

# Investing in Emerging and Frontier Markets - An Investor Viewpoint



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## 1. Executive Summary

International investors can contribute positively to the growth and development of emerging markets. These markets also offer a range of investment opportunities for investors. This research, undertaken with the support of the EBRD, seeks to understand what encourages (or discourages) international investor participation in emerging markets. For this purpose, the WFE interviewed 12 asset owners/managers with combined emerging market equity assets under management (AUM) of nearly USD 1 trillion. This research builds on prior work of both the WFE and the EBRD. The key findings are summarised below:

- While returns are important for investors, their broader investment strategy will guide how they evaluate returns and how they decide where to invest;
- Investors either exclude (explicitly or implicitly) or invest less in smaller (frontier) markets than in larger emerging markets;
- Few things would prevent investors from investing in a market but lack of certainty about ownership of shares was one of them;
- Some investors said that corporate governance (or lack thereof) was a particular challenge in emerging market investing, as was government interference in business and, in some markets, the length of time it took to open investment accounts;
- All investors were concerned with liquidity, but they measured this in different ways (e.g. at market level versus at individual stock level). Some investors required a minimum liquidity threshold in order to invest;
- Investors by-and-large regarded market infrastructure as a nice-to-have, rather than a prerequisite, with notable exceptions being the existence of a delivery versus payment settlement system and the presence of global custodians (regarded as being very important or critical); and
- All investors (bar one) looked at environmental, social and governance (ESG) factors when evaluating their investments. In some instances, poor ESG performance would prevent investment while in others, investors said they would engage with companies to look for improvement on relevant metrics.

What is clear from the research is that investors have different approaches to emerging market investment and this results in different perspectives on what is important. Overall, however, markets wishing to attract international investors should focus on the following:

- Reducing the direct and indirect costs of investment e.g. the time and effort required to open an investment account, the costs of obtaining information both about the investment process and the companies they are investing in;
- Enhancing the corporate governance of listed firms and their understanding of the relevance of ESG more broadly;
- Investing in market infrastructure enhancements – not as a starting point but to contribute to the improvement of the market over time;
- Developing the local investor base including strong, local asset managers.

## 2. Introduction

International investment is important for the development of local capital markets. Foreign investors provide capital to the local economy, participate in risk sharing, reduce domestic buy-side concentration, supply liquidity to the secondary market, and in the long-run may help reduce price volatility. In addition, international investors benefit local companies by helping them align to international best practices, contributing to the reduction of their cost of capital and enhancing their valuation. To the extent that their investment spurs the development of local financial markets, international investors also contribute to the growth and development of domestic economies. For foreign investors, investment in emerging markets offers them access to fast-growing economies, providing potentially higher returns and opportunities for portfolio diversification. This is explored in more detail in section 5.1.

Exchange operators and policymakers in emerging and frontier markets, recognising the benefits of international participation, have introduced measures to increase the attractiveness of their markets.<sup>1</sup> These include market liberalisations, alignment with international standards, and investment in market infrastructure. Data suggests that at least some of these initiatives have been successful, with increases in international portfolio flows into emerging markets. The World Bank estimates that since the mid-1990s, net international portfolio equity inflows into emerging markets have grown dramatically, totalling more than USD 955 billion over the 2000-2017 period.

Given the contribution that international investors make to market development, both the World Federation of Exchanges (WFE) (through its Emerging Markets Working Group - EMWG) and the European Bank for Reconstruction and Development (EBRD), through its Local Currency and Capital Market Development Initiative (LC2)<sup>2</sup>, have recently conducted research into the determinants of international investor activity in emerging and frontier markets.<sup>3</sup> This report, produced by the WFE with the support of the EBRD, uses semi-structured interviews with a broad range of institutional investors to build on the previous research in these areas. The purpose of the report is to provide exchange operators, securities regulators and policy-makers with greater insight into the factors that drive investment decisions, as reported by investors themselves. This should enable more informed policy focus and investment in market structure enhancements.

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<sup>1</sup> See the WFE's recently published report on International Investors and Emerging Markets for examples of some of these initiatives: What attracts international investors to emerging markets? (WFE, 2018).

<sup>2</sup> LC2 is an EBRD-wide strategic initiative that aims to promote more efficient and self-sustaining financial markets through the development of local capital markets (LCM) and broader use of local currency (LCY). This consists of four interrelated priority areas, namely 'Upgrading Capital Markets Policy Framework', 'Enhancing Legal & Regulatory Environment', 'Improving Capital Market Infrastructure', 'Expanding Product Range and Investor Base'.

<sup>3</sup> The Investor Base of Securities Markets in the EBRD Region (EBRD & IPREO, 2018).

### 3. Overview of Foreign Investor Activity

For purposes of the aforementioned EBRD research, the EBRD and Ipreo collected detailed shareholding information about countries in which the EBRD operates. We use this dataset to provide some insight into the nature of foreign institutional investment in emerging and frontier economies.

The EBRD/IPREO database contains detailed ownership information on public companies in the EBRD region. IPREO collected this information from public sources of ownership data, such as global mutual funds' portfolios or companies' annual reports.

The database distinguishes between insider, strategic, retail and institutional investment in public listed companies. Institutional ownership is in turn sub-categorised into domestic and non-domestic (foreign) investment.<sup>4</sup> For the purposes of this report we use the information on institutional ownership, particularly the foreign classification, to illustrate attributes of foreign institutional investor behaviour in the markets in this region.<sup>5</sup>

Table 1 provides a breakdown of foreign direct equity holdings (excluding ADRs/GDRs) as a share of institutional ownership by destination country. According to the EBRD/Ipreo data, foreign investors directly held at least USD 100 billion worth of public equity investments in more than 1,000 companies across the EBRD countries of operation<sup>6</sup> as at H2 2017 (data was collected between June and December 2017). This amounts to a sizable proportion of total institutional ownership throughout the EBRD countries of operation, with foreign investors accounting for over 50% of the total institutional investment in more than half the countries reviewed.

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<sup>4</sup> The IPREO data only distinguishes between foreign and domestic for the category of institutional investors. It is feasible that there are also foreign shareholders in the other categories, but it was not possible to assess this based on the data collected. More information about the database is contained in the methodology section of the EBRD/IPREO report (2018).

<sup>5</sup> This data was collected between July and December 2017 and must therefore be viewed as indicative, rather than a reflection of current holdings. Both investor holdings, and indeed even the companies listed, will have changed over time.

<sup>6</sup> These countries of operation are: Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, Egypt, Estonia, FYR Macedonia, Georgia, Greece, Hungary, Jordan, Kazakhstan, Kosovo, Kyrgyz Republic, Latvia, Lebanon, Lithuania, Moldova, Mongolia, Montenegro, Morocco, Poland, Romania, Russia, Serbia, Slovak Republic, Slovenia, Tajikistan, Tunisia, Turkey, Turkmenistan, Ukraine, Uzbekistan and West Bank and Gaza. Note that this does not imply any position on the legal status of any territory.

