Rethinking Equity Investment in Frontier Markets: Evolution breeds opportunity and diversification, while excess liquidity may prove advantageous

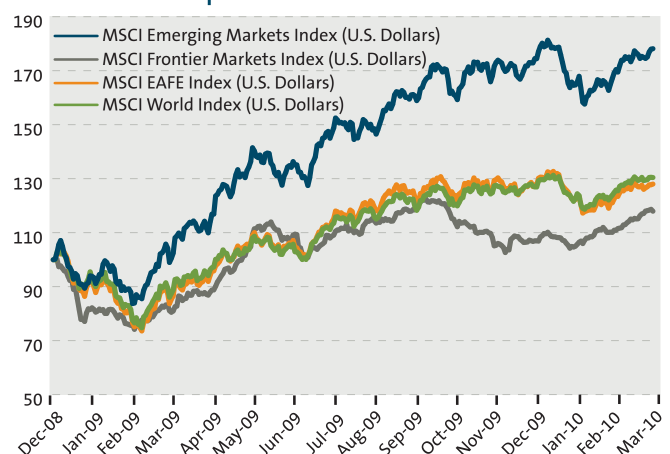
Executive Summary

- Frontier markets have lagged both emerging and developed markets in 2009. However, with valuations looking attractive, this fledgling asset class may offer opportunities for the experienced investor.
- Frontier regions have made large economic strides in recent years, as economies and capital markets have liberalized. The asset class remains under-capitalized and under-owned, with strong growth potential. As the emerging market universe matures, investors are increasingly exploring opportunities in previously untapped markets outside the emerging mainstream. In many ways, frontier markets today are similar to mainstream emerging markets 15 or 20 years ago.
- A large opportunity set, along with diversification benefits compared with other asset classes, creates potential to smooth portfolio returns. With sufficient resources, a manager can identify and exploit market inefficiencies with the aim of providing compelling risk-adjusted returns for investors over the long term.
- With economic growth rates in the frontier and emerging markets set to remain sustainably above developed markets, these regions are likely to enjoy strong capital inflows. Additionally, with historical evidence that smaller markets with low transaction volumes and market capitalizations benefit strongly from the loosening of liquidity conditions, this could prove particularly advantageous for frontier markets.
- Equity investors, while continuing to be aware of the potential for volatility of frontier markets in the short term, should recognize the long-term opportunities some of these markets offer. The potential magnitude of their economies and growth prospects are not reflected in the scale of their stock market capitalization.
- Investors, however, need to adopt a medium- to long-term focus, with active management important in assessing the potential pitfalls and opportunities of investment. With differing prospects for each frontier market, we believe that bottom-up fundamental research will provide the critical edge in navigating this nascent asset class.

There is almost universal acceptance that emerging economies have taken over as the engine of world growth. The dynamics of their economies, their growing share of world trade and increasing importance in global equity market terms are trends of fundamental and long-term significance. This has seen increasing recognition from institutional investors that emerging markets are an integral part of their equity allocations.

Emerging markets, as an investible asset class, have also undoubtedly been the primary beneficiaries to emerge from the financial crisis, attracting large capital inflows from investors searching for higher growth prospects. However, with the larger emerging markets enjoying the vast majority of fund flows, frontier markets have fallen out of favor. Indeed, as an asset class they have lagged both emerging and developed markets in 2009 (Chart 1). However, with valuations looking attractive and with conditions in place for frontier markets to gain from excess liquidity, this diverse asset class may offer opportunities for the experienced investor.

