FRONTIER MARKETS

Investors are going beyond emerging markets and blazing new trails. What are the potential risks and rewards?

BY CHRISTOPHER WRIGHT

Who would invest in suffering Zimbabwe, where inflation is close to 100,000 percent, or Lebanon, which seems perpetually on the brink of civil war? What about Vietnam, where stocks have shown they can plunge 60 percent in mere months?

In fact, such frontier markets are starting to look downright respectable. They are picking up the accoutrements of established markets—indices (S&P, MSCI, Barra, Merrill Lynch), exchange-traded funds (Deutsche Bank's fund on the London Stock Exchange along with others planned by WisdomTree and PowerShares), and an institutional following.

A universally accepted definition of frontier markets does not exist. Originally, the S&P/IFC Global Frontier Markets Index had 24 countries, including four in Latin America and the Caribbean but none in the Persian Gulf. European countries comprised half the value of the index. In contrast, the MSCI Frontier Markets Index launched with 19 countries, five of which were Gulf oil states (two-thirds of the total index value) and none in Latin America or the Caribbean.

Corbis © 2008

A boy in Hanoi walks by shelves loaded with Vinamilk. The producer of Vinamilk, the Vietnam Dairy Products Company, has the largest market cap of any stock listed on the Ho Chi Minh stock exchange. Some investors believe Vietnamese stocks, down 60 percent from their high of 2007, may offer "deep value."

Frontier market indices include countries in earlier stages of development (Kenya) as well as small but highly developed countries (Estonia) and markets recently opened to foreign investment (Gulf oil states). The dividing line between emerging and frontier markets is fuzzy. Colombia, Morocco, and Pakistan are considered emerging markets by some and on the frontier by others. Some observers define frontier markets simply as geographical locations where investors don't already have exposure.

Investors looking for performance benchmarks or places to put their money need to examine frontier indices and funds carefully for unintended country or sector bets. For example, Nigeria makes up 80 percent of the S&P Africa Frontier Index, whereas the Merrill Lynch Frontier Index is concentrated 40 percent in banks.

LOOKING AHEAD

RETURNS In the frontier markets, a lot of attention has been focused on past high returns, periods of outperformance, and low correlations. In fact, some analysts point to sky-high valuations and hint that the golden age of frontier investing has already passed. But with less available information, less liquidity, and fewer analysts following frontier markets, these markets afford at least as many opportunities for mispricings as other relatively inefficient "risky asset classes," such as small caps.

"I would expect a frontier markets index to outperform the broader emerging markets index by three or four percentage points over long periods of time," says Jeffrey Hooke, author of *The Emerging Markets: A Practical Guide for Corporations, Lenders, and Investors* as well as managing director of Hooke Associates, a corporate finance consulting firm in Bethesda, MD.

Lawrence Speidell, CFA, chief investment officer of Frontier Market Asset Management in La Jolla, CA, expects a similar premium over emerging markets and argues that the frontier offers better risk-adjusted returns than emerging markets or the S&P 500. By his calculations, the Sharpe ratios from December 1998 to March 2008 were 5.46 for the S&P Frontier Composite, 3.36 for the MSCI Emerging Markets index, 1.29 for the EAFE, and 0.34 for the S&P 500 (the higher, the better; a 3 percent risk-free rate is assumed).

As for valuations, "you see some astronomical P/Es on individual stocks that are driving the country averages in the S&P Emerging Markets Database," Speidell says (16,399 for one company—Corporation for Financing and Promoting Technology, a software and services firm in Vietnam—plus many with P/Es greater than 100). But to conclude that the story is over would be a mistake.

"There are many stocks within [frontier] markets which are extremely cheap," he says, including high-quality companies often owned in part by strong global partners. According to Donald Elefson, CFA, a portfolio manager in Somerville, NJ, for the Harding Loevner Frontier Emerging Markets Fund, a mutual fund for institutional investors with a US$1 million minimum the "denominator effect" in frontier price-to-earning ratios has not yet occurred.

"The companies in these countries are quite often underleveraged and have room for massive rationalization and enhancement of margins," he says. Better profitability will lead to earnings growth that, in turn, will support higher valuations in the future. Moreover, new listings will lead to more realistic pricing. In the early stages of market development, prices typically move in an exaggerated fashion when the universe of companies is small and inflows are concentrated on a few issues. But this phenomenon will ameliorate over time as frontier markets deepen, from, say, 2 to 15 stocks.

As Elefson points out, the financing and private equity cycle that ultimately produces new listings is still in its early days in frontier countries.

