

# New Frontiers: Qatar and UAE Graduate to Emerging Status, Leaving a Less Liquid Index Behind

Beginning May 30, Qatar and the United Arab Emirates (UAE), with a combined weighting totaling about one-third of the MSCI Frontier Markets 100 Index, will graduate to MSCI's emerging markets indexes. This transition will require frontier index funds to sell down their holdings of the countries' 22 stocks and to buy larger stakes of the index's remaining companies (emerging markets index funds benchmarked to MSCI indexes will do the opposite). Standard & Poor's has announced a similar change later this year to its frontier and emerging markets indexes (S&P's Extended Frontier Market 150 Index is the benchmark for Northern Trust's $200 million Frontier Market Equity Index strategy, while MSCI's index is the benchmark to products including an $800 million iShares frontier markets exchange-traded fund [ETF]).[1]

The transition is likely to generate substantial transaction costs for index investors, given the scale of the transition and the limited liquidity in these markets (both the markets being promoted to the emerging index, and especially the remaining frontier markets that will see their weightings increased). It will also change the character of the indexes somewhat, with modest impacts to sector weightings for frontier markets and larger impacts to the indexes' regional makeup. Investors considering an initial index-based

[1] MSCI's massive transition is being sliced into seven equal pieces so that it will be complete in late November 2014. S&P's transition is scheduled for September 2014; final details have not been announced, but somewhat alarmingly, S&P currently does not plan to divide the transition into multiple tranches. The reconstitution process is likely to be somewhat disruptive for emerging markets index funds as well, but the disruption will be limited to a much smaller slug of their fund (approximately 1% in total).

allocation to frontier markets should keep an eye on MSCI's multi-stage transition and determine whether to wait until both S&P's and MSCI's reconstitution are finished (and some existing indexed investors may wish to consider temporarily stepping aside).[2] Notably, transitions such as this are likely to be an ongoing disruption, as other markets are promoted to emerging markets status (or demoted to the frontier index) in coming years.