Chart 1: **Frontier markets have lagged both emerging and developed markets**



Source: Bloomberg (performance to 31 Mar 2010)
Rebased to 100 as at 31 Dec 2008

Identification and evolution of frontier markets

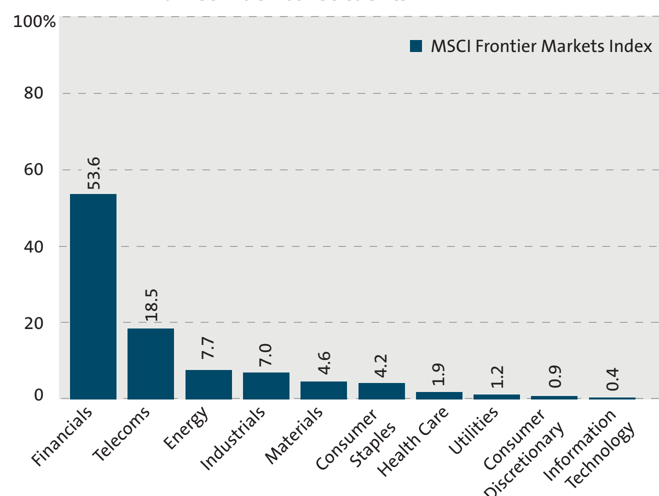
The term "frontier markets" is generally regarded as having originated in the mid-1990s when Standard & Poor's began using it as a label in its index calculations. Where exactly the boundary lies between frontier and emerging markets depends on the precise definitions used, as does the question of when a market is no longer emerging but, rather, developed. The common thread is not demographic or economic but an underdeveloped equity market. Frontier markets tend to be young, thinly traded equity markets with weak regulatory frameworks and low levels of transparency and foreign ownership. However, the evolution of the asset class in recent years has given investors the possibility to explore a much more expansive opportunity set (Table 1). Additionally, as frontier markets have become more subject to indexing, we have also seen exchange-traded funds edge into this nascent asset class.

Investors need to be knowledgeable of index compositions

It must be recognized, however, that the definition of a frontier market has not been standardized within the marketplace. For example, MSCI Barra has chosen to adopt a far greater weighting within Middle East markets. In fact, 62.5% of their index is represented by the region compared with 43.3% for the S&P Frontier Broad Market Index (Table 2). Meanwhile, the S&P index has a much broader exposure to the Americas, with Colombia making up nearly 15% of the index on its own. Therefore, it is important for potential investors who are interested in investing in these markets to choose their benchmark wisely in order to ensure that the countries in which they invest in are properly represented within their index of choice.

At the sector level, banks and financial stocks dominate, primarily as they are normally the first companies to be privatized when equitization becomes possible (Chart 2).

Chart 2: Financials dominate frontier market index constituents



Source: MSCI
As at 31 Mar 2010

Table 1: Broad opportunity set to explore

MSCI Frontier Markets Index

Americas	Central & Eastern Europe and CIS	Africa	Middle East	Asia
Argentina	Bulgaria	Kenya	Bahrain	Pakistan
Trinidad & Tobago	Croatia	Mauritius	Jordan	Sri Lanka
	Estonia	Nigeria	Kuwait	Vietnam
	Kazakhstan	Tunisia	Lebanon	
	Lithuania		Oman	
	Romania		Qatar	
	Serbia		United Arab Emirates	
	Slovenia			
	Ukraine			

S&P Frontier Broad Market Index

Americas	Central & Eastern Europe and CIS	Africa	Middle East	Asia
Argentina	Bulgaria	Kenya	Bahrain	Pakistan
Trinidad & Tobago	Croatia	Mauritius	Jordan	Sri Lanka
Colombia	Estonia	Nigeria	Kuwait	Vietnam
Ecuador	Kazakhstan	Tunisia	Lebanon	Bangladesh
Jamaica	Lithuania	Botswana	Oman	
Panama	Romania	Cot D'Ivorie	Qatar	
	Serbia	Ghana	United Arab Emirates	
	Slovenia	Namibia		
	Ukraine			
	Latvia			
	Slovak Republic			

Table 2: Indices differ in composition

Frontier Markets Regional Breakdown (%)

	MSCI Frontier Markets Index	S&P Frontier Broad Market Index
Middle East	62.5	43.3
Americas	5.2	22.2
Asia	7.4	7.5
Africa	11.3	13.7
Central & Eastern Europe and CIS	13.6	13.3

As at 31 Dec 2009

However, these are not evenly distributed across each region. Financials are heavily weighted in the Middle East and Africa markets, but less so in Emerging Europe, where many of the banks have been acquired by Western European parents.

Importantly, as with emerging markets before them, frontier markets are growing in stature. With the MSCI Emerging Markets Index having represented only around 1% of the MSCI All Countries World Index when MSCI Barra launched its index in 1988, and with it now accounting for 12.7%, the emergence of frontier markets should be seen as a medium- to long-term trend that will eventually see the asset class become an integral part of any global equity allocation.

