Arnerich Massena
Building Better Portfolios

Seeking the Investment Frontier

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> "Frontier markets seem to be the next wave for equity investors and some view these markets as the emerging markets of tomorrow."
>
> *– O'Connell, 2009*

The Wild West, the Arctic poles, space: humans have always been fascinated by the frontiers of civilization, expanding our reach into the furthest, deepest places we can find. For investors, frontier markets not only inspire excitement and adventure, but also represent a wealth of virtually unexplored opportunities. As more investors have become aware of the advantages of "globalizing" their portfolios, emerging markets countries have become inundated with investor capital seeking to take advantage of their rapidly growing economies. But there exist on the fringes a number of countries that are either earlier in that cycle of development or on its precipice. Qatar, for instance, had astounding real GDP growth of 18.8% in 2011 (*IMF, 2012*). While developed countries struggle with overleveraged debt and declines in consumer spending, nations on the frontier of economic development offer a fresh slate for growth potential.

In our exploration of frontier market investing, we will examine the following:

- What are frontier markets?
- What makes frontier markets attractive to investors?
- What are the risks of investing in frontier markets?

What are frontier markets?

Ten years ago, the BRIC countries (Brazil, Russia, India, and China) were poised to begin a period of unprecedented growth as they began to transition from developing nations into budding capitalist powerhouses. Now, investors are asking, "What's the next Brazil?"

> "Frontier markets are little different from the more popular emerging markets in their economic and political development. They are not necessarily riskier or lower in quality. They are simply smaller, less liquid and at an earlier stage of development. Furthermore, the frontier countries are home to more than 1.2 billion people who deserve to be viewed as investible."
>
> *– Speidell, 2011*

This is where frontier markets come in. Because this is the frontier, and the landscape is still being established, there is no formal agreement on which countries specifically constitute frontier markets. Many investment experts consider frontier markets to be a small subset of emerging markets — those outliers which are less developed — but some analysts are beginning to recommend that frontier markets merit a separate asset class and dedicated allocation for forward-thinking investors.

Table 1: Frontier Market Indexes

	S&P Frontier BMI	MSCI Frontier Markets Index	Russell Frontier Index	FTSE Frontier 50 Index
Argentina	✔	✔	✔	✔
Bahrain	✔	✔	✔	✔
Bangladesh	✔	✔	✔	✔
Bosnia Herze-govina		✔		
Botswana	✔	✔	✔	✔
Bulgaria	✔		✔	✔
Colombia	✔			
Côte d'Ivoire	✔			✔
Croatia	✔	✔	✔	✔
Cyprus	✔		✔	✔
Ecuador	✔			
Estonia	✔	✔	✔	✔
Gabon			✔	
Ghana	✔	✔	✔	
Jamaica	✔	✔	✔	
Jordan	✔	✔	✔	✔
Kazakhstan	✔	✔	✔	
Kenya	✔	✔	✔	✔
Kuwait	✔	✔	✔	
Kyrgystan			✔	
Latvia	✔			
Lebanon	✔	✔		
Lithuania	✔	✔	✔	✔
Macedonia			✔	✔
Malta			✔	✔
Mauritius	✔	✔	✔	✔
Namibia	✔			
Nigeria	✔	✔	✔	✔
Oman	✔	✔	✔	✔
Pakistan	✔	✔	✔	
Panama	✔			
Papua New Guinea			✔	
Qatar	✔	✔	✔	✔
Romania	✔	✔	✔	✔
Serbia		✔	✔	✔
Slovakia	✔		✔	✔
Slovenia	✔	✔	✔	✔
Sri Lanka	✔	✔	✔	✔
Tanzania			✔	
Trinidad & Tobago	✔	✔	✔	
Tunisia	✔	✔	✔	
Ukraine	✔	✔	✔	
United Arab Emirate	✔	✔		
Vietnam	✔	✔	✔	✔
Zambia	✔		✔	
Zimbabwe		✔		

Table 1 on page 4 displays the country makeup of four frontier market indexes, illustrating both the similarities and differences, and demonstrating that frontier markets span the globe, distributed across every major continent. Standard and Poor's country inclusion criteria are as follows: "S&P Indices analyzes potential frontier markets for investor interest and accessibility. A market's turnover, number of listings, and whether it has attracted a minimum amount of foreign investor interest are considered. S&P also considers a market's development prospects and in particular, whether a market is likely to develop the breadth, depth, and infrastructure necessary to sustain regular frontier index calculations." (*Standard & Poors*)

What makes a country a frontier market?

