The Frontier Line

Re-underwriting the case for emerging markets

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Forefront Thinking

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About us

Frontier Advisors has been at the forefront of institutional investment advice in Australia for over thirty years and provides advice on $900 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Our purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing; customisation; technology; and an alignment and focus that is unconstrained by any product conflicts.

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Introduction

Frontier has consistently advocated for a strategic allocation to emerging markets (EM) within an investor's global equity portfolio.

Despite this, EM equity performance has continued to disappoint over the past decade and longer, having underperformed developed markets (DM) significantly.

2025 marked a change of fortune for EM equities, prompting the question of whether this was a one-off or the beginning of a sustained outperformance similar to the mid-2000s. As such, our Equity Team took the opportunity to re-underwrite the case for EM equities and to investigate what, if anything, has fundamentally changed regarding the investment thesis.

While the ultimate goal of this paper is to identify what's changed, we initially interrogate our assumptions underpinning our strategic EM allocation, particularly the diversification benefits for Australian investors, higher excess returns potential, and long-term return premium over DM. Following this, we examine EM fundamentals, which we believe are showing signs of improvement, supported by macroeconomic (top-down) and corporate governance (bottom-up) reforms that should strengthen economic and market resilience. We explore the role of EM in providing a fundamental diversifier, particularly as it relates to US dollar cyclicality and AI exposure in the US. Finally, we identify some of the key risks investors need to be aware of when investing in EM as well as some key implementation considerations.

1. Assumptions underlying our strategic EM allocation →
2. Improving fundamentals in EM →
3. Fundamental diversification →
4. Risks and implementation considerations

Historic rationale supporting our strategic EM allocation

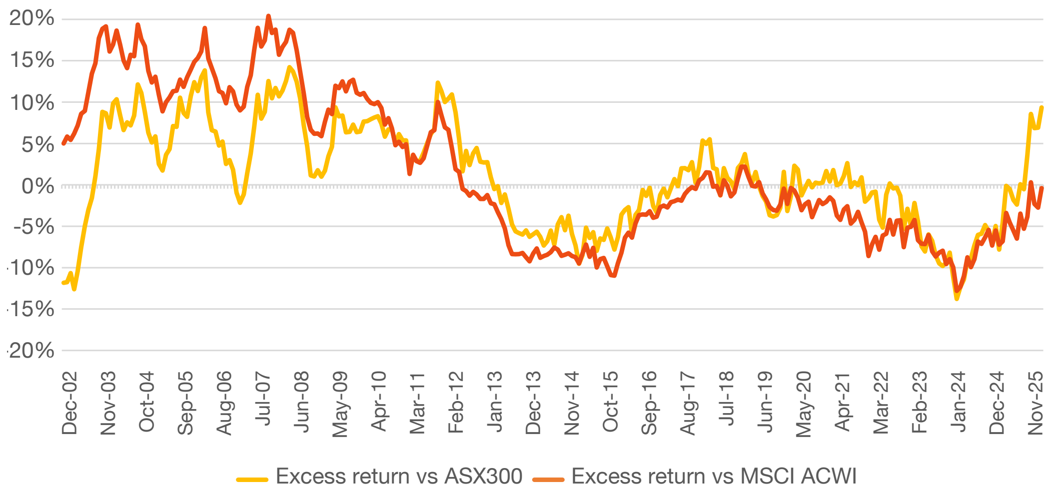
- **Diversification** - The MSCI EM has in the past exhibited lower correlations to the S&P/ASX 300 Index compared to MSCI World, indicating potential diversification benefits for Australian investors.
- **Underrepresentation in global benchmarks** - EM markets are underrepresented in global equity indices compared to their overall contribution to the world's economy.
- **Favourable economic fundamentals** - Higher GDP growth in EM provides a potential for higher earnings growth relative to DM.
- **Enhanced portfolio risk-adjusted return** - Our recommendation for an overweight to EM compared to MSCI ACWI is driven by the potential for long-term return enhancement, enhanced diversification and long-term volatility reduction.

The above rationale has supported our strategic allocation recommendation to EM within global equity portfolios. Despite the promising fundamentals, EM have struggled to realise this potential over the past decade.

Quantitative assumptions underlying the strategic EM allocation

Long-term return premium assumed for emerging markets

Chart 1: MSCI EM three-year rolling excess returns*

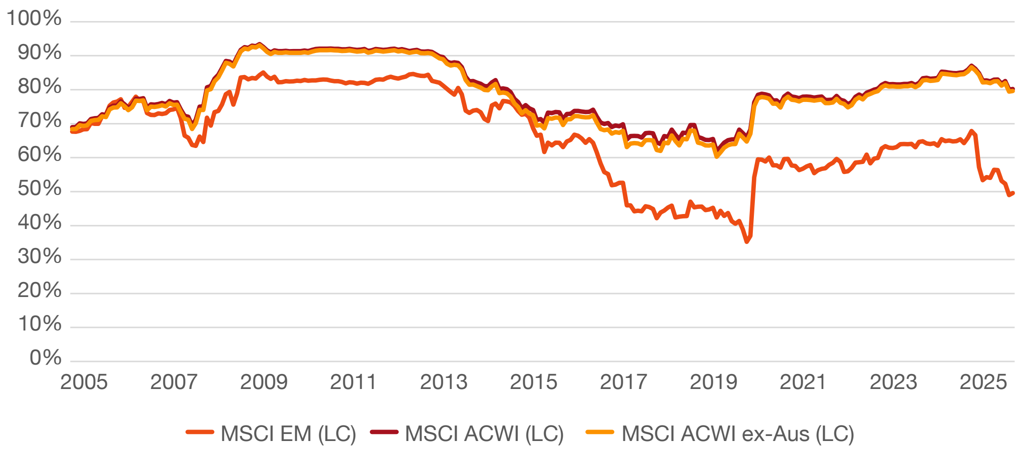


Source: LSEG Datastream
*Benchmarks are total return in local currency

Our Capital Markets Team continues to assume a long-term return premium of 1.5% for emerging market equities relative to DM owing to the additional systemic risk investing in less developed markets and relative illiquidity investors take on as part of an EM allocation. Apart from a period during the 2000s up until the middle of 2012, EM equities have struggled to sustainably achieve a return premium over global and Australian equities. The recent peak of rolling three-year excess return of ~9.4% represents the strongest level of outperformance (over Australian equities) since the late 2010s when Chinese stocks drove market returns (which also outperformed DM in 2025). Recent outperformance has also levelled the return discrepancy between EM and DM over a rolling three-year basis for the first time since 2019.

The high diversification benefits for Australian asset owners remain

Chart 2: Five-year correlation with ASX300



Source: LSEG Datastream

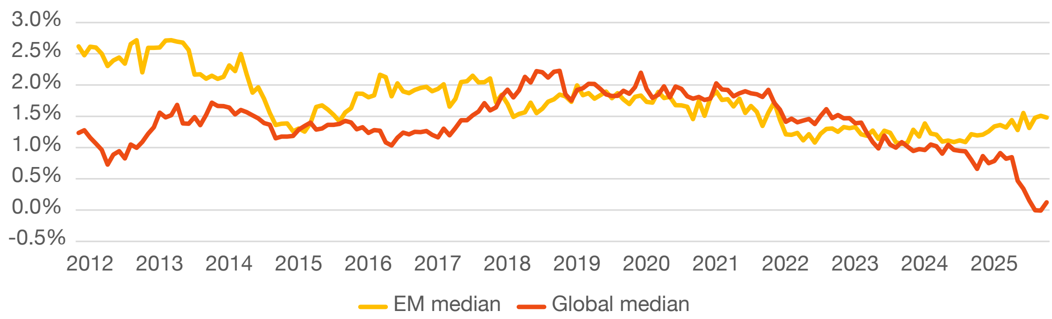
Historically, the commodity driven nature of EM has led to higher levels of correlation with Australian equities. This relationship has weakened noticeably, with EM offering higher levels of diversification benefits (compared to DM) for Australian asset owners who tend to have a high proportion of domestic equity exposure.

