Market Review

OCTOBER 2010

Sarah Orzell,
Associate Research Analyst

Frontier markets join the allocation conversation

Investors continually search for opportunities to manage risk in their portfolios via diversification. Recently, investors have turned their attention to frontier markets and are exploring the potential diversification benefits such markets may offer. Frontier markets are less developed than those in emerging countries and are generally considered more risky, and more difficult and expensive to trade in, than emerging markets. Nevertheless, investment in frontier markets has been increasing as people seek diversification from developed markets and even from emerging markets. Additionally, as investors look for new developing-market segments in hopes of achieving returns similar to those they saw in emerging markets over the past ten years, they are focusing on frontier markets as being the "new emerging markets."

To meet the new investment and benchmarking needs of investors seeking opportunities in frontier markets, Russell Investments created a new set of indexes, the Russell Frontier™ Index, for the market space.[1] In this paper we examine the performance and structure of this new index. Compared to the Russell Emerging Markets Index and the Russell Developed ex-U.S. Index, the Russell Frontier Index has historically, as provided in more detail below, provided diversification benefits with low correlation to U.S. markets and also less risk for investors. We have found, however, that the Russell Frontier Index has lagged its peers in the market recovery since March 2009.

The structure of frontier markets: country coverage

Russell's new frontier index, with 678 securities as of September 30, 2010, covers 41 countries encompassing $231.7 billion in float-adjusted market capitalization. Table 1, below, shows the constituent countries of the Russell Frontier Index, the number of securities in each and the countries' weights in the index. The last two columns of the

[1] For details on the Russell Frontier Index methodology, see "Russell Global Index Construction and Methodology", October 2010. Appendix J, pg 53. Web: <http://www.russell.com/indexes/documents/Global_Indexes_Methodology.pdf>.

table show the percentages of market cap in each country classified as large cap and as small cap.

Table 1 / Country coverage within Russell Frontier Index as of September 30, 2010

Country	# of Securities	Weight in Index	Large Cap	Small Cap
Argentina	19	4.29%	93%	7%
Bosnia and Herzegovina	1	0.02%	100%	0%
Barbados	1	0.16%	100%	0%
Bangladesh	73	6.20%	55%	45%
Bulgaria	4	0.14%	0%	100%
Bahrain	10	7.98%	97%	3%
Botswana	3	0.38%	40%	60%
Cyprus	12	3.79%	96%	4%
Estonia	5	0.26%	52%	48%
Gabon	1	0.12%	100%	0%
Ghana	1	0.16%	0%	100%
Croatia	17	1.67%	72%	28%
Jamaica	4	0.16%	76%	24%
Jordan	28	4.49%	85%	15%
Kenya	15	2.14%	81%	19%
Kyrgyzstan	1	0.04%	0%	100%
Kuwait	108	16.89%	82%	18%
Kazakhstan	9	2.52%	100%	0%
Lebanon	6	2.57%	100%	0%
Sri Lanka	23	2.12%	58%	42%
Lithuania	7	0.22%	50%	50%
Macedonia	1	0.05%	0%	100%
Malta	2	0.38%	100%	0%
Mauritius	9	1.94%	92%	8%
Namibia	1	0.14%	0%	100%
Nigeria	46	8.04%	92%	8%
Oman	29	3.14%	82%	18%
Papua New Guinea	3	3.07%	98%	2%
Pakistan	50	3.64%	70%	30%
Qatar	37	9.85%	98%	2%
Romania	8	1.14%	89%	11%
Serbia	2	0.06%	0%	100%
Slovenia	11	2.62%	89%	11%
Slovakia	2	0.08%	0%	100%
Senegal	1	0.39%	100%	0%
Tunisia	21	1.48%	64%	36%
Trinidad and Tobago	5	1.03%	100%	0%
Tanzania	1	0.04%	0%	100%
Ukraine	27	2.85%	91%	9%
Vietnam	73	3.69%	60%	40%
Zambia	1	0.03%	100%	0%

As the table shows, nine countries have all large cap securities and eight countries all small cap securities under the new Russell Frontier Index methodology. The index defines cap size on the basis of the total market capitalization of the companies it tracks. Securities are ordered by company market cap size, in descending order; the top 85% are categorized as large cap, the bottom 15% as small cap. The Russell Frontier Index assigns cap size independently of the Russell Global Index methodology, which means that large cap securities within frontier markets are not necessarily classed as large cap within the global markets context.

This new index incorporates developing countries from every part of the globe: South America, Latin America, Europe, the Middle East, Africa and Asia Pacific. The largest market region represented in the Russell Frontier Index is the Middle East, with 42.9% as of September 30, 2010.

