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Frontier Markets: Weighing the Risks

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A growing number of investors are looking to capitalize on the next wave of global development through an investment in frontier markets.

Highlights

The favorable demographics and strong growth potential of these early-state, frontier market economies provide ample opportunities.

To fully understand the risk profile of the asset class, investors need to look past common assumptions and misconceptions.

Frontier markets offer growth potential and low correlations within markets and with other asset classes, along with relatively attractive valuations.

Given the volatility of individual markets, investors may want to consider strategies that provide diversified exposure across frontier nations.

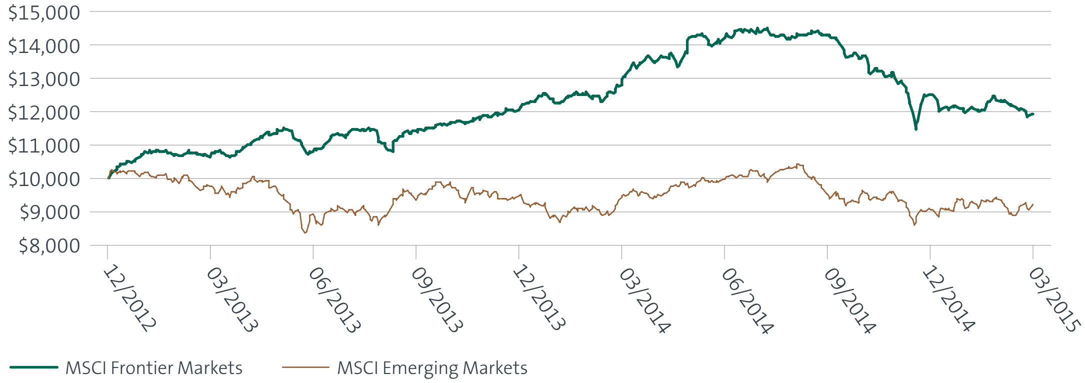
Why would investors even think about investing in fledging, so-called frontier economies half a world away? The quick answer is that some of the best-performing stock markets in the world can be found in places like Bangladesh, Kenya and Argentina. Even in a year that challenged many emerging economies, stock markets in these countries generated returns of 52%, 24% and 19%, respectively, in 2014.[1] Although past performance does not guarantee future results, investors in search of portfolio growth and diversification are taking note.

Not so long ago, even the larger emerging markets (EMs) were considered exotic. But over the past two decades they have become a familiar investment story. Now a growing number of investors are looking to many frontier markets (FMs) as the next wave of global development. Despite volatility associated with interest rate concerns, political strife and currency moves, the MSCI Frontier Markets Index gained 19.26% between the end of 2012 and March 31, 2015, compared to a -7.64% decline for the MSCI Emerging Markets Index over the same period *(Figure 1)*.

FIGURE 1

Growth of $10,000

Comparison of Monthly Returns, December 31, 2012 to December 31, 2014



Sources: Bloomberg and MSCI

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In essence, many frontier nations are the emerging markets of tomorrow. The 24 markets in the MSCI Frontier Markets Index today represent a similar share of world market cap that EMs did 25 years ago. Twenty-five years from now—who knows? One thing is clear: frontier markets are among the fastest-growing economies in the world. Over the five years from 2008 to 2013, the median compound annual growth rate (CAGR) among frontier market economies was 3.2%, far outstripping the U.S. rate of less than 1.2%. And while the U.S. economy has picked up steam, forecasts for the 2014-17 period estimate that FMs' gross domestic product (GDP) will expand at a median CAGR of 3.5%, more than the 2.8% rate forecast for the U.S.[2]

In assessing the opportunities, analysts point to the favorable demographics and strong growth potential of these early-stage economies, along with their low valuations relative to developed nations *(Figure 2)*. Indeed, the stock market value of frontier nations is equivalent to a median 23.4% of GDP, while the corresponding figure is 47.8% for emerging markets and 68.8% for the developed world.[3]

Frontier Markets

This listing represents countries in the MSCI Frontier Markets Index as of May 2015. Investors should note that index composition changes as countries grow. For example, in May 2014, MSCI reclassified Qatar and the United Arab Emirates as emerging markets.

Americas	Europe & CIS	Africa	Middle East	Asia
Argentina	Bulgaria	Kenya	Bahrain	Bangladesh
	Croatia	Mauritius	Jordan	Pakistan
	Estonia	Morocco	Kuwait	Sri Lanka
	Kazakhstan	Nigeria	Lebanon	Vietnam
	Lithuania	Tunisia	Oman	
	Romania			
	Serbia			
	Slovenia			
	Ukraine			

Investors who look past common assumptions and misconceptions about frontier markets may discover some surprising facts.