Global stock markets have become increasingly interconnected, creating a spillover effect. It reflects the degree to which different markets affect one another, be it through direct relationships (trade, finance) or common external factors (global economic conditions). Despite both Australian and EM equities being considerably exposed to commodities, we have seen the correlation between MSCI EM and the ASX 300 decouple following the COVID-19 rebound in 2021. As this divergence continues, correlation and beta have significantly dropped, with the five-year rolling correlation dropping below 0.5 as of 31 December 2025. Interestingly, when including FX exposure, this correlation reduces further.

As we will discuss later in the paper, EM has become increasingly tech and consumer-driven (i.e. Taiwan and Korea), whereas the ASX 300 has remained resources and financials heavy. There are further conclusions to draw from these developments, but for the moment we can safely assume the diversification argument of EM for Australian investors still holds as true today as it has in the past decade.

Excess return generation in EM remains robust

Chart 3: Active management alpha generation - Rolling ten-year excess returns (gross of fees)*



Source: eVestment
*EM manager excess returns assessed against MSCI EM index, global median assessed against MSCI ACWI

Managers in both global and emerging markets have undergone significant challenges in recent years. Prolonged US equity outperformance and strong gains in Chinese tech stocks from 2017 to 2021 have reduced excess returns for the median manager across both markets over the past decade. Despite market concentration posing similar challenges to EM managers (TSMC is currently ~13% of MSCI EM), the level of excess returns has remained robust compared to DM managers in recent years. The median EM manager has delivered 1.5% in excess returns over the past ten years, which compares to 0.1% for the median DM manager.

While coming down in recent years, fees within EM remain higher (in general) than in DM. We currently observe a 0.125% higher fee in EM (at the midpoint) compared to DM. This may erode the excess return advantage of EM managers, though we believe the current performance has so far justified higher fees. The excess return potential of EM has been realised in recent years compared to DM, justifying the deployment of active management in the market and upholding our excess return assumptions in EM.

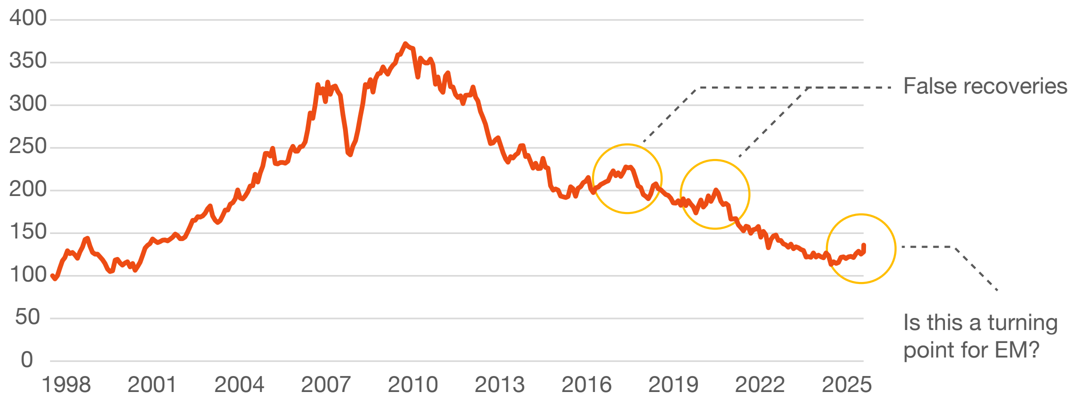
So, while all the assumptions underpinning our strategic EM weighting remain, and in some cases have strengthened today, we now turn to the question of what has changed.

A turning point in the relative performance of EM?

In the first decade of the 2000s, EM significantly outperformed DM, riding the wave of rapid growth in China, India and other emerging economies. On the back of a commodity supercycle, a falling US dollar and a continued expansion in globalisation, emerging markets became a larger part of global equity indices and asset owners' global equity portfolios. Since 2010, and despite all the favourable fundamentals, EM has substantially underperformed DM due to slowing growth in the Chinese economy; weakness in commodity prices; US dollar strength; and the tech boom in DM among other factors. The outperformance of EM over the past year marks yet another potential turning point in its relative underperformance against DM. Previous periods of outperformance in 2016/17 and again in 2019/20 proved to be false recoveries before continued underperformance.

One of the most pertinent questions facing asset owners today in their global equity portfolios is whether this recent outperformance is the beginning of sustained outperformance of EM or yet another false dawn in their relative performance struggles over the past 15 years. In the following section, we will seek to address this question and re-underwrite the case for a strategic emerging market allocation within global equity portfolios.

Chart 4: MSCI EM versus MSCI World - Cumulative excess return (in AUD)



Source: eVestment

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Improving fundamentals

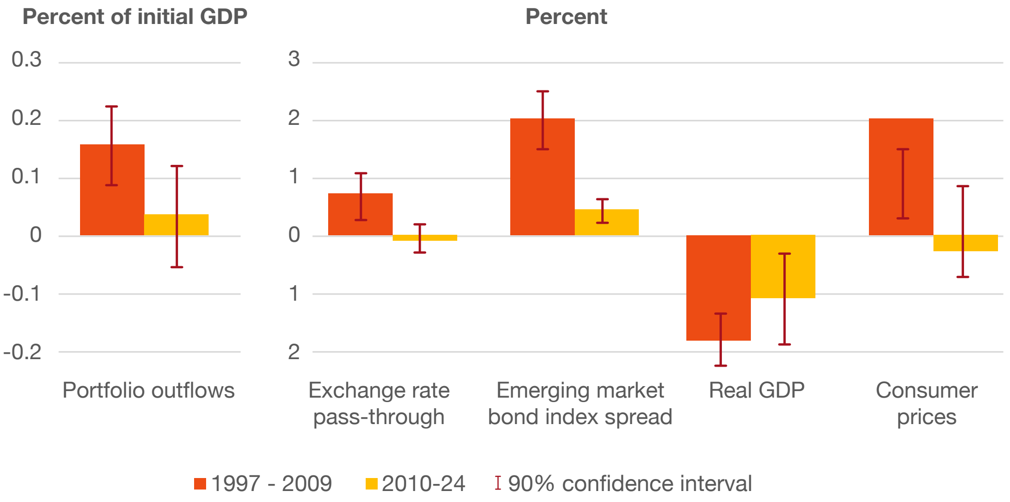
Recent policy reforms of EM economies

Investing in EM has traditionally been associated with heightened volatility, currency risk, susceptibility to capital controls (such as those seen in Russia following its invasion of Ukraine) and vulnerability to global financial shocks. These challenges often stemmed from weaker policy frameworks, limited fiscal space, and susceptibility to sudden capital outflows within many EM economies. However, as highlighted in recent papers written by the IMF and Bank of International Settlements, many countries in EM have strengthened their monetary, fiscal, and macroprudential frameworks. This shift is reducing systemic risk, improving policy credibility, and creating a more stable environment for equity investors – potentially transforming the risk-return profile of these markets. Key findings include:

- Stronger monetary, macroprudential, and fiscal frameworks have improved economic resilience in EM. More EM central banks now have explicit inflation targeting goals, while the debt burden of many EM countries is smaller than their DM peers.
- EM countries now experience smaller output losses and negligible inflation during risk-off episodes.
- This has led to deepening local currency financing, further improving the resilience of EM economies to external shocks.

The implications for equity investors are clear. Improved monetary, fiscal and macroeconomic policy frameworks across many developing economies has improved the resilience of EM. This should ultimately lead to a better operating environment for companies and greater stability in the long-term return profile of equity markets in EM.