Table 1: Share of foreign ownership over institutional ownership by destination country

(1)	(2)
Investment Destination	Foreign holdings/total institutional holdings (excluding ADRs/GDRs)
Bosnia and Herzegovina	10.28%
Bulgaria	53.93%
Croatia	11.25%
Cyprus	42.69%
Egypt	64.52%
Estonia	81.68%
Georgia	99.99%
Greece	76.26%
Hungary	96.83%
Jordan	32.98%
Kazakhstan	3.89%
Latvia	97.25%
Lebanon	10.70%
Lithuania	58.89%
Macedonia	100.00%
Mongolia	99.99%
Morocco	10.91%
Palestine	36.43%
Poland	29.12%
Romania	43.86%
Russian Federation	41.33%
Serbia	98.52%
Slovakia	19.72%
Slovenia	58.41%
Tunisia	84.38%
Turkey	70.16%
Ukraine	65.53%

Source: WFE analyses of IPREO data.

Looking at the source of these investments (Table 2) it emerges that, while funds came from as many as 70 source countries, the bulk of the investment (quantum) originated from relatively few, generally advanced economies. The United States alone accounted for over 42% of the funds invested in EBRD markets as at H2 2017, with over USD 45 billion holdings. This was followed by the United Kingdom, with 20% of the holdings, amounting to nearly USD 22 billion. Among the top 30 countries by investment size were also major Western European (Scandinavian countries, Germany, France, and Italy), North American (Canada, Mexico) and Asian economies (Hong Kong, Singapore, Japan). South Africa, an emerging market with a very developed financial sector, also featured among the 30 top source countries. The list of investor countries also includes the more advanced economies from Central Europe (Hungary, Czech Republic, Poland), and the Middle East (United Arab Emirates, Qatar, Kuwait). This is likely due, among other factors, to the geographical proximity of these countries to the investment destinations.

Table 2: Top 30 source countries by investment size (direct stock-holding)

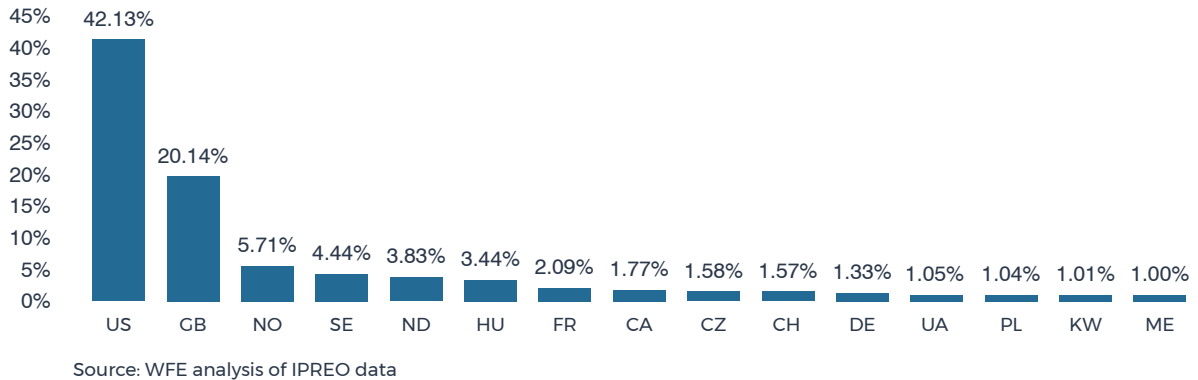
(1)	(2)
Source country	Value of foreign holdings (excluding ADRs/GDRs)*
United States	45,945,234,952.30
United Kingdom	21,959,961,146.31
Norway	6,221,780,558.06
Sweden	4,838,443,485.01
Netherlands	4,173,469,160.18
Hungary	3,753,377,187.35
France	2,280,806,378.38
Canada	1,930,345,948.28
Czech Republic	1,722,148,756.91
Switzerland	1,708,836,681.35
Germany	1,451,938,899.20
United Arab Emirates	1,143,124,546.51
Poland	1,130,911,635.51
Denmark	1,098,915,061.71
Kuwait	1,092,263,871.35
Mexico	1,080,607,580.47
Singapore	912,238,845.57
Estonia	686,303,188.64
Austria	680,724,917.40
South Africa	520,997,397.36
Finland	406,535,905.63
Hong Kong	400,554,991.57
Luxembourg	380,008,334.33
Bermuda	378,689,368.53
Qatar	360,998,834.13
Japan	294,958,182.73
Belgium	211,571,486.97
Ireland	210,075,919.73
Italy	192,048,899.67
Spain	188,546,971.06

\* Column (2): USD, full numbers.

Source: WFE analysis of IPREO data



Figure 1: Top 15 source countries by investment size



However, despite significant market reforms and liberalisation, it appears that investors still have appetite for financial instruments, such as American Depositary Receipts (ADRs) and Global Depositary Receipts (GDRs) that give exposure to emerging market companies without requiring investment through the local stock exchange. Table 3 provides a breakdown of ADR/GDR funds by destination country. The vast majority of this investment was directed towards Russian firms: foreign institutions in the sample had almost USD 37 billion invested in 55 Russian ADRs/GDRs as at H2 2017. This represented roughly 90% of the total ADR/GDR funds in the sample. Cyprus was second (USD 1.4 billion in 10 different companies), followed by Egypt (USD 981 million in 11 different companies), Kazakhstan (USD 839 million in seven different companies) and Turkey (USD 462 million in 15 different companies). As with direct stock-holding, most funds originated in the United States (over USD 19 billion, 49 of the total) and the United Kingdom (over USD 11 billion, 29% of the total), who together accounted for 78 of the funds. The rest, as per Table 4, was dispersed among advanced and major emerging economies.

Table 3: Foreign stock-holding through ADRs/GDRs by destination country<sup>7</sup>

(1)	(2)	(3)	(4)
Company country of domicile	Value of foreign holdings*	Number of companies with foreign holdings	Market cap. of companies with foreign holdings
Russian Federation	36,907,728,925.93	55	484,430,477,429.39
Cyprus	1,441,400,354.40	10	8,534,399,175.05
Egypt	980,961,467.20	11	12,281,387,303.56
Kazakhstan	839,313,065.55	7	8,029,160,549.75
Turkey	461,969,428.19	15	85,289,352,407.65
Romania	173,805,520.07	6	14,695,244,322.32
Ukraine	167,225,049.96	3	1,177,015,003.43
Lebanon	75,350,012.84	3	5,636,241,617.87
Poland	69,850,400.74	4	21,417,796,945.60
Greece	47,668,829.65	9	23,605,638,812.00
Hungary	12,850,237.16	4	24,048,306,187.80
<b>Total</b>	<b>41,178,123,291.68</b>	<b>127</b>	<b>689,145,019,754.41</b>

\*Through ADRs/GDRs. Columns (2) and (4): USD, full numbers. Column (3): full numbers.

Source: WFE analysis of IPREO data.

