (COM) highlights EM correlations with Canadian equities has the tendency to spike over various periods. As the COM further highlights, FM has an even more favourable correlation metric with Canadian equities, with a longer-term average of 0.17. Most significant, however, may be the correlation of EM to FM, which is a low 0.33 – emphasizing how the two asset classes can complement one another.

- Due to the higher risk in frontier markets as a standalone asset class, coupled with the low correlation of EM relative to FM, we feel a frontier markets exposure is best within an emerging markets allocation, which is normally deemed to be the “higher-risk/higher-return” allocation within a balanced portfolio. Since FM is still an asset class in its infancy, we feel a reasonable allocation may be between 10%-30% of emerging markets exposure.

- Asset allocation decisions should always be taken in conjunction with individual risk and return objectives. To the extent portfolio objectives allow, investors who are concerned about the return potential of their portfolios should look at emerging/frontier markets as a source of return enhancement. It is the combination of reasonable equity valuations and a favorable growth profile, both from an equity market and economic perspective, which makes emerging markets, along with the less-discovered frontier markets, an asset class that deserves consideration for a strategic position in investor portfolios.