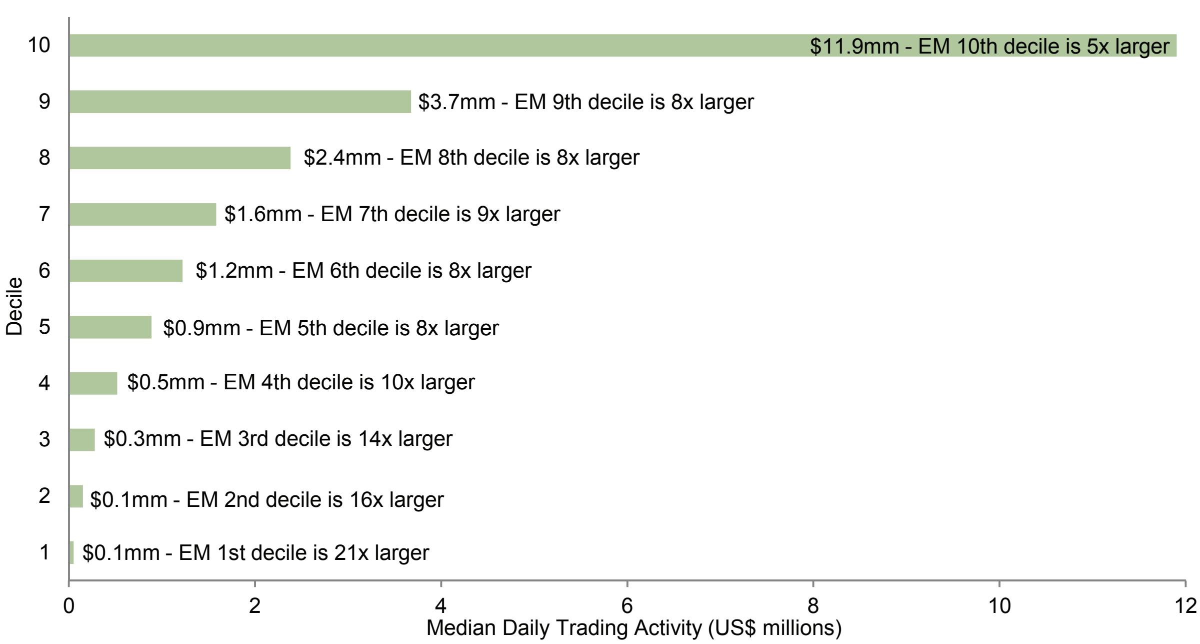
## A Very Expensive Promotion

While the Qatari and UAE securities that frontier markets index products will be forced to liquidate will likely have no shortage of buyers (the global pool of emerging markets index funds and ETFs is large), the transactions could be costly (particularly to frontier index funds that have to bulk up on less-liquid markets), given the limited liquidity of frontier markets shares. The median daily trading activity of the *most liquid decile* of frontier markets stocks is just under US$12 million—that's only one-fifth as large as the trading activity of the comparable decile of emerging markets.

[2] For many existing investors, stepping out of the product for a few months might not be helpful. An investor with a separately managed account, or one that constitutes a substantial fraction of a commingled vehicle, may incur a large transaction cost by selling down and then buying back its exposure. And of course, the opportunity cost could be significant if frontier markets outperform the investor's alternative choice during the interim period.

Median Daily Trading Activity of Frontier Market Shares by Liquidity Decile

First Quarter 2014

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Beyond that most liquid decile, liquidity drops off sharply. Amazingly, the median daily trading of all MSCI Frontier Index constituents is just US$1.1 million (the median for emerging markets is US$8.9 million). One industry rule of thumb posits that an investor trading more than 10% to 20% of a stock's average daily volume runs a high risk of materially impacting the price of the target stock.

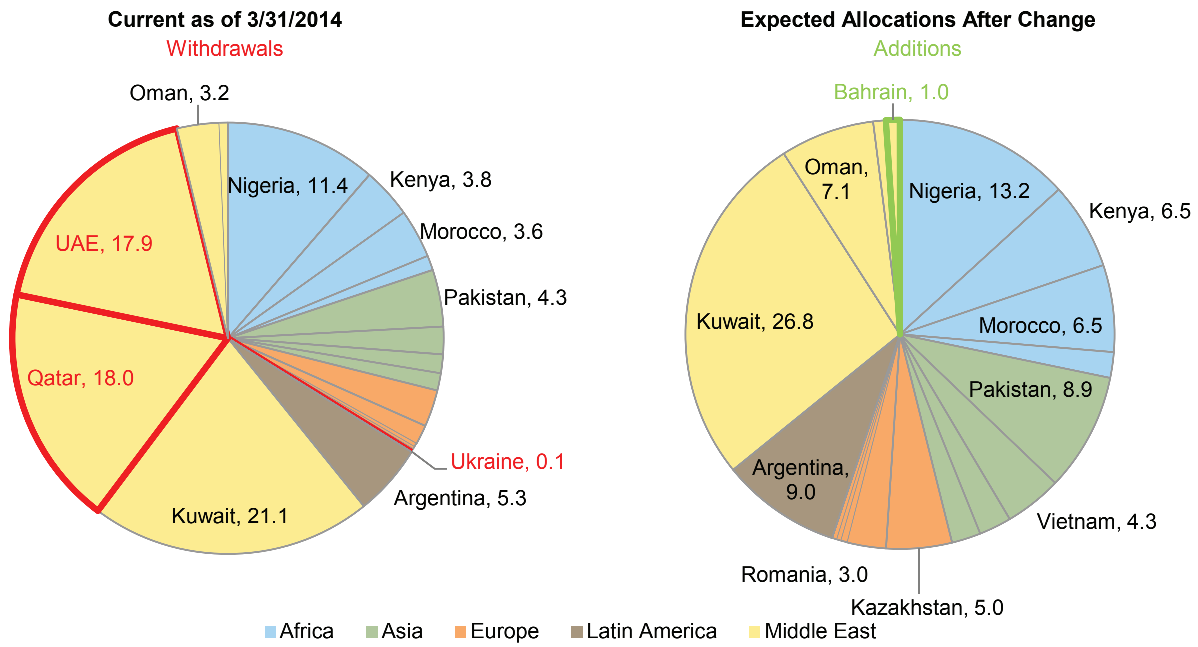
The combined effect of that low liquidity and of having to replace one-third of the index's exposure could prove to be costly for index investors. For example, as the weight in Estonia essentially doubles from 0.3% to 0.5%, the iShares MSCI Frontier 100 ETF ($821 million in assets under management) will need to purchase approximately $2.5 million of shares of the index's one Estonian firm, which has less than $175,000 of daily trading. Northern Trust has estimated that **the transaction cost from matching the S&P index's proposed overnight transition could be a punitive 200 bps or more at the fund level**. This is not a transitory impact that will be made up later; it's akin to a one-time tax of 2% assessed on an investor's frontier markets assets. The impact of emerging markets index funds swooping in to purchase Qatari and UAE shares as they get kicked out of the frontier index nest is somewhat difficult to project,[3] so actual costs could be significantly above or below that estimate. Ideally S&P will recognize the need to implement its transition in stages (similar to MSCI's plans) rather than all at once. Staging the transition may reduce the market-impact costs associated with buying and selling millions of shares to match the newly reconstituted index, but will not reduce trading commissions nor stamp taxes.