Table 4: Top 20 source countries by investment size (ADRs/GDRs)

(1)	(2)	(3)
Source country	Value of foreign holdings*	Share of the total foreign holdings
United States	19,312,645,605.27	48.61%
United Kingdom	11,598,148,048.36	29.20%
Sweden	1,202,990,807.81	3.03%
France	925,706,263.88	2.33%
Canada	800,368,187.54	2.01%
Switzerland	749,841,045.47	1.89%
Germany	727,481,179.60	1.83%
Netherlands	662,472,590.06	1.67%
China	446,349,318.15	1.12%
Hong Kong	426,273,241.65	1.07%
Russian Federation	368,466,565.01	0.93%
Singapore	362,703,458.38	0.91%
South Africa	343,619,805.82	0.86%
Denmark	326,144,661.29	0.82%
Austria	315,093,332.46	0.79%
Norway	295,390,636.19	0.74%
Bahamas	262,768,665.36	0.66%
Spain	233,862,032.11	0.59%
Finland	188,270,592.84	0.47%
South Korea	177,671,888.04	0.45%

\*Through ADRs/GDRs. Column (2): USD, full numbers. Column (3): full numbers.

Source: WFE analysis of IPREO data.

<sup>7</sup> While in the vast majority of cases the companies are listed in the country of domicile, we are aware that in a few instances the companies in question are listed only through the GDR. This results, for example in the case of Cyprus, in a situation where the market capitalisation is larger than the market capitalisation of the exchange.

## 4. Methodology

This research is qualitative in nature. We conducted in-person or telephonic interviews with 12 investors, using a semi-structured interview approach.<sup>8</sup> We shared the questionnaire that would be used to frame the discussion with participants in advance. Interviews lasted between 30 and 90 minutes and were recorded to allow the researchers to retrieve all relevant information at the data analysis stage.

The interview questions were developed jointly by the WFE and the EBRD, with input from the WFE's Emerging Markets Working Group (EMWG). They draw from the literature on the topic and leverage the prior research work of both organisations. Areas explored during the interviews included:

- Reasons for investing in emerging markets?
- Specific challenges associated with such investment?
- What exchanges and/or regulators could do to enhance the attractiveness of the market for investment?
- The relative importance or otherwise of:
  - Specific market characteristics;
  - Overall market's economic health and stage of development; and
  - Regulatory and legal considerations.

Speaking directly with investors afforded the WFE and the EBRD the opportunity to gain insight beyond what could be collected via a standard survey format. Particularly this allowed us to understand:

- The effect various market structure components have on the firm's investment decision-making process;
- The relative importance of various actions which can and/or have been taken by exchanges, policy-makers, and regulators;
- The difference between factors which disincentivise investment and those which would disqualify an investment opportunity altogether (i.e. 'red lines'); and
- Suggestions for future improvement to the investment environment.

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<sup>8</sup> Semi-structured interviews are an interview type widely used in qualitative research. It involves guiding the interviewee through a set of previously written open questions, the order of which might or might not vary. Researchers can occasionally add questions if needed, but overall follow the interview structure. Semi-structured interviews are typically used when interviewers cannot access the interviewee more than once, and typically last between 30 and 60 minutes. For a concise reference, see Jamshed (2014) (link: <https://www.ncbi.nlm.nih.gov/pmc/articles/PMC4194943/#ref6>), and references therein.

Following the tenets of qualitative research methods (and in particular, grounded theory), we aimed to obtain a diverse sample of interviewees, to enable us to obtain a variety of insights. We therefore decided to interview different investor types investing in regions around the world. We drew up the list of potential interviewees in the following way:

- The WFE Research team conducted broad market research to identify investors that would be of interest given their emerging markets activity;
- WFE EMWG member exchanges were asked to identify the largest institutional investors active in their market:
  - Where the same investor was identified by more than one exchange, the WFE included that investment institution in its first wave of interview invitations;
  - Investors submitted by only a single institution were vetted by WFE for their applicability to multiple geographies. A subset was included in interview invitations.
- The EBRD, leveraging its institutional history and particularly its learnings from the March 2018 *The Investor Base of Securities Markets in the EBRD Region* report, identified a number of institutions.

We collected observations till we reached 'theoretical saturation', that is, until it was evident that interviewing an additional investor was unlikely to generate any additional insights/themes (Aldiabat & Le Navenec, 2018; Charmaz, 2006).

To encourage participation and frank discussion we committed to keeping responses anonymous. As some participants indicated they would only be able to provide feedback if they were not formally mentioned in the report, we have opted to provide salient facts about the investors involved, rather than disclosing the names of the participating entities. This information is set out below.

To analyse the data, we extracted common and divergent themes that emerged from the interviews using thematic analysis (Bryman, 2016, pages 586-9). We adopted this approach rather than one based on grounded theory (Charmaz, 2006; Strauss & Corbin, 1991; Thornberg & Charmaz, 2014), as the purpose of the research is not to create new theory but rather to supplement and expand on the results of pre-existing research (see WFE and EBRD research referred to previously).

Table 5: Investor overview

	Investor type	EM focus areas	AUM in EM equities	Investment style
1	Asset owners – including university endowment, pension funds etc.	Global	USD ~650 billion	Combination of active and passive investment. Long-term investor. Use external asset managers but also have an in-house investment team.
2		Global		Active investment. Long-term value investor. Use external asset managers. View asset managers as long-term partners, with the length of the relationships ranging from three years to over ten years. Look for entities that have the requisite skills to invest in accordance with their investment approach, have a deep understanding of a specific investment region or market, and ideally, are present in the investment jurisdiction. Fund involved in deciding which jurisdictions they wish to invest in, and will allocate funds to managers based on their initial determination of how much they wanted to invest in a specific country. Will not invest in a jurisdiction if they cannot find a suitable (local) asset manager to execute their investment strategy.
3		Global - Dependent upon ability to find a find manager who is an expert in a certain region		Active investment. Long-term, value investor. Use external asset managers. View asset managers as long-term partners, with the length of the relationships ranging from three years to over ten years. Look for entities that have the requisite skills to invest in accordance with their investment approach, have a deep understanding of a specific investment region or market, and ideally, are present in the investment jurisdiction. Fund involved in deciding which jurisdictions they wish to invest in. Will not invest in a jurisdiction if they cannot find a suitable (local) asset manager to execute their investment strategy.
4		Global		Long-term, value investor with both active and passive investment. Use external asset managers. Use asset managers with extensive resources and broad international coverage and expertise. Asset managers have a large amount of latitude as to the specific investments they undertake. Managers decide the investment approach (active vs passive) and which markets to invest in.
5	Asset manager	Fund allocation dominated by the US (70/30 US/ex-US)	USD ~150 billion	Predominantly index-tracking
6	Asset manager (Investment Bank)	Global	USD ~25 billion	Active investment. Long-term, value investor
7	Asset manager	Small stocks in emerging and occasionally frontier markets	USD ~180 million	Active investment. Long-term, value investor. Use local research analysts in the markets they invest in.
8	Asset manager	Asia, LatAm and Eastern Europe	USD ~15 billion	Active investment. Long-term, value investor.
9	Asset manager	Global, with a focus on Europe	USD ~10 billion	Active investment. Long-term, value investor. Take a bottom-up approach, focusing on specific stocks, rather than countries specifically.
10	Asset manager (Insurance Firm)	Global	USD ~500 million	Active investment. Long-term, value investor
11	Asset manager	Asia and Emerging Europe	USD ~6.71 billion	Long-term, value investor
12	Asset manager	55% Asia, balance between LatAm and EMEA	USD ~130 million	Long-term, value investor. Bottom-up approach, focusing on specific stocks. Begin with a universe of 6,000 companies which are screened against various criteria, until they are left with 350 'investable' companies. Eventually select 150 companies for final investment.