Chart 5: IMF estimates of the positive effect of policy reform in EM



Source: IMF

Corporate governance improvements

The top-down improvements we have witnessed in policy frameworks across many EM economies have spread to the corporate level, with numerous corporate governance programs recently put in place, all with the aim of improving shareholder returns over time. Following the success of Japan's 'value-up' programs, similar programs have been launched across Korea, China and Brazil. Success in these programs may encourage other countries in the EM complex to launch similar programs for domestic companies. These reforms aim to improve how GDP growth translates into earnings growth for emerging market companies (and ultimately shareholder returns), an area that has long disappointed investors.

- **Korea:** South Korea's *Corporate Value-Up Program*, launched in 2024, aims to reduce the "Korea Discount" by encouraging companies to voluntarily improve governance, capital efficiency and shareholder returns. Participating firms must publish a three-year value-up plan with targets for metrics like ROE, P/B ratio, dividends and board independence, and update progress annually. Large companies (assets over KRW 500 billion) must include these plans in governance reports. The program offers incentives such as fee reductions, awards and priority IR opportunities, while institutional investors are urged to monitor compliance through an updated stewardship code.
- **China:** The China Securities Regulatory Commission's 2024 "market-value management" guidelines require listed companies to improve intrinsic value and shareholder returns through measures such as better governance, dividends, buybacks and investor relations. Boards and executives must lead these efforts, with stricter rules for major index constituents and firms trading below net asset value. According to Reuters, these guidelines have already begun to have an impact with the Shanghai Stock Exchange Composite Index dividend yield reaching 3.6% in 2024, an improvement of 0.83 percentage points on the year before as well as record levels of share buybacks.
- **Brazil:** Despite challenges with corporate governance reform such as the *2024-25 Novo Mercado reform*, Brazil has become the first country to adopt the International Sustainability Standards Board's (ISSB) IFRS S1 and S2 standards, with voluntary application starting in 2024 and mandatory use required from 1 January 2026. This is expected to significantly improve transparency and comparability of sustainability reporting, aligning local practices with global norms. This move will likely boost investor confidence, attract more international capital, and reduce greenwashing risks by requiring standardised disclosures and external assurance from 2027.

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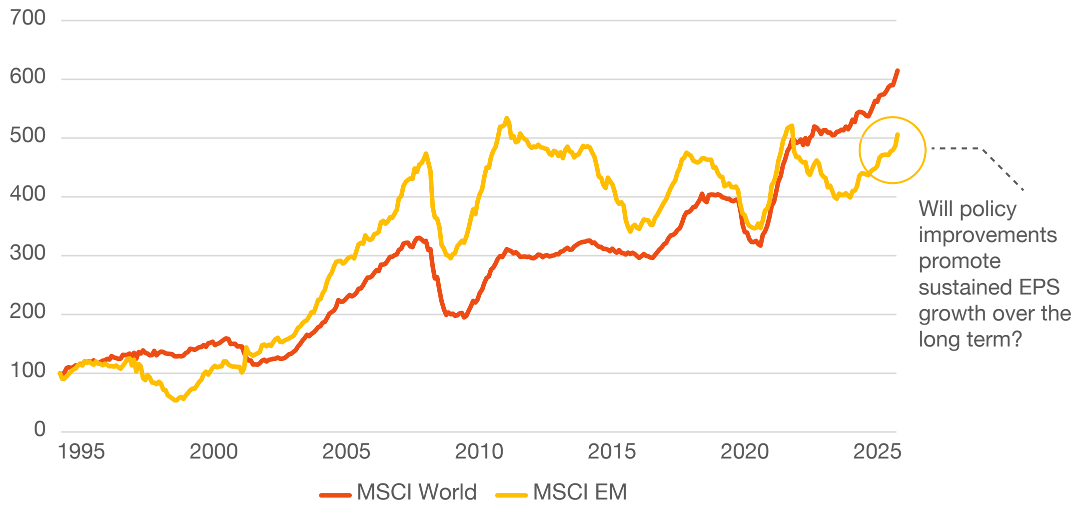
Potential for greater pass-through of EM growth to corporate earnings

Underpinning the investment thesis for EM has been a positive economic story, with favourable demographics and higher GDP growth potential (compared to DM), expected to translate into higher earnings growth for companies with emerging markets exposure. Despite the higher GDP growth being realised, emerging market companies have historically disappointed investors with limited to no pass-through of this growth into corporate earnings in the early 21st century.

Despite strong GDP growth, EPS in EM has flatlined over the past 15 years. The end of the commodity supercycle, declining returns on equity for Chinese companies, heavy equity dilution, and persistent US dollar strength have meant EM has failed to regain its 2011 peak earnings per share. These factors have also contributed to deeper drawdowns in earnings in EM.

That said, many EM economies have made strides in recent years to improve shareholder value accretion. Improved corporate governance frameworks across many emerging market economies have increased the alignment of interests between controlling and minority shareholders, with a focus on boosting shareholder returns via improving return on capital metrics. We are beginning to see these policies bear fruit with a sustained improvement in EPS growth in EM.

Chart 6: Earnings per share (EPS)



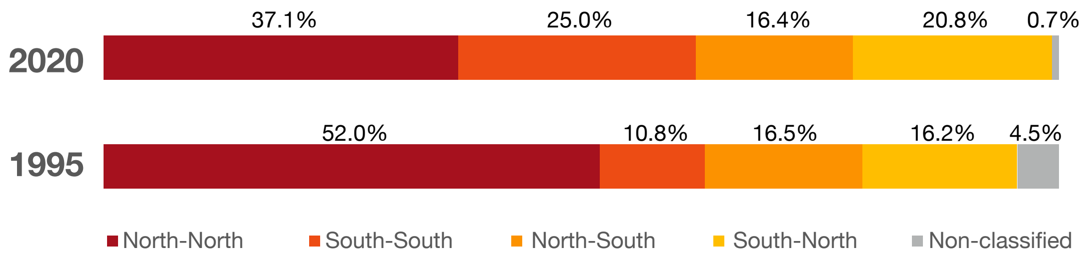
Source: LSEG Datastream

Resilience in the face of tariffs

Entering 2025, the global economy faced significant uncertainty as the threat of tariffs from the US administration became a reality on 'Liberation Day'. While many of these were partially wound back in the weeks that followed, the overall level of tariffs finished the year significantly higher. Elevated levels of economic uncertainty and trade frictions have historically been a toxic mix for EM economies which tend to be more export driven. Despite this, we saw remarkable resilience from many EM economies. In China, despite US tariffs set at more than 100% in April, before dropping to 30% in May, Chinese real GDP grew 5.9% YoY to November 2025[1]. This has been led by higher tech exports of semiconductors, autos and auto parts.

In addition to the macroeconomic reforms within many emerging markets, the past 20 years have seen deepening trade relationships between EM economies. What is often called the 'South-South trade' (between EM countries) has grown from 11% of total global trade in 1995 to 25% in 2020[2], growing at 3x the speed of 'North-North trade'. Importantly, this has occurred gradually over the past couple of decades as opposed to being a knee-jerk reaction to tariffs in 2025, indicating the sustainability of the shift. Ultimately, EM countries are now less reliant on trade with DM today and in fact trade more with one another. This trend is only set to continue as regional integration in emerging markets continues.

Chart 7: Share of global trade by developed and developing countries, 1995 - 2020



While promising, investors only have to look at the Chinese economy to understand EM countries are still heavily reliant on global trade. Notably, a growing share of EM countries' exports are destined for other EMs as regional integration increases. This explains the resilience of EM over 2025 and underscores our conviction in the investment case for EM equities in the face of any geopolitical concerns.