Frontier market countries are those nations that have a stock market but are at an earlier stage of economic development than emerging markets countries. While the individual countries that may be dubbed frontier markets vary in terms of development, politics, and infrastructure, many share at least a few of the following commonalities:

> "Two thousand years ago, everything outside of Rome was a frontier market. Three hundred years ago, everything outside of Europe was a frontier market."
>
> *– Speidell, 2011*

Labor: Frontier markets generally have younger populations than the more aging populations of developed nations, which translates into a growing labor force and increasing domestic demand. As workers in emerging countries become more sought-after (think of outsourced labor in China and India), labor costs in those markets are concurrently rising; frontier market labor, on the other hand, offers an increasingly productive labor force at a still-low cost.

Urbanisation: As infrastructure is developed, frontier countries are seeing a shift in lifestyle, leading to growth in middle-class consumers. Additionally, this allows for the beginning of growth in the private sector, shifting away from an economy heavily controlled by government or select wealthy parties.

Rich in natural resources/commodities: "Many but not all of the frontier countries are richly endowed with commodities. As expected from economies on four continents, they're diverse. Kazakhstan, for example, unearths oil, metals and mineral, while Argentina sells soybeans, corn and wheat. Vietnam excels at manufacturing." *(Gray, 2010)*

Heightened political risk: As younger economies, frontier nations may be more vulnerable to corruption and political and economic crises. A number of frontier countries are still rife with violent conflict, having unstable governments and populations. However, both the World Bank and the IMF have pledged support to these developing economies, via programs that include infrastructure development, policy advice, debt relief, and financial assistance, helping to both mitigate this risk and improve the market opportunities. (*O'Connell, 2009*)

Economic growth: The IMF projects the Real GDP growth of major advanced economies to average 1.3% in 2012 and 1.8% in 2013. While expectations for frontier market countries are not necessarily higher across the board, projections for some frontier nations are impressive:

Table 2: Real GDP Growth Projections

Country	2013 Real GDP Growth Projection (percentage)	2017 Real GDP Growth Projection (percentage)
Argentina	4.0	4.5
Côte d'Ivoire	6.2	6.7
Ghana	7.4	5.7
Kazakhstan	6.0	6.4
Mauritius	4.0	4.2
Pakistan	3.5	3.5
Qatar	4.6	7.0
Sri Lanka	7.0	6.5
Tanzania	6.7	7.0
Vietnam	6.3	7.5
Zambia	8.3	7.7

Source: International Monetary Fund, 2012

Why are frontier markets becoming increasingly attractive?

The frontier market story is complex, as you consider the unfamiliar cultures, diverse regions, and unique traditions of the global frontier. A wealth of reasons draws investors to this nascent asset class, but the macro-trends that make it particularly appealing at this time can be summed up in four words: consumers, commodities, correlation, and cost.

Consumers and commodities

The global economy has shifted radically in the last decade. The Western world is mired in debt and facing a slow climb back to growth. Developing countries, on the other hand, are expanding economically and experiencing the ballooning growth of middle-class consumers. As these new consumers arise, they will be looking to purchase the luxuries they can now afford: cars, computers, clothes, travel, etc. The raw materials and energy resources required to provide these goods will be in high demand. Many frontier countries are rich in these resources and largely untapped.

In addition to the consumer boom in emerging markets, a growing consumer base is developing in frontier markets. Their labor force is growing and ready to supply inexpensive labor for the creation of all the goods that will be needed for the new middle-class consumers of other countries, the result being new workers that become consumers in turn.

> "For Mobius [Mark Mobius, executive chairman of Templeton Asset Management] and many others, one word sums up the frontier market story: Commodities. Because they are rich in all manner of natural resources and are leading producers of, among others, oil, gas, minerals and precious metals, many frontier market countries are well-positioned to benefit from the strong demand for these resources from high-growth countries like China and India, Mobius says. Demand for these resources boosts economic growth in frontier markets, he says, which then enables their governments to increase spending in infrastructure, thereby creating interesting investment opportunities in the construction, transportation, banking, finance and telecommunications industries."
>
> *– Iyer-Ahrestani, 2011*

Correlation

Globalization has made diversification distinctly more difficult to achieve, which phenomenon can be seen in growing correlations. (Correlation is a measure of how closely the return patterns of a pair of asset classes move: a correlation of 1 denotes perfect correlation and signifies an identical return pattern. The further from 1, the more the return patterns differ. Lower correlations typically indicate a greater potential for diversification.) International developed markets have increased their correlations to U.S. domestic markets over the past decade, and even emerging markets have begun experiencing closer correlations lately.

Tables 3 and 4 display correlation statistics for the past ten years and the past three years, respectively. While frontier markets seem to be headed in the same general direction (of closer correlations), they continue to offer significantly greater diversification from domestic stocks than either international or emerging markets. Table 4 demonstrates that, in the past three years, frontier markets have shown a 0.64 correlation to domestic markets, compared to the much closer correlations of 0.91 and 0.84 for international and emerging markets respectively.