## Box 1: Defining Emerging and Frontier Markets

The use of the term 'emerging markets' dates back to 1981, when it was introduced for the first time by the World Bank economist Antoine van Agtmael. The term 'frontier market', used to describe economies with similar characteristics but relatively less developed and smaller in size, was introduced in 1992 by Farida Khambata, an economist from the International Finance Cooperation.

In general, emerging and frontier markets are viewed along a continuum and understood to have "less developed systems of accounting, regulation and other financial infrastructure" than developed markets. Their capital markets are typically less efficient (Kearney, 2012), and characterised by smaller levels of trading activity and lower liquidity than developed ones (Lesmond, 2005; Oliver Wyman & WFE, 2016). In addition, these markets are perceived to have less accounting transparency, less stringent corporate governance practices and higher political risk than developed economies (Bruner, Conroy, Estrada, Kritzman, & Li, 2002; Karolyi, 2015; Kearney, 2012; Lesmond, 2005).

The major index providers (namely MSCI, FTSE-Russell and S&P) have attempted to formalise the categorisation of markets, based on a range of economic and market-specific factors. While differences remain in approach and outcomes, the result is largely overlapping sets of countries/markets.

Looking specifically at FTSE-Russell<sup>9</sup>, markets are classified as Frontier, Secondary Emerging, Advanced Emerging or Developed. For purposes of assigning a country to a particular category, FTSE assesses so-called Quality of Market factors, namely the quality of regulation, the dealing landscape, custody and settlement procedures, and the presence (or otherwise) of a derivatives market. The less developed a market, the fewer of these Quality of Market requirements that need to be met. Thus, for example, Frontier markets in relation to Quality of Markets criteria are only required to demonstrate:

- Formal stock market regulatory authorities actively monitor the market (e.g., SEC, FSA, SFC);
- No objection to or significant restrictions or penalties applied to the investment of capital or the repatriation of capital and income;
- Settlement - rare incidence of failed trades;
- Settlement - free delivery available; and
- Transparency - market depth information/visibility and timely trade reporting process.

Secondary Emerging markets meanwhile are required to demonstrate they meet these, plus an additional four characteristics, and so on.

The Quality of Markets matrix also looks at World Bank GNP per capita data and a country's credit rating.

For a market to be classified as Emerging (Secondary or Advanced) or Developed, it must have at least three securities that meet the minimum threshold criteria for inclusion in the FTSE Global Equity Index. Relevant factors here include minimum free-float, liquidity, and number of listed companies.

As explored more extensively in Box 2, inclusion (or not) in these indices can have an impact on a market's ability to attract portfolio investment with the growth of passive investing making this ever more salient.

In addition to the index definitions, investors also classify firms as emerging or frontier by reference to their revenue source (i.e. if the bulk of the revenue is derived from an emerging/frontier market) even if the company is incorporated and/or listed in a developed market.

<sup>9</sup> See <https://www.ftse.com/products/indices/country-classification> for the latest overview of the FTSE approach to country classification.

## 5. Discussion of Interview Findings

### 5.1 Returns are important but in different ways...

As the purpose of investment is to generate financial returns, it is unsurprising that this was the primary reason cited for investing in emerging markets. However, not all investors interviewed said they expected emerging markets to provide higher returns than developed markets. Investors had different reasons for choosing emerging markets as the source of their investment returns and adopted a variety of investment approaches:

- Two investors (an asset owner and an asset manager) said they invested in emerging markets because they felt the relative inefficiency of these markets provided an opportunity to generate excess returns (extract alpha). Essentially, they indicated that as some emerging markets were characterised by less efficient price discovery, they could, through a long-term, value-based investment approach, identify under-valued companies which would provide excess returns;
- An active, bottom-up, value-based asset manager said they believed emerging market firms would generate larger returns over the long-run than developed market firms and they attributed this to the fact that these firms were under-represented in indices and investment portfolios (suggesting, again, pricing inefficiency);
- Another asset manager said that they offered emerging market investments to provide clients with a variety of investment options. They also, however, cited “cheaper valuations” as a reason for finding emerging markets attractive;
- A few investors indicated they included emerging markets as part of a global investment mandate or investment strategy rather than targeting emerging market returns specifically;
- A large asset manager that adopts a predominantly passive, index-linked investment approach, said they sought to give clients global exposure and portfolio diversification and emerging markets formed part of this strategy;
- Yet another US-based asset manager, while noting higher emerging market returns, added that lower correlation with US markets was also a driving factor for investing in emerging markets.

### 5.2 Frontier markets struggle to get a look in...

The responses to this question must be understood within the context of the definitional challenge described in Box 1. For many of the investors interviewed, the terms emerging and frontier markets were shorthand to describe certain market characteristics rather than referring to markets formally categorised as such. Thus, when we refer to frontier markets below, with two exceptions, these should generally be understood as referring simply to smaller, less developed markets.

Only two of the investors interviewed (an asset owner and an asset manager) said they explicitly excluded frontier markets from their investment universe. However, it is apparent from the other investor responses that frontier (smaller) markets struggle to attract the same levels of attention as their emerging market counterparts. For some investors, these markets were implicitly excluded (“they’re too small for our typical size of investment”), formed a much smaller part of the overall investment

portfolio, or had a much higher risk premium attached. In a few instances, investors said they bypassed the local market entirely by investing through other mechanisms (such as depository receipts). Expanding on responses:

- One asset owner that relied on local asset managers, while not excluding frontier markets, said the expected returns in some smaller markets did not justify the costs associated with finding a suitable manager;
- An asset manager said that while they invested in frontier markets, they regarded these as more problematic from the perspective of providing necessary transparency and stability. Similarly, another asset manager said while fund rules allowed them to put up to 10% of their AUM into frontier markets, they had never reached this level of exposure. They attributed this to the fact that many frontier markets did not meet the minimum liquidity and economic requirements for UCITS;<sup>10</sup>
- Another asset manager said they while they sought exposure to frontier markets, they achieved this through companies that operated in frontier markets but were listed on emerging or developed market exchanges.

This did not mean, however, that frontier markets are entirely ignored. One asset manager said they had a dedicated frontier market investment team, while two others said they sometimes preferred frontier markets as these presented more opportunities to generate excess returns (given perceived pricing inefficiency or the possibility of finding as yet undiscovered value).

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<sup>10</sup> Most of their funds are structured as UCITS (undertakings for collective investment in transferable securities), and therefore investments have to comply with particular rules as prescribed by European regulation. On the European framework for regulating UCITS, see: [https://ec.europa.eu/info/law/undertakings-collective-investment-transferable-securities-ucits-directive-2009-65-ec\\_en](https://ec.europa.eu/info/law/undertakings-collective-investment-transferable-securities-ucits-directive-2009-65-ec_en)



## Box 2: Passive investment and the impact on emerging and frontier markets

All interviewees indicated that they made some use of emerging market indices, though how they used them varied. For some, these were simply a reference point (e.g. as a performance benchmark); others used them to circumscribe their investment universe; still others invested according to the relevant index (or sub-set thereof).