## What Will the Class of 2015 Look Like?

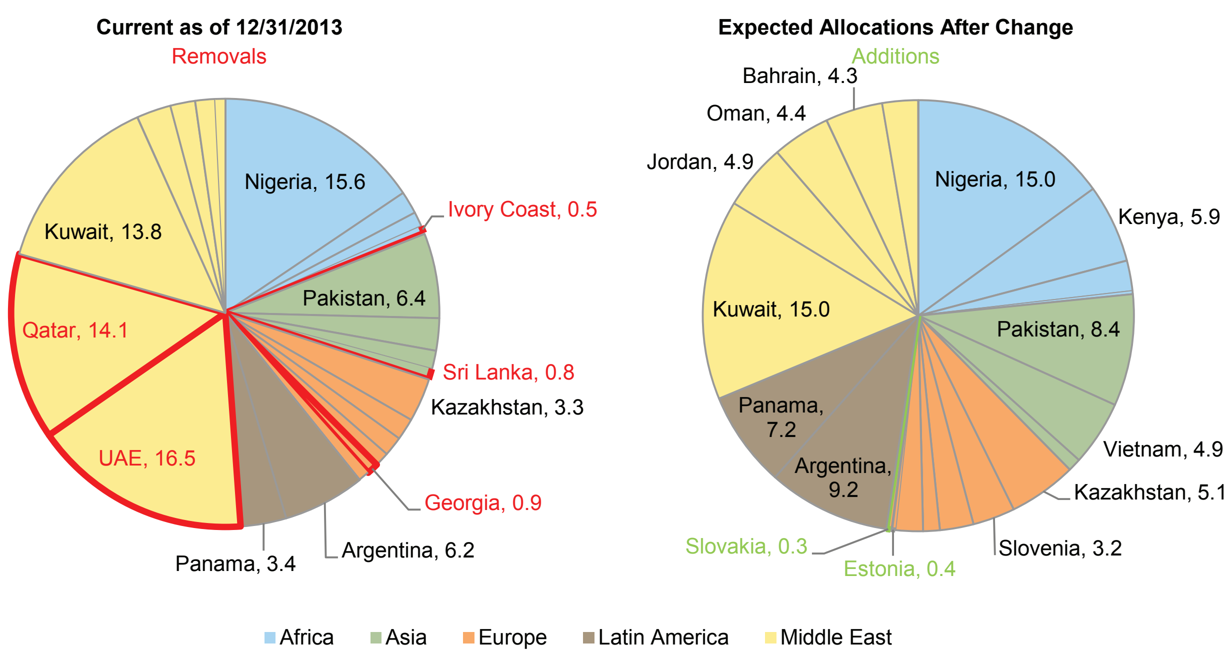
MSCI's transition is scheduled to be completed in late November 2014, and S&P's in September 2014. After they conclude, how will the newly reconstituted frontier indexes look? Both indexes will lose two large constituent countries, and the MSCI index will pick up Bahrain (adding one stock listed in the country), while the S&P index will add Estonia and Slovakia. From a regional perspective, the exposure to Middle East markets will shrink dramatically, from 61% to 36% for MSCI, and from 51% to 31% for S&P, with the other regions becoming much more weighty (in both indexes, the combined weights to Asia, Europe, and Latin America would increase by about 20 ppts).

