Uncorrelated and ex-China

BRFI provides many of the features emerging market investors typically look for...

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BlackRock Frontiers (BRFI) has enjoyed a strong run of performance over the last three years, having delivered annualised NAV total returns of 13.5%, in sterling terms, through to the end of January.

In some ways that is a validation of the argument that managers Sam Vecht, Emily Fletcher, and Sudaif Niaz have been making, namely that the trust provides exposure to countries which offer high GDP growth potential and lower correlations with developed markets. This is arguably something that emerging markets no longer offer in the way they once did.

Taking a step back, one of the key attractions for emerging markets among investors is a desire to take advantage of their large-scale economic growth potential. China's rise over the last few decades is a prime example of this, with GDP increasing more than 40x since 1990.

Companies also tend to receive less analyst coverage than those listed in developed markets. As a consequence, there is more opportunity for professional investors to gain an informational edge and identify attractively valued companies.

However, the manner in which indices are constructed means investors eager to take advantage of these sorts of opportunities would arguably be better off looking at an investment universe like BRFI's, which includes both frontier and emerging market indices but excludes the eight largest countries, by market cap weighting, in the latter.

BRFI's investment universe offers investors what is arguably a more compelling proposition as a result. There are a couple of reason for that. One is that China remains predominant in emerging market indices. Although it is way down from it's high, when it exceeded 40%, it still constitutes around a quarter of the MSCI Emerging Markets Index. Given the mix of political tensions with the US and the Chinese government's capricious attitude to large swathes of its own economy, this is not necessarily a market some investors may want to be invested in.

Another factor is that index rules mean many countries that have really 'emerged' beyond emerging market status continue to be included in emerging market indices. For example, Taiwan and South Korea both have developed economies and high living standards. Investors are unlikely to benefit from the sort of large-scale economic growth potential that you would associate with an emerging market as a result. And yet the two countries constitute almost 30% of the MSCI Emerging Market Index.

To top this off, these countries are also deeply interconnected with the global economy, meaning there is little they offer in the way of diversification. Taiwan's semiconductor industry may be appealing, for example, but you are hardly diversifying away from US tech by investing in it.

BRFI's investment universe and portfolio offers meaningful diversification in this regard, with the companies it invests in typically being far more driven by endogenous factors that are specific to the local economy.

One consequence of this has been that returns are not strongly correlated with other developed or emerging market indices. BRFI's returns have been strong over the last three years and that has continued, thus far, into 2024.

Kaspi, a Kazakhstani company that is active in financial services and e-commerce, provides one example of why that's been the case. The company generates all its revenue from within Kazakhstan and has seen several years of double-digit earnings growth. The company is now so predominant in its home country that it is looking to expand into the Caucuses and other central Asian countries.

It's a similar story with some other major holdings in the BRFI portfolio. For example, Indonesian firm Bank Central Asia is currently BRFI's second-largest holding. It has seen substantial growth in the last five years, largely fuelled by growth in the Indonesian economy. Consumer lending revenue, for example, increased by close to 15% year on year in 2023, with sales for car and personal loan products both growing by over 20%.

Indonesia is also a good example of how BRFI's investment universe can enhance exposure to countries where there is more runway for the sort of growth that emerging market investors are typically looking for. Companies listed in the country made up 13.8% of the trust's portfolio at the end of January, compared to only 2.0% in the MSCI Emerging Markets Index.

Another key factor that is worth considering here is the absence of China. Emerging market funds have, like the benchmark, tended to be heavily influenced by the world's second-largest economy. As BRFI excludes China, it is not subject to the distorting effect the country can often have on emerging market fund performance. It also means that investors aren't exposed to the risks that the country arguably poses today, whether that be due to tensions with the US or the government's own regulatory measures.

That is not to say that the BRFI portfolio is without risks of its own. However, investors looking for ex-China exposure to emerging markets, as well as the sort of rapid GDP growth that we think of emerging markets providing, are likely to find many facets of the trust appealing.

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