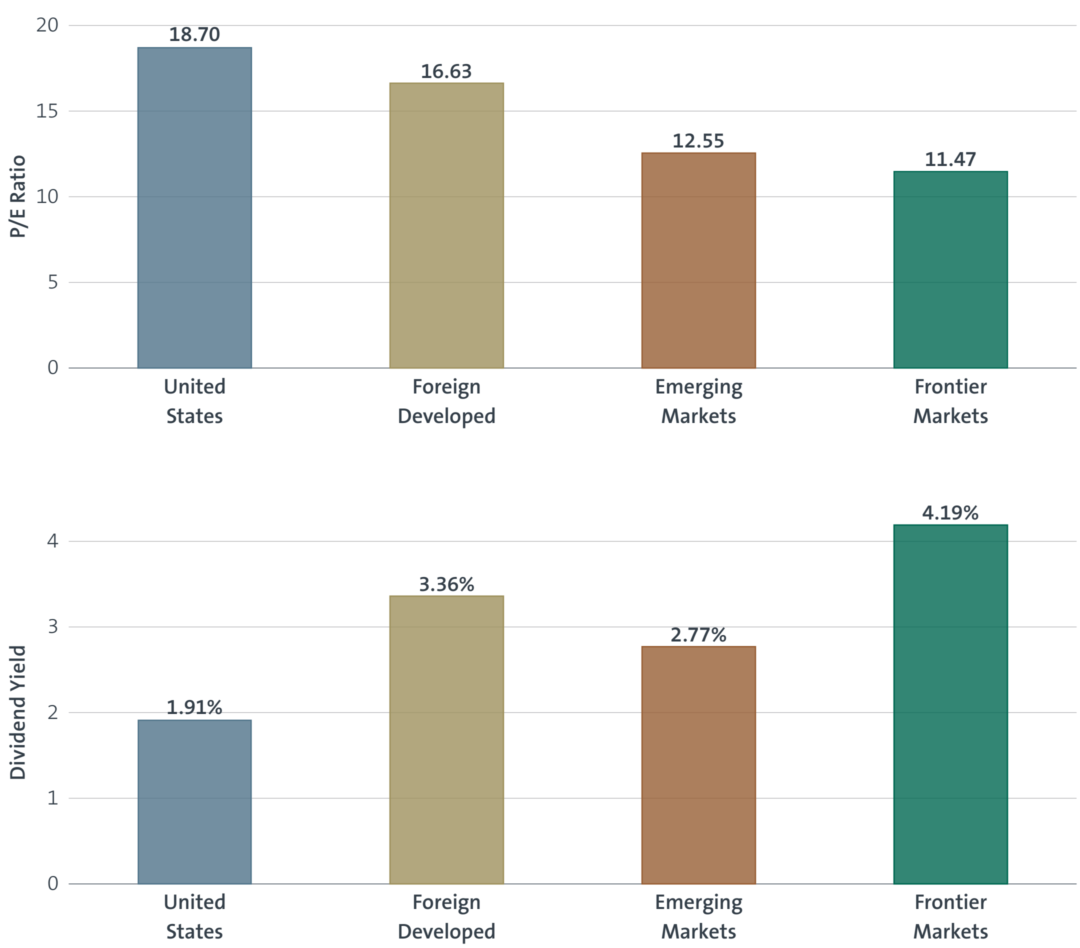
But the question looms: what about the risks? Spreading sectarian clashes in the Middle East, economic woes in Argentina, election violence in Kenya—such troubles understandably give investors pause. It's important to remember that FM nations lack the level of political stability, financial infrastructure, and legal and regulatory framework that characterize more developed markets. Language and cultural barriers, physical distance and less abundant information all factor into the aura of risk surrounding frontier markets.

Investors are right to be cautious; frontier markets are no exception to the principle that excess returns come with additional risks. But to fully understand the risk profile of this nascent asset class, investors need to look past common assumptions and misconceptions. Those who do may discover some facts surprisingly different from what they might expect. What follows is a brief survey of key investment considerations and risks for those venturing into the FMs, as well as our views on how investment strategies can be designed to help mitigate risks.

FIGURE 2

Growth Potential at a Relatively Low Price

Comparison of Price-Earnings Ratios and Dividend Yields, as of December 31, 2014



Sources: Bloomberg and MSCI

Past performance does not guarantee future results.

Political and Sovereign Risks

Frontier market stocks are often dominated by companies that are driven more by the local economy than by global macro trends.

When investing in countries where civil and political unrest can be common, there can be a risk of market disruption. For example, an eruption of massive protests in Ukraine drove its stock market down 3.5% between November 21 and December 17, 2013, but made almost no ripple in other FMs. In fact, during that period the broader frontier index was up 1.7% and Ukraine's nearest frontier neighbor, Romania, saw its market rise by 1.3%.[5]

That's because frontier markets have had an unusually low correlation to each other. Spanning the Americas, Europe, Africa, the Middle East and Asia, these far-flung economies have little in common beyond being in a similarly early stage of development. A major development might roil the economy in Nigeria or Argentina, but will have little or no effect in Estonia, Kuwait or Vietnam.