CORRELATIONS Correlations among developed markets typically range from 0.85 to 0.95. Five-year correlations with the S&P/IFC Global Frontier Markets index, however, are much lower, for example, around 0.22 with the S&P 500 and 0.42 with the MSCI Global Emerging Markets (GEM) index, says Christian Deseglise, global head of emerging markets for HSBC Global Asset Management headquartered in London. He expects correlations to remain low because "the behavior of local frontier markets is likely to remain driven mainly by local factors in coming years."

Amy Schioldager of Barclays Global Investors says a basket of frontier market countries will have less risk than an emerging markets vehicle.

Globalization has not touched frontier countries to the same degree, so they are less reliant on imports and exports than emerging markets are. The performance of frontier stocks is more dependent on local economies, which are all very different from each other. A dairy company has the largest market caps of any stock listed on Vietnam's Ho Chi Minh stock exchange; in the Middle East, banks and construction are dominant. Consequently, correlations between frontier countries are extremely low (0.09), making the asset class an excellent

portfolio diversifier, according to Amy Schioldager, managing director in the equity and capital markets group for Barclays Global Investors (BGI) in San Francisco.

Speidell believes correlations with developed markets will remain relatively low (0.30 or 0.35) for the foreseeable future. Schioldager, on the other hand, expects that if frontier economies grow and become more integrated globally, correlations will rise over the long term, but the outstanding diversification benefits will not disappear overnight. A factor contributing to a rise in correlations is the growing link between Eastern European markets and the developed world. Some investors now buy and sell Eastern European stocks based on the prospects for the regional economy as a whole, without making a distinction between frontier countries, such as Romania and Bulgaria, and emerging markets, such as Poland and Hungary.

RISKS VOLATILITY The dispersion of returns around the mean averages 27 percent for Barclays Global Investors (BGI) individual frontier markets, making them riskier on a stand-alone basis than emerging markets, which offer lower volatility (roughly 20 percent). Because of the low correlations among country pairs, however, the volatility of BGI's entire set of frontier countries is only 13 percent. "When you combine a basket of frontier market countries," Schioldager says, "you actually end up with less risk than an emerging markets vehicle."

"The likelihood that Nigeria will move in sync with, say, Ukraine, is limited and the same can be true between many other pairs of countries, such as Vietnam/Qatar," Christian Deseglise elaborates. "As a result, the overall volatility of a frontiers index should remain moderate."

LIQUIDITY Investors have repeatedly expressed concern that frontier markets lack the capacity to absorb institutional inflows, a problem because large blocs can move stock prices substantially. "Vietnam in the last two years, and several Middle Eastern markets before, provide real-life examples of such disruptions," Deseglise says. Donald Elefson points out that risk also exists on the way down. If an institution loses confidence in a country and takes its money off the table, the move to the downside is amplified. BGI has crossed off its list several countries in Africa (including Kenya and Ghana), at least for now, because of liquidity concerns. Investors must be mindful of the trading dynamics of each market. "You can move money into most of these markets as long as it's done over time and in a controlled fashion," Schioldager says.

In a universe of 270 of the frontier stocks with the largest market caps, Speidell concludes that 80 percent of the average daily frontier trading volume is in the Middle East, but that figure still leaves US$120 million in daily volume elsewhere. With 78 stocks trading more than US$500,000 a day, the asset class offers reasonable liquidity for institutional investors. Moreover, liquidity concerns should ease as frontier markets deepen.

SHAREHOLDER RIGHTS In general, minority shareholders have fewer rights in frontier countries. "If you think minority stockholders have a problem in a country like the United States, Russia, or Brazil, you can just double that problem in a small frontier market," Jeffrey Hooke says.

Jeffrey Hooke, managing director of Hooke Associates, "would expect a frontier markets index to outperform the broader emerging markets index by three or four percentage points over long periods of time."

COWBOY CAPITALISM Some frontier markets are still dominated by a speculative mindset, according to Hooke. Local retail investors gamble on stocks the way they bet on horse races. Hooke also worries about shenanigans arising from weak regulation (some frontier stock markets are only a few years old), insider trading, and market manipulation. Leading country risk expert Marvin Zonis remembers a time when companies with political influence couldn't be delisted from the Shanghai stock exchange, no matter how flagrantly they violated the rules. (Zonis is professor emeritus at the Graduate School of Business at the University of Chicago, principal of Marvin Zonis + Associates and co-author of *The Kimchi Matters: Global Business and Local Politics in a Crisis-Driven World*).

Settlement and safe keeping issues are enough to keep Elefson out of some countries entirely. For example, he won't invest in the Ukraine for now, despite its many attractions, because of

unacceptable problems, such as being required to sign a purchase-sale agreement for every trade, not knowing where shares are physically held, or having to remit funds before securities transfer. He doesn't want to end up in the same situation as other investors who never received their shares. In his view, the rise of the private account in these markets is a very dangerous situation. "It's too easy for nonregulated investment vehicles to invest in a country and trust the local counterparty with too much responsibility," he says. "There will be casualties in every frontier market at the intermediary level." He advises retail investors to invest only in registered funds that must meet regulatory tests for custodial and settlement procedures.