Because of their lower correlations to other asset classes, frontier markets offer an opportunity to more deeply diversify a portfolio. While macroeconomic shifts might sway developed markets to move in lockstep, frontier markets may still be driven more by fundamentals and local and regional economics.

Table 3: Correlation Statistics June 2002 to March 2012

	U.S. S&P 500	**International** MSCI ACWI ex-U.S.	**Emerging** MSCI Emerging	**Frontier** MSCI Frontier Market
U.S. S&P 500	1.00	0.90	0.82	0.54
International MSCI ACWI ex-U.S.	0.90	1.00	0.95	0.64
Emerging MSCI Emerging	0.82	0.95	1.00	0.59
Frontier MSCI Frontier Market	0.54	0.64	0.59	1.00

Source: Ibbotson

Table 4: Correlation Statistics April 2009 to March 2012

	U.S. S&P 500	**International** MSCI ACWI ex-U.S.	**Emerging** MSCI Emerging	**Frontier** MSCI Frontier Market
U.S. S&P 500	1.00	0.91	0.84	0.64
International MSCI ACWI ex-U.S.	0.91	1.00	0.95	0.77
Emerging MSCI Emerging	0.84	0.95	1.00	0.73
Frontier MSCI Frontier Market	0.64	0.77	0.73	1.00

Source: Ibbotson

"Financial liberation in these [frontier] markets is in its infancy making them less integrated to the global market. While each market is integrated differently, the overall level is small, hence the low correlation with broader markets."

– O'Connell, 2009

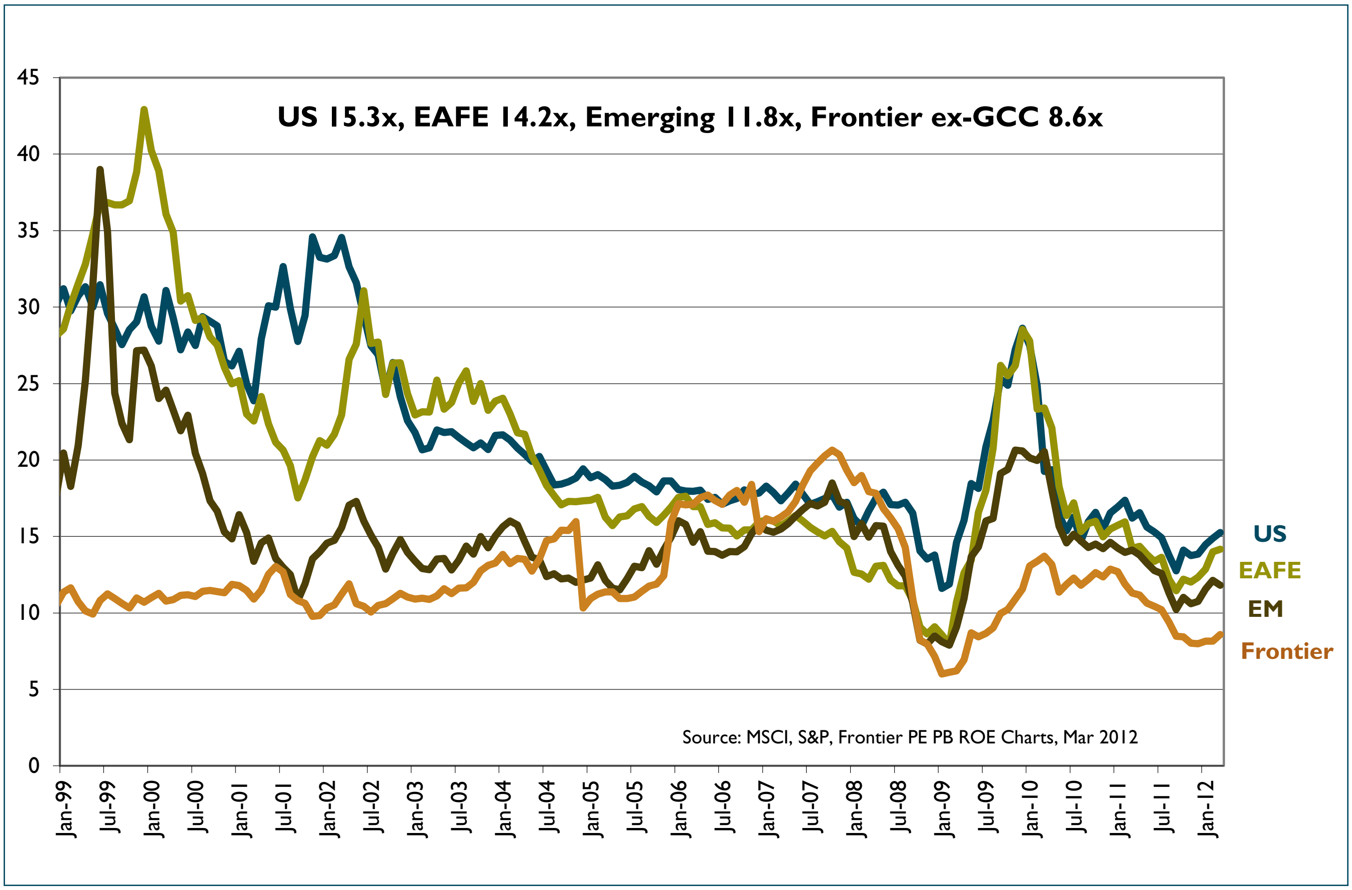
"Because of [their] diversity, their stock returns tend not to move in lockstep with those in developed and emerging markets, Mr. Papageorgiou of Acadian [Asset Management] said. They can zig when the developed world zags. And returns in the frontier regions even tend not to track one another."

