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Frontier Markets

The Basics

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OpenFunds' interest in Frontier markets was ignited in 2013. During the Christmas period, I met Chris Liljefors, one of the founding partners of Tundra Fonder, a leading Frontier Markets equities investor, in Sri Lanka. Our discussions got me fascinated. When I returned to Europe I resolved to learn more about Frontier Markets.

The available literature on this asset class is relatively thin. I decided I would probably learn most by talking with the investment team at Tundra. We met on several occasions over a number of months, and then undertook full due diligence. The result was a decision to work together. OpenFunds became the distributor of Tundra's funds. In this short paper I want to explain what we learned and why we took this decision.

Private and institutional investors tend to think of Frontier Markets as unexplored. The economies of these countries are generally in earlier stages of economic development, and their capital markets less mature than Emerging Markets. But an increasing number of Frontier Markets have reached a stage of development that enables investors to participate in strong structural growth. They offer exposure to growing domestic demand, strong economic growth potential, and attractive demographics. They exhibit low correlation to each other and relatively low levels of liquidity and transparency. They are also under-owned and under-researched. These are some of the very reasons they present opportunities for managers with proven stock picking capabilities.

Country-specific factors have a significant bearing on equity valuations in Frontier Markets, making country allocation and bottom-up security selection skills critical. At the same time, it is difficult to find talented Frontier Market investment managers; in our view there is a clear early-mover advantage to be gained by securing capacity with the best managers. In our view Tundra Fonder is such a manager.

In this paper we provide an overview of equity investing in Frontier Markets, define these markets, discuss important investment themes, historical performance, and the key investment challenges. Investors who are comfortable with the risks associated with equity investing in Emerging Markets, and who have the flexibility to accommodate a less liquid allocation within their portfolio, could be wise to considering Frontier Markets.

1. Frontier Markets equities constitute the one segment of the equity market that is typically missing within both private and institutional portfolios.

I thought that missing out on more than a third of the world's population (this includes countries which today are not yet included in any indices, such as Myanmar) is probably not very wise because Frontier Markets countries have high rates of economic growth, favourable demographics (large, young population with literacy rates comparable to Emerging Markets) and strong fiscal positions (relatively low debt to GDP ratios). The political and structural stability of these countries is improving and several of them are poised to become manufacturing and production hubs as a result of technological advances combined with low labour costs.

2. Frontier Markets equities are not as risky as many think and offer true diversification in a diversified equity portfolio.

Frontier Markets equities tend to have low correlations to both Developed and Emerging Markets equities, but also amongst themselves. The reason is that Frontier Markets are more local in character and tend to have more idiosyncratic risks because they are less integrated with the global economy. The relatively low correlation that these countries often exhibit to one another provides further attractive opportunities for diversification.

3. Frontier Markets equity valuations are interesting compared with Developed and Emerging Markets.

Valuations in frontier markets generally are attractive when compared with Emerging Markets and Developed Markets. The table below shows that the MSCI Frontier Markets Index was trading at a trailing P/E ratio for 2015 of 9.2, compared to 11.4 for the MSCI Emerging Markets Index and 15.3 for the MSCI World Index. In terms of P/BV, Frontier Markets exhibit attractive valuations at 1.3, equal to the MSCI Emerging Markets Index and versus 1.9 of the MSCI World Index. Finally the dividend yield for Frontier Markets is much higher at 4.1%, compared to 3.1% for the MSCI Emerging Markets Index and 2.7% for the MSCI World Index.

	Market capitalization in billion USD	P/E 15	P/B	ROE (%)	DY (%)
Developed Markets	41,716	15.3	1.9	11.0	2.7
Emerging Markets	6,519	11.4	1.3	10.7	3.1
Fontier Markets (incl. GCC)	270	9.3	1.3	13.2	4.1
Fornier Markets ex GCC	214	9.2	1.3	14.6	4.0

Source: MSCI, Bloomberg

How Frontier Markets are defined – two different approaches

For investors that do not understand or feel entirely comfortable with this asset class, it is important to define what Frontier Markets are. I believe that the best way is to start is by comparing the main characteristics of Frontier Markets with Emerging and Developed Markets.

