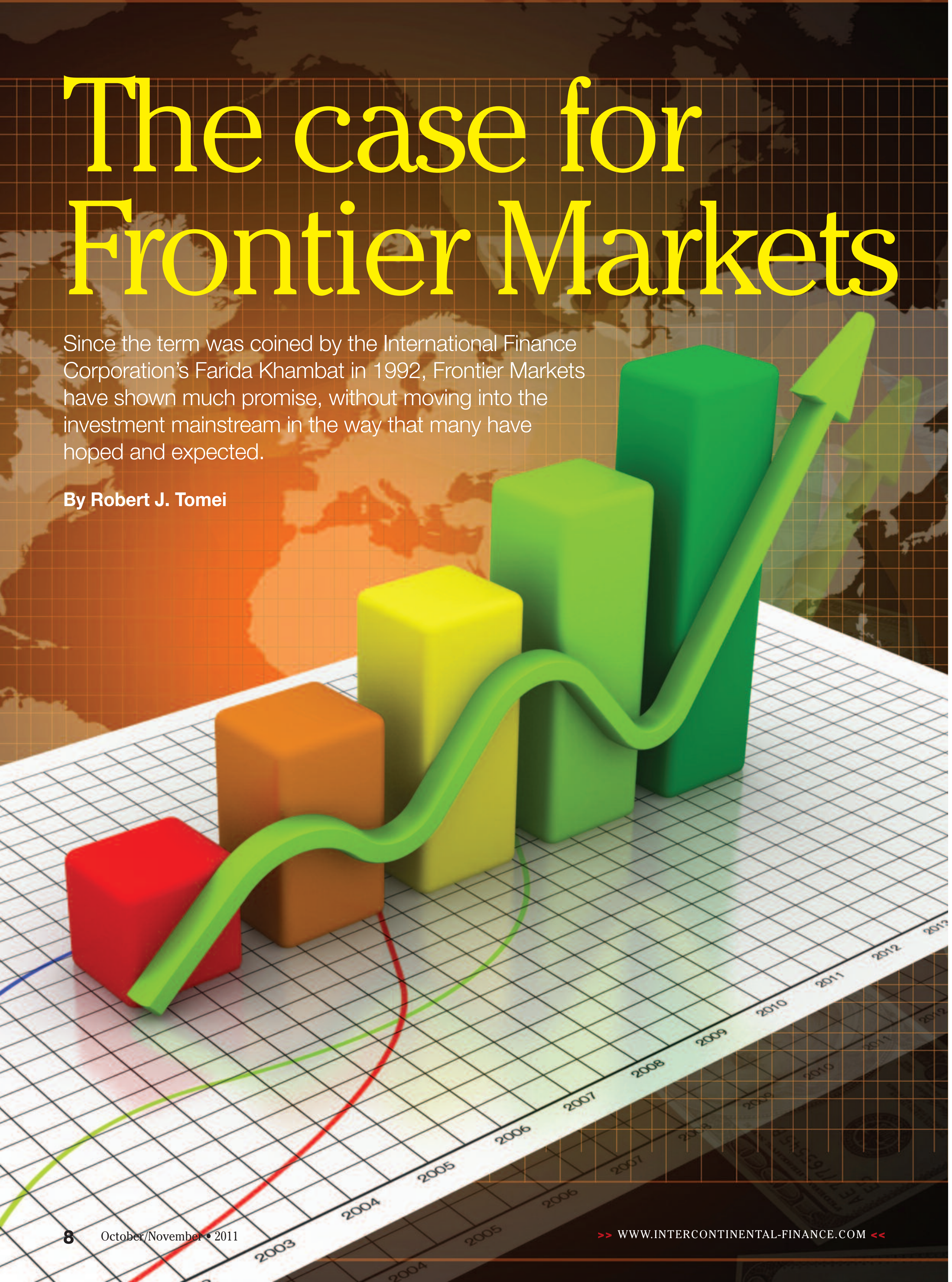

The case for Frontier Markets

Since the term was coined by the International Finance Corporation's Farida Khambat in 1992, Frontier Markets have shown much promise, without moving into the investment mainstream in the way that many have hoped and expected.

By Robert J. Tomei

The term Frontier Markets is used to refer to a subset within the broader field of Emerging Markets, which share some key characteristics: they are investable, but have relatively lower market capitalisation and liquidity than the more developed emerging markets (most notably the "BRICs"- Brazil, Russia, India and China).

While there is no definitive list of countries that fit these conditions, most attempts to list Frontier Markets comprise around 20 to 40 core countries, spread across Asia, the Middle East, Africa, South America and Eastern Europe. Among the most commonly listed in Asia are Indonesia, Vietnam and Kazakhstan; in Africa, Nigeria and South Africa; in the Middle East, Egypt and Qatar; in South America, Peru, Columbia and Chile; and in Europe, Ukraine and Romania.

For many investors, the prospect of investing in Frontier Markets has become increasingly attractive as traditional 'safe' investments have been shown to be anything but. In the developed world, volatility and uncertainty have been coupled with low yields, driving managers further afield in search of better returns. Crisis after crisis in the developed world has removed the sense of security from what would previously have been considered safe bets.