Corbis © 2008

The current political situation in Iran makes the Tehran stock exchange off-limits for many international investors, but one expert on political risk and frontier markets is forecasting developments that may lead to brighter prospects.

COUNTRY RISK BGI's frontier fund is not currently investing in Lebanon because of the political and economic situation there. Speidell stays out of any country where, in his view, property rights are in jeopardy, which currently means he is not invested in Venezuela, Bolivia, or Ecuador.

Political upheaval can potentially wipe out investment value overnight. Military coups, ethnic strife, and separatist movements are but a few of the political risks investors may find in frontier countries, with Lebanon, Kenya, and Pakistan providing recent examples of unrest.

Donald Elefson, CFA, points out that the financing and private equity cycle that produces new listings is still in its early days in frontier countries.

Commercial country risk indicators do a poor job of predicting political instability, Marvin Zonis says. There are too many variables, and more importantly, nobody knows how to weight them, he says. Bond spreads don't help in this regard either.

In gauging country risk, Zonis looks at, among other things, whether well-armed groups or other political forces threaten the viability of the central government. For example, in the Caucasus state of Georgia, the separatist movement is geographically remote and operates on the periphery. Therefore, the threat level in Georgia is much lower than in Iraq, where militias carry out attacks in downtown Baghdad, or in Somalia, where violent groups control large swathes of territory.

Zonis also assesses the depth of the bureaucracy and strength of governmental institutions. Egypt and Mexico have powerful bureaucracies that reach all the way down to the village level. Domestic security threats (Islamic revolutionaries in Egypt, drug cartels in Mexico) are minimal. In contrast, the former Shah of Iran did not have the same bureaucratic reach. "The Shah was on top, and it looked great. He had an army, and everyone walked around with medals. But he didn't have a strong bureaucracy," Zonis says.

Sharing BGI's judgment about Lebanon, Zonis would not get involved there because the political center is fractured and could easily collapse.

To put country risk into perspective, Schioldager says "the bottom line is that countries that most investors are already in are as risky, if not more risky, than many of the frontier market countries." An example is the coup that took place in Thailand in 2006. Some frontier countries are more stable than emerging markets, and Amy Schioldager cites EU members Estonia, Latvia, Lithuania, Bulgaria, Romania, and EU candidate Croatia as examples. Moreover, country risk can be diversified away, as illustrated by the low correlations among country-pairs mentioned earlier.

ACTIVE OR PASSIVE?

BGI's Frontier Markets Fund, announced in March 2008, is a pooled vehicle for institutional investors that applies a "smart passive" approach. It seeks to provide index-like beta exposure and returns but chooses countries based on internal research and stocks for their liquidity, not their fundamental company data. Given the fund's risk-return profile and low correlations with traditional asset classes, institutional investors use the fund to extend their emerging markets exposure or as an alternative investment, according to Schioldager.

Passive investing may be preferable for institutions investing large sums of money. But Hooke argues that superior returns in frontier markets come from active management because difficulties in obtaining information make bottom-up stock picking a more lucrative activity. A lot of company information is written only in the local language, is published infrequently, and does not include much analyst coverage.

HSBC Global Asset Management launched an active fundamental frontier fund in February 2008 through its Halbis Capital Management unit. The fund combines top-down analysis (political and economic risk) with bottom-up research (cash flow and qualitative factors) in 60 countries. Deseglise believes that the fund's approach will outperform passive strategies over the long term. He also maintains that "a global approach mitigates concentration risk and volatility," thus giving HSBC's fund an edge over specialized regional managers and funds.

Corbis © 2008

The Petroleos de Venezuela refinery in Jose, Venezuela, is part of a joint venture between TotalFinaElf (France), Statoil (Norway), and PDVSA (Venezuela). Despite such high-profile international investment in this market, Larry Spiedel, chief investment officer of Frontier Market Asset Management, avoids countries such as Venezuela where he considers property rights to be in jeopardy.

TOP-DOWN OR BOTTOM-UP APPROACH?

There's plenty of disagreement on this point as well, as one might expect. BGI asserts that internal and third-party research shows that, generally, country factors drive returns in emerging markets. "Markets will rise and fall as a whole," Schioldager says. "We've seen that in Vietnam, where the entire market has fallen 50 percent since last November. It's not individual stocks or sectors, it's the whole market."