The structure of frontier markets: deeper market capitalization coverage

Prior to the market downturn in late 2008, small cap emerging markets had been growing in size, as illustrated in Table 2, which shows the total company cap for the largest and smallest companies in the Emerging Markets and Frontier Indexes. Over time, the market cap bottom of the Russell Emerging Markets Index has been rising, with the notable exception of 2009 during the severe downturn. What was previously considered small cap in emerging markets is now being excluded from the investment universe. The bottom of the Russell Frontier Index extends to companies with as much as $124 million less in market cap than constituents of the Russell Emerging Markets Index. The Russell Frontier Index covers a smaller spectrum on the total company market cap scale, with a $20 billion spread between the top and bottom company, compared to the Russell Emerging Markets Index's $283 billion spread; however, its deeper coverage offers greater small cap exposure for investors.

Table 2 / Largest and smallest total company market cap in Russell Frontier and Russell Emerging Markets Indexes as of month-end May 2000 to month-end May 2010

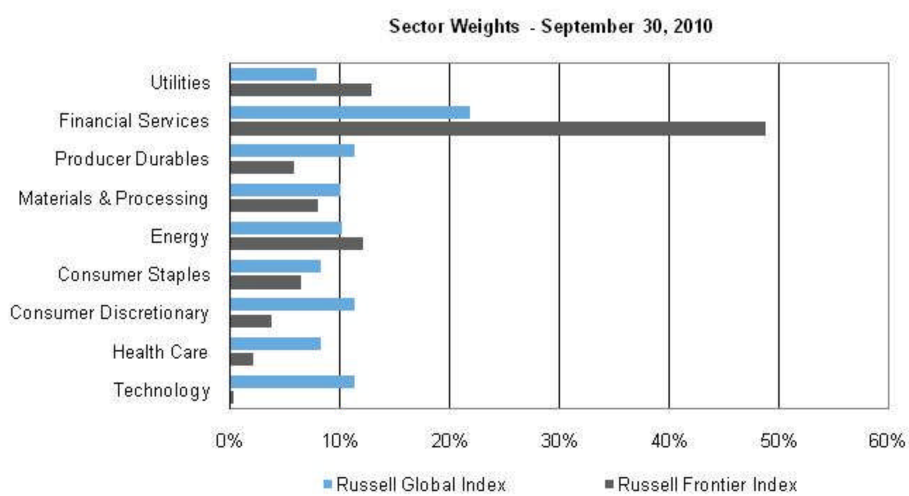
	Largest Company ($)		Smallest Company ($)	
	Frontier	Emerging Markets	Frontier	Emerging Markets
5/31/2000		102,460,792,900		45,845,004
5/31/2001		90,166,698,387		136,818,112
5/31/2002		58,800,742,424		123,723,270
5/30/2003		127,787,976,600		121,839,528
5/31/2004		84,599,185,100		152,268,620
5/31/2005		101,189,011,201		170,817,006
5/31/2006		248,462,767,466		218,552,758
5/31/2007	30,370,188,975	234,248,054,739	127,087,073	266,941,296
5/30/2008	26,494,444,487	448,319,386,069	112,105,680	257,024,033
5/29/2009	16,498,867,000	348,129,341,021	48,207,155	58,934,704
5/31/2010	19,771,596,827	282,807,159,691	62,492,745	185,843,569

The structure of frontier markets: sectors

Even though frontier market cap goes deeper into the universe of stocks than emerging markets, providing coverage of smaller companies, frontier markets are not an extension of small cap emerging markets. Frontier countries carry their own unique sets of risks and rewards. Their markets are less transparent, less liquid and more volatile than emerging markets. Much of this is due to the burgeoning stock markets in countries which are working toward fully established and stable governments.[2] The inclusion of 42 countries in the Russell Frontier Index helps diversify political risk.

Despite the risk of governmental instability, interest is growing in investing in these countries, which are, in general, rich in natural resources and which have growing, prominent consumer classes. Such factors have led many investors to believe that the potential for significant growth is present. However, it is important to note that many countries' governments control natural resources and agriculture operations, eliminating those industries from the public investable market universe. As previously noted in Russell Investment research, "Frontier markets are more likely to reflect capital-intensive industries such as banking and major manufacturing, which constitute only a small part of the real economies."[3] The sector weights reflect this effect dramatically when compared to global sector weights.

