

POLICY NOTE: MARKET INDICES

Emerging and frontier market indices: From sustainability to sustainable development

October 2023



SUMMARY

- **MOBILIST research argues for a transition from sustainability indices to indices that contribute to sustainable development in emerging market and developing economies (EMDEs).**
- **Index construction is one of the most important influences over capital flows to EMDEs: Passive funds, growing in popularity, track market indices directly, while allocators use indices as benchmarks against which to assess the performance of active funds.**
- **Yet increasingly popular sustainability and ESG indices are dominated by high income and larger emerging markets, while mainstream emerging and frontier market equity indices exclude more than 75% of developing countries.**
- **New market indices that reflect potential for outsize growth and diversification could mobilise capital in support of EMDEs' sustainable development.**

CONTEXT

Index construction is one of the most important influences of capital flows to emerging and frontier markets.¹ In addition to directly informing the allocation of resources managed by increasingly popular tracker funds (see Figure 1), these indices serve as benchmarks against which the performance of more actively managed strategies are assessed. MOBILIST research shows that even ostensibly active investors in the larger emerging markets have relatively limited scope to deviate from their performance benchmark, instead preferring to 'hug the index'.²

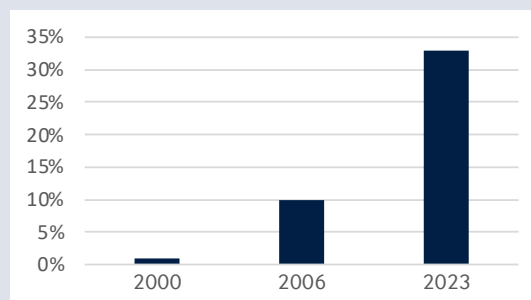
Market participants continue to express discontent with existing benchmarks for emerging and frontier economies:

- Weights in leading equity indices are heavily concentrated among a small number of larger emerging markets, while more than 75% of developing countries were at the time of writing altogether excluded from at least one major emerging and frontier market equity benchmark.⁴ Figure 2 shows higher income markets even dominate sustainable development impact indices.
- Investors have pointed out that there is a mismatch between index construction methodologies and portfolio objectives. This is because most equity indices assign larger weights to long-established large firms

in large markets, representing a disconnect with allocators' search for growth and diversification in EMDEs.⁵ Similarly, the tendency to assign companies to an equity universe based on their listing jurisdiction ignores the contribution of firms listed in higher-income markets to the sustainability and economic development of lower-income markets.⁶

- Mainstreaming of environmental, social, and governance (ESG) considerations into market indices may also work against EMDEs. Smaller companies and those in smaller EMDEs are less likely to be covered by

Figure 1 – Passive Holdings as Proportion of Foreign Money in Emerging Markets³



¹ <https://www.mobilistglobal.com/research-data/drivers-of-investment-flows-to-emerging-and-frontier-markets/>

² Ibid.

³ <https://uk.fieracapital.com/en/insights/evolving-country-concentration-in-emerging-market-indices/>

⁴ MOBILIST. Market Indices For Sustainable Development. October, 2022.

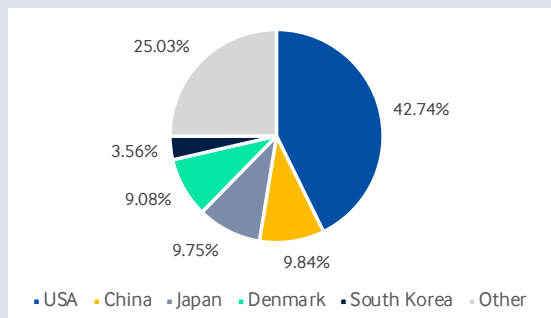
⁵ Indicative backtesting suggests that developing country equities are indeed less correlated with global markets than other emerging markets and perform at least as well as high-income countries in the emerging/

frontier universe over a five-year horizon. (See Footnote 4).

