MOBILIST

MOBILISING INSTITUTIONAL
CAPITAL THROUGH
LISTED PRODUCTS

DRIVERS OF INVESTMENT FLOWS TO EMERGING AND FRONTIER MARKETS

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About MOBILIST

A flagship UK government programme, Mobilising Institutional Capital Through Listed Product Structures (MOBILIST) supports investment solutions that help deliver the climate transition and the United Nation's Global Goals in developing economies. MOBILIST focuses on mobilising institutional capital to spur new scalable and replicable financial products. MOBILIST invests capital, delivers technical assistance, conducts research and builds partnerships to catalyse investment in new listed products. For more information about the MOBILIST programme visit our website.

About This Report

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EXECUTIVE SUMMARY

- We have analysed the impediments to greater flows of institutional investment into emerging and frontier markets particularly in respect to information asymmetries. This was based on interviews with 52 market professionals working in a range of functions from pension funds to asset managers and consultants.
- We focused on investment decisions by pension funds, sovereign wealth funds, endowments and asset managers (including insurers). Generally, such institutions have small allocations to emerging markets and even smaller allocations to frontier markets. Large pension funds generally allocate 10%-20% and sovereign wealth funds on average allocate 22%. Foundations provide a potential catalytic source of capital with appetite for social-first impact investment that could de-risk investments for commercial investors.
- We broke down the investment decision process to top-down factors and bottom-up factors. Top-down factors include traditional asset allocation strategies based on risk and return expectations, as well as funds' liquidity needs, risk tolerance and return targets. Top-down decisions include the imposition of ESG policies on portfolios. Various "push" factors also determine top-down decisions including global monetary policy conditions.
- Bottom-up factors include target market and issuer features. These include political stability, financial market regulation and infrastructure, market liquidity and currency convertibility fiscal conditions, local economic factors and valuations of firms.
- Regarding top-down factors:
    - We found generally negative views on the returns outlook for emerging markets. This was driven by both recent underperformance in emerging markets and a relatively negative outlook for emerging markets growth relative to developed markets. This was often contrasted with the period from 2000-2008, which was seen as a "golden age" for frontier markets, with significant outperformance and significant marketing of prominent funds and investors. The general case made during that time – that emerging markets offered "catch up" growth prospects and low correlations with developed markets – is no longer convincing investors.
    - These expectations, as well as the historic data that usually factors into models, mean that some large asset owners are expecting to down weight emerging markets in their asset allocation strategies.
    - An increasingly significant factor is the application of environmental, social and governance (ESG) considerations in forming an investment policy. There is a very wide set of practices and assumptions about ESG. Motives for applying ESG include seeking alpha, limiting reputational risk and marketing. Generally, however, funds applied screens that either excluded or down-weighted emerging and frontier markets. While ESG is classically applied to companies, increasingly fund managers are applying ESG assessments to countries, both for sovereign debt but also as part of the assessment of firms in those countries. This effectively creates an "ESG ceiling" for many markets. The probability that ESG strategies could systematically direct capital away from emerging and particularly frontier markets was seen by interviewees as a perverse outcome.
    - Amplifying this tendency is the lack of good ESG data in many emerging and frontier markets. Data tend to be more available regarding environmental factors

than social factors, and some interviewees reported that this tends to mean environmental factors are more decisive in emerging and frontier market investment decisions, as models tend to be driven by the more available environmental data.

- Some interviewees used an active ESG approach in addition to, or instead of, ESG screening. Active approaches aim to identify investment opportunities that would directly improve ESG outcomes, rather than only screen out investments that did meet ESG criteria. Interviewees often used the Sustainable Development Goals (SDGs) as a set of targets, selecting investments that would maximise delivery on the SDGs. These approaches focused on "additionality" – i.e., the addition to the stock of positive ESG outcomes, however these are measured. However, our interviewees reported significant challenges in developing systematic additionality investing, particularly related to accessing data.

- Bottom-up considerations focused on features of the markets themselves. While classically bottom-up analysis focuses on valuations at individual security level, in global emerging market strategies such analysis is applied at country through to firm level. These considered:
  - Political risk, including probabilities of adverse policy changes, convertibility of currency and fiscal sustainability.
  - Market regulation including reliability of custody and settlement when trading on domestic exchanges.
  - Availability of market data with some frontier markets criticised for poor data such as market depth, volumes and trade prices. Interviewees were also concerned about being disadvantaged in local market knowledge around trading conditions including volumes and expected spreads. Such weaknesses related to poor regulation or poor technology used by exchanges.
  - Market development, particularly the extent to which domestic institutional investment can diversify flows, enhance liquidity, build greater domestic transparency and provide political support for good capital markets regulation.
  - Valuations were naturally a material bottom-up consideration and respondents highlighted the data challenges to confidently undertake them including weak corporate reporting in many emerging markets (but interviewees downplayed the impact of different accounting standards).
- These bottom-up considerations are all varieties of information asymmetries in that investors must factor in higher risk premia because investment costs and the outlook for investments are more uncertain. However, emerging market specialist managers described these conditions as the reason that emerging markets and frontier markets offer alpha. They saw their competitive advantage being the ability to manage these information asymmetries, even though they are welcoming in general of efforts to improve market conditions. Managers emphasised that emerging and (more so) frontier investing requires active strategies and extensive on-the-ground research.
- Several market-based innovations have attempted to deal with these asymmetries. Global depository receipts and secondary listings can (but do not necessarily) help with liquidity, custody and settlement risk and some reporting improvements for issuers. Similar outcomes can be achieved with total return swaps issued by investment banks. Some investors use political risk insurance to manage risk and there are various providers of alternative data to provide innovative insights for market and firm-level outlooks.
- Our recommendations to MOBILIST include:
  - Commission research to develop concepts of ESG additionality and practical tools for investors to deliver it, including momentum indicators and indices that upweight

capital recipients who are thereby enabled to deliver on SDG targets. Alongside this research wider education is needed to shift the perceptions of reputation risks (often called “headline risk”, being the risk of a newspaper headline that focuses attention on their funds). Funds should recognise that a strategy that deliberately biases capital from the poorest regions most in need of it, is itself a headline risk.

- Particularly in frontier markets with weak capital markets and under resourced firms, simple digital information gathering and dissemination tools need to be developed to capture both traditional market information and ESG information. These need to be low-cost for both the issuer and investor.
- Domestic financial market development is crucial to attract more global flows. Several development finance institutions have active programmes to assist governments to develop local financial systems. Further research should identify areas that MOBILIST can collaborate to catalyse domestic market development. Such efforts can complement the mobilisation of global capital flows, which can be used to crowd in domestic investors.
- Insurance is generally underutilised, with our research showing that portfolio managers seldom appreciate the risk implications of issuers that obtain insurance cover. London’s commercial insurance market, as well as the export credit insurer in the public sector, could provide mechanisms to improve both risk products and the understanding of the function of these by professional investors. As part of investment mobilisation, therefore, we recommend collaborating with the insurance industry to develop political risk insurance tools for portfolio investors, including expropriation risk and risk of disruptions to the convertibility of currencies and repatriation of investment proceeds.

01

PROBLEM STATEMENT AND RESEARCH QUESTIONS

01 Problem Statement and Research Questions

The problem statement that has guided this research is:

Emerging and frontier markets require significant investment volumes to develop but developed market investment allocations fall short of these requirements. This shortfall is driven in part by information asymmetries that face developed market investors relative to issuers in the target markets. We will investigate drivers of investment allocations to emerging markets to determine what mechanisms can be developed to overcome these information asymmetries and improve investment flows.

This problem statement encapsulates the four research questions we have aimed to answer:

1. Strategy: How do asset allocators rationalise their emerging/frontier economy listed market strategies? How does this vary between allocators, markets and asset classes? How has the rationale evolved over time? How does this work within segregated funds and in multi-asset funds? How does asset manager firm level strategy affect multi-asset or global funds vs specialist funds for emerging and frontier markets?
2. Information: To what extent do information asymmetries determine which emerging and frontier market economies and listed asset classes are prioritised by international investors? What are the cost benefit analyses that fund managers consider in dealing with these asymmetries? How do these asymmetries differ between EM dedicated and multi-asset funds? What role can EM specialists play across firms and funds? Where does climate expertise sit in large funds and how knowledgeable is it of specific emerging market issues?
3. Solutions: What market-based or policy/regulatory solutions have helped overcome information asymmetries for two or three case study emerging/frontier markets or asset classes? These could include cross-listing, peer networks, investment platforms, in-market local partnerships, M&A and mandatory disclosure frameworks.
4. Outlook: How are allocation strategies for emerging and frontier market listed assets changing (and likely to change) in the context of key megatrends, including a slowdown in China, rapid urbanisation and infrastructure demand, the rise of mandatory ESG disclosures and climate change? How are research budgets/headcounts and/or other solutions set to evolve to deal with asymmetries of information? We also consider some other large structural shifts including developed market central bank deleveraging and the impact this has on emerging/frontier flows.

In answering these research questions, we focused on the investment decision perspective. The case studies contribute to understanding how a market has changed from an institutional investor perspective, with policy/regulatory solutions implemented at market level that have unlocked greater investment flows.

02

CONCEPTUAL FRAMEWORK

02 Conceptual Framework

Modern portfolio management includes bottom-up and top-down investment analysis (Goetzmann 2020) in determining which assets to hold in a portfolio. Bottom-up analysis examines investment instruments to determine a case for investment (B. Graham and Dodd 1934). Top-down analysis considers portfolio-wide features including macroeconomic assumptions and correlations between assets. Top-down decisions include asset allocation targets, benchmarks and overall portfolio features such as compliance with environmental, social and governance (ESG) factors. Bottom-up decisions consider the outlook for earnings from individual securities, the risks associated with investing in those securities and the risks to the outlook.

Our analysis adopts this framework in assessing the factors that constrain flows. Investors make allocation decisions based on mandates and investment policy statements, including time horizon, liquidity needs, risk tolerance and, occasionally, other factors such as ESG and impact objectives. The mandate in the case of asset managers, and the investment policy statement in the case of pension funds and other asset owners are binding on investment decisions. Our conceptual framework prioritises this point as no amount of development at the product level can overcome constraints that exist at the investment policy level.

In contrast, individual investment opportunities in emerging and frontier markets present (or fail to present) specific opportunities for appropriate return and risk, and the satisfaction of other objectives. Typically, top-down factors are exogenous to the particular sovereign or firm being considered while bottom-up analysis considers endogenous factors. Top-down and bottom-up decisions are not independent. Conceptually it may be the case that there are top-down allocations to emerging markets that fail to be invested because of a lack of bottom-up opportunities. A related concept is the existence of push and pull factors in investment decisions. Push features include economic conditions outside the host country (exogenous) such as global interest rates while pull factors consider features within the host country (endogenous) (Kim, Choi, and Kim 2013). Top-down analysis tends to identify push factors while bottom-up analysis focuses on pull factors. These can be in tension with each other.

We consider “return” to include both traditional financial returns and more recent concepts such as social return on investment (Arvidson et al. 2013) and the satisfaction of impact or ESG factors. Return and risk objectives are top-down decisions, including how returns are conceptualised. The assessment of individual investment opportunities in terms of their ability to meet those objectives is bottom-up.

The concepts of “emerging” and “frontier” markets are also treated inconsistently. For investors, the most important definitions are those incorporated into indices, and we have been guided by the proximate definitions these provide rather than debating the definitions that are used in determining index eligibility. The MSCI Emerging Markets index, for example, consists of shares listed in 24 countries and the MSCI Frontier Markets index a further 28 countries. Bond indices tend to have a wider inclusion as many governments can issue at sufficient scale even if their domestic companies cannot. Beyond these there is a further category that is sometimes called “fragile” states, which have not been considered in this study.

The report begins with an analysis of the broad market structure, including the types of investors and market infrastructure like indices, benchmarks and data providers. We then briefly consider the features of key asset classes.

Having set this background, the focus of analysis is on the decision making at top-down and bottom-up processes and how these factor into emerging and frontier market flows.

03

METHODOLOGY

03 Methodology

We have used a mixed methods approach centred on a qualitative interview-based research process supported by desktop secondary research to develop conceptual and theoretical clarity and quantitative research on market data.

Interviews used a semi-structured questionnaire based on observational research principles. Our intention was to understand investment behaviour as it is practised. While our interviews sought to obtain specific information, we also allowed interviewees wide latitude to provide input they considered relevant. This ensured we did not lead interviewees to predetermined conclusions. We also assured interviewees that they would not be cited by name or organisation. Among other features of this approach, it allowed an insight into contemporary practice in fast-changing market conditions. The interviews took place in February and March 2022, a period marked by several prominent global events including the Russian invasion of Ukraine, rising global inflation and interest rates and the lingering effects of the Covid-19 pandemic. This had practical implications on the fieldwork as many potential interviewees were unable to engage because of the intense demands on their time to manage through these challenges. But the methodological risk is also that recent events may have played an outsized role in the input provided. We attempt to draw out and manage any such impact in the analysis of the report.

In total, 52 interviews were undertaken. Respondents were selected to provide a range of relevant perspectives, including asset owners, asset managers, various consultants and sell-side analysts (see Appendix A for a list of the types of respondents). We also interviewed several data providers and other experts. Interviews were mostly done via Microsoft Teams, with a few exceptions where Zoom was used to accommodate system requirements and one interview was done in person. Interviews were 30-90 minutes in duration, with most at 60 minutes.

This input was consolidated and coded in developing the insights, providing data we present at various points in this report. However, the majority of input provided by interviewees was anecdotal, sharing opinions and experiences. We draw on these anecdotes through direct quotes in the report, helping to provide colour on the practices of investors. We draw on the literature and quantitative data sources to provide context and wider evidence to interpret these. Qualitative information gathered through the interviews helps us understand in much greater depth, from the perspective of investors themselves, what the aggregated data mean. It allows us to begin to untangle what the processes are that lead to the broad trends we see in the data.

04

INTRODUCTION

04 Introduction

Substantial investment is required into emerging and frontier markets to deliver on the sustainable development goals (SDGs). The UN estimates that the annual investment gap for developing countries is $2.5tn from 2015 to 2030 (Giroud and Ivarsson 2020), implying total additional investment flows of over $37.5tn, equivalent to approximately 20% of the market capitalisation of all the world's stock markets and bond markets combined. The 2030 goal is now only eight years away, adding urgency to finding ways of stimulating investment flows to emerging and frontier markets.

This investment gap is over and above the current annual investment of $1.4tn into emerging and frontier markets. The potential economic growth that would follow a successful improvement of living standards to meet the SDGs would be an attractive opportunity for return-seeking capital. Yet, as we discuss in this report, the performance of emerging and frontier markets has lagged developed markets over the last decade, a discouraging outcome. This presents a paradox in that flows are needed to boost development, yet a lack of development constrains flows. As we show in this report, this is becoming more acute.

Typically, investors are focused on generating returns and managing risk, but increasingly this standard portfolio management approach has been complemented by a concern over the effects of investment on society and the environment. This has the potential to support development, including the social and environmental targets of the SDGs. Such investment strategies, in which financial outcomes are not the only goal[1], have evolved into the global environmental, social and governance (ESG) movement. Yet, as we show in this report, investors interpret ESG in different ways, not all of which are positive for development. As we discuss below, many investors integrate ESG into their investment decisions by screening out investments that fail to meet ESG benchmarks, which can include corruption perceptions, levels of inequality and other metrics. This can bias capital away from countries with the largest investment gaps.

Information asymmetries worsen the investment case for emerging and frontier markets. These arise where investors have less information than investment insiders and cannot make optimal investment decisions. Asymmetries have long been a feature of financial markets (Jensen and Meckling 1976) and are extensively analysed in information economics (Stiglitz 2002), but the development of ESG as part of investment decision-making has substantially increased the scope for such asymmetries. Issuers, be they sovereigns or companies, that can provide the necessary information to investors will be able to meet ESG investment requirements and so attract more capital. As we report below, the experience of professional investors is generally that information is scarce in emerging and frontier markets, particularly ESG-related information. The literature confirms this: high-performing ESG firms tend to provide rich information (DeLisle, Grant, and Mao 2021), including financial information. As we outline in this report, emerging, and frontier markets more so, are not environments of rich information either for firms or sovereigns.