Figure 1 / Frontier sector weights compared to global sector weights, September 30, 2010



The financial services sector is heavily overweight in the Russell Frontier Index compared to the Russell Global Index, mainly due to a high concentration of banks in Kuwait, Qatar and Nigeria. In fact, banks make up 37% of the index. The technology, health care and consumer discretionary sectors are extremely underweight compared to the global market as represented by the Russell Global Index. This is expected, as the countries in the Russell Frontier Index are in the earlier stages of development and

[2] Crawshaw, Hanekom and Lin, "New Frontiers in Equity Investing." Russell Investments, November 2008 p. 5.

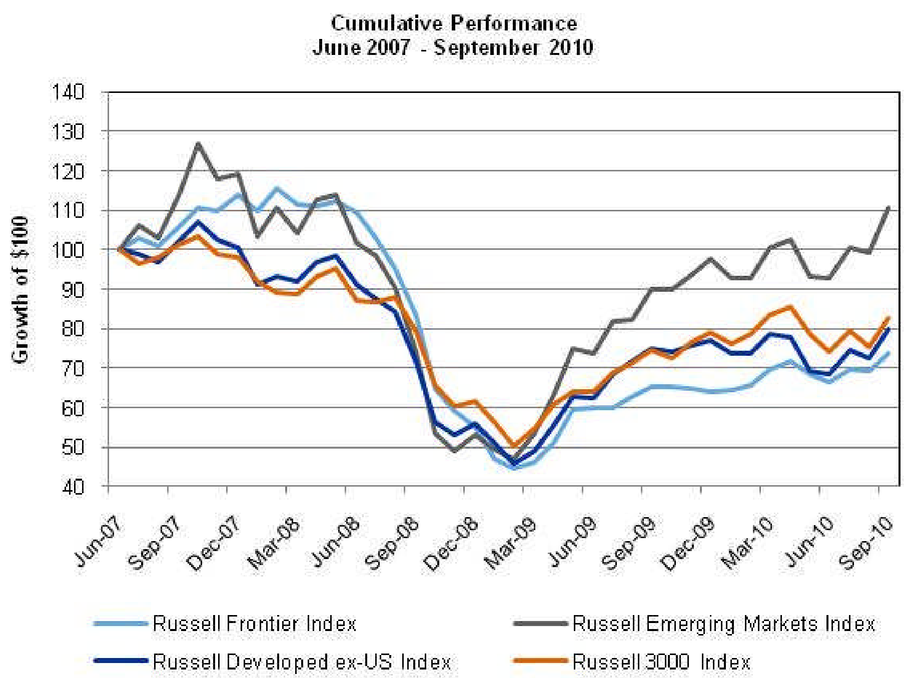
[3] Ibid., p. 3.

many have not reached a point of high investment in developing technologies or healthcare.

Frontier markets: recent performance

Figure 2 shows the growth of a $100 investment made June 29, 2007 in the Russell Frontier Index, Russell Emerging Markets Index, Russell Developed ex-US Index, and Russell 3000® Index, held through September 30, 2010. While all four indexes experienced similar performance through February 2009, the Russell Frontier Index has lagged its Emerging Markets Index counterpart significantly since the market rebound began in March 2009.

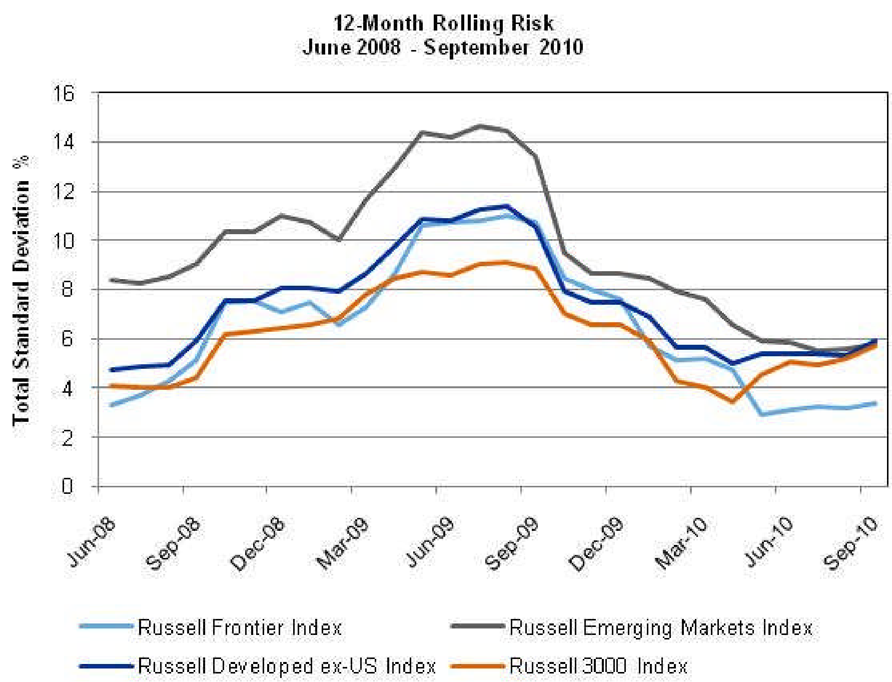
Figure 2 / Growth of $100 in global markets from month-end June 2007 to September 2010



Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.