Generally speaking, Frontier Markets can be thought of as "a subset of Emerging Markets, and they are typically economies at the lower end of the development spectrum. They are the generally smaller, less developed and less liquid emerging market countries that are considered to be in the nascent stages of development. In essence, they represent what some emerging market countries such as Brazil, Russia, India and China were 20 to 25 years ago." *

The index providers approach

		Frontier Markets	Emerging Markets	Developed Markets
Economic development	Sustainability of economic development	No requirement	No requirement	GNI/capital 25%>the World Bank high income threshold for 3 consecutive years
Market accessibility	Openness to foreign investors	At least some	Significant	Very high
	Ease of capital inflow/outflow	At least some	Significant	Very high
	Efficency of the operation	Modest	Good and tested	Very high
	Stability of the institutional framework	Modest	Modest	Very high
Market size & liquidity	Number of co meeting standard index criteria	3	3	5
	Company size (full market cap)	USD 516 mn	USD 1032 mn	2065 mn
	Security size (float market cap)	USD 37 mn	USD 516 mn	USD 1032 mn
	Security liquidity	2.5 AT VR	15% AT VR	20% AT VR

Source: Tundra Fonder

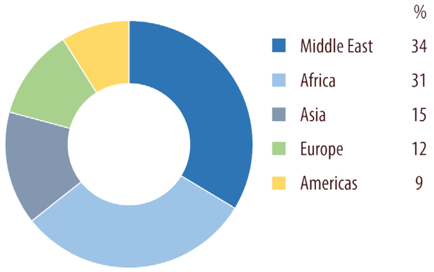
Index providers such as MSCI and FTSE distinguish Frontier Markets from Emerging Markets mainly by capital market size, liquidity, and accessibility thresholds on foreign ownership. The ability to invest in a market is a primary criterion for the classification of a country into either the Frontier Markets or the Emerging Markets index.

Economic development, in particular per capita GDP, plays a secondary role. When looking at regions and countries, market-cap-weighted Frontier Markets indices such as those from MSCI or FTSE mostly include stocks listed in the Middle East, Africa, Asia and the former Soviet Republics.

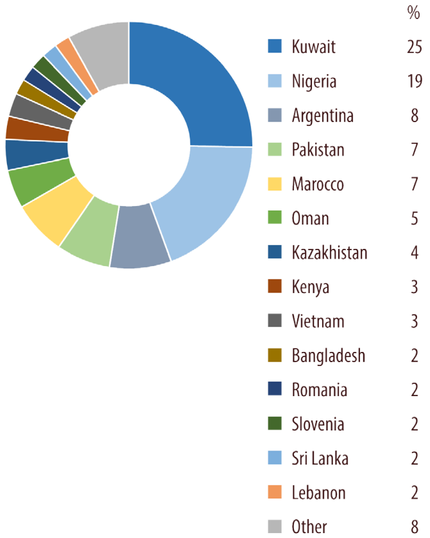
The outcome of this approach can be seen in the graphs below which break down the composition of the MSCI Frontier Market Index by region, country and sector as of end-2014.

* http://mobius.blog.franklintempleton.com/2014/03/12/frontier-markets-find-footing/

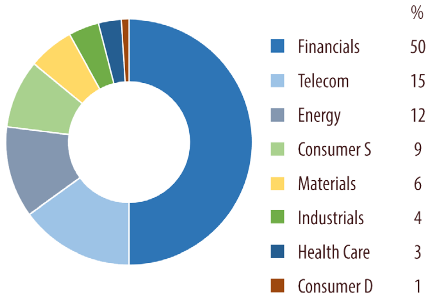
Regional



Country



Sector



Source: MSCI

What surprised me when I first saw these numbers is the fact that the Middle East is the region with the highest weight and Kuwait counts for 25% of the index. Kuwait.... a country with less than 5 million people and a high dependency on oil revenues? The reason these resource-rich nations are part of the Frontier Markets indices is because they have restrictive foreign ownership limits on their exchange-listed companies.

Tundra's approach

Tundra's approach also made a lot of sense to me. By excluding the GCC (Gulf Cooperation Council) countries in their global portfolio, Tundra's story is one of high growth achieved by concentrating on countries with low per capita GDP figures and large populations. Growth in these countries is underpinned by factors such as urbanisation, foreign direct investment and productivity.
According to UNPOP less than 60% of the populations of countries included in the MSCI Frontier Market Index live in urbanized areas. This compares to over 80% in the Developed Markets. Urbanisation is normally associated with infrastructure investments, higher productivity and higher personal levels of income, and therefore higher consumption. Foreign direct investment is an important driver of economic success in Frontier Markets. Most of the foreign investment has gone towards sectors such as consumer goods, mining and energy infrastructure. Finally labour productivity in Frontier Markets is relatively low when compared to OECD standards. Nevertheless, productivity has improved rapidly from low levels over the past couple of decades. Improvements are driven by investments in infrastructure and energy production as well as through higher school enrolment. As an example Sub-Saharan Africa had one of the highest levels of growth in university attendance globally during the period 1991-2005, with an annual growth rate of approximately 9%.