While indices have always been important tools for investors, the increase in passive investment<sup>11</sup> has made them much more significant. The growth of passive investment is undoubtedly one of the major investment trends of the past two decades.

In the US, for example, as at end of 2017 total assets under management (AUM) of passively managed funds (including mutual funds and exchange traded funds (ETFs)) reached USD 6.7 trillion, compared with USD 11.4 trillion managed by active funds.<sup>12</sup> During the course of 2017, over USD 690 billion flowed into passively managed funds, with a USD 7 billion outflow from active investment.<sup>13</sup> As at end 2017, total US equity assets under passive management was over 45% of the total, up from just 20% in 2007. The trends are similar in Europe and Asia with increases from 13% to 33% and 24% to nearly 48%, respectively.<sup>14</sup>

This move of funds to passive investment vehicles (such as ETFs) is also evident in emerging and frontier market investment. Inflows into emerging market equity exchange traded products (ETPs)<sup>15</sup> reached USD 51 billion in 2017 with associated AUM of USD 371 billion (10% of total AUM of equity ETPs).<sup>16</sup> This growing reliance on indices for purposes of passive investment makes index inclusion<sup>17</sup> (or otherwise) that much more important for emerging and frontier markets, with one investor suggesting that the effect is that index providers increasingly determine how capital is allocated.

As noted earlier, assessment for broad market index inclusion is a two-stage process.

The first step is the 'country classification'. As explained in Box 1, major index providers classify a market as developed, emerging or frontier, according to their own country classification criteria. These consider factors that assess a country's economic development and market accessibility (including liquidity) and reflect the views and practices of the international investment community.<sup>18</sup>

The second step is the determination of the index weight i.e. how many companies from a particular market are included in the index and the weight they are given in the index. The weight of a company is determined by its market capitalisation, adjusted for the free-float of the shares (i.e. shares that are actually available for trading).

<sup>11</sup> Passively managed funds include open-end mutual funds and exchange traded funds and products (ETFs and ETPs) which replicate benchmark indices and are managed to track the index.

<sup>12</sup> Morningstar

<sup>13</sup> Morningstar

<sup>14</sup> Institutional Investor: Passive Investing Rises Still Higher, Morningstar Says – May 21, 2018 – available at: <https://www.institutionalinvestor.com/article/b189f5r8g9xvhc/passive-investing-rises-still-higher,-morningstar-says>

<sup>15</sup> ETP is a general term that includes an ETF, Exchange Traded Note (ETN) and Exchange Traded Commodity (ETC).

<sup>16</sup> BlackRock Global ETP Landscape (December 2017), available at: <https://www.ishares.com/uk/institutional/en/literature/etp-landscape-report/monthly-industry-highlights-december-2017-en-emea-pc-etp-landscape-report.pdf>

<sup>17</sup> The WFE's research on emerging market investment found that inclusion in the MSCI Emerging Market Index was statistically significantly positively associated with an increase in inflows into the market.

<sup>18</sup> MSCI (<https://www.msci.com/market-classification>)

This approach has the following consequences:

- Countries that are not classified as either frontier or emerging will not receive the passive investment flows they would if they were part of the index;
- As the free-float of companies in emerging and frontier markets is typically lower than that of companies listed in developed markets, their representation in global indices, and consequently the funds they attract, will be smaller than those of even similar-size companies listed in developed markets. To illustrate, the unweighted market capitalisation of the emerging markets included in the MSCI All World Index<sup>19</sup> is 25% of the total, but for index purposes, the weighting is reduced to 10%;

The indices (and consequently the allocations) are dominated by the largest companies in the largest markets. Thus, China accounts for 31% of the MSCI Emerging Markets Index, followed by South Korea (13.87%), Taiwan (11.31%), India (9.18%), Brazil (7.51%). The remaining 19 countries in the index account for only 27.31% of the total weight.<sup>20</sup> The table below sets out the index classification and associated index weighting across FTSE and MSCI of several EU member country markets.

Table 6: EU member countries classified as Emerging or Frontier Markets (as of 30 November 2018)

Country	MSCI			FTSE Russell		
	Country classification	Weights in a classification* (%)	No. of constituents in a classification*	Country classification	Weights in a classification** (%)	No. of constituents in a classification**
Bulgaria	-	-	-	Frontier	0.15	2
Croatia	Frontier	1.64	4	Frontier	0.52	4
Cyprus	-	-	-	Frontier	0.00	0
Czech Republic	Emerging	0.21	4	Advanced Emerging	0.22	5
Estonia	Frontier	0.31	1	Frontier	0.30	4
Greece	Emerging	0.27	9	Advanced Emerging	0.33	11
Hungary	Emerging	0.32	3	Advanced Emerging	0.40	4
Latvia	-	-	-	Frontier	0.00	0
Lithuania	Frontier	0.22	2	Frontier	0.25	2
Malta	-	-	-	Frontier	0.00	0
Poland	Emerging	1.24	22	Developed	0.13	14
Romania	Frontier	4.70	5	Frontier	6.85	11
Slovakia	-	-	-	Frontier	0.00	0
Slovenia	Frontier	1.66	2	Frontier	2.41	6

Source: MSCI, FTSE Russell \*MSCI Emerging Markets Index, MSCI Frontier Markets Index \*\*FTSE Developed Index, FTSE Emerging Index, FTSE Frontier Market Index

<sup>19</sup> The MSCI AW Index includes 2,784 constituents from 23 Developed Markets and 24 Emerging Markets (EM) countries. The index claims to cover 85% of the global investable equity opportunity set.

<sup>20</sup> MSCI (as at 30 November 2018)

To tackle these structural challenges, the EBRD, together with the European Commission and international and local partners, is currently exploring the feasibility of creating a new benchmark index such as the CMU<sup>21</sup> Index; and assessing, together with leading index providers and Nasdaq Baltic, the feasibility of a pan-Baltic single classification similar to the MSCI WAEMU index based on a regional approach.

The EBRD believes the creation of an EU-wide CMU Index would facilitate greater local and foreign capital inflow from a broader range of investors and will enhance access to finance for all sectors of the economy, especially SMEs. It may also help to partly overcome the different country classifications of EU member states as the markets will be seen as 'CMU asset class' if properly branded. This will create a level playing field for those EU capital markets which are located in smaller countries with a lower market classification which are currently not on the radar screen of international and regional investors.

### 5.3 Politics and economics matter in different ways

Investors varied as to the extent they monitored political and economic developments in an investment jurisdiction, and how they responded to these. Overall, while investors kept track of economic and political trends, their focus was on the extent to which these might impact the investment strategy or the ability of the investment to generate returns. More specifically:

- One asset owner said they did not pay too much attention to political issues because these tended to be too volatile to base investment strategies on;
- Two asset owners said they did not track these themselves, but they assumed their asset managers considered them as relevant factors in their investment decisions;
- A few asset managers said they were not that focused on broad macro-economic developments because their investment focus was on individual companies;
- The index-linked asset manager pointed out that certain economic components are incorporated into the index assessment and that their individual portfolio managers and relevant custodians also monitored risk factors;
- Yet another asset manager said that poor economic growth prospects in a country did not necessarily deter them as they looked for companies that could outperform the economy. He added that they had dedicated economists within the firm who created toolkits to assess macroeconomic risk, and while these were used predominantly for fixed income investments, they also included the outputs into their discount rates for determining company valuations;
- One asset manager looked at macroeconomic factors that might impact currency stability such as the current account deficit, fiscal deficit and levels of inflation, and said these might impact their investment decision.