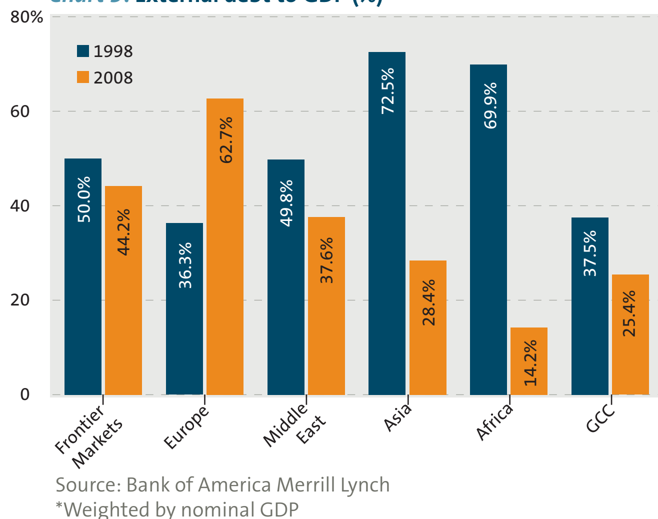
Robust characteristics and strong fundamentals continue to provide a compelling case for investment

Of course, emerging markets have enjoyed much of the spotlight since markets bottomed in March 2009. However, it is important to recognize that the fundamental reasons cited for investing in frontier markets in the first place are still valid. The asset class remains under-capitalized and under-owned, with tremendous potential for economic growth. Corporate and personal debt levels have risen in recent years but remain low by global standards and, although the pace of growth has been negatively impacted by the global recession, it is unlikely that this will continue. Indeed, many regions have made great economic strides in recent years and, across these markets, government balance sheets are generally in good order (excluding Eastern Europe). This robust growth is additionally underpinned by a young population in most frontier countries at a time when the developed world is aging rapidly.

A good example that the perceived risks from frontier markets have fallen due to policy improvements is illustrated by how far external debt as a share of GDP has fallen in almost all regions (Chart 3). This has been the most dramatic in Africa, where it has fallen from approximately 70% to just over 14%. Although, a large proportion of this can be attributed to the 'Paris Club' decision to relieve Africa of most of its debt in 2001.

Encouragingly, growth in both frontier and emerging markets is set to remain an enduring theme. Massive projected urbanization means that not only are resources required to build cities, but as their wealth grows, this is likely to spur corporate and consumer spending. There is also an urgent need for infrastructure investment. After years of neglect, infrastructure is ripe for development and renewal. In its landmark 2006 study of global infrastructure, the OECD estimated annual world infrastructure spending over the next two decades at 2.3% of world GDP, or $1.4 trillion per year—about half of which will take place in developing economies. Meanwhile, the World Bank has estimated that, while developing countries currently invest 4% of their GDP on infrastructure each year, they should be investing closer to 9% on new projects and maintenance. Additionally, with frontier countries generally under-leveraged compared with both developed and emerging economies (Chart 4), there is also strong potential for future credit growth.

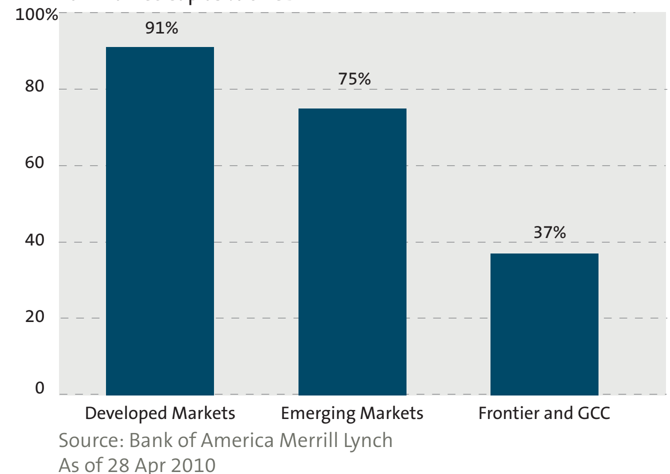
Chart 3*: External debt to GDP (%)