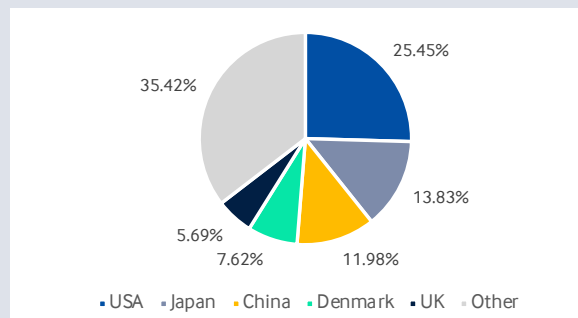
⁶ For example, Samsung Electronics is now the largest foreign investor in Vietnam by far, creating 100,000 jobs, and its Vietnamese operation generates a total revenue of USD74.2bn and export turnover of USD65.5bn. This has had a substantial knock-on effect on local industry; by now, 210 Vietnamese enterprises are participating in Samsung's supply chain. Companies like Samsung, which contribute greatly to the development of ODA-eligible countries, could be considered for index inclusion if no other way exists for the inclusion of certain ODA-eligible countries or sectors.

Figure 2 – Country Weights in Leading Impact Indices

a. MSCI ACWI IMI SDG Impact Select⁷



b. MSCI ACWI Sustainable Impact Index⁸



global ESG data providers, and where company-level data gaps exist some data providers substitute with Sovereign data.⁹ Sovereign ESG scores are highly correlated with per capita incomes, meaning that substitution of Sovereign for corporate data would penalise companies in lower-income countries. Moreover, many mainstream ESG metrics are backward-looking and do not account for EMDEs' transition to greener and more sustainable practices and technologies.¹⁰

Allocators are considering alternatives. The process of changing one's benchmark can involve material 'switching costs', which can make asset managers and asset owners reluctant to take this step. However, potential changes to the most established frontier market

equity index and to the regulations covering index providers are causing allocators to reconsider their options:

- Vietnam's ambition to be upgraded from frontier to emerging market status by 2025 could drastically reduce the liquidity and overall investability of the frontier index. As of March 2023, Vietnam represented almost half of the daily trading volume of the frontier investment universe.
- Regulators in the United Kingdom and the United States are considering appropriate measures for index providers, particularly in the case of ESG benchmarks that are often built on subjective, opaque, and inconsistently applied methodologies.¹¹

POLICY IMPLICATIONS

Additional and alternative indices should be developed, tested with allocators, and scaled.

Without a benchmark tailored specifically for assets with the potential to drive sustainable development in EMDEs; allocators seeking diversification, growth, and SDG impact through passive strategies will default to investing predominantly in developed markets or larger emerging economies. New indices that respond to allocators' performance and liquidity requirements may be needed. These indices should consider:

- 1. Universe** – Companies could be categorised in terms of the jurisdiction(s) in which they create value and not (or not only) the country in which they are listed. This could see the inclusion of companies listed in regional or developed markets while also contributing to the SDGs in EMDEs. Such a move could also support liquidity and the performance of the benchmark.
- 2. Weighting** – Companies could be weighted by factors other than market capitalisation, more fully reflecting the growth and diversification opportunities that attract allocators to EMDEs in the first place.

- 3. ESG** – Scoring and weighting could capture a company's ESG momentum or relative performance compared to peers operating in the market or sector where they create value.
- 4. Impact** – Simple approaches to assessing a company's SDG impact tailored to EMDE countries' priorities – for example, on jobs, tax, and climate adaptation – could be tested and scaled.

Such technical innovations are needed, but new indices will not in themselves enhance capital allocation. New benchmarks must be demanded, adopted, and scaled if they are to create value. MOBILIST's engagement to date has highlighted issues with existing indices and identified new entrants and new products reaching the market. However, adjusting existing benchmarks or designing and adopting additional indices will require collaboration between index providers, asset allocators, issuers, policymakers, and regulators. MOBILIST will continue to work with partners in this endeavour, recognising the scale of the opportunity to unlock passive and actively managed capital for EMDEs.

⁷ <https://www.msci.com/documents/10199/ec1f8832-c160-b843-6ae6-b60c337f972f>

⁸ <https://www.msci.com/documents/10199/6d2b3e68-90e0-448e-bd52-eaf0397539d1>

⁹ <https://www.mobilistglobal.com/research-data/resetting-the-esg-investment-paradigm-to-support-emerging-markets-developing-economies/>

¹⁰ Ibid.

¹¹ <https://www.sec.gov/news/press-release/2022-109>; <https://www.fca.org.uk/news/news-stories/fca-outlines-improvements-needed-esg-benchmarks>