Chart 8: Exports to the US and merchandise trade

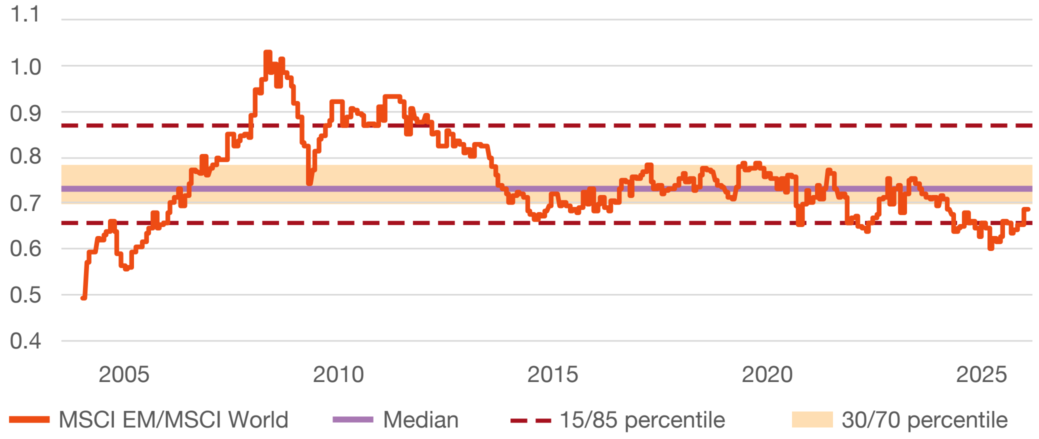
Source: LSEG Datastream

1 Source: Reuters

2 Source: IFM

Valuations

Chart 9: Emerging market relative forward price/earnings ratio



Source: LSEG Datastream

Chart 10: MSCI cyclically adjusted P/E (CAPE)

Source: LSEG Datastream

Despite recent increases, the current valuation of EM (relative to DM) provides a solid entry point for long-term investors wishing to establish or increase their position to EM.

With the continued strong performance of global equities following the COVID-19 rebound, concerns regarding the valuations of risk assets globally are well founded. While not necessarily cheap in an absolute sense, EM currently offers compelling relative valuation appeal for investors wishing to maintain equity exposure at more tolerable valuation levels.

With improving fundamentals at both a macroeconomic and corporate level, the spread between DM and EM multiples could narrow closer to their historical median. However, in absolute terms EM valuations look full on both a trailing and forward basis. Both medians sit comfortably above the long-term median.

The gap in valuations arguably speaks more to the extreme levels seen in DM, more specifically the US. Countries within EM look full in terms of valuations, particularly in the larger markets of India, Korea, Taiwan, and to a lesser extent China. However, a positive rerating remains possible, given the cyclical macro environment remains supportive. Ultimately, while EM isn't cheap on a stand-alone basis, for investors wishing to gain exposure to equity beta, it remains the most reasonably priced out of all the major market regions.

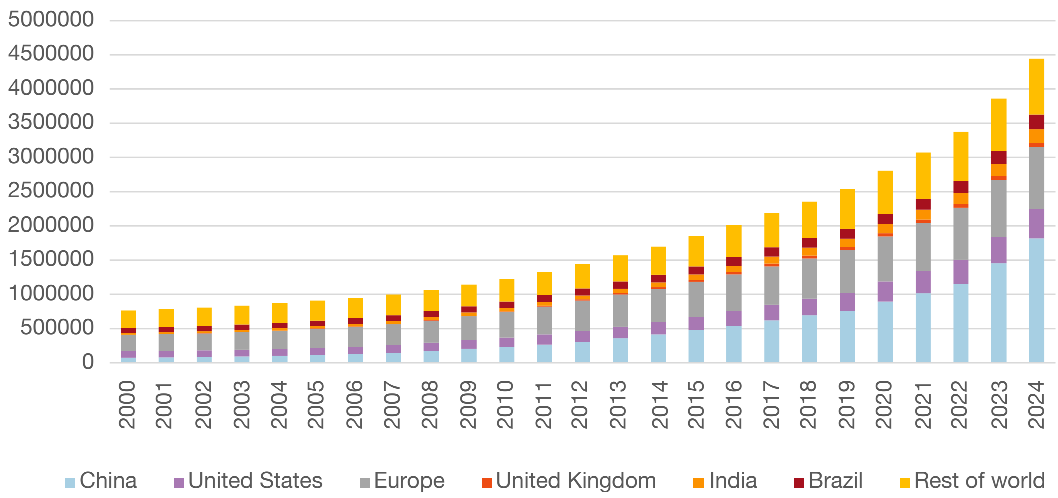
The ESG risks in emerging markets are evolving

While not underplaying the heightened ESG risks still present in emerging markets (e.g. bribery, corruption, modern slavery), there has been an improvement in the ESG landscape. In addition to the improvements in governance and macroeconomic policies, there has also been a significant change in the role emerging markets are playing (most notably China) in the energy transition. We have also been exploring AI-related ESG risks such as the double-edged sword of humanoid robotics and data privacy considerations. However, combined, emerging markets represent an improved ESG proposition for investors today.

The original roadmap for the energy transition was led by policy in DM, while EM lagged. Over the past five years, this has evolved with some economies in EM leading investment and innovation in clean technologies.

As clean tech has become the most economic option, the EM transition has accelerated. EM economies are forecast to lead the path to electrification going forward as China continues to invest significantly in clean technology. China has prioritised technological innovation over the past decade to drive its low-carbon transition, with a focus on advancing energy technologies. Within the framework of China's 1+N policy system for carbon peak and carbon neutrality, the development of low-carbon technologies is actively encouraged to foster the synergistic advancement of carbon emissions reduction and economic development, supporting a green transformation and high-quality growth. Chart 11 is just one of many instances where China has become a global leader in a certain clean technology. Frontier's recent trip to China was focused on companies at the forefront of automation and AI deployment, however, it also highlighted how strategically important industries, including those tied to decarbonisation (such as EVs and renewables) are transforming the economy and in some cases moving China up the value chain.

Chart 11: Renewable electricity installed capacity



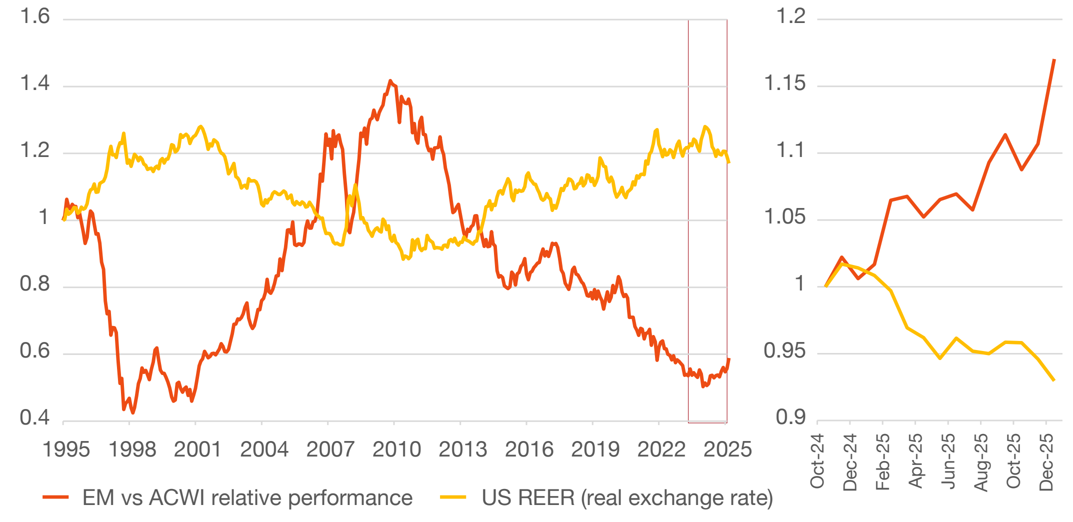
Source: Frontier Advisors, International Renewable Energy Agency (IRENA)

While risks remain, it is fair to say the ESG credentials of EM have improved significantly over recent years, highlighting another lens on the improving fundamental picture of EM.