Perhaps more important than specific political and economic features, was the notion of policy certainty. Almost every investor interviewed suggested the content of individual economic policy or political decisions was less important than being certain as to what the policy was, thereby allowing them to assess how it impacted their investment decisions.

<sup>21</sup> Capital Markets Union (CMU)

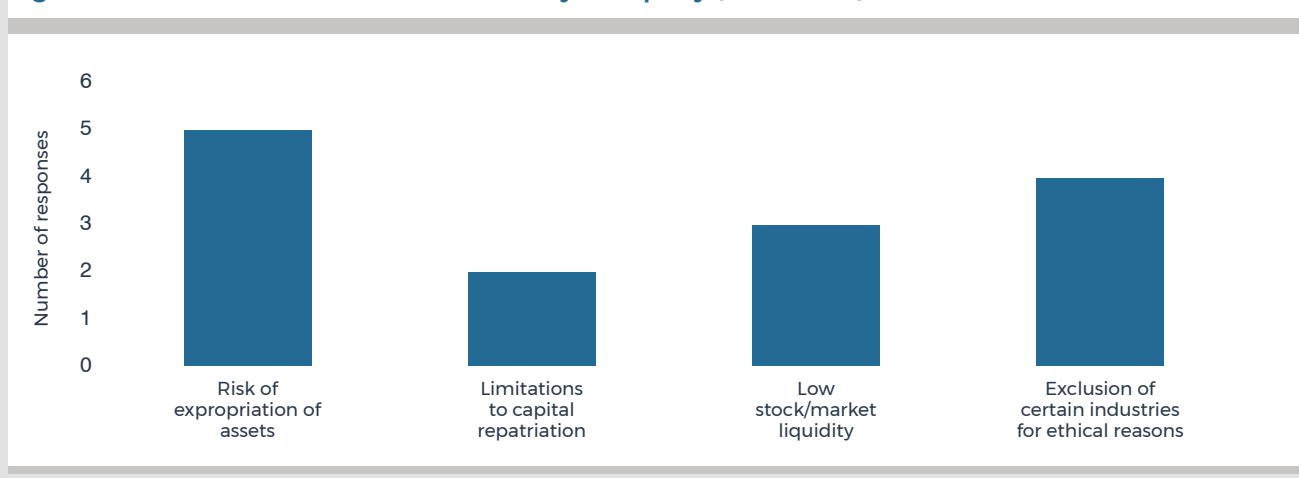
## 5.4 ‘Red lines’? Depends how you define them...

Investors claimed to have very few ‘red lines’ (factors which, if present or absent, would prevent an investor from investing in a particular market).

Other than obvious constraints (such as the presence of sanctions or a limiting investment mandate) the only other red line that was specifically mentioned by several investors was lack of certainty of title/fear of expropriation (i.e. the investor could not be certain that their ownership in the shares they had bought would be legally protected). One asset manager said the presence of capital controls (specifically restrictions on repatriation of capital) was a red line for them, but other investors said while this was something they factored into their risk assessment and valuation it didn’t necessarily preclude investment. Another said while they had no specific red lines, their experience in one market, where officials had attempted to use a change in capital controls to extort funds, meant they no longer invested in that market.

When one expands the definition of red lines to include screening factors (at both market and company level), the set of exclusions are larger than initially suggested. While not mentioned as an explicit ‘red line’ four investors excluded certain product categories for ethical reasons (arms and tobacco in two cases, and coal or coal-based products, in three cases) while several investors, indicated that they needed a minimum market or company size and/or minimum market and/or company liquidity to invest (see Section 5.7 below for more discussion). In a few instances, poor corporate governance could result in a company being excluded (see Section 5.12).

Figure 2: Reasons not to invest in a country/company (“red lines”)



## 5.5 Emerging market investment can be challenging...

Inherent in the classification of a market as emerging or frontier is that it lacks certain characteristics that are present in more developed markets. For some investors these are difficulties to be navigated; for others, these result in pricing inefficiencies that make markets more attractive (though even these investors acknowledge there are benefits to addressing some of the points set out below). Investors highlighted the following as specific challenges they associated with emerging market investment (note, not all of these were mentioned by all investors):

- Some investors said emerging markets were characterised by large numbers of state and/or family-owned businesses. The suggestion was that these types of firms may be more prone to governance challenges, including poor treatment of minority shareholders and corruption concerns;

- Several investors (four) cited government interference (even if not as a shareholder) in business operations as a serious deterrent to investment. One investor said this was their major problem with emerging markets investment;
- Three investors reported that in some markets, opening investment accounts took a very long time and was overly onerous. They stressed, however, that this was not the case in all jurisdictions;
- Two investors mentioned poor quality and lack of timely issuer disclosure as a particular challenge; and
- Shallow depth of market/lack of liquidity was highlighted as an explicit challenge for three investors.

Other concerns were:

- Relatively high transaction costs;
- Quality of real-time market data; and
- Lack of reliable information about requirements for investing in the market and/or inconsistent information.

## 5.6 ...particularly when you're a minority shareholder

Investors were very conscious that some of the challenges of investing in emerging markets exacerbated the risks they faced as minority shareholders. Consequently, several investors said they favoured investment in companies where they were able to have an impact. They therefore viewed access to company management as critical and were very focused on the existence of appropriate minority shareholder protections.

Flowing from this, investors said they were opposed to companies using differentiated or dual-class share (DCS) structures. However, all investors said they might still invest in a company with a DCS structure, if the rest of the investment proposition was compelling, though they would discount the shares of those companies. One investor said they will not invest in companies that issue shares with no voting rights.

## 5.7 The relevance of the market profile and importance of market features depends on investor strategy and mandates

Investors were asked specifically about the importance of market features such as the number and size of listed companies, market liquidity, volatility and research coverage of the market to their investment decision-making. Responses to this varied widely and appeared to be driven by differences in investment strategy, mandates and compliance requirements.

- Liquidity: Of all factors, this emerged as the most relevant. Several investors said liquidity was important to very important, though how they assessed liquidity varied:
  - For some, this was overall market liquidity (as reflected by value traded in the market);
  - Others looked at the liquidity of individual stocks they were interested in. One asset manager (long-term, value-based, bottom-up) said they required a company to have minimum average daily turnover of USD 1 million to consider investing while for another this was several times higher, at USD 7 million;
  - The pension fund manager said liquidity was relevant to the extent that it allowed them to assess whether they were getting best execution; and

- The index investor noted that the requirement for a certain threshold liquidity was embedded in the index determination.

One investor that said liquidity could be important warned against companies in smaller markets cross-listing on other markets. In his view this simply fragmented already limited liquidity and potentially undermined the development of the home market.