There are many market interventions that are designed to reduce asymmetries. Extensive corporate financial audit and reporting processes, management incentives and corporate governance structures are the traditional response to classical information asymmetries. ESG is gradually developing interventions to solve information asymmetries too, including ESG indices, independent ESG ratings, online origination platforms and information guarantees such as green bond and social bond frameworks that define how the use of proceeds can be verified. Such technology reduces asymmetries and thereby reduces the costs of trading, leading to lower costs of capital for firms and governments. However, the development of information mechanisms such as these also requires resources, leaving many emerging markets in a double bind. Research in the United Kingdom on origination platforms that attempt to match investors and investees for place-based impact investment opportunities and standardise this process also demonstrates that information is one constraint among many (Impact Investing Institute 2022). In particular, impact opportunities tend to have unique product and development features, meaning each new opportunity, rather than region or asset class, will have its own, specific information needs and dealmaking cannot be standardised.

[1] Although, our research included several investors who argue that ESG is return enhancing, effectively reducing it to a return maximising strategy

Furthermore, more information about investment opportunities often cannot substitute for trusted relationships between parties that make (especially novel or unusual) deals possible.

Nevertheless, there is a vibrant emerging markets investment industry. As we show in this report, those who succeed in their investment strategies focus on first-hand, on-the-ground research. This makes the costs higher than traditional investments, but our interviewees make clear that the financial rewards can justify these costs, including when the aim is to deliver additional social and environmental investment to meet the SDGs.

The insights that follow stem from conversations with 52 experts, ranging from large asset owners with portfolios invested in emerging and frontier markets to asset managers who run them. We have also interviewed consultants who advise pension funds and other investors, investment bankers who raise new investment for new projects in Africa, as well as specialist data providers and others. These experts generally were emerging or frontier market specialists, which brings a level of confirmation bias – we are talking to people who already believe, to varying degrees, that emerging and frontier markets are an investment opportunity worth grasping. Many more investors have no emerging markets exposure and either have not considered or have actively chosen to reject them. This is the constituency that could make a big difference to the flows of capital to emerging and frontier markets. This research identifies how specialist investors solve the information asymmetries and other challenges that discourage those who do not invest. We identify from them the barriers to increased flows and the opportunities for MOBILIST to contribute to resolving the challenges.

This report starts with a description of the major types of investors that are relevant to the discussion. Many of these were covered in our primary research, though not all (for example, retail investors). We draw out the specific objectives they have and the key features that affect their decisions on allocations to emerging and frontier markets. We then consider other aspects of the structure of investment markets, including indices and various market interventions that aim to resolve the challenges investors face in allocating capital to emerging and frontier markets. We then consider the asset classes and the features of these that are relevant to greater flows.

The second half of the report analyses the investment decision-making process, starting with top-down considerations and then bottom-up. This draws out the various information asymmetries that frustrate analysis and therefore the allocations that can be made.

The study points to the challenges that investors in emerging markets face, but it also provides a timely reckoning with how these challenges can be addressed to increase finance to emerging and frontier markets in their efforts to deliver on the SDGs.
These challenges centre on the availability of information.

05

MARKET STRUCTURE

Investor Types

The investment world ranges from giant sovereign wealth funds to micro specialised impact funds. This diversity supports markets by ensuring there is a mix of investment incentives that can balance out demand and supply. In the interests of building flows to emerging and frontier markets it helps to understand some relevant features of fund types.

Pension Funds

Pension funds are the single largest source of institutional capital, with $35tn invested worldwide (OECD 2021). However, they are also generally seen as one of the most conservative of investor categories. As suggests one investment manager at a DFI that coinvests with institutions: “we have bumped into a very conservative investment culture and that is the way institutional investors are groomed and how they look at investing. It is all based on track records and liquidity and not doing things those other investors don’t do, so [it’s] typical herd behaviour”. That fund manager talks of frustrations with traditional investors who demand 20 years of data on price performance and other requirements which make it difficult to develop new impact investment products.

Pension fund investment strategy differs materially for defined contribution (DC) and defined benefit (DB) funds. In most jurisdictions, DC funds are required to maintain segregated accounts for each fund member and to provide regular valuations of portfolios. This imposes a higher liquidity requirement and generally means DC funds have lower emerging and frontier market exposures, with one estimate putting DC emerging market allocations at 0.5% of assets in the third quarter of 2021 (Callan 2021). This is arguably inefficient for investors – pension funds have long time horizons and members should be able to afford to sacrifice liquidity in return for a liquidity premium. Recognising this general point, several developed markets have begun reforms to create long-term investment vehicles that DC funds can access, although the illiquid assets generally targeted are infrastructure and private equity (see FCA 2021 and European Commission 2020).

DB funds, in contrast, hold a diverse portfolio to meet long-term liabilities to members. They are more easily able to hold emerging markets investments. Certain large global defined benefit plans such as the Ontario Teachers’ Pension Plan hold exposures to emerging markets fixed income (36% of the $16bn credit portfolio is in emerging markets sovereign debt), and real estate (9% of a $29bn portfolio), but no equity (that was separately disclosed) (Ontario Teachers’ 2020). The largest pension fund in the UK holds £82bn of assets, with 6.5% invested in emerging markets equity and 9.7% in emerging markets debt (USS 2021).

In 2003, the California Public Employees’ Retirement System (CalPERS) summarily terminated exposures to markets, including Malaysia, Thailand, India, Indonesia and China, based on political and economic issues. It adjusted its approach in 2007, incorporating instead a principles-based approach that would allow investments in companies that met ESG criteria no matter the country (Eccles and Sesia 2009). However, by this year, the fund was significantly underweight in emerging markets, though was considering increasing its emerging markets bonds exposure to 5% from 1%, a change that would require CalPERS to purchase $25bn of emerging market debt (Massa, Xie, and Gittelsohn 2021). CalPERS manages $500bn of assets, so relatively small changes in asset allocation can have a big impact on flows. Other pension funds we interviewed had reasonably large emerging markets exposures, although there was concern that given underperformance relative to the US market, these exposures were set to be reduced.

Our interviews identified the reticence of pension funds to take greater emerging and frontier market exposure because of reputational risk and, relatedly, the ESG screening approaches used. Reputational risks are quite distinct from traditional investment decision-making and can result in investment strategies that conflict with optimal portfolio strategy. For example, funds that avoid emerging markets exposure because of concerns over

Pension funds have also been investing increasingly in private equity (though largely in developed markets), particularly among DB funds. CalPERS, for instance, has recently raised its target for private equity asset allocation to 13% and had invested nearly 10% last year (Baruch 2022). Private equity shares some illiquidity features with emerging markets, though it has far higher investor control of ultimate investee company behaviour. Private equity and debt could, however, present a mechanism to overcome challenges with public capital markets in emerging and frontier markets.

Nevertheless, as with other institutional investors (see the foundations section below), investment strategies that intend to deliver on SDGs are still very new. In the view of an experienced pension fund consultant, while there may be significant interest among pension funds in emerging market equities – mostly as part of global funds but also within dedicated emerging market funds – exposure to impact opportunities is minimal, especially within frontier markets.

This is difficult to shift – setting up an emerging markets strategy for a large pension fund comes with high start-up costs. An asset consultant said “it’s going to be hard for me to justify or to endorse a recommendation to allocate to emerging markets, unless the pension funds are willing to put at least 5% in. And the reason for that is that there’s no point spending time, officer time, advisor time, monitoring and investment if it’s not going to move the needle at the total fund level. Why bother? So, because there’s a cost associated with doing that, unless the fund is willing to put in at least 5% there’s not really much point”.

Respondents were asked if they knew about any pension funds in the UK that had made an impact investment in an emerging market. One consultant said: “you know, there is movement in the UK [around the responsible investment of pension funds], but it really remains at the beginning of the journey… if you have a Venn diagram of pension funds doing impact investments and pension funds investing in emerging markets, the sort of middle of the Venn diagram is so small that actually I think I will struggle … in terms of giving you very concrete examples”.

This is reinforced by a common view among interviewees that there is a lack of transparency in reporting about impact, whether this is due to a lack of knowledge or experience, a proliferation of reporting frameworks for impact, or reasons relating to a desire for privacy or protection of proprietary information. The latter factor is far more evident among corporate pension funds compared to local government or DC schemes where disclosure requirements are more stringent.

In the first consultant’s engagements with pension funds, the primary reason for not engaging with impact investing over the years has remained consistently the lack of information and knowledge of impact investing. This tends to dominate concerns about conflicts with fiduciary duty and questions around the investment pipeline and a lack of opportunities, and the scale of impact investments.

However, interviewees remain optimistic that this state of affairs will change – primarily due to pressure from regulators around sustainability disclosures, more awareness from pension holders about responsible investing (see for example the Make My Money Matter campaign) and a “mindset shift” among consultants to pension funds, specifically around the compatibility of fiduciary duty with impact investing. Pension funds tend to rely heavily on consultants and “getting them on board” is regarded as key.

Sovereign Wealth Funds

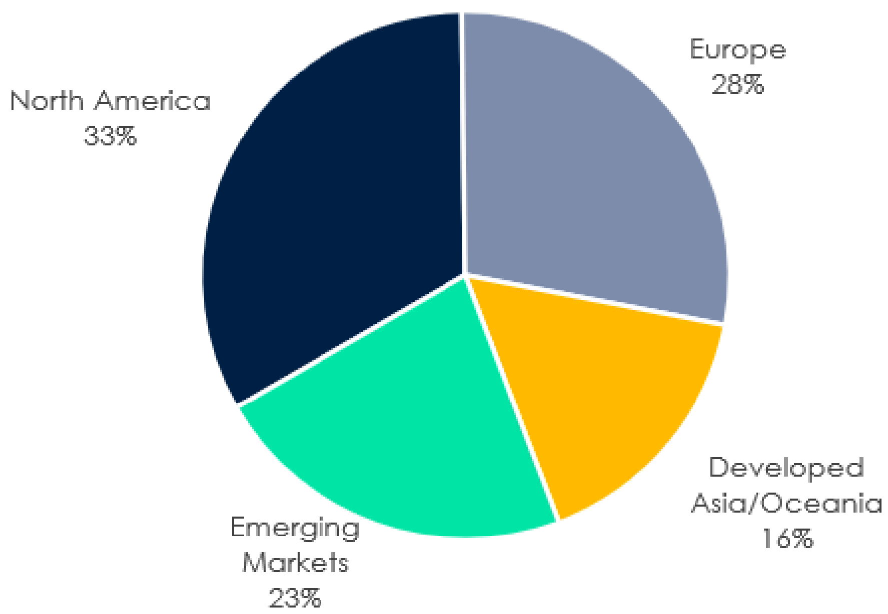
Sovereign wealth funds (SWFs) manage $10.5tn in assets (Lopez 2022) while a further $21.4tn is held in prefunded public pension funds. Such national pension funds are often categorised with SWFs as they exist to satisfy a liability facing the state and often have similar investment-decision characteristics (i.e., investment strategy is heavily influenced by governments). The SWF universe consists of many divergent strategies. Some focus exclusively on domestic development agendas while others follow regional strategies.

The world's largest SWF is Norway's Norges Bank Investment Management with $1.4tn in assets. It has equity interests in over 9,000 listed companies across 69 countries holding an average of 1% of each. Norway's fund is an interesting case study as one of the world's largest investors with a well-developed and articulated investment strategy. It is instructive that the fund has had a mixed history in emerging markets. In 2018, about 7% of the fund was invested in emerging markets, but at that point it undertook a review of its strategy (Nicolaisen and Slyngstad 2019). The board considered the relative underperformance of emerging markets and the various sources of risk that emerging markets posed. Among these was the "reputational impact" of the financial, political and operational risks. The fund was ultimately instructed by its political lead, the Norwegian finance ministry, to remove emerging market debt from its benchmark, with the intention of reducing "transaction costs in the management of the funds" (Samson 2019). The fund had held 8.2% of its fixed income holding in emerging market debt, with debt targeted at 30% of the fund's total holdings. The fund continues to hold some exposure to emerging market debt as a way of generating alpha, but its benchmark sets the performance expectations.

Other funds like Singapore's GIC have $34.3bn, of which 13%-15% is invested in emerging markets, though its sister fund Temasek has 29% of its assets invested in emerging markets. Overall, research by SWF Global found that 22% of SWF assets were invested in emerging markets, the lowest proportion in six years.

Figure 1: Destination regions of SWF investments in 2021

Sovereign wealth funds studied by SWF Global invested $219bn in 2021, with emerging markets receiving 23%.



Source: SWF Global (Lopez 2022). Note: based on sample of SWFs

Sovereign wealth funds present a good opportunity for increased emerging and frontier market flows. There is arguably less sensitivity regarding reputational risk and far less sensitivity to liquidity risks.

Foundations

UBS Global Philanthropy estimated that a large sample of 260,000 foundations held about $1.5tn in assets in 2018. The bulk of these are held in Europe and North America (97%) (Johnson 2018). There is significant scope to increase the proportion of these assets dedicated to the achievement of the SDGs in the developing world. This is firstly due to foundations' location on the impact end of the investment spectrum: traditional philanthropy is concerned primarily (or only) with social impact rather than financial returns. Secondly (and relatedly), foundations' larger tolerance for financial risk relative to other types of institutional investors (at least with their operating budgets) can be useful in blended finance vehicles that make individual transactions or vehicles more investable for commercial investors, thus increasing the pool of capital committed to impact (Spengler, Arnoldi, and Moses 2021).

Foundations that support initiatives in emerging and frontier markets typically deploy grants, with minimal interest in financial investment vehicles. This follows the traditional foreign aid approach. Like aid, however, there is increasing interest in improving the sustainability of the support provided and of the grantee organisations themselves by incorporating repayment conditions and results-based contracting terms, among others. A director of a large European foundation said of her foundation's move from philanthropy to impact investing: "if we want to leave and we don't want to work anymore, there won't be enough money to sustain the benefits of our work. I mean, we're creating dependencies and we cannot sustain this [with traditional philanthropy]".

To pursue impact investing, this foundation established two new entities: one that would build on the work of the foundation in Africa in venture philanthropy, and another asset management firm which would establish an evergreen debt fund to grow (especially agricultural) companies in sub-Saharan Africa. The former entity provides grant support, convertible loans and technical assistance (for example in relation to impact management and measurement), to build the capacity of grantees to become self-sustaining social enterprise-type organisations. This in turn builds a pipeline of investable companies for the asset management firm, and more broadly, assists these grantees' ability to access capital in the financial markets.

A benefit of impact investing for foundations is that grants can be recycled: the possibility of repayment potentially makes every dollar spent go further as it can be redeployed to new projects and organisations. A particularly important role for foundations is in blended finance vehicles. Here their greater tolerance for financial losses can be wielded to secure their participation as providers of catalytic first-loss capital (CFLC). Foundation capital is invested in a layered structure with a higher risk profile. Should the underlying investment activity underperform, the foundation is the first to take losses. This loss absorption (up to a certain extent) can make investments further down the waterfall more appealing for commercial investors who otherwise would not be able to accept the risks, be those lack of liquidity, lack of track record and information about investees, or lack of experience among investors themselves. This de-risking role by foundations can be used to build demonstration cases for a particular investment or type of investment. This is a market-building exercise that could make impact investing more doable by commercial investors (Spengler, Arnoldi, and Moses 2021).