Fundamental diversification

Historical relationship exhibits a link between US dollar levels and MSCI EM outperformance

Chart 12: EM relative outperformance and USD real exchange rate



Alongside what we view as improving fundamentals in EM, recent market developments regarding the length in the USD cycle, US exceptionalism leading to concentrated DM benchmarks and the AI buildout, have only strengthened the diversification argument for EM equities.

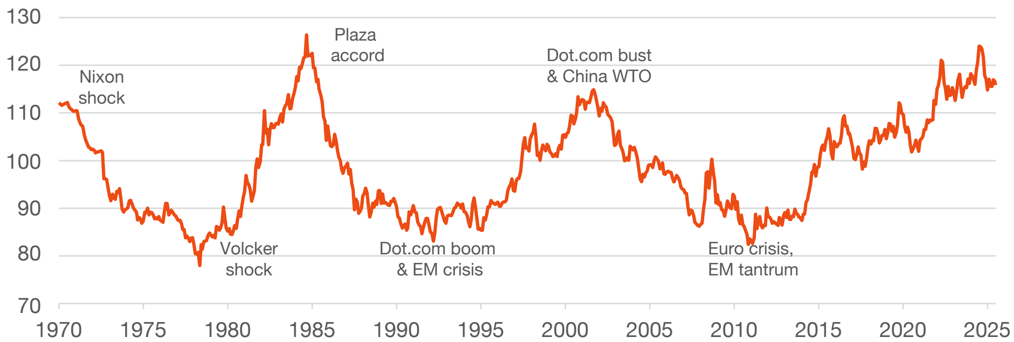
Historical analysis tells us in periods of weakening US dollar, EM equities tend to outperform relative to DM equities. The last decade has seen a sustained US dollar upcycle, and a corresponding prolonged period of underperformance for EM equities. This relationship has worked in favour of EM equities this calendar year, which has seen MSCI EM outperform MSCI ACWI. Fourteen of the 20 most traded EM currencies have appreciated against the dollar, compared to just four in 2018.

A weakening US dollar lowers hard currency debt costs, improving firms' purchasing power. This also increases the purchasing power of domestic consumers within EM countries, improving domestic consumption growth. During these periods investors tend to reallocate to domestic assets, boosting local markets' liquidity. Uncertainty around the US dollar and subsequently US equities could lead to EM asset owners, who like most global asset managers are heavily invested in US assets, repatriating capital back into EM equities.

A sustained EM equity rally could see institutional investors neutralise their material underweight position in EM (5.3% of global equity AUM is in EM mandates (JP Morgan), in comparison to EM's 10.8% share in MSCI ACWI). Commodity prices, a key driver across many EM economies, tend to rise as US dollar weakens. Major commodities are priced in US dollars, making them relatively cheaper for non-US buyers, boosting global demand. A weaker dollar also boosts unhedged EM equity returns for US investors through favourable currency effects.

Dollar cycles are far more entrenched and deeper than other economic cycles

Chart 13: USD real trade weighted index



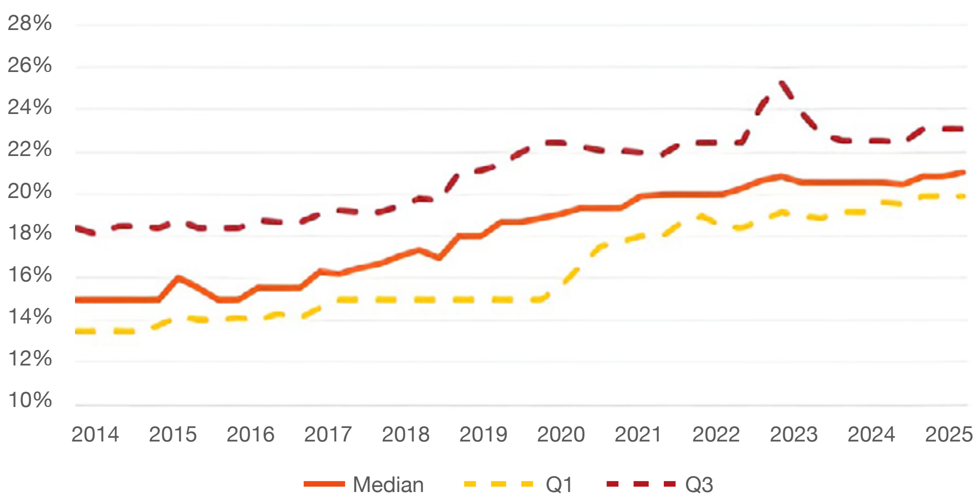
Source: Bloomberg

Despite retreating from its peak, the US dollar level remains high, as does the length of the current upcycle. This comes at a time when the exposure of Australian institutional investors is at multi-decade highs.

Dollar cycles typically last 16-20 years, far longer than other economic cycles. Dollar cycles tend to be slower to form, difficult to shift, and longer to unwind. Since 1970, we have seen three full dollar cycles; each shift in the cycle caused by significant catalysts. The current US dollar upswing has been particularly pronounced in its duration.

It is beyond the scope of this research paper to speculate on the beginning of the US dollar downcycle. We do, however, want to point out the total foreign currency exposure of Australian institutional investors has grown by over 30% over the past decade. Analysis by our Defensives and Alternatives Team highlights the median superannuation fund retains ~21% of foreign currency exposure (before overlays or derivatives), up from 15% in 2014. With US equities representation in global benchmarks growing rapidly over the past decade, funds' overall exposure to the USD is estimated to make up ~60% of this.

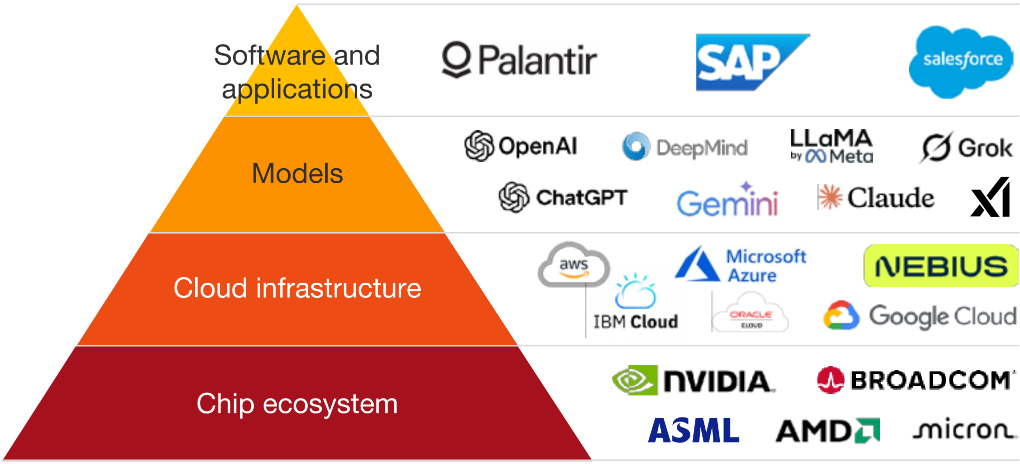
Chart 14: Median MySuper currency exposures have increased over time



Source: APRA, Frontier Advisors. Quarterly strategic asset allocation data from 2013 - June 2025

At a time when Australian investors' exposure to the USD has arguably never been higher, it is prudent to highlight the diversification benefits EM equities can often provide during USD downcycles.