Source: Bank of America Merrill Lynch
*Weighted by nominal GDP

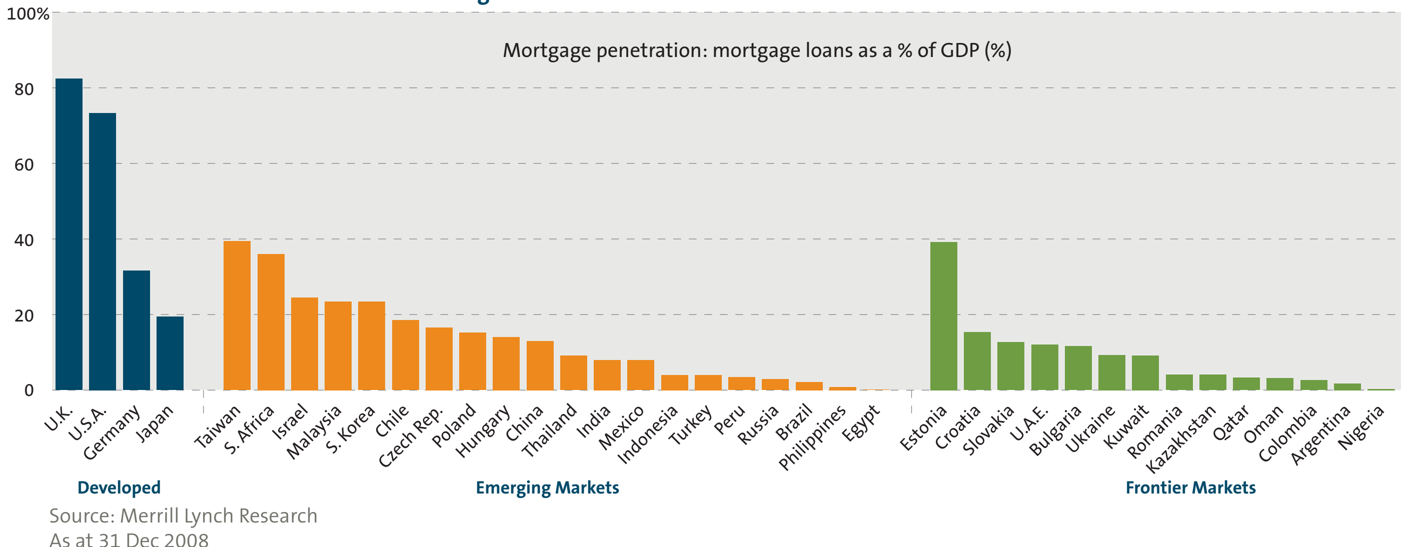
***Chart 5*: Frontier markets are under-capitalized**

Full Market Cap as % of GDP



Source: Bank of America Merrill Lynch
As of 28 Apr 2010

***Chart 4*: Frontier markets are under-leveraged**



Source: Merrill Lynch Research
As at 31 Dec 2008

There is also strong evidence that frontier countries have a long way to go with regard to capitalization. Today, frontier markets represent just over 1% of world market capitalization and, as a share of their own GDP, have ample room to catch up with both their developed and emerging market counterparts (Chart 5).

Against this positive backdrop, however, investors still have to remember that frontier markets do carry higher individual risk. These are markets that are at the beginning of their evolution, and this brings with it its own inherent challenges. What perhaps is more prudent for investors to consider, however, is that these markets are very much where emerging markets were 15 or 20 years ago. With investors generally recognizing how important emerging markets are today to their equity allocation, an allocation to this area may prove sagacious.

Negative real interest rates, stronger economic growth, and increased risk appetite may generate greater alpha for frontier markets

When we examine what is happening in the world today, whether "decoupling" exists or not, what is evident is that advanced economies are headed for a period of below-trend economic growth. Meanwhile, because of much stronger domestic structural drivers of growth for frontier and emerging markets, there is likely to be a sustained expansion in the spread between the growth rate of emerging and developed economies. With economic growth rates in the frontier and emerging markets set to remain sustainably above the developed markets, in both real and nominal terms, it is very likely that individual corporate earnings will follow suit. With that higher level of profitability, there is a distinct possibility that emerging regions will enjoy strong capital inflows over the next few years. The more established emerging markets have already seen evidence of this in 2009, but frontier markets have yet to enjoy the same attention.