In developed markets – particularly the US and UK – there is already some noteworthy impact investing activity where a local foundation has provided CFLC for investment in local social enterprises. But this is much less true for European or American foundations making impact investments (rather than pure grant deployment) in emerging markets. This is partly because blended finance is still very new. It is also due to the relative size of foundation capital versus the rest of institutional investment capital: $1.5tn of about $154tn (Johnson 2018). The amount of philanthropic capital available to mobilise large amounts of commercial investment is thus very limited.

This constraint was mentioned by two of our interviewees, who hoped that DFIs could play a larger mobilising role. This could be in the provision of, for example, first loss capital to de-risk commercial investment and to complement philanthropic capital. However, one interviewee mentioned that instead, in their experience of planning for blended finance, DFIs based in some developed markets often take senior positions in blended finance vehicles. This reduces the potential for capital mobilisation.

Problems relating to track record and information about social enterprises in the home countries of European and British foundations are exacerbated in emerging and frontier markets, where foundations might not have local expertise or knowledge, or where local social enterprises are far less established. An additional role for DFIs in sharing data was suggested by another interviewee. "As you know there are lots of data vendors – MSCI etc – and to be frank for some companies these are very prohibitively expensive datasets". DFIs and other public sector entities were regarded as potentially having an important leading role in this regard.

One way that foundations are working around the size and information constraints is by establishing funds of foundations. This has shown promise in Spain, where 11 foundations – under the leadership of an experienced impact investing foundation – have pooled portions of their operating budgets with a shared governance structure to make sizeable impact investments in Spain, while increasing participating foundations' knowledge and practical experience of impact investing and venture philanthropy.

A final, large source of philanthropic capital to mobilise for the SDGs in developing countries are university endowments. Harvard University, for example, holds an endowment that is larger than the GDP of Bolivia, with the top 10 endowments in the US holding more than $200bn in assets (Moody 2021). Fiduciary duty tends to be interpreted as ensuring the long-term viability of the university. This longer-term focus is amenable to social impact investing, which typically has longer time horizons than financial performance. However, investment strategies tend to the conservative.

A final point worth mentioning is that impact tends to be pursued through foundations' operating budgets, rather than in the investments made with the foundations' endowments. Endowments (from which operating budgets flow) represent larger pools of capital but tend to be invested in the same ways as other institutional investors: financial risk/return analyses dominate. One of the large British foundations in our research has committed to allocating 10% of its endowment to impact. However, investments within this allocation are made almost exclusively in the UK. This is because impact investments are perceived as novel and relatively untested even within the domestic context: navigating this new terrain in unfamiliar emerging markets seems too complex for the time being.

Asset Managers

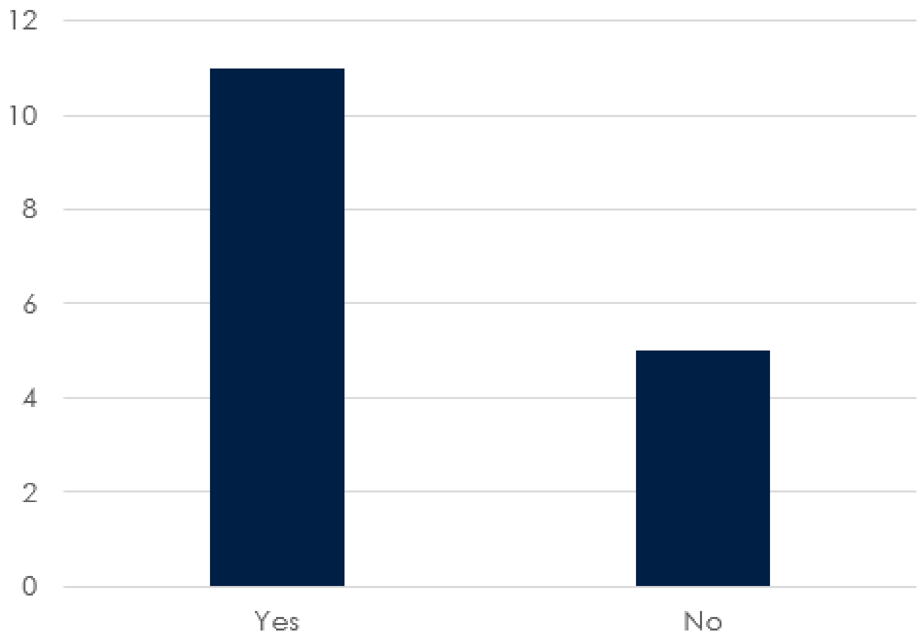
Asset owners and retail investors often outsource the management of their assets to asset managers who manage portfolios according to specific mandates. Asset managers tend to set up funds based on perceptions of market interest or create segregated mandates for large institutional clients which are managed according to that mandate.

Asset management firms range from very large, topped by BlackRock with over $10tn in assets under management (Wigglesworth and Agnew 2022), to countless small managers with specialist orientations. UK-headquartered asset managers have $9.4tn in assets under management (AUM), of which $36bn is managed in emerging markets equities and $8.7bn in emerging markets debt (The IA 2022). Of the total AUM, 24% is on behalf of retail investors and 76% on behalf of institutional investors. Asset managers range from highly active investors conducting extensive on-the-ground research and engaging with companies and sovereigns, to passive managers who mechanically track an index. The industry consists of large houses with portfolios across the globe to specialist houses including several specialist emerging market asset managers.

We conducted several interviews with specialist emerging markets fund managers with both fixed income and equities mandates. These revealed that emerging markets asset managers tend to be more active with greater latitude to invest outside of their benchmarks in terms of their mandates. This flexibility allows managers to handle some of the features of emerging and frontier market assets including lower liquidity, the fact that many indices capture only a limited portion of the potential investment universe, and the fact that index constituents can be changed frequently. The firms we interviewed were of two types: general houses managing varied mandates across the world and emerging markets specialist houses. Universally from our interviews, general houses endowed a specialist emerging and frontier markets team with the task of managing emerging and frontier portfolios, often split between debt and equity. The specialist managers operated dedicated teams, so in practice large and specialist houses are largely comparable.

Based on the 16 asset managers interviewed, we found that all large houses had dedicated emerging markets teams. Only the specialist emerging markets managers did not.

Figure 2: Does your investment process differ for emerging/frontier investments? Does your firm have different management teams and mandates?



Asset managers define their emerging and frontier market universes in different ways. The most material guide is the inclusion or exclusion of markets and firms in emerging and frontier indices, with the MSCI Emerging Markets index being the most common for equities and the JP Morgan Emerging Bonds Index for fixed income. However, given that managers can invest outside of benchmark, funds also often hold investments that are not included in the main indices. This means that unlike mainstream funds that restrict themselves to the universe of their benchmarks, many emerging and frontier market funds are open to persuasion that assets that do not meet the criteria for inclusion in a benchmark are nevertheless worthy of investment. Sub-investment grade debt, for example, may continue to receive flows even if excluded from indices. However, because funds are judged on their performance against benchmarks, the expected returns from any investment outside the benchmark must be higher than that expected for the benchmark itself.

Some asset managers separate their emerging and frontier market strategies into separate funds with different mandates and benchmarks. We found that emerging markets managers will still hold frontier exposures in an emerging market fund in an effort to generate alpha, both in debt and equity funds. Specialist frontier funds have, according to our interviewees, become increasingly rare, particularly regionally specialised funds like Africa or frontier Asia. As we discuss below, top-down strategies have been supported with themes like the "Next 11" frontier markets, or the African emerging consumer, that gained traction in the early 2000s but have since lost market relevance.

Asset managers are often twinned with insurance companies. This is because insurers issue policies that are backed by investment portfolios and because insurers hold capital that is invested for a return. We have not treated insurers as a separate category in our analysis (except in terms of investment insurance cover, below) though asset manager mandates are often set in terms of insurance products and central capital management.

Retail Investors

Retail investors are often considered to be less significant than institutional investors in respect of flows, but in some markets make up a significant component. Retail activity varies widely from market to market, making up 23% of investment volumes on the Australian Stock Exchange (Zhang and Miller 2021), 13.5% of the UK stock market and 15.6% of European stock markets (including the UK) (Watt 2016). Retail investors range from high-net-worth families who can control assets comparable to institutions to wage earners who trade a stock portfolio. In the US, 52% of households own stocks, holding more as a group than mutual funds (SIFMA 2019), while 31% of Australians own shares directly (Zhang and Miller 2021).

Retail investors do not face the constraints that many institutional investors face in that they hold smaller interests with fewer liquidity constraints and have flexible time horizons. They also are free to apply any filtering mechanism of their choosing. Research finds that retail investors show only cursory interest in ESG factors (Nagy and Obenberger 1994) (Moss, Naughton and Wang 2020). However, retail investors tend to have a home country bias (J. R. Graham, Harvey, and Huang 2009) which affects their interest both in emerging markets and other developed markets. Investors in small-cap stocks tend to be more retail than institutional (Harwood and Konidaris 2015), which would overcome one source of resistance to emerging market stocks, given emerging market companies are generally smaller. The development of domestic retail investors can be an important component of overall emerging market flows.

Many emerging market fund managers we interviewed see the retail client base as an important source of flows but tend to see high net worth investors as more stable and providing economies of scale. One large emerging market equities fund, for example, splits institutional and retail 40/60 and considers retail the faster-growing source of flows.

In markets where retail investors have a high degree of discretion, particularly through tax incentivised savings structures like personal pension plans (Australia, UK) and tax-free savings accounts (Canada, UK), a large pool of capital is under control of individuals who could be attracted to emerging markets. Such investors tend to be overconcentrated in domestic markets and would benefit from the diversification that emerging markets exposure could provide.

Indices and Benchmarks

Index construction is one of the most important influences of flows to emerging markets. Portfolios are given a benchmark against which the performance of the portfolio management can be assessed, often in the form of an index. Popular benchmarks for emerging markets are the MSCI Emerging Markets Equities Index and the JP Morgan Emerging Market Bond Index (EMBI). The EMBI does not distinguish emerging and frontier markets, though the MSCI index series includes a separate frontier index. Some funds use absolute measures such as "inflation plus 100 basis points" as benchmarks, whilst others blend together several different indices. Benchmarks are tightly regulated in most markets and funds have disclosure rules on benchmarks and consistent reporting on them (FCA 2019).

Table 1: MSCI index constituents

MSCI Emerging Markets	MSCI Frontier Markets
Brazil	Bahrain
Chile	Bangladesh
China	Burkina Faso
Colombia	Benin
Czech Republic	Croatia
Egypt	Estonia
Greece	Guinea-Bissau
Hungary	Iceland
India	Ivory Coast
Indonesia	Jordan
Korea	Kenya
Kuwait	Lithuania
Malaysia	Kazakhstan
Mexico	Mauritius
Peru	Mali
Philippines	Morocco
Poland	Niger
Qatar	Nigeria
Saudi Arabia	Oman
South Africa	Pakistan
Taiwan	Romania
Thailand	Serbia
Turkey	Senegal
United Arab Emirates	Slovenia
	Sri Lanka
	Togo
	Tunisia
	Vietnam

Source: MSCI

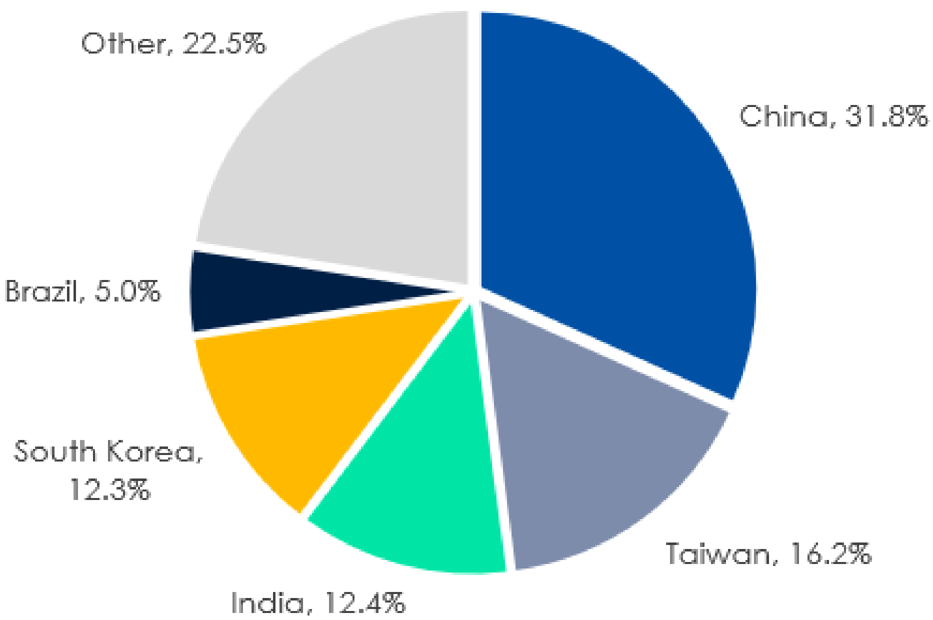
05
Market
Structure

Our interviewees were consistently unhappy about how benchmarks affect strategies for emerging and particularly frontier markets. Index construction rules regularly clashed with portfolio objectives. However, our interview with an index construction expert made it clear that the challenges to building effective indices in the relatively narrow field of frontier markets are substantial. “You have this vague notion of barriers to entry for foreign investors, so we implemented a classification framework for local currency fixed rate government bond markets so that you can think of that accessibility. We consider capital controls, bond market structure, the foreign exchange market structure then the settlement and custody”. Such considerations are not as critical for developed market indices.

One of the challenges is that the “emerging markets” narrative is heavily driven by index performance. This is dominated by the larger markets within the index. China stands out, and together with Taiwan and South Korea makes up over half the index (see Figure 3), implying that emerging markets are driven by East Asia. Thus, the emerging markets index performance is heavily driven by East Asia’s performance. Emerging markets specialist investors find this difficult to address with clients who perceive all emerging markets as exhibiting the same performance features. Yet there is great diversity both in geography and underlying economic drivers. East Asian stocks tend to be dominated by information technology and financial firms, whereas other regions such as Africa have significant resources exposure.

Within the index, East Asia dominates, making the emerging markets investment basket appear far more homogenous than it really is, to the frustration of many emerging markets fund managers.

Figure 3: MSCI Emerging Markets Index Country Weights



Source: MSCI

The concentration problems also arise in frontier indices. For instance, the FTSE Russell Frontier Emerging Markets Government Bond Index, a new index introduced in March 2021, has a 24% weighting to Egypt – too great a concentration for most frontier fund mandates. Additionally, funds are concerned with the frequent changing of index constituents, with each change requiring funds to enter or exit investments, triggering a herd behaviour that can influence prices negatively for the fund, especially in smaller markets.

Research illustrates the impact that index exclusion or inclusion can have. One study of the MSCI Emerging Markets index found convincing evidence of permanent price effects from index inclusion and exclusion which occurs in the period from before the announcement of the change to after inclusion, with a pronounced short-term drift after inclusion (Hacibedel and Bommel 2006). The price impact in emerging markets ranges in studies from 2% to 7% for additions measured over 70 days before the inclusion, with deletions from indices accompanying a 17% decline measured over 100 days before the exclusion (Afego 2017).

Our research found some frustration with the frequency of inclusions and deletions in emerging market indices. Given that most emerging market funds have space to invest off benchmark, they are not compelled to exit or enter on inclusion or exclusion, but face the pricing impact nevertheless.

For funds that include ESG factors, interviewees also pointed to the lack of proper social-focused indices, with index construction dominated by more easily available environmental data. Efforts have been made to develop solutions by larger index providers, such as the MSCI ACWI Sustainable Impact Index (SII), which includes companies that derive at least 50% of revenues from products and services that address environmental and social challenges. Interviewees again were concerned that these did not identify momentum in a way that could support an additionality-focused investment strategy. Such an index would be difficult to construct but could use the static approaches such as the SII but weight for the momentum of issuers in the index over time.

