UAE reclassification opens door to new investors: The National, June 23, 2013

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MSCI's decision to reclassify the UAE and Qatar markets to emerging status from frontier status has been three years in the offing.

Formally, the reclassification will coincide with MSCI's May 2014 semi-annual index review. The latter implies that funds tracking the MSCI benchmarks will start to invest only after the reclassification takes effect next May. Both Qatar and the UAE will have a 0.45 per cent weight each in the MSCI Emerging Market Index.

The most significant potential benefits of reclassification include an increase in portfolio flows with the entry of foreign institutional investors and passive or index-tracking investors. Institutional investors are restricted to investing in developed and emerging markets.

The market reclassification means that a new class of investors can enter the Qatar and UAE markets. With the upgrade some analysts estimate that the UAE and Qatar markets stand to attract about 1 per cent or up to US$500 million, of total global investments in the emerging markets space annually.

Market reclassification acts as a signal to investors that economic and financial policymakers are committed to maintaining the technical conditions to maintain their new status as an emerging market, including the sufficient size of listed companies and liquidity, orderly market conditions and markets accessibility, which include openness to foreign ownership, ease of capital inflows and outflows, an efficient operational framework and the stability of the institutional framework governing the markets.

Greece has recently lost its developed market status and Egypt is likely to revert to frontier status.

The Qatari and UAE markets have rallied this year, largely boosted by hopes of an MSCI upgrade and the entry of new investors. The Dubai Financial Market is among the top global performers this year, rising 45.5 per cent to date, while Abu Dhabi’s exchange has added 38 per cent and Qatar is up 10.6 per cent.While the announcement is likely to provide a near-term boost, one needs to be cautious of the resulting euphoria and market hype.

Following the financial crisis and subsequent sudden stop in capital flows, in the past two years there has been a reversal with foreign investment into emerging market economies (EMEs). While this is largely because of stronger macroeconomic fundamentals in the EMEs, portfolio flows where boosted by a massive injection of liquidity through quantitative easing by the United States and European Union central banks (and the Abenomic Bank of Japan recently).

This has resulted in record low interest rates and the search for higher returns in emerging markets. However, caveat emptor is in order.

Reclassification is not a panacea for market ills or underperformance. In a research report we examined the effect of reclassifications on markets. The empirical results based on 13 market reclassifications since 1980 suggest that the date of announcement of a market upgrade does have a positive effect on market returns, but the evidence also suggests a negative effect on the market on the actual event of reclassification, with prices falling.

While this may seem paradoxical, such a result is consistent with the initial announcement of an announced reclassification leading to an “overshooting” of prices. This involves investors speculatively bidding up securities prices and returns before the actual reclassification event in the expectation that foreign investors will be entering the market, resulting in prices falling following the actual reclassification event.

Exuberance and market hype accompanying market reclassification can lead to asset price bubbles.

Typically, reclassification (both upgrades and downgrades) have followed or been accompanied by economic and financial policy reforms, including improvements in market infrastructure.

Both Qatar and the UAE have already undertaken technical market infrastructure reforms to upgrade into emerging market status: the former by raising the limits on foreign ownership of companies and the latter by improving the securities settlement systems. But much remains on the reform agenda.

Governments in the GCC, including reclassified Qatar and the UAE, have to liberalise access to their markets by removing barriers to ownership by foreign investors. You cannot claim to be global hubs while imposing barriers to entry and access to markets.

Listed companies must improve their corporate governance in accordance with international standards, focus on disclosure and transparency and substantially improve management and financial reporting in accordance with International Financial Reporting Standards, including timely reporting of their results. Regulators need to ensure compliance and upgrade requirements in accordance with international developments, notably on environment, corporate social responsibility and corporate governance standards.

Reclassifications are best viewed as signalling a confirmation and recognition of policy reforms and changes in market conditions. Hence an identification problem may arise whereby improved market conditions are attributed to market reclassification decisions, whereas they are because of prior policy actions and reforms that lead to a reclassification.

The prize for the UAE and Qatar is to become regional if not international capital markets, with the strategic goal of possessing the capacity of managing and controlling their own wealth and being able to allocate capital internationally from their home base.

All countries are striving to attract capital and investment. Competition is increasingly global. The dictum is: “Now, here, you see, it takes all the running you can do, to keep in the same place. If you want to get somewhere else, you must run at least twice as fast as that.”