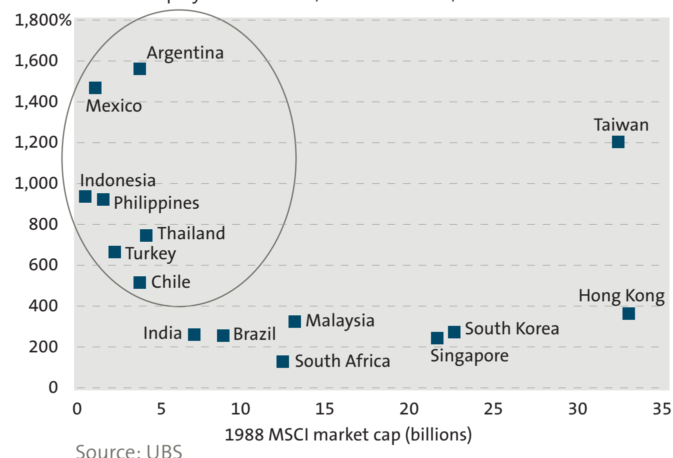
Loose liquidity conditions could prove advantageous for frontier markets

Meanwhile, with developed economies likely to sustain a period of negative real interest rates, liquidity conditions may continue to remain loose for some time. This bodes well for emerging and frontier markets. Additionally, there is historical evidence to suggest that countries with low transaction volumes and market capitalizations in particular can benefit strongly from a loosening of liquidity conditions. The period from 1988 to 1994 provides an appropriate comparison: the developed world had endured at least two years of recession, while interest rates in the U.S., Europe, and Japan were in the process of sinking very rapidly. Combined with this, all three regions had very anemic growth, along with extremely weak equity market performance. By contrast, Asia and Latin America—the investible emerging world at the time—growth fundamentals were much stronger through that global recessionary period, and this followed through into positive stock market performance.

Interestingly, however, lining up markets according to their market capitalization, there was a clear distinction in terms of equity performance. The scatter plot in Chart 6 illustrates the relationship between initial 1988 MSCI equity market capitalization and the subsequent cumulative trough-to-peak U.S. dollar return through the mid-1990s. As can clearly be seen, any market that began with a market cap of less than US$5 billion outperformed in a very strong way, with gains of 600% to nearly 1,500% over the next five years. By contrast, with the very notable exception of Taiwan, any market with a starting market cap over $5 billion simply saw gains more in line with their relative underlying nominal growth.

***Chart 6*: Excess liquidity drives performance for smaller markets**

Peak cumulative equity market return, U.S. dollar terms, 1987–94



Source: UBS

Therefore, with similar conditions currently falling into place, smaller markets may see much stronger gains in a world where external inflows are driving price action. This could be very advantageous for frontier markets, where a small amount of liquidity can have a real impact in terms of returns.

Diversification and risk/return relationship

One of the challenges for investors in recent years has been the rising correlation among asset classes that has reduced diversification. Even rising correlations among the more mature emerging markets has required investors to look farther afield for diversification opportunities. Of course, while the recent financial crisis emphasizes how strongly the world becomes correlated when we encounter a protracted slowdown and a subsequent bear market, frontier markets do continue to harbor greater diversification benefits compared with their emerging counterparts. As Table 3 illustrates, not only have frontier markets tended to have much lower correlations to world equities than their more-mature emerging market brethren, but they also provide additional diversification within the emerging market space itself.

There are a number of reasons for this low correlation. Frontier markets remain quite local in character, driven by their own internal economic and political dynamics. Foreign investors also tend to play a less important role in these markets. Moreover, the small number of securities in many of these markets means company-specific factors play a far more important role.

More surprisingly, frontier countries appear to be less volatile than other emerging equity markets when analyzing the standard deviation of indices (Chart 7). This largely reflects lower liquidity and lower efficiency within the frontier space. Admittedly, individual frontier markets can have high volatility. However, when amalgamated together into an index or portfolio, volatility is dramatically reduced, primarily due to the very low correlation between individual countries.

Valuations and the search for higher risk-adjusted returns

Due to their nature, it is more difficult to evaluate valuation metrics compared with other asset classes. Investors are hampered by a lack of reliable consensus earnings forecasts for most markets, while even historical valuation data can prove difficult to retrieve. Since January 2008, MSCI has calculated trailing P/E, P/B, dividend yield, and ROE data for each market; however, these multiples, while useful, can give a distorted view given that (1) most country indices have only a handful of stocks and are thus heavily affected by company-specific anomalies; and (2) earnings visibility is generally low in these markets. It is clear, however, from the MSCI data now available that frontier markets have become less expensive; the region's trailing P/E has fallen from 17.8x in February 2008 to 14.5x as of December 2009 (Chart 8). This is a reasonable de-rating, albeit largely in line with how global markets have performed. Additionally, with annual returns for the last seven years (Table 4) reflecting outperformance against most asset classes surveyed (excluding 2006 when the Middle East experienced a sharp correction following unsustainable gains for shares), there seems to be a good case for investment.