Data Providers and Sell-Side Research

Our interviewees were strongly oriented towards doing their own research. There was limited appetite for sell-side research that typically guides investors in larger markets. “We don’t use sell side a huge amount,” said one emerging markets manager at a larger house. “Everything we do is primary research. Sell side can help with idea identification so it is useful to have a flow of information from them. We also do use the sell side in some instances for access to management and the large-scale conferences can be helpful.”

Relationships with sell-side brokers can be a constraint too. A pension fund manager said: “to get a relationship with the trading broker you want someone who is servicing your whole fund, from the US to Asia, for it to be worth their while. Once in a while we like to talk to the local teams on sell side, but we tend to find people who are too close are overly optimistic or pessimistic.”

Another manager from a small emerging markets-oriented hedge fund echoed the sentiment: “It is very important to be on the ground. South Africa you can cover from London but when investing in Egypt, networking in Ghana or Kenya, just to know a broad range of institutions and the people who run them and your local investor base, you have to be there. The sell side can have good contacts and can help with the initial introduction, but I wouldn’t rely on them beyond that.”

Another manager of a large impact-oriented asset manager that invests exclusively in emerging markets cites having local offices in each operating region as key to the maintenance of their comparative advantage. The firm’s investors – who do not know enough about emerging markets themselves – are attracted to this firm’s funds because of the diversification and decorrelation from other parts of their portfolios.

A growing group of alternative data providers is evolving to support this thirst for unusual approaches to overcoming data asymmetries. Interviewees talked of using satellite imagery to count how many ships are leaving ports as a way to get ahead of official data on economic activity. Rainfall and drought information can similarly be drawn from satellite information and be used to inform market expectations. Such alternative sources of data can provide breakthrough opportunities in emerging markets and overcome the weaknesses of traditional data generation through formal data gathering institutions such as national statistics agencies and central banks. The role of digital innovation, big data and artificial intelligence has the potential to drive radical breakthroughs here.

06

ASSET CLASSES

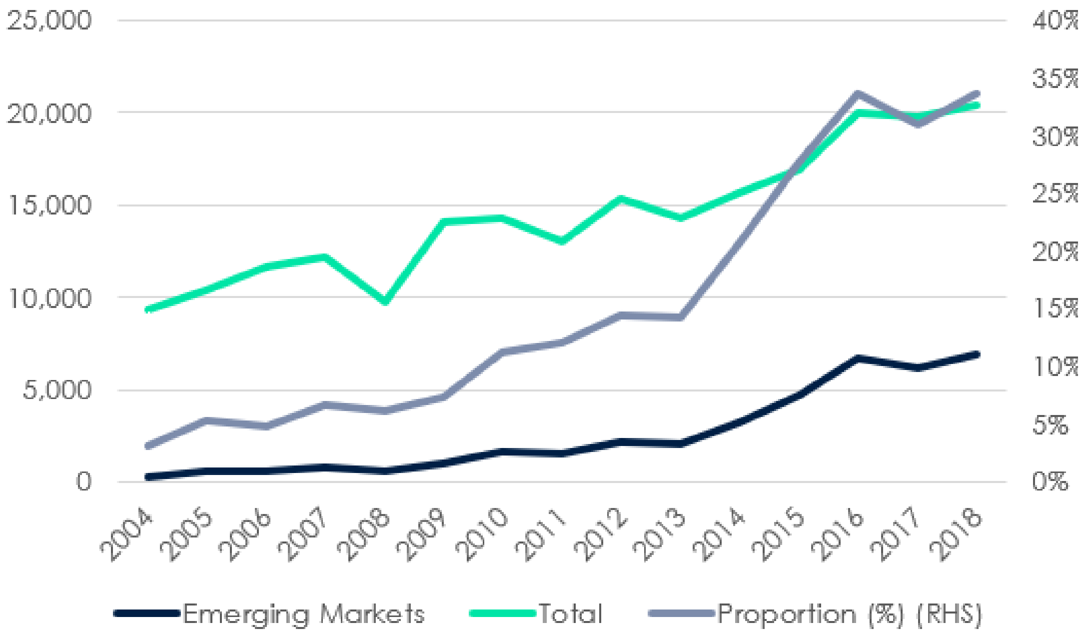
Flows to emerging markets are influenced by different asset class features, although there are common issues that concern investors in both fixed income and equities.

Fixed Income

Bond issuance has grown dramatically for emerging markets. Having accounted for 3.2% of global issuance in 2004, in 2018 they accounted for 33.7%, raising $6.7tn (SIFMA 2019). However, emerging markets are generally shorter tenor, so emerging markets account for just 2.4% of total bonds outstanding (the US is 41%) although this is up from 1.3% in 2004.

Emerging markets have been gaining global market share of debt issuance, particularly since 2013

Figure 4: Global annual debt issuance (USDbn) and EM proportion (%)



Source: (SIFMA 2019)

The growth in issuance is clearly a major success story in the improvement of flows to emerging markets, and global asset managers are frequent holders of emerging, and to some extent frontier, fixed income securities. This success reflects improvements particularly in sovereign issuers' ability to satisfy global investor requirements and reflects the success of efforts to support sovereign market development by institutions like the World Bank.

Interviewees who manage fixed income portfolios were clear that improvements in governance, fiscal management and technical support to governments to build issuance programmes have enabled this growth.

The growth opportunity in fixed income is now focused on green, social and sustainability-linked bonds. Emerging markets have begun to issue these instruments, but there is significant opportunity for increased issuance of these instruments within a wider sovereign debt strategy. The development of green and social yield curves in emerging markets would be an important development step by providing price discovery for private sector issuers like banks to also issue green and social bonds.

Equity

Emerging markets have also grown equity issuance but not to the same extent as fixed income. In 2004, 8.0% of issuance was in emerging markets, which had grown to 19.5% in 2018. From a market cap perspective, emerging markets were 17% of the $74tn in global market capitalisation, up from 4.0% of the $36tn market in 2004 (SIFMA 2019).

Emerging markets' share of equity capital raising grew rapidly in the first decade of the 2000s but has flattened since. However, the endowment of historic equity raising means that from a market-cap perspective, emerging markets are only 17% of equity markets.

Figure 5: Emerging markets' share of global equity market capitalisation (%)

Source: (SIFMA 2019)

Our interviewees, including in-house pension fund portfolio managers and asset managers, tended to track about 100-150 companies. The MSCI Emerging Markets Index includes 1,410 companies, ranging in market capitalisation from $7,5tn to $65m. The largest exposures are to financials (21%) and information technology (22%). Despite emerging markets being often linked to basic commodities, materials make up only 9% of the index. China is the largest market (32%), followed by Taiwan (16%), India (12%), South Korea (12%) and Brazil (5%). As one pension fund internal portfolio manager says: "there is very little differentiation in the top 10 [shares] in the MSCI. Almost everyone owns those, and it is 38% of the benchmark. The place to differentiate yourself is the bottom 500."

Scale and liquidity are more of a problem for equity investing than fixed income. Bond issuance tends to be in larger tranches but the equity investment universe, particularly in frontier markets, includes many small, illiquid counters.

Generally, asset owners look to specialist emerging markets fund managers to manage emerging markets portfolios, often on a segregated portfolio basis. This is because of a perception that emerging markets equities requires specialist skills to overcome information asymmetries. However, we interviewed large pension funds and a sovereign wealth fund that did undertake emerging markets portfolio management in house. Allocations were determined by an actuarially modelled asset allocation strategy that optimises portfolios for risk tolerance and liability cash-flow requirements. The illiquid nature of equity counters can theoretically be managed by taking a longer-term buy-and-hold approach, but we found little appetite for this approach (which we discuss further under liquidity issues below).

One of the impact-oriented asset managers in our sample does all deal origination and due diligence itself but stays away from equity entirely. Evergreen debt is preferred for its investments in African social enterprises. This is due to the perceived absence of secondary markets for equity trading in Africa, though the interviewee sees growth in the secondary markets in larger economies like Nigeria and Ghana.

Overall, however, equity remains a vibrant area of emerging market investing. One large asset manager put it this way: “it is a very wide-ranging asset class with a lot of nuance and local issues you need to understand and account for. It is partly why we have invested in local talent across our team so in our view we have hired local individuals who understand the culture and historical context and, in some markets, can overcome the language barrier. We actively seek the inefficiency that exists down the market-cap size. The generic emerging markets universe is 1,500 companies, but there is a very long tail of opportunity of 3,000 where you are unlikely to get sell-side coverage and within that you have to have a local presence. That’s where we see opportunity.”

IPOs

A different set of issues arise regarding initial public offerings (IPOs). The listing of new companies is important to expand investment in emerging markets. Some interviewees were open to IPOs in emerging markets. “We do IPOs – we think they are a fruitful source of alpha,” said one emerging markets equities fund manager. “We treat it the same way as any other investor and vet it the same way. There is no reason not to do IPOs in frontier markets either, but you have to trust the liquidity. We would look at the size of the business, the size of the free float, look at what that implies for liquidity in the local market context. You can get some idea of what to expect.”

Other investors, however, insisted that a track record is a precondition to investing, both to understand financial performance and trading liquidity. Efforts to encourage an openness to IPOs, however, may support additionality. New companies coming to market in emerging markets with a clear developmental investment case should be able to attract the interest of global institutions. There are clearly opportunities to facilitate such engagements with the wider investment banking community who arrange IPOs.

One investment banker we interviewed explained the challenges in marketing new investments to UK institutions. “You have kind of bipolar capital – one is very conservative, only interested in domestic opportunities with a little bit of safe exposure around it. For them, even taking exposure to UK-listed companies with operations outside the UK is a scary proposition. The moment it has foreign exposure, even in Europe, then suddenly they don’t know what’s there, don’t understand the politics, the currency, anything pretty much. Then there are a whole set of mandates for developing to frontier to Africa. In that segment you find people who are 1) more receptive 2) have a mandate and 3) actually know what they are doing. With a focus like that it is easier to engage with them and for them to see the value proposition. If you come with the value proposition there is a good chance they will put some money in it – they won’t bet the farm but will wet their feet.”

It also depends in which particular market the company is active. The same investment banking interviewee said that “every country has its own risks. China is attractive. They will be interested in Vietnam, India, Sri Lanka, South Africa, a couple of Latin American companies, South Korea, Philippines. Call those blue-chip markets with large stocks that are liquid and visible. But for the second-tier emerging markets, the response you get is ‘give me a sure bet and then I’ll think about it’.”

Unlisted Assets

Private equity and debt are attracting increased attention from pension funds, sovereign wealth funds, endowments and high-net-worth-individuals. While private equity is not a new asset class, its efforts to grow in emerging markets are slowly gaining traction, while it is increasingly incorporated into pension fund portfolios worldwide. Real estate is a further asset class in the unlisted domain, though the assets can be held through listed real estate investment trusts and other forms of investment vehicles.

Several interviewees see private equity and debt as mechanisms to overcome liquidity challenges, particularly in frontier markets, and to have a more direct hand on the ESG performance of investee companies. One specialist manager in sub-Saharan Africa said: “In the SADC [Southern African Development Community] region the listed equity market is very small and that is not likely to change anytime soon. Private markets are sometimes the only opportunities so international investors need to be as open minded about private as they are about public markets.”

From an impact and ESG perspective on investing in Africa, private market assets can be attractive. “You can create a very tangible statement of what you are buying,” said one asset owner.

But unlisted investments also present bigger information asymmetries. “In terms of unlisted funds, data availability is a challenge and it affects transparency, making it harder to attract flows. In Africa, countries where governments have made a push for the digitisation of registries and access to corporate information easier, the digitisation of data is more advanced. There’s more transparency,” says a specialist data provider in Africa.

Investment into unlisted opportunities is often characterised by high due diligence costs as investors must conduct detailed analysis. There is also the difficult challenge of undertaking due diligence of private equity and debt fund managers in emerging markets. One potential solution is to use funds of funds domiciled in developed markets. One asset consultant we interviewed is setting up US-based funds of funds to facilitate flows to emerging market private equity portfolios. “We’re targeting US institutions. They’re intended to be the first step into the institutional market in the US,” he said. “We’re selling ourselves as a risk management firm. We’re focused on the best markets with the best managers and we’re on the ground.”

Nevertheless, the challenge of liquidity remains clear for unlisted assets. Institutional investors have to some extent built an appetite for the liquidity characteristics of unlisted assets and make specific asset allocations for private equity and debt. But, as we discuss below, this is a challenge for defined contribution funds in particular. One potential solution is listed investment trusts that hold such illiquid assets. These provide a means to access liquidity at the portfolio level, so overcoming the problem of the illiquid nature of the ultimate investments.

07

TOP-DOWN CONSIDERATIONS

Emerging markets feature in many investment portfolios. The MSCI All Country World Index (ACWI) has a 12% weighting for emerging market equities, which includes 24 countries (MSCI 2022). These index indications are out of proportion to underlying economic activity – about 34% of global GDP in 2020 was in emerging and frontier markets according to the International Monetary Fund assessment which categorises 20 countries as emerging markets (IMF 2021). However, one cannot conclude that market capitalisation is out of proportion to economic activity in emerging markets as much of this economic activity may be funded by issuers listed in the developed markets. For investors aiming to diversify across the investment opportunity set, some allocation to emerging markets is prima facie appropriate. This case does not extend to frontier markets, which most fund managers see as an additional asset class which makes a small contribution to the overall investment universe and is usually not included in commonly tracked indices.

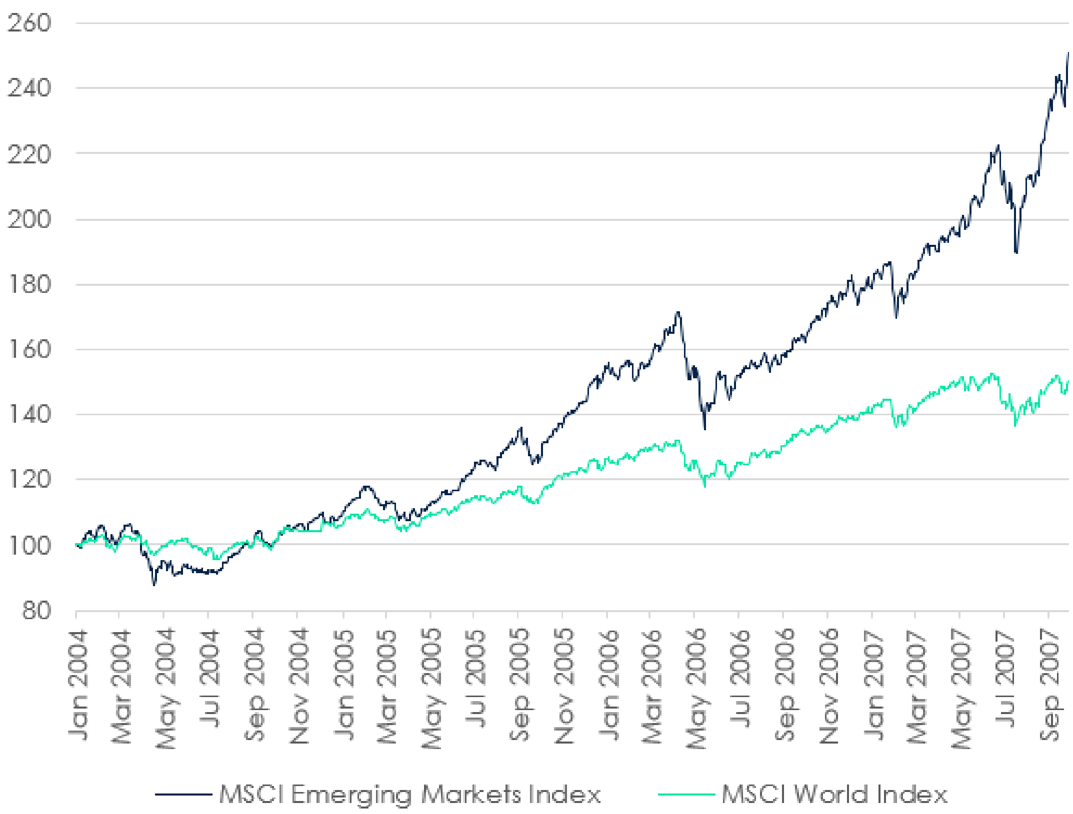
Against this starting point, our interviewees highlighted several factors that may lead investors to be underweight in emerging markets. We consider these under the headings below.