By contrast, a few investors said that they were not overly concerned with liquidity as they adopted a long-term investment strategy.

- Number of listed companies: A number of investors (five) also identified having a larger number of listed companies as important, though again, their reasons for this varied:
  - An asset owner that believed emerging markets offered opportunities because of their relative inefficiency, said that more listed companies increased the likelihood of finding under-valued companies;
  - Another asset owner said the presence of more listed companies was crucial to their investment decision and added that exchanges should actively be working to attract companies to list;
  - For the index investor, the number of listed companies and their size are part of the index categorisation and weighting in the index.

One of the asset managers, on the other hand, said they would invest in a market with only one listed company, if the company was attractive.

- Research coverage: Not only was this seen at best as a nice-to-have, but two investors said lack of coverage appealed as it suggested greater inefficiencies and more opportunity to discover value. Investors that relied on local fund managers or analysts said this was not something they were concerned with; and
- Volatility: No investor said volatility would discourage them from investing and a few said explicitly that as long-term investors they were not particularly focused on volatility. One asset manager pointed out that market attempts to control volatility in some instances actually exacerbated the situation. Another asset manager, while not expressing concern with volatility, said that emerging markets were prone to volatility and attributed this at least partly to foreign portfolio in- and outflows.<sup>22</sup>

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<sup>22</sup> This somewhat contradicts a result in the WFE's recent empirical research which found a negative correlation (though not highly statistically significant) between emerging market volatility and foreign investor inflows. This apparently contradictory finding can be at least partly explained by recognising that volatility may be symptomatic of other factors (such as an unfavourable election outcome or a credit ratings downgrade). Thus, while the investment outflows may correlate with the volatility, they may be in response to these other factors, rather than the volatility itself. In addition, the investor response to these factors, may contribute to volatility, thus making it more difficult to isolate cause and effect.

### Box 3: Research coverage – post MiFID II

It is apparent from the interviews that regulatory requirements, such as the need to align with UCITs requirements, may indirectly limit the ability of investors to access certain markets. Similarly, the 'unbundling' requirement under MiFID II, where sell-side research is required to be unbundled and priced separately from execution of equity trading, may reduce the availability of information about companies in emerging and frontier markets.

The unbundling requirement means that asset managers must set budgets for investment research, leading most firms to take the cost on themselves. Nasdaq has pointed out that "the regulatory changes will result in decreased research and less analyst coverage of Small and Medium Sized companies (SMEs) likely to affect their market visibility, and thus hurt their opportunities to attract investors and to raise funding."<sup>23</sup>

Companies in emerging or frontier markets are relatively small (Table 7) and therefore face higher risks of being removed from the research coverage of international brokerage firms due to the low demand from fund managers. This will increase the information costs for fund managers who might be interested in these companies, as there are few qualified local firms who fulfil their requirements.

Table 7: The largest constituent of EU member countries classified in MSCI Emerging or Frontier Markets Index (as of 30 November 2018)

Country	MSCI country classification	The largest constituent of a country	Float Adjusted Market Cap. (USD billion)
Croatia	Frontier	HRVATSKI TELEKOM	0.96
Czech Republic	Emerging	CEZ CESKE ENER ZAVODY	4.15
Estonia	Frontier	TALLINK GROUP	0.35
Greece	Emerging	OTE HELLENIC TELECOM	2.90
Hungary	Emerging	OTP BANK	8.96
Lithuania	Frontier	BANK OF SIAULIU	0.16
Poland	Emerging	PKO BANK POLSKI	9.44
Romania	Frontier	BANCA TRANSILVANIA	2.09
Slovenia	Frontier	KRKA	1.55
<b>Average size of the constituents in the developed market index (MSCI World Index)</b>			<b>23.78</b>

Source: MSCI

To address these concerns, the EBRD is developing a pilot research coverage programme for a limited number of SMEs listed on exchanges in its countries of operations. The aim of the pilot programme is to encourage international investors to invest in listed SMEs and to assess the impact of the availability of investment research on market liquidity.

<sup>23</sup> MiFID II: How It Could Hurt Small- And Medium-Sized Companies, Markus Mild / Principal Compliance Analyst & Regulatory Strategy, Nasdaq (6 July 2018)

## 5.8 Market infrastructure – trading and post-trade:

Investors were asked about the importance of market infrastructure features (both trade and post-trade) to their investment decision-making. Factors they were asked to consider included the presence of an electronic trading platform, ability to short-sell, presence of market makers, and the ability to engage in securities lending and borrowing etc.<sup>24</sup> Overall, investors rated these as ‘nice-to-have’ to ‘important’ but noted that the absence of these features would not prevent investment. The only consistent exceptions to this (where the presence of these was regarded as critical) were:

- Existence of a Delivery versus Payment (DvP) settlement system; and
- Presence of global custodians (mentioned by one investor as being a UCITS requirement).

In addition, some investors expressed a strong preference for a T+2 settlement system<sup>25</sup> and regarded the availability of near real-time pre- and post-trade data as being important. Similarly, a few investors noted their strong preference for omnibus accounts. One investor said they decided not to invest in a market when they learned that share certificates were warehoused in physical form with no back-up in place if the certificates were destroyed.

A few investors suggested that investment in market infrastructure (e.g. an electronic trading system) could contribute positively to the overall market development, but only once more fundamental issues are addressed.

## 5.9 Listings requirements / information disclosure

With regard to company reporting, investors by-and-large said they preferred financial reporting to be IFRS-aligned and for there to be English-language disclosure and reporting.<sup>26</sup> While in most cases these were highly desirable rather than critical to the investment decision, it was clear that investors that regarded this as important were less likely to incur the costs of doing the necessary translation for companies listed anywhere other than the “largest, most attractive markets”. Investors who relied on local fund managers said English language reporting was less relevant for them.

<sup>24</sup> See the questionnaire in Appendix 1 for the full set of features.

<sup>25</sup> There is consensus that lower settlement cycles are associated with lower costs, mitigation of counterparty risk and reduced margin requirements for clearing participants (see <http://www.ftseglobalmarkets.com/issues/issue-77-june-august-2014/towards-harmonisation-of-global-settlement-cycles.html> and <http://www.statestreet.com/ideas/articles/shortened-settlement-cycles.html>). In addition, following the migration to a T+2 settlement cycle in European capital markets (see <https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/market-infrastructure/past-initiatives/csdr-migration-to-t-2/>), exchanges are increasingly harmonising their settlement cycles, both in the developed and in the emerging world. The US, Canada, Mexico, Peru and Argentina all moved to a T+2 settlement cycle during 2017 (see <https://www.gbm.hsbc.com/financial-regulation/market-structure/t2-us-canada-mexico-peru>). The Stock Exchange of Thailand adopted a T+2 settlement cycle in 2018 (See <https://focus.world-exchanges.org/articles/journey-moving-towards-t2-thailand>) while B3 recognises the importance of moving to a T+2 settlement cycle and plans to move to this model in 2019 (source: [http://www.bmfbovespa.com.br/en\\_us/news/t-2-settlement-cycle.htm](http://www.bmfbovespa.com.br/en_us/news/t-2-settlement-cycle.htm) and WFE data). Other WFE emerging market member exchanges who have a T+2 settlement cycle are: the Amman Stock Exchange, BSE India Limited, Borsa Istanbul, Dubai Financial Market, Kazakhstan Stock Exchange, Moscow Exchange, National Stock Exchange of India, Taipei Exchange, Taiwan Stock Exchange, and Egyptian Exchange (Source: WFE data).