As we discussed earlier, however, late 2008 and 2009 has seen frontier markets underperform. Much of this can be attributed to their more mature counterparts, with the reality being that in February 2009, when investors were venturing back into the emerging space, they were primarily attracted to the larger BRIC countries. These were large economies that investors were confident of surviving the crisis and were trading at historically low valuations. In other words, why invest in perhaps more unknown entities such as Oman, Qatar, Nigeria, Vietnam, etc., when it was possible to invest in China on low double-digit valuations. Consequently, at the end of 2009, the larger emerging markets have become more expensive, while frontier market prices have struggled. With these valuation discrepancies rising, 2010 may require

***Table 3:* Frontier markets offer real diversification benefits**

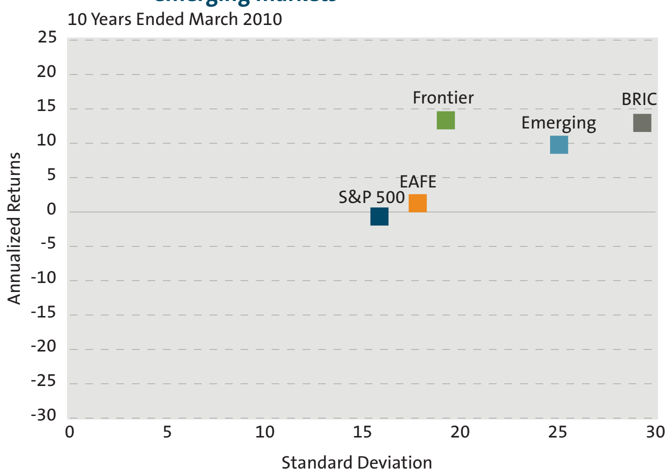
Correlation Matrix (June 2002 – March 2010)

	MSCI AC World	MSCI Emerging Markets	MSCI Europe	S&P 500	Global Bonds*	MSCI Frontier Markets
MSCI AC World	1.00					
MSCI Emerging Markets	0.92	1.00				
MSCI Europe	0.97	0.88	1.00			
S&P 500	0.97	0.83	0.92	1.00		
Global Bonds*	0.26	0.27	0.31	0.16	1.00	
MSCI Frontier Markets	**0.60**	**0.58**	**0.60**	**0.53**	**0.20**	**1.00**

Sources: Zephyr Style Adviser and T. Rowe Price
*Barclays Capital Global Aggregate Index
(June 2002 is the inception date for MSCI Frontier Markets Index)

***Chart 7:* Volatility is lower compared with other emerging markets**

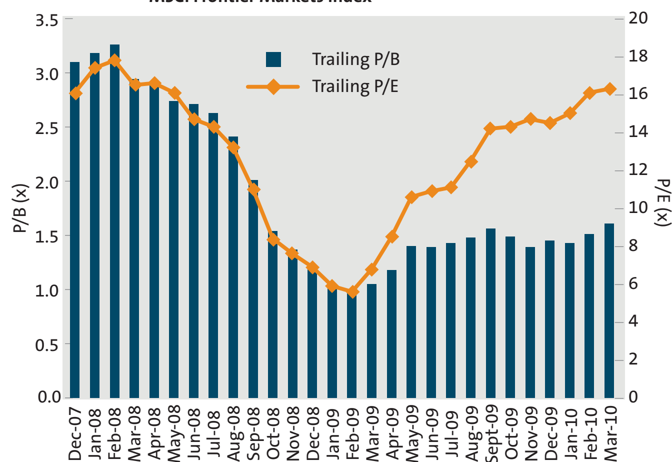
10 Years Ended March 2010



Source: InterSec Research

***Chart 8:* Valuation metrics have become more attractive**

MSCI Frontier Markets Index



Source: FactSet

investors to look elsewhere within the emerging world to find value. This may have already started with the first quarter of 2010 reflecting outperformance versus other regions of the world.

Approaching investment in this distinctive area

A key consideration for investors is the difficulty of generalizing across a widely dispersed set of economies facing very different levels of development, economic conditions, and structural constraints. Frontier markets are not homogenous. There is considerable variation in political stability, economic performance, openness to foreign investors, corporate governance practices, and exposure to exchange rate risk.