Risk, Return and Traditional Portfolio Management

The traditional case for emerging market exposure is that such markets have scope for higher growth than developed markets and returns that are uncorrelated with developed markets, providing scope for improved risk. Emerging markets have to "catch up" with global living standards and generally have younger populations that can be assumed to provide greater productivity and consumption while their economic growth rates are driven by factors quite different to those in the developed world. Some evidence supports this view, particularly from the period between the 1998 emerging markets crisis and the 2008 global financial crisis. From January 2004 to the pre-crisis peak of November 2007, emerging markets delivered three times the returns of developed markets (see Figure 6), although with a relatively high correlation of 0.98. An interviewee noted that this period was characterised by the emergence of China as a major manufacturer and a long commodities upcycle

In the first decade of the 2000s, emerging markets strongly outperformed, attracting considerable investor interest and allocations.

Figure 6: Emerging markets performance prior to the global financial crisis (indexed to 100 at the start)



Source: MSCI/InFront Finance

07
Top-Down Considerations

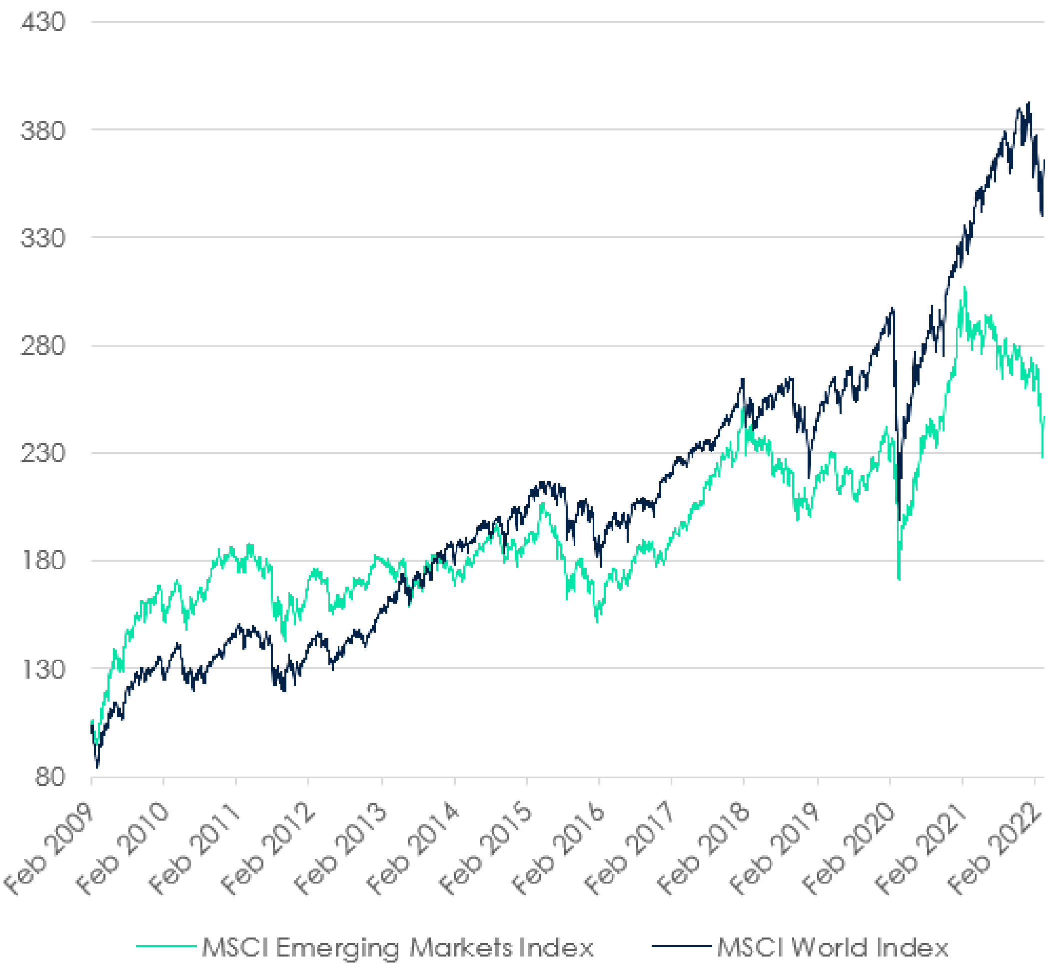
One interviewee who manages the emerging markets tranche of a $90bn pension fund said on this basis the fund asset allocation strategy provided a significant 11% allocation to emerging market equities, forming about 20% of the overall equity allocation. This relatively high allocation was set in 2017 based on historic emerging market performance and capital market assumptions, in which the momentum of strong earlier performance led to higher capital market expectations.

That was a positive period for emerging market investing. High profile funds like Franklin Templeton under the guidance of Mark Mobius were able to attract significant inflows. The term “BRICS” was first coined by Goldman Sachs economist Jim O’Neill (O’Neill 2021) who later coined the “Next 11” including Bangladesh, Egypt, Indonesia, Iran, Mexico, Nigeria, Pakistan, Philippines, South Korea, Turkey and Vietnam as a set of frontier markets. These concepts excited investors and several funds were set up by asset managers to capture these flows.

However, the performance of emerging markets has not met the hype of those years. Indeed, since the 2009 market lows, the MSCI World index of developed markets has provided a 266% return against 147% for the MSCI Emerging Markets index (see Figure 7), although the correlation fell to 0.94 during this period. This outperformance is driven by many factors, including the growth of technology firms particularly in the US and the consolidation of firms in developed markets.

The last decade has seen significant underperformance of emerging markets, which has diminished wider enthusiasm for the asset class.

Figure 7: MSCI Emerging Markets vs MSCI World Index post the GFC



Source: MSCI

The pension fund interviewee quoted above expects emerging market exposure to be significantly down weighted in the fund's asset allocation strategy when the imminent five yearly review of market assumptions leads to a new asset allocation strategy for the fund. While market expectations should be about future performance, the actuarial modelling will use past performance data to assess correlations and returns, which is expected to result in lower emerging market exposure.

This expectation was confirmed by other interviewees. An emerging markets equities strategist at a large investment bank said the attractiveness of emerging markets has certainly suffered due to the relative underperformance of the past several years. Future performance is also expected to be relatively weak. For example, JP Morgan's long-term capital market assumptions, reviewed in 2022, are that emerging market growth will be weaker than developed markets primarily because of downgraded growth forecasts for China and India (JP Morgan 2022). Sell-side analysts emphasised that the emerging markets investment case in equities is now driven by bottom-up analysis, showing the strong valuation features of companies that trade at a significant discount to developed market stocks. We will return to this point below.

Another important top-down theme is global monetary policy. The unprecedented low interest rates and high liquidity in global markets since the global financial crisis, amplified during the Covid-19 pandemic, have supported a search for yield. This has to some extent dominated investment decisions regarding emerging markets. The particular features of emerging markets, or of the asset class as a whole, can be drowned out by the push factors of global liquidity. Emerging markets flows have taken a "risk-on" and "risk-off" pattern with flows moving as global risk appetite increases or decreases. Some of our interviewees argue that this has made emerging markets less of an asset class with specific return and risk features, instead they are hostage to global monetary policies. Others however push back against this narrative. A specialist emerging markets fixed income manager says: "From the top-down perspective, the liquidity story makes a lot of sense but from a bottom-up view, there are so many geopolitical challenges. And the flows of investment trails performance – so you need at least a year of outperformance and in reality, two to three years before you get proper flows." These factors dominate the short-term risk driven flows.

ESG Considerations

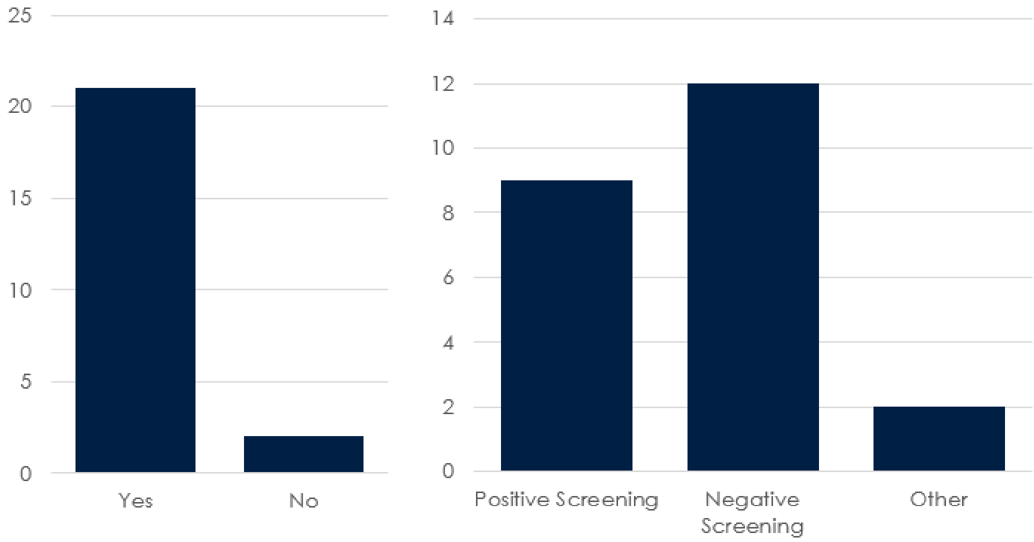
Many asset owners have integrated ESG into their investment decision-making processes and policy statements and asset management funds are routinely assessed and measured against various ESG benchmarks. It is difficult to measure the extent of ESG integration into investment strategies, however the Global Sustainable Investment Alliance (GSIA) estimates that more than $35tn was managed according to sustainable investment criteria in 2020 (GSIA 2021). This can be compared to estimates of the total institutional investment market at around $100tn (Heredia et al. 2021).

Investors, regulators, academics and other market participants are still forming an agreed set of standards regarding both disclosures and investment approaches for ESG investment. There is no single authoritative body that can define terms for the global investment management industry (CFA Institute 2020). ESG is often used interchangeably with "sustainable investing", "triple bottom line" or "responsible investing" although these terms can also sometimes be given more specific meanings. ESG strategies can range from exclusionary screening to active investment stewardship. Among the many standards in use, arguably the United Nations Principles for Responsible Investing (UN-PRI) has become the most recognised, with more than 2,500 signatories and $85tn in funds under management at the end of 2019 (Matos 2020). Our interviewees frequently referenced the UN-PRI, but also often referred to the SDGs and the EU's Sustainable Finance Disclosure Regulation (SFDR) that was introduced in March 2021, as having an important influence on their ESG strategies.

07 Top-Down Considerations

From a top-down perspective, we found several approaches. Broadly these divided into exclusionary and weighting approaches. The difference depended on the intentions and objectives of the fund in adopting ESG. There were also clear regional differences in practice between European (more focused on additionality), American (more focused on marketing of ESG) and Asian (more focused on ESG as an alpha strategy) investors.

Figure 8: Do you screen at country level in your investment decision process? (LHS) And if you do screen is your process positive or negative screening? (RHS)



Note: Both asset owners and asset managers included (n=24).

For some funds ESG is primarily a way of enhancing returns. The assumption is that well-governed countries and companies generate better long-term returns. Issuers that have a positive social performance with good relationships with communities and labour are also more likely to be lower risk. Similarly, those with sustainable environmental practices are thought to be lower risk.

Where ESG is seen as a source of alpha, it is debatable whether ESG really is a different investment strategy to traditional portfolio management. Such investments do not differ in fundamental motives from traditional risk-adjusted return maximisation. We interviewed managers of dedicated emerging markets ESG funds who could demonstrate through back-testing that their ESG approach resulted in superior returns. These were funds that adopted an explicit "ESG integration" approach with ESG built into the investment decision-making process. Such funds were marketed primarily as a way to improve returns rather than a way of doing good. Such alpha strategies may have their merits, although different evidence can be found in the literature including that "sin stocks" like alcohol, tobacco and gaming outperform (Hong and Kacperczyk 2009) and that sustainability portfolios underperform by limiting the universe of investment opportunities (Lee et al. 2010).

In contrast to performance concerns, particularly among asset owners, we found the purpose of ESG was largely to reduce reputational risk. For large pension funds, foundations and some sovereign wealth funds, ESG lessened the risk of a public backlash should they be identified as being invested in companies involved in undesirable practices ranging from pornography to arms manufacturing, or in countries with poor human rights practices. The timing of our research coloured this concern – some asset managers and owners we spoke to could point to the fact that their ESG approach resulted in underweight, if not zero, exposure to Russia. Given that Russian sanctions have significantly damaged returns while creating negative headlines for some funds, this was being seen as a strong endorsement particularly of exclusionary ESG approaches.

Reputational risk is particularly acute in the context of emerging markets. To quote one example from a sell-side emerging markets analyst: “A lot of German investors lost money in Steinhoff [a South African company] but significantly more lost money in WireCard [a German company]. But they shout a lot more about not doing any more investing in South Africa. There is a lot more [media] headline risk and loss aversion for emerging markets.” This provides a succinct example that illustrates the reputational line that emerging markets investment must walk.

In our interviews of market participants, a key issue we explored was whether ESG would increase or decrease flows to emerging markets. Somewhat counterintuitively, many of our respondents believe that ESG is overall negative for emerging markets and even more so for frontier markets. “In practical terms on any scoring system you end up scoring emerging markets poorly,” said the portfolio manager of a specialist emerging market debt fund. “That is deleterious for emerging market flows and is an important aspect that is going to be hard to deal with [for development]”.

In practice, a fund that benchmarks itself against a broad global index like MSCI ACWI, and then applies exclusion or weightings based on ESG considerations, would be underweight for countries and issuers on features that are more common in emerging markets such as weaker judicial systems, independent media and weaker rankings on corruption perception indices or labour standards.

This approach to ESG clearly frustrated some of the asset managers we interviewed. “I would like to launch a fund that aims to achieve progress on SDGs because the poorer you are the worse your ESG score,” said one specialist emerging markets bond manager. “I would like some mandates that define sustainability as achievements with SDGs. I think we can run quite a large fund that has that mandate and goal.”

There are also tensions between elements of ESG. One senior portfolio manager for sustainable investing explained scenarios in which such tensions can arise: “You can have a coal-based energy producer who is a large employer and keeps the lights on in a country. There are strong ‘S’ reasons to invest but the ‘E’ counts against it.” In such cases, the fund will look at the detail of segregated mandates in deciding how to weigh up different factors.

These comments illustrate a sharp conceptual distinction in ESG approaches, those that are fundamentally about screening out ESG risk and those that are fundamentality about delivering improvements in environmental and social performance in markets. The latter we term “additionality” conceptions of ESG, a term that several interviewees used.

There is clearly a risk that ESG in its screening mode will serve to systematically bias capital away from poorer regions. Such regions have the greatest need for investment to fund development. While generally ESG is thought of as a strategy to make the world a better place (Matos 2020), if the outcome is to bias capital away from the poorest regions it arguably will be failing, at least while emerging and frontier markets are unable to meet the standards used for ESG screening.