Others opt to buy companies, not countries, one reason being that buying economic growth is a naive approach. Studies show a negative correlation between high country growth and good investment performance. The problem is that growth gets priced in. Moreover, Marvin Zonis cautions that good economic growth in a country does not necessarily translate into good financial performance at the company level. It took a long time for companies in China, for example, to show decent profits even though the Chinese economy was booming.

HSBC emphasizes company more than country factors. "Bottom-up analysis is the primary driver of investment decisions," Deseglise says. "There are huge variations amongst companies in the same country in terms of management skills, disclosure standards, valuation efficiencies, corporate governance, and availability of information." Speidell agrees: "One can find overlooked companies that have strong franchises, or even monopolies, and strong strategic investors." He looks for quality companies reflecting various themes, such as property development in the Middle East; the purchasing power of the middle class, which is on the rise in many frontier countries (consumer staples and finance); or beneficiaries of China's foreign infrastructure investments (especially in the resource-rich countries of Africa).

Hooke also advocates a bottom-up approach to picking the best companies,

especially companies that have been irrationally beaten down in a broad-based decline. In his view, such companies have more potential than the country to outperform later.

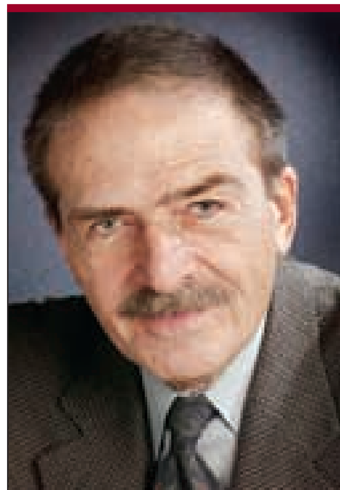
Elefson notes, however, that too many managers are enamored with high-quality companies and great management teams in countries that are economic disaster areas. "Country is very critical in the frontier markets," he says. "When an economic uncertainty hits a fledgling, nascent market, stock picking matters a lot less."

Investors that don't pay attention to country dynamics run the risk of being surprised, as happened with Mexico in 1994 and Asia in 1998. "Country is where the risk lies in [frontier markets]," Elefson says.

POST-CRASH INVESTING

If investors treat frontier markets as a high-risk, high-reward alternative asset class similar to small caps that push out the efficient frontier, they will pick up an additional 3–4 percentage points of return by holding a diversified basket of securities over the long term. But the best potential for stellar returns is to buy countries as they exit a crisis. Post-crash investing can be very rewarding. Consider the case of Brazil, a non-frontier market. In 2002, an investor buying into the iShares MSCI Brazil Index exchange-traded fund (EWZ) at US$5+ when an International Monetary Fund (IMF) bailout was being discussed could have earned a return of 2,000 percent when the fund reached US$102 in 2008.

Today, deep value may be available in Vietnam, which, at the time of this writing, is down 60 percent since its 2007 peak.



Country risk expert Marvin Zonis cautions that good economic growth in a country does not necessarily translate into good financial performance at the company level.

PARIAH STATE OR THE NEXT BIG OPPORTUNITY?

Iran will afford some great investment opportunities in coming years, country risk expert Marvin Zonis says. Poor economic decision making and international sanctions cloud Iranian stocks for now, but Zonis predicts that upcoming elections in Iran will produce a new set of leaders eager to reintegrate with the global political and economic order. Investing in Iran is currently illegal for U.S. investors, but a new U.S. presidential administration may adopt a less confrontational stance toward the Persian state, possibly leading to an easing of investing restrictions.

Zimbabwe may also offer deep value and, believe it or not, still attracts some foreign investors despite its ongoing turmoil. Even without an ETF, it is possible to get passive exposure to a country by investing in the top five stocks or the top stocks in different industries without regard to fundamentals.

Donald Elefson is sympathetic to the post-crash investment theme. He pursues such opportunities aggressively with a long-term concentrated approach in frontier and "forgotten" emerging markets (such as Thailand), along with other country themes (e.g., good long-term economic prospects in Nigeria).

THE SAME BUT DIFFERENT

Frontier markets are often compared with emerging markets from 15 or 20 years ago. A difference this time is that institutions that might have delayed entering an emerging market like Brazil have put money to work in frontier markets relatively early in the game. Also, generally speaking, frontier markets "are starting from a better financial and economic base," Elefson says. "They have all the similarities and possibilities for exciting returns over the next 5–10 years without a lot of the baggage emerging markets had to carry."

Perhaps someday people will talk about the BULGE countries (Bangladesh, United Arab Emirates, Lithuania, Ghana, Ecuador) the way they talk about the BRIC countries today.

Christopher Wright, an award-winning writer in Arlington, Virginia, publishes his own investment newsletter and country risk reports.