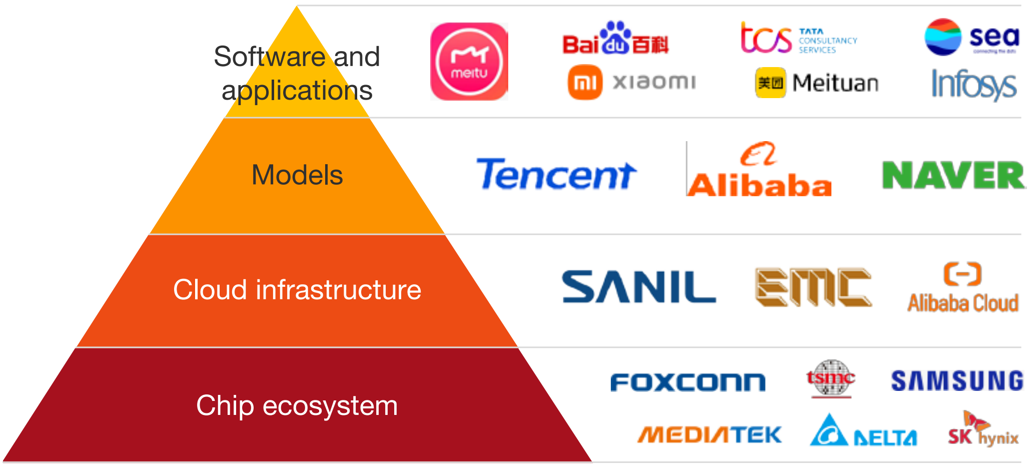
Investors' current AI exposure in developed markets is concentrated



Investor discussions often describe the AI ecosystem as a pyramid comprising four layers: chip ecosystem, cloud infrastructure, models and software/applications. A key question for 2026 remains how best to gain exposure to this theme, particularly where long-term value will ultimately accrue within the pyramid? We published a paper in December 2025 relating to navigating the AI revolution in international equities.

Given the uncertainty and wide range of outcomes possible, a diversified allocation across all layers is the most prudent approach for global equity investors. While not exhaustive, our recent research highlights leading companies driving the AI revolution above. Notably, these firms represent over 25% of the MSCI World benchmark, with exposure concentrated in the middle layers – cloud infrastructure and models. Such concentration poses risks if value shifts to other segments, as occurred with infrastructure providers during the dotcom era.

AI exposure of emerging markets is complementary to cloud infrastructure



Emerging markets offer a broad exposure to the AI thematic, with many EM companies at the forefront of new AI software and application development. Despite TSMC representing ~13% of the benchmark, emerging markets offer a more diversified exposure to AI than the hyperscaler and LLM dominated DM benchmarks.

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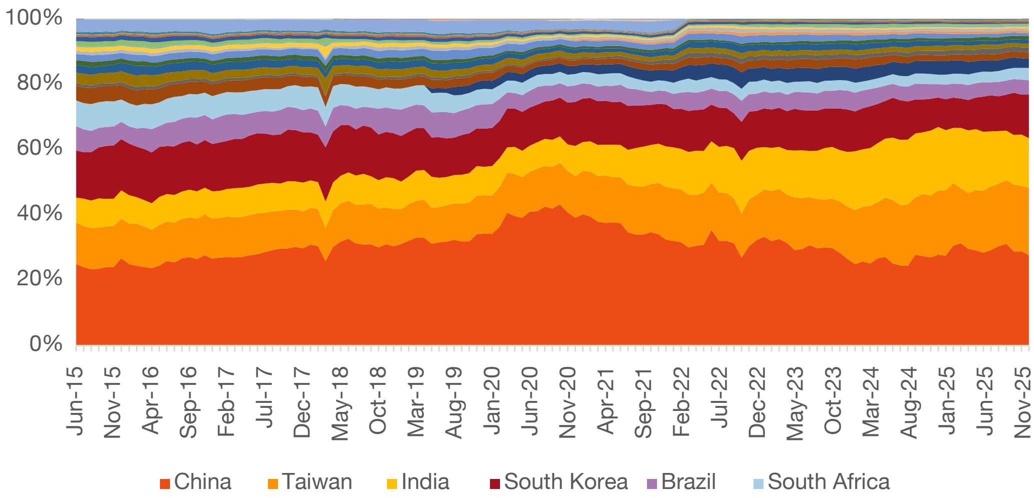
While more concentrated at an index level, diversification benefits go beyond just the headline index exposures:

- Large EM index constituents such as Alibaba, Tencent, Xiaomi, Samsung and SK Hynix have exhibited limited to no correlation with the Mag-7 index.
- AI exposure of EM index centres around software and application developers as well as the physical ecosystem surrounding semiconductor chips.
- Our recent US research trip indicates managers are finding a number of opportunities down the capitalisation spectrum in EM that stand to both directly and indirectly benefit from continued developments in AI.

Ultimately, EM equities offer asset owners a crucial chance to diversify their AI exposure to complement holdings in large US technology companies, and in particular the hyperscalers, at a time where investors are beginning to question capex commitments. DM AI leaders trade at premium multiples, do EM companies offer cheaper exposure to the same secular trend?

Index composition of EM offers broad sector and economic exposure

Chart 15: MSCI EM country composition



Source: LSEG Datastream

2025 highlighted the diversification benefits of an EM allocation. Outperformance came from several regions. Emerging Europe in Q1, Korea and Taiwan in Q2, China and South Africa in Q3, and Korea again in Q4. The current breadth in EM can insulate investors from the sharp swings in US stock market catalysed by the concentration in AI and technology stocks. Despite Taiwan, China and Korea being heavily tilted to technology, there are other regions less so, namely Brazil, India and Mexico that still have a compelling structural growth backdrop. If the US market were to draw down due to AI and broader technology concerns, emerging markets could provide a helpful counterbalance to this risk.

EM's regional diversification supports portfolio balance relative to developed market benchmarks. Over time, the MSCI EM index has evolved into a more structurally advanced universe. China, Taiwan, India and South Korea, now the dominant index weights, have delivered sustained growth in real GDP per capita over the past decade, with long run CAGRs that rival or exceed those of many developed economies. This steady compounding has lifted technological sophistication, productivity and financial-market depth across these markets, resulting in an EM benchmark that is progressively less defined by 'traditional' emerging-market cyclicality and more by stable, structurally driven growth dynamics. In essence, EM equities are much less 'EM' than they were in the late 90s and mid-2000s, representing an improved proposition for investors.

Risks and implementation considerations

Geopolitical risks highlight alternative construction approaches

EM has historically been treated as a single asset class, with Australian asset owners typically accessing global equities through ACWI-benchmarked mandates or unit trusts that invest across both developed and emerging markets. In recent years, geopolitical considerations have become increasingly influential in EM portfolio construction, with China standing out as the largest source of idiosyncratic risk within the asset class. As a result, more investors are seeking to articulate a distinct view on China exposure. We have also observed growing interest in EM ex-China strategies, with a small number of clients progressing beyond the conceptual stage to separate their EM exposure into EM ex-China mandates alongside a dedicated China allocation. While this remains at the margin, many investors are increasingly open to alternative approaches to structuring EM portfolios, including country-specific allocations. These exposures can be implemented in a variety of ways, including as part of a higher tracking error, opportunistic global equity bucket, or as a complementary allocation within the broader EM portfolio.

That said, excluding China entirely from EM allocations should be approached with caution where exposure is not being maintained through a standalone allocation. While it has fallen in recent years, China's share of EM indices is expected to remain significant over time, and adopting an EM ex-China structure does not eliminate indirect exposure to Chinese economic conditions. A large number of non-China-domiciled companies retain meaningful sensitivity to China, whether through commodity exports, manufacturing linkages or supply-chain dependencies. Moreover, removing China from EM materially reduces the investable universe and stock breadth, although this may be partly offset by improvements in regional and sector diversification.