A separate point that compounds these effects is the information problems of ESG. Specialist ESG managers we interviewed were generally negative about the quality of ESG information provided by traditional financial data houses. Two emerging markets debt funds and an equities fund we interviewed, had built internal models relying on 30 to 50 data sources including World Bank data on development indicators, the Corruption Perception Index maintained by Transparency International and the governance ratings in the World Economic Forum’s competitiveness index. These were used to exclude countries that fell below a threshold score, or to weight exposures in combination with other analysis. Several interviewees pointed to the distortion that is arising from much-improved climate disclosure but weak social disclosure. Standards like the Taskforce on Climate-related Financial Disclosures (TCFD) have been widely taken up particularly by financial institutions in reporting their climate impact, making it relatively easy to tilt portfolios on climate emissions, but there are no comparable measures of social impact. As a result, the path of least resistance is for funds to tilt portfolios more for the “E” than the “S”. An interviewee who runs an emerging markets equities fund said: “If I invest in a renewable producer, I can tell pretty tangibly how much carbon is reduced. In the social space you start talking about education, health and sanitation, so it is harder to measure and quantify which has [made it more difficult to invest in such projects].”

Table 2: Spontaneous mentions of sources for ESG data in interviews

Source	Mention count
In-country analysts	4
Sustainalytics	1
MSCI ESG index	1
ESG company reports	4
Bloomberg	6
Cedit Rating Agencies	1
National Statistics	2
Refinitiv	3
IMF/World Bank	3
Other	8

Note: includes asset owners and asset managers who provided any response. N=18

The “G”, however, is also material, particularly for activist investors. One specialist emerging markets fund manager highlighted the potential upside from active engagement with the board and management teams. The investment starts the process towards potential additionality. This, however, depends on having a reasonably large interest to be able to gain access to the board.

For companies (and governments), there are multiple ESG disclosure standards and stock exchanges are inconsistent in the requirements they set. There are several efforts to impose standardisation, including a new International Sustainability Standards Board announced at COP26 in Glasgow under the auspices of the International Financial Standards Board (IFRS) Foundation (IFRS 2021). IFRS has gone a long way to imposing consistent standards across the world for financial reporting and the hope is for a similar outcome for ESG reporting.

As another ESG emerging markets specialist fund manager put it: “Clients have this view that you can create a fund and immediately solve things. But actually, you are just going out and buying things that exist already. You are not contributing to impact. You can have an ESG index fund and you chuck as much money as possible at it, but the prices just go up. The incremental impact is nothing.”

Investing for ESG Additionality

There is a growing view that ESG can be recast in terms of additionality. One practice within this perspective is impact investing, which aims to deliver positive ESG impact, although impact investing can sometimes be interpreted as strategies that prioritise social returns over financial. Additionality strategies, however, have the potential to offer greater alpha than ESG in its screening mode as they can actively drive growth in more dynamic markets.

However, as with ESG, there are few settled concepts related to additionality approaches. Some investors interpret ESG as having an additionality orientation, for instance by actively selecting investments based on their ability to contribute to meeting the SDGs, but resist the term “impact”. For our purposes, the definition of the Global Impact Investing Network (GIIN) helps to capture the notion of additionality: “Impact investments are investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return” (GIIN 2022). The GIIN estimates that over 1,720 organisations managed $715bn in impact investing assets as at end-2019, although a GIIN survey of a sample of investors found that only one third was invested in publicly traded debt and equity (Hand 2020).

Another development cited as important by many interviewees is the EU’s SFDR (European Union 2019) that was promulgated in March 2021 and will have a second phase implementation in January 2023. The SFDR specifies required disclosures for funds that promote themselves as following ESG practices. It introduced the concepts of Article 6, Article 8 and Article 9 funds. Article 6 funds have no ESG considerations. Article 8 funds promote “among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices” (European Union 2019). An Article 9 fund “has sustainable investment as its objective and an index has been designated as a reference benchmark”.

While market practice is still evolving in response to these standards, Article 9 funds are generally seen as those intending additionality, for instance targeting the delivery of the SDGs, although some disagree. One interviewee pointed out that a fund that only invests in existing sustainable assets like renewable energy plants would quality for Article 9, even though the assets would still exist without the investment, so there would be no additionality. Article 9’s requirement for an index benchmark is also difficult for impact funds as there are no well accepted index methodologies. The market expects clarifications and amendments to come with phase 2 of the standard and some funds have held off classifying their funds as Article 9 until then.

The information challenges for additionality investing are even greater than those faced in screening. Screening can simply exclude investments that do not meet information hurdles. However, to identify investments that offer enhanced environmental and social outcomes, greater due diligence and monitoring is required. An investment in a fossil fuel company, for example, may enable that company to reorient its production to sustainable energy and therefore have significant additionality (given the contemporary geopolitical issues at the time of the interviews, some even suggested arms companies should be reconsidered). For funds aiming to “do good”, this would be an attractive concept.

However, for funds that employ ESG to minimise headline risk, an additionality approach may not be desirable. It would leave such firms vulnerable to accusations of talking ESG but not practising it, if it continued to have exposures, for example, to fossil fuel investments, even if they could demonstrate additionality. This problem extends to entire countries, for example having investments with strong social impact in countries that might be singled out for serious human rights abuses. This is a public perception problem that many interviewees were acutely aware of and highlight as a serious impediment to additionality strategies.

One interviewee drew a comparison between additionality focused ESG investing and venture capital investing. Venture capital expects a high failure rate. When an investment must be written off, it is not considered a failure of an investment manager but a reflection of the risk involved. Similarly, additionality focused ESG would require investing in high-risk countries with weak institutions and significant information asymmetries. There is a greater probability of failure, but equally the impact of the investment could be significantly higher. A public culture that accepted this risk/return balance in additionality focused ESG investing would lessen the headline risk.

One suggestion was that large investors need to be more conscious of a very different kind of headline risk – the risk of being singled out for not investing in development, with portfolios biased against poorer countries. Several interviewees agreed that a public education and marketing function is needed that promotes the importance of investing for development. According to an ESG emerging markets fund manager: “The language is really important. A huge amount is about raising awareness and having the government talking about [making an impact], which is really important. That can tilt incentives in the right direction. Government more than anyone can encourage a flow of capital.”

For funds that focus on additionality, the primary challenge to greater flows is the costs of data gathering and analysis. In this regard, interviewees made the following comments:

- To access all but a token allocation by large funds, impact investing needs appropriate indices and benchmarks. While the construction of such indices was widely recognised as being difficult, the absence of any such indices transfers the task of determining the appropriateness of the investment to the investor, and many investors lack capacity to systematically assess the impact of an investment;
- Impact investments usually do not have a significant track record. Even where impact can be assessed, it is often the case that the financial risks cannot. Without a track record, investors are unable to use traditional tools to form expectations about the probability of returns;
- Monitoring costs are high. The monitoring infrastructure of traditional financial markets, from audit firms to the financial press, are well developed, whereas for impact investing there are few commonly agreed approaches and there is limited existing infrastructure to monitor and report on the impact performance of investments.

The one area of success is the development of green bonds, social bonds and other sustainability-linked investments. There has been dramatic growth in this asset class, with cumulative issuance of $2.10tn by July 2021 with almost $500bn issued in the first half of 2021 alone (Climate Bonds Initiative 2021). These are well understood among fixed income investors and have attracted flows that are impact-oriented as well as flows from more traditional ESG funds. Green bonds and social bonds are typically issued by governments and development finance institutions, though commercial banks and some other private sector firms are increasing issuance, in terms of frameworks set by the International Capital Markets Association. The use of proceeds is generally restricted to a set of green or social investment categories. The attractiveness of this asset class is indicated by the "greenium" that investors pay for green bonds relative to standard sovereign issuers, which interviewees put at about seven basis points below standard issuance. This is a thin margin within spreads that can be a few hundred basis points, but nevertheless indicates the market appetite.

However, the additionality of such investments was questioned by some of our interviewees. One fixed income fund manager argued that as money is fungible, sovereign green and social bond issuance simply displace "normal" debt raising but do not change what investments are being made by governments. Some managers with an impact orientation assess social bonds for additionality. "We want to know how this social bond is going to improve quality of life," said one emerging markets fixed income manager, adding that such questions can be about long-term returns. "Quality of life is going to attract people which is going to raise your tax base, which is going to improve the economic returns to us," he noted. This example shows how it is possible to be both an impact additionality investor and a returns maximising investor.

However, there is a different conception of impact "with a capital 'I' where there may not be return of capital, or return on capital that is below the market," as one ESG specialist fund manager puts it. This "social first" investing prioritises social return on investment above financial return. Such strategies are growing in importance but tend to be backed by philanthropic rather than mainstream capital. Some large foundations, for example, include social-first investing into their portfolios in a way that blends their investment objectives with their philanthropic objectives. Of course, philanthropic spending can be recast as a "zero financial, positive social return" investment; social first investment puts such investment somewhere between zero financial return and normal market returns.

Social first investors can be an important mechanism to unlock greater capital by providing loss capital designed to compensate for the information constraints and risk appetite of large institutional investors. One example we were given by an investment banker was of a Nigerian insurance company that was initially invested in by an impact investor who then took an activist role in improving governance and systems in the insurer, elevating it to the point where it could be sold on a commercial basis and prepared for a capital market listing. This suggests a possible strategy where impact investors build or turn around existing assets with a view to on selling these to commercial capital.

Frontier vs Emerging Markets

As discussed above, the definitions of these terms are driven by indices. The historic performance of these indices is regularly used in return and risk analysis modelling to inform asset allocation strategies for funds. Within the global investment universe, frontier markets in particular can be constrained by liquidity features, irrespective of correlation or return considerations. This usually results in very small allocations to frontier markets, if any.

A challenge that came through clearly in interviews is that frontier markets (and emerging markets to a lesser extent) are currently out of favour. As one real estate fund manager specialising in frontier markets put it: “If you go back 10 or 15 years, there were prominent frontier market themes and people were raising funds to invest into frontier market stocks. It was a massively fashionable thing. Every house from BlackRock to Fidelity was doing it, all the way down the spectrum, announcing ‘we’re launching frontier funds’.”

But this trend has reversed. “Unfortunately, the last six years have seen all of those funds close to the point where today there’s probably only a handful left. There are numerous reasons for it. Obviously, the cycle is not going well but stocks have not done well fundamentally. But I think the main problem is liquidity because it becomes a vicious circle. Without liquidity, you don’t find investors and without investors, you don’t find liquidity. The biggest frustration of unlocking institutional investment into frontier market companies has been the lack of either trading liquidity or index inclusion.”

This comment draws together several factors that have played into a decline in frontier market strategies managed by asset managers. The relative lack of returns discussed above, has been compounded by the liquidity factors discussed further below. These have contributed to a less tangible lack of enthusiasm for frontier market exposure in particular. While investment strategy is driven by the data, capital market expectations have been coloured by these experiences.

Top-Down Conclusions

While ESG investing may detract flows from emerging and frontier markets, we should expect that additionality strategies would lean against this. However, assets allocated to impact investing (which is one variety of additionality strategies) are considerably less than ESG. Only a third of GIIN’s estimate of $715bn of impact assets are thought to invest in public markets, whereas ESG-aligned funds amount to $35tn, implying impact investment amounts to less than 1% of ESG flows. To amplify the potential improvements in flows, our research findings support the need to develop a conceptual framework that clarifies how ESG can be delivered in a way that achieves additionality to lean against the exclusionary approach that biases capital away from emerging and frontier markets.

By shifting the conversation to additionality, we would expect that fund strategies would begin to take development into consideration. This development would need to be widespread so that retail and fund members share an understanding of how additionality differs, ultimately reducing the reputational risk fears that funds currently have about emerging markets exposures. MOBILIST could also contribute to multinational efforts on disclosure standards to highlight the importance of development-related disclosures.

Our research also highlights several information gaps that frustrate investment into emerging and frontier markets, particularly for additionality strategies. Traditional investment strategies are likely to be biased against emerging markets given underperformance over the last decade and relatively weak growth forecasts. As we discuss below, bottom-up perspectives can still identify significant yield opportunities, but these are expensive and difficult to assess. The more systemic information gaps are the lack of benchmarks and indices for additionality oriented investment funds.

08

BOTTOM-UP CONSIDERATIONS

The line between bottom-up and top-down is fluid. Traditionally, top-down analysis is thought to include macroeconomic forecasts that can then direct flows towards particular asset classes. But from a global emerging markets perspective, bottom-up analysis includes the country level, particularly for fixed income securities. A country that is undergoing positive political and economic change, for example, may command investment attention it does not gain from a top-down perspective. A bottom-up investment process that often involves on-the-ground research includes assessment of domestic economic and political issues, as well as the specific features of investment opportunities.

But emerging markets also suffer from a lack of bottom-up investment opportunities. As one emerging markets fund manager put it: "I have had funds where I've had to give back the cash [to investors]. We just couldn't buy the assets with the money we'd been allocated". This concern that top-down allocations then face bottom-up constraints was echoed widely by interviewees, particularly in frontier African markets.

Interviewees highlighted that the particular features of markets make a big difference in allocation decisions. This is true both for fixed income investment but also equity and other asset classes, though the emphasis shifts per asset class. Fixed income analysts are focused on the fiscal and economic outlook for countries and the political factors that drive these. Equity analysts are focused on the profitability of companies, though there is also a clear belief that equity valuations depend to some extent on the quality of the state. A market with a progressive policy agenda is likely to see companies outperform.

Emerging markets fund managers, whether fixed income or equities, have a more active and less benchmark-focused approach compared with developed market funds which more closely follow the index (which we explore more fully below). Emerging and frontier markets are often seen as a source of alpha largely because the risks are greater, information more scarce, and more skill is required from the portfolio manager.

Political Stability

Investors want well-regulated markets and stable political environments with improving governance over time. Generally, emerging markets suffer from a lack of political recognition of the importance of capital markets, leaving investors wary. "Good regulation creates an enabling environment, but you cannot regulate something you don't understand," says one emerging markets fixed income investor. While risk is fundamental to market performance, political risks can add to financial risks in emerging markets.

In our interviews, the following market features were pointed out by fund managers, asset owners and sell-side analysts in respect of stability:

- The legislative quality, legal system and extent of corruption perceptions of the market are important to investors. Investors say these are difficult to assess fully, with a lack of available information on many markets. Specialist emerging market investors make these issues a focus of their expertise and believe they can identify excess return opportunities that are not available in developed markets because of their insights. However, mainstream more "passive" investment generally restricts investment in markets perceived as unstable;
- Political risk is related to the point above, but investors will assess countries for the extent of democratic stability, including free and fair elections, peaceful transfer of power, a free press and an independent judiciary;
- Currency convertibility. This is highlighted consistently as important. Investors in Africa in particular point to the importance of free convertibility of currency to reduce risks that the proceeds of an investment cannot be realised. Several examples make the point clear: Zimbabwe's dollarization and then de-dollarization of its domestic exchange has meant foreign investors cannot sell and repatriate proceeds from that country. More material, however, was the imposition of currency controls in Nigeria, a larger market that was progressing from frontier to emerging status. In 2015 and then again in 2020, the Nigerian central bank imposed controls to prop up the value of the

Naira, making it very difficult for foreign investors to exit after selling on the local exchange (Stubbington 2022). One Africa-specialist fund manager told us the Nigerian actions caused investor confidence to fall across African assets, resulting in that fund manager deciding to wind up a long-running Africa fund;

- Well-functioning independent economic institutions. An independent central bank is highlighted by many of our interviewees as a crucial check on the balance of political forces in an economy. Related to the currency management, above, an independent central bank is better positioned to maintain financial stability and manage inflation, ensuring that interest rates are appropriate;
- Structural reforms that support the economic outlook. A country in the process of proactively implementing reforms that support economic activity will be improving the outlook for both debt and equity investors. “These attract capital leading to a virtuous cycle,” notes one interviewee;
- Domestic savings market, which can provide liquidity and capacity for domestic financial markets infrastructure as well as regulatory stability. We comment further on this below.

Development efforts, particularly by the World Bank through its Joint Capital Markets Programme, have been focused on supporting countries to develop the institutional structures to encourage global capital flows (World Bank 2020), including market regulation which we consider next. Some interviewees also pointed to the role played by IMF programmes to improve market attractiveness. Says an emerging markets debt investor: “Like when Egypt was borrowing from the IMF you are almost importing some external credibility. As a result, you felt more confident you would get paid back. Obviously, it doesn’t always work – Argentina being a classic example of repeatedly going into programmes that don’t lead to resolutions.”