[3] Will the larger transaction volume from the forced transactions translate to tighter bid-offer spreads and less market impact? Currently, MSCI projects that the weightings of Qatar and UAE in the main emerging markets index would be 0.6% and 0.7%, respectively. Given the more than $200 billion of assets indexed to MSCI emerging markets indexes, emerging markets index managers would need to purchase Qatari and UAE shares equivalent to several average days' trading activity, depending on the stock. On April 28, Reuters reported that MSCI was weighing a moderate decrease in the two countries' allocations in the MSCI Emerging Markets Index, due to foreign-ownership constraints.

MSCI Frontier Markets 100 Index Country Allocations Before/After Planned Reconstitution




S&P Extended Frontier 150 Index Country Allocations Before/After Planned Reconstitution



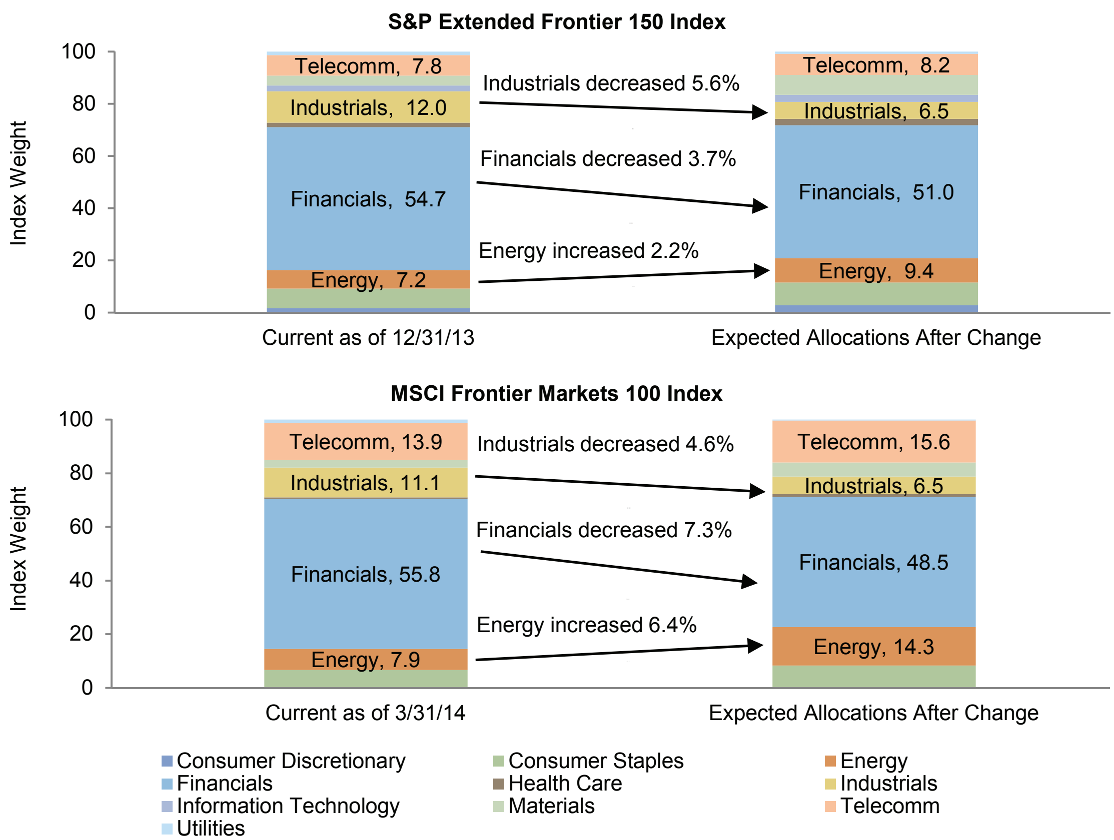
That said, the indexes will continue to have hefty exposure to the shares of energy-producing markets (including many Gulf markets, Nigeria, and Venezuela).