Diversification through a global portfolio

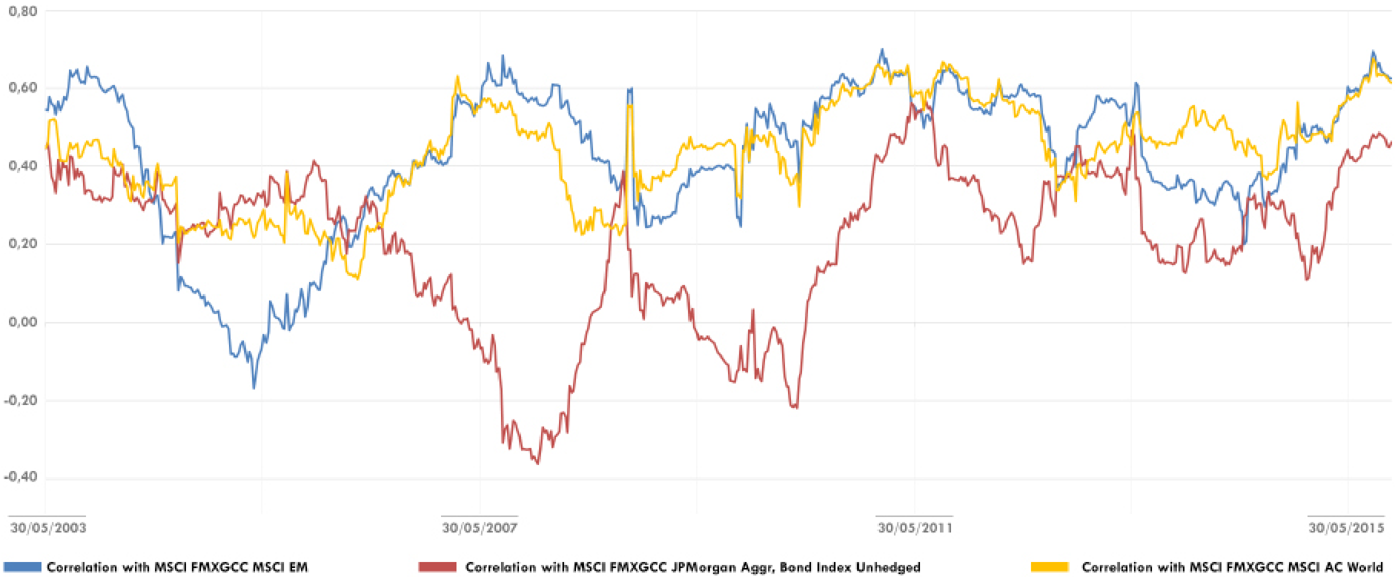
I also did not expect to find that many of the Frontier Market countries exhibit low correlation to each other. As mentioned above, this happens because the economies of these countries are generally more local in character and tend to have more idiosyncratic risks because they are less integrated with the global economy. Take Pakistan and Bangladesh. Looking at their populations, growth trajectories, geographical proximity and common history, we might expect their stock markets to be positively correlated – even if only moderately so. In fact, the correlation of the two countries is -0.21, as the next graph indicates.

Country correlation matrix

	Pakistan	Nigeria	Vietnam	Sri Lanka	Bangladesh	Kenya	Argentina
Pakistan	1.00						
Nigeria	-0.10	1.00					
Vietnam	-0.05	-0.29	1.00				
Sri Lanka	0.39	0.30	0.11	1.00			
Bangladesh	0.34	0.03	0.27	0.04	1.00		
Kenya	-0.08	0.14	-0.07	-0.03	0.08	1.00	
Argentina	-018	0.16	-0.44	-0.40	-0.05	0.46	1.00

Source: MSCI, Bloomberg
Note: MSCI country indices, return in EUR, monthly data July 20th 2013 - July 21st 2015