– Gray, 2010

Cost

Frontier market stocks, just like those of emerging markets a decade ago, tend to be priced very competitively. Low valuations and high dividend yields combine to form a very attractive prospect for investors. Figure 1 shows the relative price/earnings ratio of frontier markets versus other asset classes, demonstrating attractive valuations in frontier market stocks.

Figure 1: Price/Earnings Ratios



Source: Frontier Market Asset Management

Frontier markets: risky business?

Undeniably, investing in frontier markets does not come without risk. Investors should keep in mind that frontier countries' development is often a volatile and unstable process, not necessarily proceeding along a straight course.

Local politics and regulations can have a significant impact on stock trading, and it must be understood that in frontier countries, governments and regulators may seem more capricious. Any time rapid change occurs, as with industrialization, volatility is to be expected. Many frontier countries are beginning to see improvements in government, with peaceful elections and increased economic freedom, but the likelihood of a shifting or unstable regulatory environment may be heightened in this investment universe. Furthermore, there is always the possibility that development of a frontier country can be delayed or even reversed due to political and governmental volatility.

Frontier market investing may also be subject to significant liquidity constraints. Investors should realize that they are participating in long-term development in what, in many cases, is a nascent private sector. Capturing the opportunities and dislocations available may require capital lockups and long periods of illiquidity. Furthermore, simply placing trades is in some cases an extended process involving high transaction costs, making short-term investing in frontier markets a largely inefficient enterprise.

Exchange-rate risk presents another consideration for frontier market investors. While this risk is present in any non-U.S. investment environment, it may be more significant in frontier markets. Currencies may be more volatile due to political instability, and hedging currency in these markets can be difficult to impossible.

The risks of frontier investing are potentially mitigated by focused attention from the World Bank and IMF, working to increase the efficiency of foreign markets and promote global development. Also, Lawrence Speidell of Frontier Market Asset Management points out that many frontier markets score more highly on the Heritage Foundation's Index of Economic Freedom than more developed nations. *(Speidell, 2011)* This index, based on ten categories including business freedom, trade freedom, investment freedom, and corruption, evaluates the overall ease of doing business in that country, and can provide a measure of the relative risk versus other countries. On this scale, Mauritius ranks higher in economic freedom (77.0) than the United States (76.3). Bahrain, Estonia, and Qatar are all in the top 25, dubbed "mostly free." To see the full list of country rankings, visit www.heritage.org/index/ranking. The growing levels of economic freedom enjoyed by many frontier countries suggests that they have built up some momentum toward infrastructure that will attract long-term capital.

How to invest in frontier markets

Given the opportunity set frontier markets present, expanding into the frontier is of interest to many investors. However, frontier countries pose undeniable risks, many of which are complex and differ from country to country. Venturing into the frontier, as when entering any unfamiliar and potentially treacherous area, requires a good guide.

> "For those investors interested in new or unconventional investment opportunities, the fast-growing frontier markets may offer a compelling case for investment. Investors pursuing a frontier market strategy must acknowledge, and even embrace, the risks inherent in these investments."
>
> *– O'Connell, 2009*

It is possible to access frontier markets via a passive approach, but only the most liquid of opportunities (a limited subset) is likely to be included in passively-managed funds or ETFs. To gain access to these unique markets, we believe that it is essential to work with active managers who have developed focused expertise in frontier markets. Expert active management has the capability of uncovering the price dislocations and specific opportunities that may be more liquidity-constrained, but also better performing. We want someone who knows the ins and outs of each nation's bureaucratic system, and has a pulse on local politics.

At Arnerich Massena, we are excited about the opportunities presented by frontier markets. We believe that macro-economic trends are favorable to this universe, and that micro-trends in some of these areas hold the promise of potential rapid growth. Additionally, we feel that the diversification opportunity is significant. We are well aware of the elevated risks present in this investment universe. For that reason, we work closely with active frontier managers who are highly familiar with the countries in which they specialize. We look for people who are not just analyzing paper, but are on the ground and have first-hand knowledge of the frontier markets in which they invest.

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