

## Effect of Frontier/Emerging Market Reclassifications on share prices

Market reclassification by index providers does not happen often, so investors do not always factor its potential effects into estimating their expected portfolio returns. About \$10 trillion of assets are benchmarked to MSCI's developed-, emerging-, frontier-, and stand-alone–markets indices. Changes in the composition of this provider's indices will have a material impact on investment flows. For example, when MSCI announced in June 2013 that Qatar and the United Arab Emirates would be promoted from Frontier to Emerging market status as of June 2014, these markets increased by 54.3% and 98.3% respectively during the period.

### Study

Given the huge importance of the MSCI indices and the fact that reclassifications require thousands of asset managers to decide how to react, it is surprising that there has been little systematic study of what happens around reclassification events. Apart from some event-driven broker research, there are only two scientific publications on this subject. The most recent article was published in 2017 in the CFA Institute Financial Analyst Journal: "Investing in the Presence of Massive Flows" by Burnham, Gakidis and Wurgler.

Looking at 17 MSCI reclassifications between 2000 and 2015, the authors investigated what happens to market returns before, during, and after reclassification. They found that when a market is upgraded, for example from frontier to emerging, its MSCI country index rises, on average, by 23.2% between the announcement date and the effective date, or when the reclassification occurs. A year after the reclassification, most of this extra performance is given back through a -12.4% return. Similarly, when a market is downgraded, the average performance between the announcement date and the effective date is -12.5%. A year later, the market enjoys a 23.3% return.

### Not efficient

Although the above sample is relatively small the analysis still gives an indication that apparently markets are not efficient. It is also striking that the markets do not suddenly rise or fall with a reclassification but that this goes gradually. This offers opportunities for investors to anticipate or respond to such events.

Pakistan (2017) and Argentina (2019) recently promoted from Frontier to Emerging Market status. Both cases confirmed the expected direction of the price movements we learned from the analysis above. The market in Pakistan rose more than 26% in the run-up to the promotion and dropped more than 28% in the following year. Argentina rose more than 15% in the year before the promotion and has since fallen by more than 25%, measured in euro.

The exit of Argentina out of the Frontier Market (FM) index, left a huge gap since the country had the second highest weighting (15%) within this index. The gap was filled by giving the remaining countries a higher weighting. Kuwait has therefore become even larger within the FM index with a weighting of no less than 31.5%; so actually a promotion within the index itself.

At the same time MSCI announced that Kuwait will most likely be promoted to the Emerging Market (EM) index by June 2020. Partly due to these developments, the market in Kuwait is up by 20% since the start of the year.

### **Vietnam**

Looking ahead we see that Vietnam is most likely the next candidate that will benefit from the above statistical trends. Once Kuwait exits the Frontier Markets index, Vietnam will become the largest country within the FM index. So that means a promotion within the index itself, whereby the weighting increases from 18% to around 27%.

In addition, MSCI is expected to announce in June 2020 that Vietnam will be promoted to the index of emerging countries per June 2021. MSCI-EM inclusion is significant for Vietnam as there are about \$200 billion of ETFs that track the MSCI-EM index. When Vietnam gets included in the MSCI-EM index it will almost certainly trigger over \$3 billion of inflows to its stock market.

October 2019

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