One common thread, however, does emerge; a number of frontier countries have a strong correlation to the price of commodities. This is especially high in the Gulf, African, and Latin American regions. Indeed, we have seen many oil-producing countries' fiscal and current accounts turn positive as a result of rising commodity prices during 2009. Therefore, the outlook for commodity prices is an important factor that investors should consider when approaching investment.

A focus on fundamental bottom-up research is important

Frontier markets also operate in a much less efficient space in terms of analytical coverage. This lack of broad research coverage can often lead to price anomalies. Within each region, there can be quite polarized underlying returns. As such, there is a pressing need for active management. The ability to conduct in-depth research and identify high-quality companies with low-leverage, cycle-tested management teams is imperative to any investment approach. However, this requires sufficient resources and a research platform that can effectively synthesize industry-specific and stock-specific analysis.

Approaching investment can be tackled in a number of ways, and it is sensible for potential investors to investigate their existing global, emerging, or regional managers to ascertain what capabilities they have in this area and to assess whether they need to augment their exposure. However, it is important that any manager who invests in frontier countries has the resources and ability to delve deeper into the opportunity set. It is also prudent to recognize that regional and sector risk concentration can exist, certainly when you consider that MSCI has such a high concentration in Middle East markets and the financials sector. Importantly, regardless of how one accesses frontier markets, the investment potential is apparent. However, there are risks associated with investment, and, on an individual basis, some countries will continue to remain high risk. Therefore, the evergreen theme of bottom-up fundamental research is imperative to understanding both the opportunities and risks associated with this nascent asset class.

Table 4: **Frontier markets have outperformed on a relatively consistent basis**

	2003	2004	2005	2006	2007	2008	2009	Q1 2010
MSCI AC World	34.6	15.8	11.4	21.5	12.2	-41.9	35.4	3.2
MSCI Emerging Markets	56.3	26.0	34.5	32.6	39.8	-53.2	79.0	2.5
MSCI Europe	39.1	21.4	9.9	34.4	14.4	-46.1	36.8	-1.7
S&P 500	28.7	10.9	4.9	15.8	5.5	-37.0	26.5	5.4
MSCI Frontier Markets	**43.6**	**22.7**	**72.7**	**-8.9**	**42.1**	**-54.1**	**11.7**	**11.4**

Source: FactSet
Performance measure in U.S. dollars

Potential risk factors of investment

Frontier markets exhibit higher risks than other countries, with varying levels of liquidity, valuations, and corporate governance. Even the most stable of countries still face the natural vulnerability that comes with being a small, open economy subject to the whims of financial markets and global economic trends. The recent events in Dubai make this all too clear. As a result, it is important to manage these risks appropriately by maintaining a broad exposure across the investment universe.

Liquidity is also much lower than in emerging and developed markets, while regulatory frameworks are still in an early state of evolution. There is limited history of public ownership of corporations in most of these markets, and many frontier market firms have been slow to improve transparency and communications with investors. Another factor to consider when investing is the political backdrop. Encouragingly, we have seen greater political stability in recent years, particularly in Africa, but there still remain problems on an individual basis. Therefore, an allocation to frontier markets deserves serious thought. Investors in the asset class are strongly advised to set long-term goals for investment and need to be comfortable in accepting a generally higher degree of risk tolerance.

Conclusions

The financial crisis and the subsequent sharp rise in risk-aversion levels has seen frontier markets fall out of favor. However, as the emerging markets of today eventually progress to become part of the developed world, investors will begin looking for the next emerging story. While available information is often sparse, local regulations are varied and complex and research coverage by analysts and brokerage firms is limited, these were also obstacles that emerging markets encountered 20 years ago. Challenges such as these

create opportunities for investors to uncover neglected companies with healthy or improving operations and to identify stocks that have been ignored by the mainstream investment community. With a focus on quality, frontier markets may prove rewarding and can make a significant contribution to portfolio returns.

How to gain exposure to frontier markets is up for debate, and investors should question how deep down the opportunity set managers or plans explore. There are also higher risks associated with investment, and, therefore, active management is crucial. Importantly, the long-term fundamental reasons for investing remain largely intact, and, with the flexibility of a broad range of investments across a large opportunity set, the asset class does offer opportunities to generate alpha. Additionally, with valuations looking attractive and having underperformed in 2009, this diverse asset class may benefit from a reassessment of valuations.

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