But there was a view from interviewees that there are potentially easy interventions that would quickly help improve the attractiveness of certain markets for flows without difficult political constraints. A sovereign debt investor said: “Low hanging fruit is investor relations and data provisioning. Sovereigns can just give regular updates once a quarter in person or by video-conferencing. Some issuers do monthly written economic updates. Data provision is generally pretty poor, especially for African sovereigns, [it is] very hard to get regular, up to date info. Sometimes you are waiting for once-a-year IMF Article IV reports. If they can improve on that it would immediately improve investor interest in their story.”

Another fixed income emerging markets specialist argues that sovereigns can achieve much with effective marketing, particularly around sustainability. “For me, if you can get your narrative right with your small green bond, you gain a badge for sophistication and forward thinking that can affect the way the market looks at your vanilla issuance too. It amounts to marketing. Somehow Rwanda got the marketing right and you could see that in flows that were out of proportion to the fundamentals.”

Market Regulation and Structure

Related to the above, investors need to be confident that the market they are trading in operates efficiently with no settlement risk or custody risks. This requires a level of development of the market and regulations, including well-developed listing and trading rules for stock markets and bond exchanges. Supporting infrastructure including clearing houses and securities depositories are critical for investors. Many of these elements can be delivered through international partnerships with clearing houses and depository infrastructure in developed markets. As we discuss below, interventions like depository receipts and secondary listings can also address some of these issues.

Structurally, markets also need an ecosystem of related functions that are all appropriately regulated. There needs to be a competitive broker sector to support trade and offer services to global investors. Global investors are more easily able to contract with global supplying brokers who in turn either directly or through agency relationships manage trade in domestic markets.

Market regulation also needs to manage information asymmetries. Our interviewees were less concerned with the classic asymmetry risk of issuer insider knowledge, given that they usually see the information challenges as a competitive advantage and believe in the on-the-ground knowledge gathering, but are more concerned about the quality of national statistics and market data. In certain thinly traded markets, foreign investors can be frustrated by not being able to see market depth fully or have the knowledge of market demand and supply factors that local investors do have access to.

Liquidity

One large pension fund pointed out that despite its emerging markets equity fund holding over 100 exposures, the smallest was of $35m. Such an investment can only happen in relatively large, liquid companies. Funds are faced with both concentration risk and liquidity problems. A passive investor like most pension and insurance funds does not want to hold too great an interest in a stock which would force more active stewardship. They also need to be able to trade in and out of a stock without too large an impact on the price on entry or exit.

One pension fund emerging markets equity specialist said: "The way we run the portfolio, you have a liquidity requirement you have to meet. You should be able to liquidate a certain percentage of the position in three to five days. So, once you have made the decision that you are allocating to equity, it automatically comes with a liquidity filter. For us, when we buy the small caps in emerging markets, we move the price getting in or out. Our risk team runs liquidity risk and sends a list of what they may call stale prices – highlighting stocks that are a liquidity problem. And there will be a dim view if your portfolio has a lot of that."

Another interviewee described an experience when his insurance-owned asset manager was given a segregated mandate by the UK-based insurance parent to manage $200m into assets in Africa ex-South Africa. "So we went fishing in Africa and unfortunately had to limit their enthusiasm. It is great that they gave us $200m but we could only use $100m because the liquidity wasn't there. Often it is not the size of the companies but the size of exchanges that is the limiting factor. If the company wasn't tiny, it was tiny from a liquidity perspective."

Another interviewee set out an approach to handling liquidity in which they offer clients a spectrum of liquidities from private equity to listed equities, with different liquidity options within various funds, e.g., daily exit, weekly, out to several year lock-ups. Regulatory development is supporting these hybrid approaches, however many developed markets place clear constraints on institutional funds requiring daily pricing.

While interviewees focused on the liquidity available in listed companies and some listed debt, some also pointed to the need for an effective and liquid foreign exchange market to facilitate exchange and hedging. A fixed income manager at a sovereign wealth fund said: "A well-functioning FX market is key to providing inflows. We need an FX forward market to hedge exposure and it is also a requirement for inclusion in a lot of indices like the WIGBI. Generally, the FX market is easier to transact in – we have more problems in the bond markets themselves, but some FX markets are the binding constraint we find."

Several initiatives have attempted to support liquidity improvements. Depository receipts, secondary listings, investment trusts and others can potentially aid liquidity, as we discuss below, though the role of domestic investors is also critical, which we consider next.

Domestic Market Development

Several interviewees pointed to the importance of a large, domestic saving pool. Of course, the absence of domestic capital is often precisely the problem that foreign investors can solve, but it also means that liquidity in the markets is much smaller.

It also limits the diversity of the investor pool which makes asset prices more volatile. This issue is also related to political risk – where there is a large domestic savings pool there is a stronger domestic political bloc to support good market practices. “What you don’t want is a white guy riding into town to invest in a project and then taking all the returns out of it. You are better off having local capital for local solutions but you need to enable individual countries to have savings institutions for that,” says a specialist ESG fund manager.

Another Africa-specialist manager concurs: “The money for Africa is transient. I don’t think you build markets and infrastructure based on that. If anything, you have to build your local market, your local pension funds and savings culture, because until you’ve got that you shouldn’t be worrying about the billions of dollars waiting to come in. That money comes in and out and is not there to stay.”

Domestic market development is a focal point of the World Bank’s Joint Capital Markets Programme, including regulatory reform to build domestic pensions industries. Other development finance institutions have programmes to strengthen domestic capital markets including USAID (through blended finance vehicles to catalyse institutional flows) and the European Investment Bank (through EIB Global which intends to mobilise billions from private investors). The FCDO has also supported projects such as Financial Sector Deepening Africa that are working to improve savings and financial systems in Africa.

A market infrastructure provider in Africa echoes the point: “For a healthy financial market ecosystem, you need diversity of clients because what we’ve seen through the current marketplace is that there’s a lot of cyclicality and the markets are also very interconnected. And the healthier the mix of the participants, the better viewpoints you get in terms of trade activity and to deepen that liquidity.”

While larger emerging markets are generally thought of as having reasonable domestic savings sectors, one asset consultant who has worked extensively with pension funds on emerging markets said: “There is a perception that institutional investors in emerging markets – for example in Nigeria, South Africa – aren’t doing enough to develop local markets. I don’t see any adventurous Nigerian or South African pension funds. We need to find ways to support emerging market institutional investors to innovate and build markets such that track records gets built and more developed market investors can pile in.”

It is clear that domestic development has the potential to resolve many of the constraints facing foreign investment, although the development needs can be substantial, requiring large multi-year programmes of support.

Information, Data and Reporting Standards

To some extent, IFRS has removed much of the international concern over incomparable reporting standards. This is despite IFRS not being universally applied because the number of markets where IFRS is not used has shrunk to the point that investors feel comfortable either avoiding those markets or familiarising themselves with the local standards.

Literature shows that IFRS adoption improves the performance of emerging markets (Ben Cheikh and Ben Rejeb 2021) but specialist managers see coping with the information challenges of unusual accounting standards as giving them an advantage. The most cited exception to IFRS is Russia followed by China, but one interviewee said the far bigger problem is the domicile of the companies and the information available about beneficial owners than the accounting standards. “Generally, a non-IFRS standard is not really exclusionary,” says a pension fund manager. “The bigger problem is the information blackout by some domiciles, like Chinese companies in the Cayman Islands who use variable interest entity (VIE) structures in which the actual economic participation in the company is difficult to determine.” VIEs are used by many Chinese companies to circumvent domestic restrictions on international ownership – they allow foreign investors to participate in the performance of Chinese companies, but do not amount to an ownership interest in terms of Chinese law (Stinebower 2021). As a result, it is very difficult to determine what rights the investor has.

When it comes to frontier markets, interviewees described the disclosure by listed firms as generally poor. One interviewee who works in data dissemination for African frontier markets described this as a result of the resource environment they operate in. "They're stuck in their mindset. They're dealing with their actual situation on the ground. They don't have the tools and resources to communicate in accordance with international standards and why should they anyway?" Of course, weak communication damages investor interest which damages liquidity, which further removes the incentives to communicate. "There's lots of these bad practices in the market, so for example stockbrokers will finance a conference call between the company and clients and because they cover the costs for the call, the audience belongs to the brokers. And the transcripts don't get out." These kinds of practices present classic information asymmetries from the perspective of offshore investors.

On the whole, though, our interviewees did not see information asymmetries as a disadvantage. According to an emerging markets equities manager: "It's a double-edged sword – [lack of information] is also a positive. Information is a challenge but the instances where we invest is partly because of that challenge – the lack of news flow, the questionable quality of accounting. If you have confidence, you have done the work appropriately and know the company well – the inefficiency is there, and the alpha is more material. We are not going to invest in a company we haven't met so most of what we are going to get is where we know them – from talking to the management, spending time talking to their suppliers, customers, competitors, etc."

Such on-the-ground work provides advantages to specialist fund managers but it comes at a high cost for on-the-ground research and larger teams to undertake. While the lack of information excites active investors, general passive market flows are much larger and will move where there is sufficient information and low-cost ways to verify it.

Market data is another constraint for investors, particularly in frontier markets. This was a point that some interviewees said separated emerging and frontier markets: the availability of consistent and frequent market data including trading data. One data provider working in frontier African markets spoke of frequent website breakdowns that could go on for days without resolution. There was a suggestion that a simple development step would be to create data dissemination standards for frontier markets with compliance marketed to international investors.

As discussed above, another important data concern was to inform ESG decision models. A large impact-oriented asset manager working in over 90 emerging and frontier markets said: "Impact and ESG information is the most difficult information gap. We literally have to put this together ourselves. And even if we have lots of experience in emerging markets, depending on the types of investees, there is limited available info. So we have to engage with investees, really guide them on how this info is crucial from our perspective. It could be anything. We are working now on a gender diversity and inclusion initiative. And you'd be surprised on how thin even the basic information is, e.g., ethnicity of clients, diversity at large. And how they don't see that this info is important – not only because you want to know your clients, but also to see it as a business opportunity. The sophistication of the impact management and measurement systems has evolved, but not necessarily the supporting data and the collection of the data on a regular basis by our investees. Generally, the conception is more data is better. But less could be more if you have the right kind of data."

The data demands of ESG were frequently flagged. A data gathering professional working in frontier markets described it as an "ESG and sustainability tsunami that appears to be taking the world over" and that African frontier market companies will struggle. "Companies are ignoring the extraordinary pressures on them [to produce data]. They don't have the resources and you know it doesn't exist in African markets."

This theme of issuers in emerging markets not being able to generate the required data was picked up by several interviewees. One suggested it presents a clear development opportunity – to engage with issuers and sovereigns to create a set of simple, low-cost information gathering tools that would fill the gap to some extent.

A key debate among our interviewees was whether ESG data quality could be priced into investments. One active investor in African frontier markets believed this was key: "We price in the risk – due to lack of information. We pay a slightly lower value for a deal when relying on imperfect information. We are also very patient in getting to the information that we require," he said. This approach, however, requires a patience and willingness to assess information quality that larger asset managers would not entertain. And many, concerned with reputational risk, dismissed the idea that you can price for information quality in ESG risk. Said a portfolio manager at a sovereign wealth fund "The emphasis is on avoiding potential blow-ups in your portfolio. If you can't get the information to satisfy yourself that an investment meets your ESG requirements, then you avoid it. You don't try and price for it – the universe is big enough to easily move on."

Valuations

The most obvious bottom-up consideration is the valuations of available assets. Emerging markets do present value on many standard indicators for equities investors. The MSCI EMI has a price-to-earnings ratio of 16.2x against the MSCI World Index of 24.2x while dividend yields are also generally higher for most historic periods. The concern expressed by most interviewees is the growth outlook, given the decade of underperformance of emerging markets relative to developed markets. Valuations can be frustrated by data gaps, which was highlighted as a concern particularly in frontier markets, but specialist managers again pointed out that these gaps provided the alpha opportunity.

However, the consistent view was that aggregates in the form of indices obscure the genuine opportunities to find value given the lack of analysis generally available on emerging markets, particularly equities. The view was that general emerging market valuations overall are dominated by China, given it accounts for a third of the index. Current fears over regulation, Covid strategies and relationships with the US have made the outlook for China particularly uncertain. Several of our interviewees expressed exasperation that the emerging markets case was being compromised by China and called for mechanisms to focus attention on the "ex-China" emerging markets. In other markets the opportunities to identify undervalued assets were considered abundant.

09

MARKET FAILURE INTERVENTIONS

When investors are concerned with liquidity, custody or other arrangements in a domestic market, service providers have aimed to resolve these problems. The problems being resolved, however, come in many forms. In some cases, solutions overcome failures created by host governments. For example, western investors struggled to gain access to Chinese "A" shares, which for many years were restricted to Chinese citizens, while "H" shares were listed in Hong Kong and available to foreigners. However, A shares tended to trade at a discount to H shares. To arbitrage this gap, various structures were created for foreign investors to channel investment into A shares. To avoid the potential regulatory pitfalls, many investors traded using American Depository Receipts listed on US exchanges. China has since made it easier to invest in A shares, and the MSCI EMI has begun to include A shares in the index. However, there is still high perceived risk about potential future regulatory actions that Chinese authorities may undertake that would affect foreign participation in A shares (Viswanathan 2021).

In our research, we investigated other examples of how investors overcome some of the challenges presented in investing directly into emerging and frontier markets. We consider these below.

Depositary Receipts and Secondary Listings

Depository receipts, commonly referred to as Global Depository Receipts (GDRs) or American Depository Receipts (ADRs), are instruments listed in developed markets that reference a share or other instrument listed on an emerging or frontier market exchange. In practice, investment banks hold the underlying shares in custody in a developing market and list the depository receipt which provides a back-to-back economic exposure to the underlying asset.

This approach addresses information asymmetries particularly regarding custody and settlement arrangements in emerging markets. ADRs are traded in familiar developed markets. The arranging investment bank takes on the custody and settlement risk in the home markets and develops specialised skills to manage these. Regulators may also require additional disclosure over and above that required by home markets. For example, in the US, the Securities & Exchange Commission requires ADRs to file Form 20-F annual reports, although otherwise disclosure requirements are the same as home countries (SEC 2012). Some studies have shown that ADRs do improve liquidity and give companies with ADRs a pricing premium (Atanasova and Li 2018).

GDRs from 44 countries are traded on the London Stock Exchange with around $700m traded/day (London Stock Exchange Group 2014). At the time of writing, Russia was the most common source country for ADRs, with South Korea, India, Egypt and Kazakhstan also among the most traded source countries. The Ukraine crisis has tested the extent to which GDRs can insulate investors from domestic risks, with trade in GDRs on Russian stocks effectively suspended.

However, our interviewees had mixed views on the utility of GDRs. The head trader from an emerging markets focused fund manager said: "Sometimes ADRs help but sometimes it can be just a token thing. If it's just to say, 'I'm listed there', but there's no action going on there, all the action is in another jurisdiction, it doesn't achieve much."

A pension fund manager says he preferred to trade Russian stocks through GDRs: "In Russia we were doing it because some of the London lines are more liquid but sometimes you buy the local line because it tracks the index price more closely. The ADRs could be useful but not so much for liquidity – rather because it saves me having to have an account in some markets where we don't trade much and are dealing with compliance."

Secondary listings are similar to ADRs, although usually imply higher commitments to report and otherwise comply with the listings rules of the secondary exchange. A secondary listing can improve liquidity and lower the cost of capital (Abdallah and Ioannidis 2010), and improve disclosures, reducing information asymmetries. Companies tend to prefer exchanges that are geographically convenient or represent hubs for capital specialising in similar issuers. For example, African issuers often obtain secondary listings in

London while emerging Asian issuers often list in Singapore. These hubs develop investment communities with specialist insight and risk appetite for regional investment. Firms can also take multiple secondary listings, which some literature suggests maximises the benefits (Ghadhab and M'rad 2018).