If it occurred today, the reconstitution would not meaningfully impact valuations for the index. MSCI's UAE Index trades at 1.8 times book value, and its Qatari index trades at 2.0 times book value, compared to the broad index at 1.8 times, so removing Qatari and UAE shares will not move the valuations needle (assuming relative valuations remain stable until the transition is complete).

Compared to the significant regional shift, the changes will have a smaller impact on sector weights. Exposure to financials will decrease by a handful of percentage points in both indexes, as will industrials exposure. Energy exposure will increase moderately.

Overall, the indexes will retain their essential character post-reconstitution, with banks and other stocks within energy-sensitive markets claiming the lion's share of allocations.

Frontier Markets Index Sector Allocations Before/After Planned Reconstitution



## And What About the Next One?

Longer term, investors should be aware that the 2014 reconstitution is just that; future years will see future transitions, and some of them may be even more disruptive. Any move to promote Kuwait, for example, could further reduce the liquidity of the remaining components: Kuwaiti stocks will account for nearly one-fifth of the trading activity of the reconstituted MSCI Frontier Markets 100 Index. Investors will likely avoid some of the transition impacts with active managers, because those funds don't need to wait for the official transition and can position themselves as liquidity providers rather than forced buyers or sellers.

For investors that prefer a passive approach, an eventual solution might be an index that *combines* frontier and emerging markets (since both face disruptive transitions of this sort), which would sharply limit the disruptions related to these periodic promotions and demotions. Indexes along these lines are available, though we do not know of any commingled investment vehicles that track them. A costly 2014 reconstitution might just spur the product-development teams at fund managers to work out a proactive solution to these disruptions.

## The Bottom Line

The reconstitution of 2014 promises to leave a substantial mark, both in terms of the changes to index makeup (which we view as generally neutral in terms of exposure and somewhat negative in terms of the diminished liquidity of the remaining index) and in terms of potential transaction costs (which we view as painful indeed).

We will be watching the index transitions as they begin in late May, paying attention to trading activity and transaction costs in our ongoing dialogue with index-fund managers and index sponsors. We would encourage frontier markets investors to do the same, particularly index-oriented investors, which may wish to evaluate the risks and costs of stepping aside temporarily. ■

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## Exhibit Notes

**Median Daily Trading Activity of Frontier Market Shares by Liquidity Decile**
Source: Bloomberg L.P.

**MSCI FM 100 Index Country Allocations Before/After Planned Reconstitution**
Source: MSCI Inc. MSCI data provided “as is” without any express or implied warranties.

**S&P Extended Frontier 150 Index Country Allocations Before/After Planned Reconstitution**
Sources: Northern Trust and Standard & Poor’s.

**Frontier Market Index Sector Allocations Before/After Planned Reconstitution**
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