Who could have predicted the US flirting with a debt default, the extent of Europe sovereign debt crisis, or the Swiss Central Bank's aggressive response, seeking to peg the Swiss Franc to the Euro? When combined with the huge volatility seen in equities markets and a general consensus that the developed world will not see a return to healthy growth for some time, it seems necessary to take a broader view of investment options.

For many, the natural alternative to developed world investment has been to look at the fast-growing BRIC economies. However, there are some significant challenges with investments here. One is that of excessive competition; so many investors are looking to benefit from the opportunities on offer that it is increasingly hard to find competitive returns which can justify the level of risk which investment in these markets necessarily entails.

Evidently, opportunities in the BRIC economies are far from risk-free; the trials and tribulations of Sino Forest, a major Chinese lumber firm listed in Canada, being a recent case in point. High profile investors stood by their stakes in the company when questions were raised over its accounting practices and revenue prospects. Weeks later, when trading of shares in the company had been suspended (after dropping by 70%) and the CEO had resigned in disgrace, it seems clear that this confidence was misplaced.

It must be said that Frontier Market investments also have their risks, but the cost of investments reflects this. The key is to understand these risks, and to be in a position to weigh up the underlying value of each investment opportunity with the help of local expertise and specialist knowledge. Part of the appeal lies in these countries' relative insulation from the present economic downturn; Frontier Markets tend to be relatively loosely correlated with the economies of the developed world, unlike those of the BRICs. In any circumstances, this would make frontier investments an attractive option when constructing a healthily diversified portfolio, but given the developed world's current economic weakness, the low-correlation of frontier economies means they currently stand out as markets in which there is useful growth for investors to exploit.

In the past decade, Frontier Markets have vastly outperformed not only the US and Europe, but also the BRIC equity markets. Some Frontier Markets also boast healthier macroeconomics than the OECD. Debt, trade balance, currency stability, inflation, and investment levels in most of these markets have shown measurable improvements over the past two decades. The Nineties' view of developing nations as crippled by sovereign debt is very much a caricature of the past - having been eclipsed by larger-scale sovereign debt crises in the Eurozone.

Frontier Markets also feature relatively low volatility, due to having less short-term money flows than the BRIC markets, with volatility falling to less than 10% on the S&P Frontier Markets Index. The key to successfully investing in these countries is local knowledge, and a deep understanding of the current market conditions in each country in which one invests.

For a fund of funds, the way to achieve this is to pick managers who have a unique understanding of a particular market, which they can put to use seeking out the best risk-adjusted returns by spotting (and securing exclusive access to) the most attractive opportunities.

The impressive performance of Frontier Markets lie in the key drivers: the commodities which they currently export, combined with the growth opportunity afforded by industrializing societies and the rapid emergence of a new global middle-class.

The first of these two factors is already evident. As the growth of the BRICs intensifies competition for global resources, the Frontier Markets which have access to relatively underexploited deposits of raw materials are set to benefit from prices which are likely to remain high for some time.

However, looking at the countries which have had the most success over the second half of the twentieth century, it has tended to be manufacturing-led economies (as in South Korea and China) which have made the greatest strides over the long term. Fortunately, many frontier economies have huge potential for a move into manufacturing, for export but also for domestic consumption, thanks to the emergence of an ambitious middle class.

Using a measure employed by The World Bank, the developing world's middle class can be defined as those earning between $2 and $15 per day. $2 per day is widely used as a measure for absolute poverty; and those earning more tend to be able to save money rather than subsisting off of their wages and, so, tend to be upwardly mobile and capable of driving a consumer-led economy.

Between 1990 and 2005 the total number of people in this range almost doubled, from 1.4 billion to 2.6 billion, rising from one-third of the developing world's population to half. Southeast Asia alone is on track to add 250 million middle class consumers between 2004 and 2014. Part of this process is driven by demographics. In contrast to the aging populations of much of the developed world as well as China and Russia among the BRICs, rising populations and purchasing power in developing economies are swelling demand for consumer goods and services.

The more attractive economic environment is supported by ever-improving political conditions in most Frontier Markets. There is a significant (but by no means universal) trend towards political stability, often driven by a younger generation of leadership, and better governance as Frontiers assert themselves on the world-stage. Mongolia is a fine example for this development.

In countries like Vietnam, Indonesia, Sri Lanka and South Africa, political stability indicators are growing year by year. It is also possible to mitigate against instability through the use of insurance; many credible Private Equity managers take out risk insurance to protect against climatic or political tail-risk.

However, despite these recent improvements, it is fair to say that in general, governance and accountability in these regions are not as strong as could be expected in the developed world. To address this, a particularly fierce level of diligence is imperative and ensuring that accountability is being enforced at the investment fund level is key to minimising investment risks.

The focus has to be on selecting high quality managers who rigorously comply with international regulations and enforce accounting standards.

Of course, any attempt to address such highly varied range of countries can only offer a broad overview. Opportunities and risks vary greatly within the bloc, and making a success of frontier investing means looking beyond these generalisations to the specific context of each investment. However, it is quite clear that throughout these young, dynamic and growing countries, there are huge opportunities to be uncovered, and strong returns to be made..

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