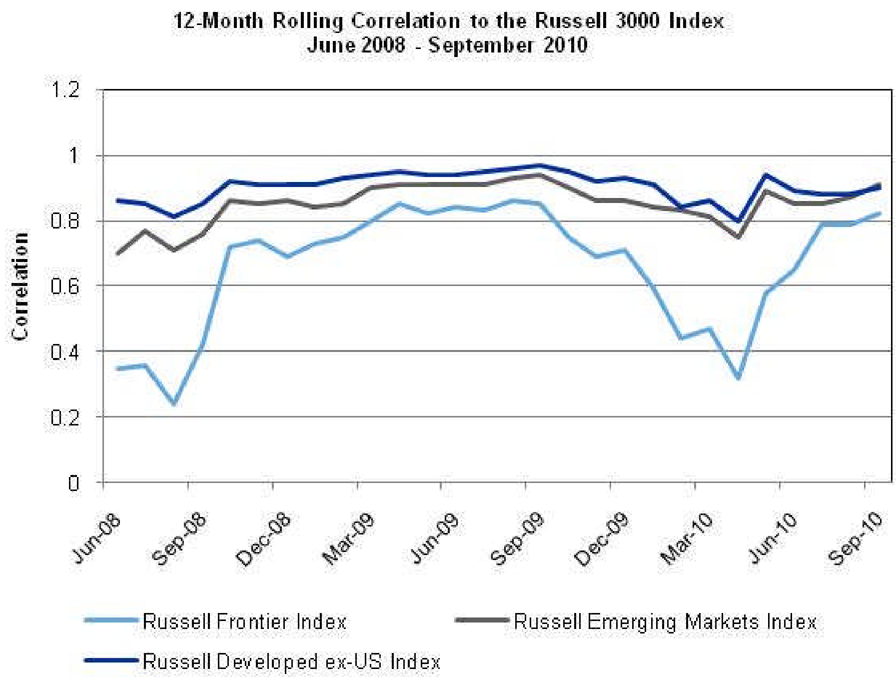
Conventional wisdom assumes that volatility has historically been higher in frontier markets than in developed and emerging markets; however, in the past three years, frontier markets have exhibited lower volatility. Figure 3 shows that in this period, volatility of the Russell Frontier Index has consistently been lower than that of the Russell Emerging Markets Index and the Russell Developed ex-U.S. Index, but it has been intermittently higher than the volatility of the Russell 3000® Index, a measure of the U.S. broad market. The Russell Frontier Index became the least risky broad market segment in May 2010 and remained so through September 2010.

Figure 3 / 12-month rolling volatility, month-end June 2008 to month-end September 2010



The frontier segment of the global market has been attractive to U.S. investors because it has provided a certain level of protection from global and domestic market effects during the recent global economic downturn. Figure 4 shows that the correlation of frontier markets to the U.S. broad-market Russell 3000® Index has been significantly lower than its correlation to Russell's Developed ex-U.S. and Emerging Markets Indexes.

Figure 4 / 12-month rolling correlation to Russell 3000 Index, month-end June 2008 to month-end September 2010



While the Russell Frontier Index did experience high correlation to U.S. markets between October 2008 and September 2009, outside this period the index shows great diversification, with correlation reaching as low as 0.24 in August 2008. The decrease in correlation from late 2009 to April 2010 is attributable to the frontier markets' slower recovery compared to U.S. markets.

Conclusion

As risk-embracing investors seek to dive deeper into global markets and gain access to more countries and smaller companies, a new market segment is being established. The new frontier of investing, frontier markets, is joining the asset allocation conversation. Over their short indexed histories, frontier markets have provided greater diversification opportunities than emerging markets have. While frontier markets are experiencing slower recovery, they have also historically offered reduced volatility to investors as compared to emerging markets.

Increasing investor acceptance of frontier markets opens doors for countries that have previously been viewed as either too politically dangerous or too economically unsound for inclusion in the global investable universe. Investors' bringing capital to these markets will encourage countries to further expand and integrate into the global arena.

For more information about Russell Indexes, call us or visit www.russell.com/indexes.
Americas: +1-877-503-6437; APAC: +65-6880-5003; EMEA: +44-0-20-7024-6600

Disclosures

First use: November 2010.

CORP-6399