We continue to support a strategic, dedicated allocation to EM within global equity portfolios. At the same time, we recognise alternative EM portfolio construction approaches may be appropriate for some investors, depending on their risk preferences, governance framework and objectives. Any such allocation should be assessed in the context of an investor's existing look-through exposure to China to ensure comfort with aggregate exposure levels, particularly given the range of well-documented China-specific risks that warrant a higher risk hurdle. We highlight the suitability of each approach (integrated, standalone countries, carve out) in Table 1.

Table 1: Assessing the suitability of investors investment approach

Integrated	Suitable for small and medium-sized clients with low appetite for complexity and relatively high fee sensitivity.
Standalone country allocations	Suitable for large investors with a relatively high tolerance for complexity and lower fee sensitivity, who have the resources to manage dedicated country allocations. This may also suit investors that are under allocated to markets such as China and India, or lack targeted exposures through existing managers (i.e. A-shares or Indian mid-caps), as well as those seeking country exposures above index weights.
Carve out (e.g. EM ex China + China)	Suitable for large clients with a relatively high tolerance for complexity and lower fee sensitivity, who can allocate specialist resources to manage asset allocation decisions when deviating from benchmark weights, or investors seeking greater control over specific country exposures, such as China.

EM ex-China and China

Moving to a combined EM ex-China exposure plus a standalone China country allocation will drive deviations relative to those implied by the MSCI EM index. This will naturally impact an investor's portfolio exposure in terms of style; cyclicals versus defensives; as well as sector and country tilts at the overall portfolio level. Table 2 identifies the pros and cons to a carve out model.

Table 2: Carve out model (e.g. EM ex-China + China) pros and cons

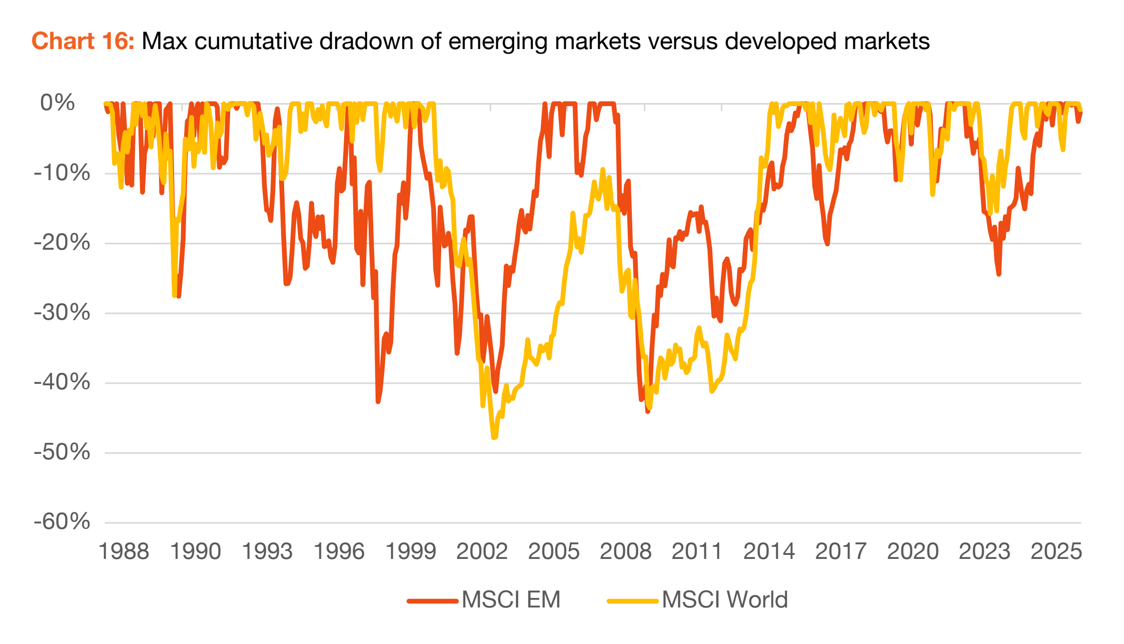
Pros	Cons
• Better calibration of overall and specific EM exposure carved out. This can lead to improved implementation efficiency (including divestment) and more targeted determination of a portfolio's underlying exposure in idiosyncratic markets like China. • Investment manager has specialist knowledge in Chinese markets, rather than an EM manager with a more generalist approach to emerging markets. • Declining correlations with rest of EM implies diversification benefits can be achieved by separating and re-weighting.	• Transfers part of asset allocation decision within EM from PMs to asset owners. • Adds complexity for investors in portfolio construction, risk management and manager selection. • Deviation from the allocations implied by the MSCI EM Index will impact investors' portfolio exposure in terms of style, cyclical versus defensive, sector and country tilts at the overall portfolio level. • Implementation might be challenged if there is reluctance from preferred managers to carve out China for example from their investment universe. Although this is less of an issue than it was.

We support a strategic, dedicated allocation to EM within global equity configurations. At the same time, we are supportive of some investors considering alternative approaches to portfolio construction in EM. The rationale for making standalone country allocations within EM has arguably improved as it relates to markets like China and India. This could be for risk-control and exposure management purposes; portfolio completion; return enhancement; or a combination thereof.

Risks in emerging markets remain heightened relative to developed markets

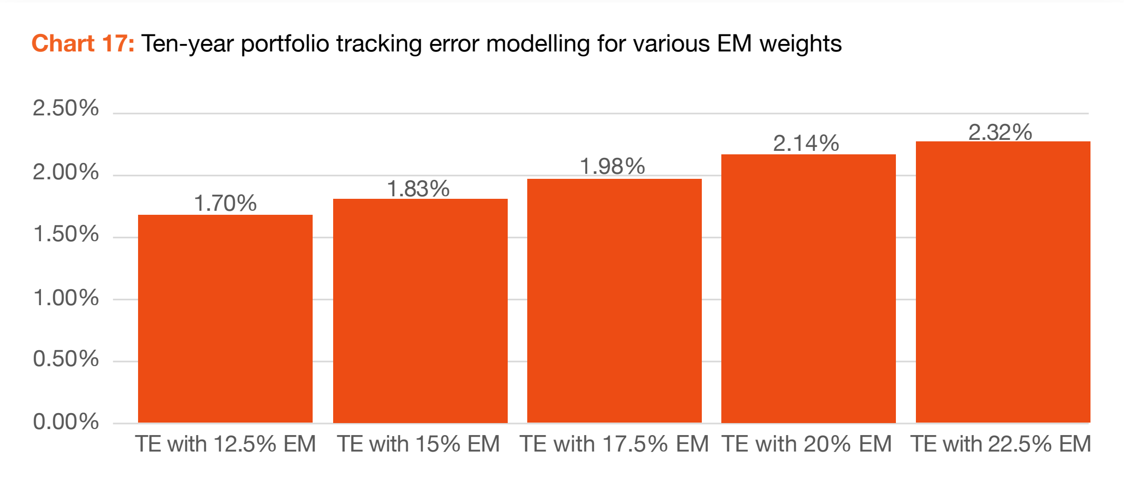
Investors need to remain wary of the heightened risks within EM. Regulatory or political risks can occur often without warning and lead to sharper and more frequent drawdowns. This supports the case for an active approach in EM.

- Emerging markets carry heightened regulatory risk, as governments may prioritise social or political objectives over shareholder returns, with limited transparency or warning. A stark example occurred in China in 2021, when the CCP's "Double Reduction" policy effectively banned for-profit K-12 tutoring overnight, forcing companies to convert to non-profits and prohibiting listings and capital raising. The policy erased over US$100 billion of market value, with leading education stocks such as New Oriental and TAL falling more than 90% within days, illustrating how regulatory intervention in EM can abruptly invalidate viable business models and permanently impair investor capital.
- There are numerous other examples to cite, with one portfolio manager we regularly engage with stating at least one EM country traditionally goes through a crisis every five years. In Russia, sanctions and capital controls following the 2022 Ukraine invasion led index providers to remove Russian equities at an effective value of zero, forcing permanent investor losses. In Turkey, recurring political intervention in monetary and capital markets has triggered sharp currency and equity sell-offs and emergency market controls, materially raising the risk premium for investors.