<sup>26</sup> Some investors noted that the lack of English-language disclosure was not solely an emerging market issue, but also a challenge in some developed markets.



## 5.10 Regulatory and legal considerations

Some investors noted that having contract enforceability and enforceability of netting and collateral positions was critical, as was the presence of strong insolvency or bankruptcy frameworks. For others this was either not specifically assessed or not regarded as critical. Two investors noted regulatory membership of IOSCO and/or exchange membership of the WFE as being positive indicators of commitment to international best practice.

Most investors regarded the presence of shareholder protections as being important to critical. This stems from the need to ensure that as minority shareholders, they are adequately protected. In some instances, it was very clear that investors believed minority shareholder rights were not always well-protected in emerging markets. However, a small number of investors said they would still invest even if relevant minority shareholder protections were not present, should the expected returns justify the risk.

## 5.11 Some investors are focused on the market composition

While there were no consistent themes on the question of whether foreign investors were concerned about concentration in the local investor base or other foreign investors in the market, the following observations are worth noting:

- One asset manager said after an experience where brokers executing on their behalf in a particular market had colluded to front-run their order, they preferred markets that had a more competitive broker environment;
- A few asset managers said they regarded the presence of local, institutional investors as a positive feature as this was likely to suggest greater market efficiency, and stability (lower volatility);
- One asset manager, while noting the positive benefits of local institutional investors cited above, also said this was likely to reduce inefficiency and therefore their ability to extract alpha.

## 5.12 ESG factors are important, no matter how you frame them

While investors might have different views on which environmental, social and governance (ESG) factors are relevant, and adopt different approaches to incorporating ESG factors, almost every investor<sup>27</sup> (including the index investor) said these were part of their investment decision-making and/or subsequent engagement. The primary reason given for this was because they believed mismanagement of these issues was likely to impact on the ability of the firm to produce returns over the long run.<sup>28</sup> Some investors noted that while they looked at ESG factors in both emerging and developed market investments, these issues were more likely to be relevant in emerging markets.

<sup>27</sup> The only exception was one university endowment fund, that said they thought it was very difficult to utilise ESG screens or frameworks in emerging markets. By contrast, the other university endowment fund had a formal policy on climate change as well as an advisory committee that provided input on social and ethical questions regarding investment decisions.

<sup>28</sup> This is separate from the exclusions mentioned earlier in the report where some investors excluded certain categories of investment entirely. These can more properly be understood as ethical investment positions or possibly (in relation to coal-divestment) as part of a broader climate-change strategy.

Looking at ESG in more detail:

- Corporate governance was important for all investors. Two investors (active asset managers) said explicitly that if a firm had poor corporate governance (as defined by their internal evaluation) they would not invest in that company. One investor explained that they performed an extremely detailed assessment of the corporate governance practices of the companies they invest in; analysed the structure and the composition of the boards, the nature of their transactions (they had a “related party transaction scorecard”), and even the independence of their accountants. They said they did not invest in firms where they were uncomfortable with their corporate governance practices. A large asset owner, in addition to excluding companies with poor environmental performance, also excluded companies that engaged in poor governance practices, such as corruption;
- Other investors said they assessed governance as an indicator of the firm’s ability to manage risks and opportunities, including those stemming from environmental and social factors (i.e. better governed companies were better at this);
- A few investors said they incorporated relevant ESG factors into their determination of the discount rate for the investment or expected cost of capital for the firm;
- One investor said that if the industry overall performed poorly on ESG factors, they might invest in the least-worst performers, with the intention of working with the firm to improve their performance over time;
- Flowing from the above, five investors (including the index investor) said that engaging with companies directly on ESG issues was a core part of their investment process, both when deciding whether to invest and throughout the life of the investment; and
- Most investors took a nuanced approach to incorporating ESG factors i.e. they did not adopt a one-size-fits-all approach but assessed which factors were relevant to which industries, size of company etc.

Investors rely on a variety of sources for company ESG information, including third party vendors and ratings agencies, as well as corporate reporting. However, one investor said they were somewhat sceptical about the accuracy of company ESG ratings and/or reporting and said they supplemented this with peer assessments and other information sources.

## Conclusion

The findings of this qualitative research report support those of our earlier quantitative research, and provide additional insight into how investors approach emerging market investment. Investors are not uniform in their investment approach. Thus, while they pursue investment returns, how they do this varies according to their investment strategy. These differences result in different views as to what factors make a market more or less attractive from an investment standpoint. Investors even diverged on the extent to which they wanted an emerging or frontier market to resemble a developed market. For many, having the market aligned with international best practice was highly desirable. For a few, this would remove the perceived investment opportunity. Despite these differences, there are several common themes that present opportunities for emerging market exchange operators and relevant regulators and policy-makers. These are set out below.

- Removing frictions helps – these include the time and effort to open an investment account, and investment costs, such as taxes, particularly if these are specific to foreign investors;
- Frictions include the costs of obtaining information – making concise, accurate easy-to-access information available about, for example, how to open an investment account, relevant regulatory provisions, tax information, and local brokers, reduces the costs for investors of finding out that information themselves. This is particularly relevant for smaller markets. As noted, investors may be willing to incur these search costs in larger, more liquid markets but are unlikely to do it for smaller markets;
- Following from the points about information availability, custodians are an important source of information for foreign investors – exchanges should engage with those operating in their markets as a channel to engaging with foreign investors;
- In many instances, investors are investing in specific companies, not the market. While exchanges and regulators do not have control over the economic performance of the companies listed on their markets, they can work to enhance the quality of corporate reporting (both through appropriate requirements, that are enforced, and company education), to emphasise the importance of an effective investor relations function that enables investor engagement with the firm management, to promote effective corporate governance and to educate companies about the relevance of ESG factors for their strategic decision-making;
- Market structure enhancements (electronic trading system, post-trade infrastructure etc.) will not attract investors into the market but they will improve perceptions of a market and in some instances, all else being equal, may make one market more attractive than another. Similarly, IFRS reporting and English-language disclosure are factors that enhance the attractiveness of companies in a particular market;
- Strong, local asset managers are beneficial and, in some instances, the determinant of whether an investor invests in the market; and
- Development of the local market is as important as attracting international investors and can in fact assist in attracting these investors. As noted, while foreign investors are not necessarily overly concerned about volatility, high levels of volatility will reduce the attractiveness of the market for local firms looking to raise capital, which reduces the range of investment options available in the market. Diversification of the investor base is therefore important. In addition, some investors have a preference for markets with a well-developed local institutional investor base.<sup>29</sup>

<sup>29</sup> Noting one investor said they preferred markets with high levels of retail participation because this improved their ability to find under-valued stocks.

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Investing in Emerging and Frontier Markets –  
An Investor Viewpoint

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