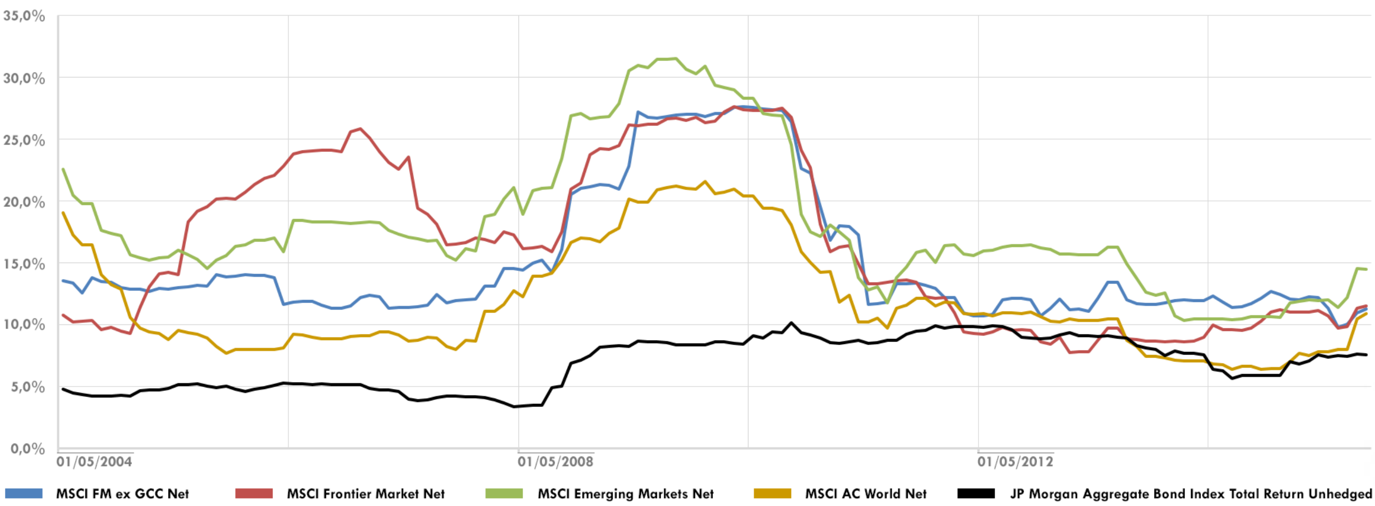
MSCI FM XGCC Correlation



Source: MSCI, Bloomberg
Note: 1 year rolling weekly data, allin EUR

The relatively low correlation between these countries creates excellent diversification opportunities when building and managing a regional or global portfolio.

Global asset class volatility



Source: Bloomberg, MSCI, Tundra

And since the correlation between Frontier Markets and Emerging and Developed Markets is also relatively low, Frontier investments can provide valuable diversification within a more conventional equity portfolio. Frontier Markets also tend to exhibit less volatility than Emerging Markets during periods of market turmoil due to low foreign participation, whereas foreign fund outflows from Emerging Markets can be severe. The corollary of increasing foreign ownership in Frontier Markets will of course be increased correlation to Emerging and Developed Markets.

Active versus passive

There are few passive investment vehicles providing exposure to Frontier Markets. Of the existing Frontier Market ETFs, most have been struggling to maintain a low tracking error due to bigger spreads, higher commissions, FX spreads and limited liquidity in the underlying equities. Given the benchmark's heavy weighting towards financials, it is a sub-optimal way to gain exposure to the attractive domestic consumer growth potential that exists in Frontier Markets. There are two main reasons to believe that active management in Frontier Markets will deliver a positive pay off:

- Poor analyst coverage: Frontier Markets have inherent information inefficiencies. Active managers doing bottom-up research can gain an information advantage and decide to go long or not to invest in specific stocks.
- Long-term investment horizon: Investment decisions based on single stock research and a longer investment horizon will incur considerably lower transaction costs than short-term investment styles.

Conclusions

Frontier Markets have a number of attractive features for investors, particular in the current market environment of slow growth in all major economies, rich equities and bonds and low bank deposit interest rates.

- Frontier Markets equities are becoming increasingly investable, making capacity issues less of an issue for institutional investors.
- Demonstrable diversification benefits and growth potential.
- High levels of economic growth and relatively low levels of consumer and sovereign debt are good pre-conditions for higher growth.
- Attractive valuations - often below the levels of equivalent businesses in Developed and maturing Emerging Markets.
- Favourable demographic trends, low labour costs and technological advances are all good pre-conditions for higher growth and will support the development of Frontier Markets in the future.

Frontier Markets offer equity investors some of the best opportunities for higher returns and diversification. Investors who are not intimidated by a certain level of illiquidity and have the stamina to ride through periods of market stress should consider adding some Frontier Markets exposure to their Emerging Markets allocations.

The views expressed in this paper are those of the authors and should not be used without appropriate advice.