Source: Frontier Advisors, eVestment

Tracking error impact of various dedicated emerging market weights



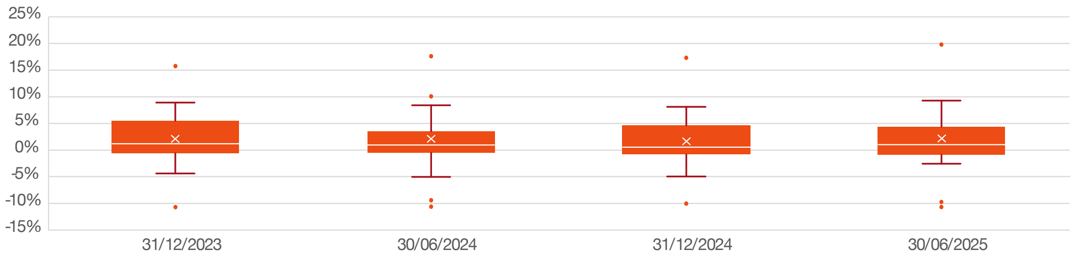
Source: Frontier Advisors, eVestment

Chart 17 illustrates the tracking error impact across various allocations to emerging markets. Our previous research has highlighted the dominant role EM beta can take in overall portfolio risk. Therefore, investors need to be conscious of these impacts when sizing their dedicated EM allocation.

- This scenario analysis is based on the same process used in the YFYS section of the configuration by constructing a multi-manager portfolio (based on our moderate alpha configuration) and calculating an ex-ante tracking error over ten years under various levels of dedicated EM allocations.
- Tracking error scales in a linear fashion as the emerging markets allocation increases, though the overall share of EM beta as part of total portfolio tracking error scales exponentially and is something investors need to be wary of.
- Investors such as superannuation funds with a regulated benchmark are able to control for this risk by separating their EM allocation from their global equity portfolio, thus eliminating the benchmark mismatch that comes with an overweight allocation to EM.

Peer relative positioning

Chart 18: Super fund's active positioning in emerging markets over time*



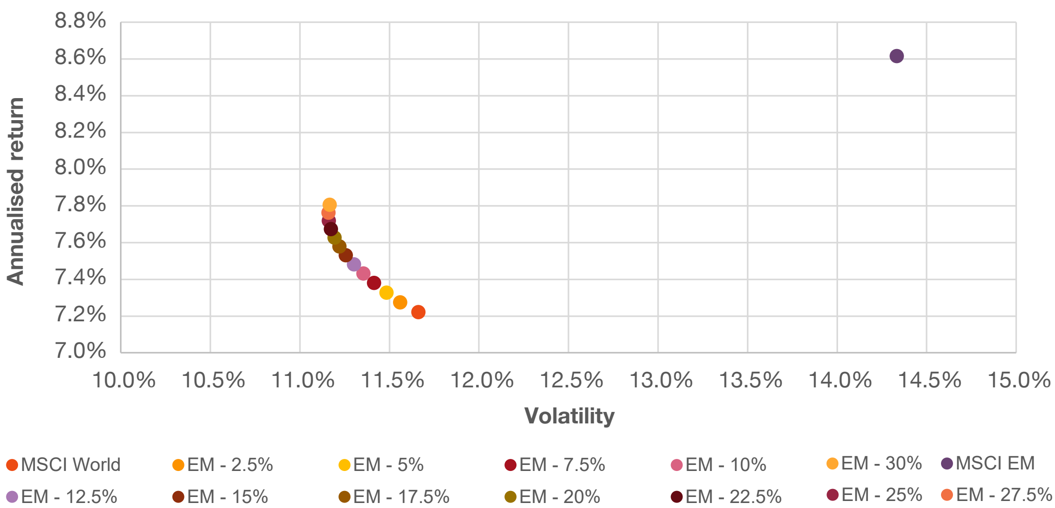
Source: Frontier PHD analysis, Style Analytics
* Active position relative to MSCI ACWI ex-Aus

The starting point for deciding the appropriate allocation to EM should be based on an asset owners' risk tolerance and conviction. We do, however, understand peer relative positioning also plays an important role when it comes to sizing this position.

- Since our first analysis from PHD data in December 2023, there has been a reduction in the spread of active positioning to EM as funds became more cognisant of the benchmark relative risks and clustered around the ACWI benchmark weight.
- Over the past six months, we observed a slight increase in the overall allocation toward emerging markets from the SR50 cohort. While we acknowledge this increased weight may be partially explained by the relative outperformance of EM over the first six months of the year, the median fund has doubled its EM overweight from 0.5% to 1%. Not shown here is the average industry fund which is currently 2% overweight EM versus its weight in the ACWI.
- While the overall trend for superannuation funds has been gravitating towards EM's weight within the ACWI benchmark (~12%), there is a strong case for investors to hold a structurally higher weight owing to the reasons identified in this paper.

Continued support for a strategic allocation to emerging markets

Chart 19: Impact of adding an EM allocation to a global equities portfolio – historical analysis*



Source: Bloomberg, Frontier Advisors.
*Created from monthly returns on respective USD to AUD Indices over period February 1999 to December 2025

Based on both a forward-looking view (utilising our capital market assumptions) and historical evidence, there continues to be support for a higher dedicated EM allocation within global equity portfolios than many investors have today.

- As shown in the charts above, the addition of a dedicated allocation to EM equities improves the risk-adjusted characteristics of a purely indexed ACWI portfolio.
- Notably, using historical analysis (using MSCI World and MSCI EM data), we find an allocation from 22.5 to 27.5% in EM equities remains on the efficient portfolio frontier without compromising on overall portfolio risk (volatility). In practice, however, we understand risk (volatility) is only one factor alongside other considerations such as peer risk, tracking error budgets and idiosyncratic EM risk which will ultimately determine EM allocations within a global equity portfolio.

The final word

If not now, then when?

2025 was the first year that EM outperformed the US since 2017. Before this, EM had outperformed in every year over the first decade of the millennium aside from 2008, marked by the GFC. One of the most pertinent questions facing asset owners today in their global equity portfolios is whether this recent outperformance of EM is the beginning of a more sustained outperformance. EM beta remains one of the most influential levers in a portfolio today that investors can use to generate excess returns.

We continue to support a strategic, dedicated allocation to EM within global equity portfolios. In summary, while there are certainly risks to be aware of when investing, including geopolitical, lower liquidity, economic volatility, the following represent key reasons for EM to be a strategic allocation within a portfolio:

- Greater diversification benefits (including by sector and economic) in an era of US concentration across institutional portfolios.
- Strengthened regulatory frameworks including corporate governance and from a macroeconomic perspective.
- Underrepresentation relative to their contribution to the world economy.
- Enhanced risk-adjusted portfolio return.
- Favourable economic fundamentals.
- Proven resilience in the face of tariffs.
- An improvement in the ESG landscape.
- Relatively attractive valuations.

In addition, emerging market equities offer asset owners a crucial chance to diversify their AI exposure away from the US, and in particular the hyperscalers, at a time when investors are beginning to question capex commitments. We are also at a time when Australian investors' exposure to the USD has arguably never been higher, and it is prudent to highlight the diversification benefits emerging market equities can often provide during USD downcycles.

As such, we encourage investors to reassess their EM allocation believing 2026 marks a compelling point in time for Australian investors to grow or establish their exposure to EM equities. If you want to discuss this paper in more detail, please reach out to your consultant or a member of Frontier's Equities Team.

Learn more

Get in touch with your client team or a member of our Equities Team if you would like to learn more about emerging market equities and how it can fit into your portfolio.

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