However, despite the literature arguing that secondary listings provide value to companies, our research, similar to ADRs, was not convincing. One emerging markets equity manager said:

> "We don't really care where a business is listed – we care about the soundness of that capital market structure and the liquidity of that stock. A London listing is probably not a bad thing although it could be detrimental to the local market if volume is shifted to London as a result."

One interviewee that manages a frontier real estate portfolio presented an interesting case study of their efforts to improve liquidity through secondary listings. The company began with a listing in Johannesburg, then moved its primary listing to Mauritius with a secondary listing in London, and finally moved its primary listing to London. Each step did improve liquidity, though it remains some way off the levels it aspires to.

Total Return Swaps

Certain investment banks have attempted to develop instruments that provide the same economic performance as a listed share (or debt instrument) in an emerging market but in a way that removes all of the domestic capital markets infrastructure risks. A total return swap pays a yield to the bank's counterparty, indexed against a reference asset, such as an emerging market listed share. The bank will hedge its risk by using its international infrastructure to buy the underling share itself, but then pay the yield to the counterparty who faces the bank's credit risk only. The bank manages the custody and other risks in holding the stock.

"We have done it at the margin," says one emerging markets equities manager. "The fees make it prohibitive usually, but there can be a case for shorter term exposures where we don't have our own infrastructure to assess the risks. We do, though, have to worry about the counterparty risk facing the bank and look at our overall exposure levels to that counterparty".

Exchange Traded Funds (ETFs)

Notionally ETFs should provide investors with ways to gain broad exposure to indices without the difficulty of managing liquidity and issues with custody within each market. Our interviewees did cite the use of ETFs as a useful mechanism in some respects, though usually because it solves tax or jurisdictional challenges. One fund, for example, avoided direct investment in Taiwan in terms of commitments to Chinese clients, but held exposure through US-listed ETFs that allowed it to track its benchmark more closely. Another fund used ETFs as part of its tax strategy – obtaining exposure through ETFs avoided challenges with withholding taxes in direct market exposures.

However, emerging markets ETFs, both in fixed income and equities, are generally considered to have large tracking errors, reflecting the liquidity issues when rebalancing. There are also relatively high management fees.

Risk Insurance

One approach to mitigating information asymmetries is to use insurance. Various government-backed, multilateral and commercial insurance options are available to limit various political and commercial risks investors may face in emerging and frontier markets. We interviewed both insurers and investors to assess this set of interventions.

Export Credit Agencies (ECAs) are known as the insurers of last resort due to their function of assuming political risks and deterring harmful host governments' behaviour, so that their insured clients can invest in risky markets (Markwick, 1998). By purchasing export credit insurance (ECI), investors can successfully strengthen their position in the host (destination) country, allocating the burden of political and commercial risk to insurance agencies. ECI policies typically provide both political risk insurance (PRI) and commercial risk insurance (CRI). ECI policies are offered by international organisations, such as the Multilateral Investment Guarantee Agency (MIGA), state-sponsored export credit agencies (ECAs) such as Export Development Canada (EDC) and the US' Development Finance Corporation (DFC), and public insurance agencies and private commercial risk insurance companies (Odkhuu, 2009; Papanastasiou, 2021; van den Berg, Beveren & Lemmers, 2019 and Wu, 2020). Commercial insurers provide comprehensive cover for political violence, expropriation and convertibility of currency available through Lloyds of London (Lloyds 2022).

Table 3: PRI and CRI events

Political risk events	Commercial risk events
Confiscation, expropriation and nationalisation of all or any material part of the business or assets of the foreign buyer/borrower;	Insolvency – sequestration, liquidation or judicial management of a borrower;
Change in Law – discriminatory decree or regulation by the host government which prevents normal business operations of the enterprise;	Protracted Default – an undisputed payment default by a borrower.
Transfer Restriction – loss incurred due to any action taken by the host government that prevents currency conversion;	
War and Civil Disturbance – loss incurred due to acts of war, revolution, insurrection, civil war, civil commotion and sabotage;	
Breach of Contract – loss incurred due to a material breach of contractual obligation(s) by the host government;	
Protracted Default – payment default by a sovereign borrower/ guarantor or state-owned entity;	
Terrorism and piracy.	

The benefits of insurance agencies providing ECI goes beyond monetary indemnification. Moreover, it is not only the insurance/guarantees that mitigate political risks (direct impact), but also the insurance agencies' market-leverage (indirect impact) that influence the governance of investment projects. PRI mechanisms include various policy requirements, operational conditions and performance standards that not only influence the engagement of the insured investors, but also shape the regulatory authority of host governments and affect local communities. PRI plays a particularly crucial role in the governance of energy and infrastructure projects due to the complexity of this sector and its importance to states and local communities (Papanastasiou, 2021). In general, international and national insurance agencies may act as indirect regulators of host country public policy, influencing policyholders' decisions on sensitive subjects such as the environment, human rights, local culture, and domestic laws. Below we highlight products offered by most ECAs that are relevant for overseas investors

Table 4: Insurance products offered by most ECAs

Financing	Insurance	Guarantee Schemes
Buyer Credit facilities	Overseas Investment Insurance	Bond support scheme
Direct lending	Export insurance	Export development guarantee
Lines of credit	Bond Insurance	Export working capital scheme
Standard buyer loan guarantee		General export facility
Standard buyer loan guarantee		General export facility

Such insurance products are focused on limiting exposures of investors and commercial counterparts to developing countries. Insurers will actively manage the risks they face and certain forms of insurance may not always be available across all countries. For example, at the time of our research, one insurance provider with a significant exposure in Russia was expecting this to decrease significantly due to the geopolitical tensions. Insurers screen the destination country of the exports; , more work goes to screening and structuring a sovereign project compared to a private or corporate project. Most insurers have a global presence as this is a very niche market and they rely on people on the ground for in-country developments, especially in developing countries. People on the ground are mostly local employees of the ECA and are responsible for assessing the macroeconomic environment and subsequently feeding the head office with information on the ground. Overall, allocation decisions are based on the ECA's insurance capacity, country risk of the destination country and risk/return. In this way, insurers can solve for some of the information asymmetries facing global investors, using their on-the-ground research and assessment capacity to absorb and manage risks that investors are then protected from.

This insurance can improve investor interest in emerging markets. Few of the investors and asset managers we interviewed were active users of political risk insurance. An exception was one interviewee who manages a frontier market property portfolio through a London listed entity and uses political risk cover to de-risk the portfolio. "Our philosophy has always been, 'We'll do the hard work: making sure there is governance, diversification, no tenant risk, hard currency revenues.' And then we also overlay a political risk insurance cover against expropriation of our assets and any restrictions on externalising proceeds. So we've completely derisked Africa. All investors need to do is bring their capital." However, the interviewee said that portfolio investors do not immediately appreciate how political risk insurance is solving the information asymmetries they face in assessing countries for political risk. The natural concern is that domestic issuers and investors are closer to the home political environment and therefore able to price these risks better. This suggests that investor appetite could be improved if awareness was built among potential investors that political risk can be managed through insurance products.

ESG considerations are also increasingly important for insurers. From our interviews, most insurers assess ESG factors as part of the project due diligence to ensure there are no negative ESG features of projects. One insurer informed us that they recently developed their internal climate policy and have also introduced new products such as green guarantees. Most ECAs are also working with other ECAs in the OECD to improve green products. "We conduct social impact assessments on our projects before underwriting them to ensure the projects will not cause any harm to the local community in the export destination. In terms of positive outcomes for the country, these are more difficult to assess and generally provided by big sponsors, consultants and technical advisers structuring the project," says one sovereign risk insurer. "Our insurance strategy going forward is to focus on climate friendly projects, particularly in Africa as this is the continent with the highest potential for renewables. Hopefully this strategic move will see our Africa exposure increase significantly in the coming years." This suggests an additionality conception of ESG which bodes well for the use of political risk cover in future African projects, particularly in renewable energy.

Investment Trusts

One approach to mitigating information asymmetries is to use insurance. Various The UK has a fairly unique asset class in the form of investment trusts. These largely hold illiquid assets like infrastructure and private equity exposures, but offer liquidity by being able to trade the portfolio. There are more than 300 investment trusts, and there has been something of a renaissance for investment trusts with the launch of several sustainability and impact focused investment trusts (McDougall 2021). The group includes 13 emerging markets specialist investment trusts (Wealth Manager 2022).

Investment trusts have the potential to solve for some of the challenge to emerging and frontier markets in that they can hold large interests in private market assets, reducing transaction costs and having sufficient interest to enforce governance and disclosure standards. They also overcome the liquidity constraints through a listed structure.

Investment trusts can work according to interviewees. One emerging markets equity specialist fund manager said: "It doesn't really exist anywhere else, it is a legacy in the UK. It depends on what you raise on day one. For these closed-end funds, the risk if it's a listed vehicle and people want to take capital out, you have a valuation NAV discount problem." This points to a problem trusts have experienced to varying degrees in that the market value can drift below the net asset value (NAV) by quite substantial margins. This makes it inopportune to raise new equity to finance further asset acquisitions during the life of the trust, leaving them to be somewhat static buy-and-hold investors.

The view is that investment trusts can work for social and environmental impact vehicles but "you really need to have positive returns or you will forever damage the public perception of the opportunity," said one interviewee.

Interviewees added that an obvious mechanism to improve investment trust usage is to provide them with tax advantages – allowing for inclusion in tax advantaged vehicles like self-invested personal pensions (SIPPs) and individual savings accounts (ISAs), or allowing tax deductibility for investments into specific categories of investment trust. “If you give a tax benefit that would drive flows, that would amount to a 50% discount which could afford to cover a lot of losses.” Of course, tax incentives can support investment flows of any sort and justification would depend on the policy priorities of the government of the day. Given, however, that supporting investment flows is a policy concern of the UK government, the inclusion of investment trusts and other funding vehicles that facilitate investment into emerging and frontier markets into tax advantaged structures like ISAs and SIPPs may be appropriate.

10

CONCLUSIONS AND RECOMMENDATIONS

One of our interviewees, an asset consultant to pension funds, makes a clear point on the likely success of interventions to promote flows: "If trying to promote flows of sustainable finance to emerging and frontier markets, start with those asset managers and investors who already have some exposure to these markets in traditional financial instruments. You can't create interest in sustainable finance in emerging markets if an interest in emerging markets isn't there already. Experience also matters: investors assign greater risk to what they don't understand."

The task of developing political stability and appropriate market infrastructure in developing and frontier markets is enormous. However, this study makes clear that there is potentially low hanging fruit that could reduce information asymmetries, lower transaction costs (particularly information costs) and thereby build investment flows to emerging markets.

We have outlined above relatively simple changes that could be made by finance and monetary authorities in emerging markets – for example, holding monthly or quarterly calls with sovereign investors to explain fiscal performance and economic data. This would build relationships with investors that would help overcome concerns on data quality and frequency. The harder work of improving statistics agencies and data reliability is important, but simple programmes for greater interaction with investors can achieve a lot too. Another investor points out the importance of marketing by emerging markets: "Sometimes the fundamentals don't support it, but when they have a story to tell, particularly around sustainability and ambitions to improve, that can make a certain market appear more attractive."

Similarly, a marketing effort is needed in the developed world to deliver on the SDGs. Large investors like pension funds and sovereign wealth funds need to develop their understanding of the impact of decisions that starve emerging markets of capital. Some work needs to be done on ESG and shifting the narrative from exclusion to additionality. Large investors should be looking to report on how they have changed the world, rather than the parts of it they have avoided. Drawing public attention, for instance through ratings of large investors on their developmental impact, could be a mechanism to focus on the issue.

Further development can be achieved with sustainable finance. Green bonds and social bonds offer a discount to "normal" bonds, but this can be developed by building out yield curves for these instruments and working on building investment flows. The qualifying criteria for the use of proceeds also needs to be developed to ensure there is genuine additionality.

We conclude with some recommendations and opportunities for further research to support the MOBILIST programme:

Solve for Data Gaps

A key problem, particularly for frontier markets, is that traditional financial data is difficult to obtain. Some domestic capital markets do not provide stable regular data on trading performance or company announcements. Sovereigns do not provide sufficiently current or high-quality statistics. Firms do not provide frequent quality information on operations. In many markets these failures are simply because of a lack of capacity to develop efficient digital interventions. Further research should be undertaken on how to develop simple low-cost mechanisms to gather data from frontier markets and make it easily available to global investors.

This point is becoming more urgent as demands for ESG data grow. Quite apart from the risks of screening out markets most in need of capital for development, markets may simply find themselves 'uninvestable' because investors cannot find the ESG data needed and therefore default those markets out of the investable universe. Both environmental and social data are problematic. Social data is harder to measure and less central to the geopolitical concerns of developed markets, but it is important that the social impact of foreign investment is also tracked, particularly to deliver on SDG additionality.

Focus on ESG Additionality

The risk of systematically biasing capital away from the poorest regions because they cannot score well in ESG screening models needs to be actively confronted. This would be a perverse outcome, failing to deliver SDGs by worsening the poverty and lack of infrastructure that holds back development in emerging and frontier markets.

Public discussion is needed about the importance of additionality in ESG. Tools need to be developed to make this feasible, including simple low-cost ways of measuring impact, and investment tools like indices to enable investors to track benchmarks for additionality investments.

Identify Opportunities to Develop Local Markets

DFIs and multilateral development institutions run various programmes to develop domestic financial systems and mobilise international capital. MOBILIST should study these efforts to identify areas where it can complement and catalyse them by mobilising investment to support domestic market development. As a centre of global emerging markets investment, London offers a natural advantage that could be used to enhance domestic market development.

Explore Insurance Products

Our research suggests that insurance is underused in managing information asymmetries. London is a commercial insurance centre and the UK public sector includes various political risk insurers. This can be the basis to build products and market them, both to issuers for use in developing their investment case, but also to investors to understand how political risk insurance can undo the information asymmetries regarding political risks that arise for foreign investors, particularly sovereign investment opportunities.

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11

APPENDIX: KEY FEATURES OF INTERVIEWEES

11 Appendix: Key Features of Interviewees

Investor Type	Number of interviewees
EM Specialist Asset Managers	7
Pension Funds	3
Sovereign Wealth Funds	3
Development Finance	2
Sell-Side Analysts	6
Large Firm Asset Managers	17
Asset Consultants	8
Other	6
	52

Interviewee location	Number of interviewees
London	21
Johannesburg	6
New York	4
Madrid	3
Cape Town	2
Harare	1
Leeds	1
Gaborone	1
Port Louis	1
Geneva	1
Dubai	1
Paris	1
Rome	1
Nairobi	1
Melbourne	1
The Hague	1
Tokyo	1
New Hampshire	1
Oslo	1
Pensylvania	1
Luxembourg	1

11 Appendix: Key Features of Interviewees

Interviewee firm HQ	Number of interviewees
UK	16
USA	11
South Africa	8
Spain	3
France	2
Zimbabwe	1
Botswana	1
Switzerland	1
Dubai	1
Italy	1
Kenya	1
Australia	1
Netherlands	1
Japan	1
Norway	1
Mauritius	1
Luxembourg	1

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Chemonics International leads the implementation of the MOBILIST Research and Policy Platform in partnership with Lion's Head Global Partners.

PwC LLP is MOBILIST's Sustainable Infrastructure Competition Manager.

Palladium Impact Capital leads the implementation of the MOBILIST Product Platform in partnership with 18 East Capital.

MOBILIST has been endorsed as a Catalytic Initiative by the CEO Principals of the Glasgow Financial Alliance for Net Zero (GFANZ), the global coalition of leading financial institutions committed to accelerating the decarbonisation of the economy, chaired by Mark Carney, the UN Special Envoy on Climate Action and Finance and anchored in the UN's Race to Zero campaign.

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