At the same time, frontier stock markets are often dominated by domestically oriented sectors, such as banks, telecommunications and consumer companies that are driven more by the local economy than by global macro trends. As a result, between January 1, 2009, and December 31, 2013, the average intercountry correlation among MSCI Frontier Markets Index nations was 0.36 as compared with 0.63 for countries in the MSCI Emerging Markets Index and 0.76 for the MSCI EAFE Index.[6]

Our takeaway is that, given the diversity of frontier markets and the low correlations among them, gaining exposure via a strategy that invests across a broad cross section of FMs can potentially help dampen the risk in any one country.

Volatility

Individually, frontier markets can be quite volatile. But because they are so diverse and relatively uncorrelated, as a group they have actually been less volatile than the MSCI Emerging Markets Index or the S&P 500 Index in recent years *(Figure 3)*. This low group volatility reinforces our belief that a broadly diversified approach to frontier market investing is critical.

A recent Morningstar analysis cites other reasons why frontier markets have been less volatile than EMs. Morningstar points out that EM equities have been considered a "risk-on" asset class and that during "risk-off" periods, investors have left in droves. "Given the relatively low foreign investor penetration in frontier-markets stocks and bonds, [the frontier markets] asset class has not been as susceptible to this hot money-driven volatility," Morningstar concludes.[7]

FIGURE 3

As a Group, FMs' Volatility Has Been Relatively Low

Comparison of Annual Volatility, as of December 31, 2014

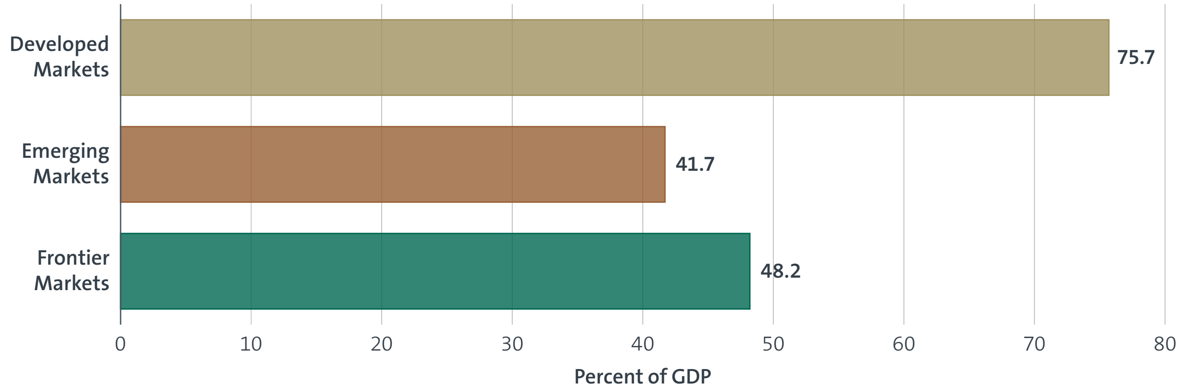
	Annual Volatility	
	MSCI Frontier Markets	MSCI Emerging Markets
2003	9.43	13.59
2004	7.73	15.21
2005	16.01	11.99
2006	14.85	18.21
2007	7.99	20.60
2008	24.13	41.02
2009	20.48	26.45
2010	9.63	18.11
2011	10.74	22.41
2012	5.78	14.47
2013	7.28	13.30
2014	10.65	11.24
Average	12.06	18.88

Source: MSCI

FIGURE 4

Less Developed Nations Enjoy Lower Debt-to-GDP Ratios

Mean Public Debt as a Percentage of GDP, 2014 Estimated



Source: CIA World Factbook, 2015

Fiscal Stability and Corruption

At a time when many developed nations are grappling with serious fiscal challenges, one might assume that frontier markets are in even worse straits. In fact, the reverse is probably true. Having learned their lessons from earlier defaults, crashes and bailouts, many frontier nations have generally tightened up their fiscal policies and, as a group, are on solid fiscal ground. As a result, frontier nations generally have far lower sovereign debt levels than developed nations *(Figure 4)*.

Contrary to widely held perceptions, corruption is not rampant in all FMs. For example, according to Transparency International's 2014 Corruption Perceptions Index, the United Arab Emirates is ranked 25th, Estonia is ranked 26th and Botswana is ranked 31st on the list of least corrupt countries. These are all ahead of larger developed markets like Portugal (33rd) and Spain (37th). Ranked at 156 out of 178 nations, Zimbabwe is the lowest-scoring frontier nation on the list—that is, among the most corrupt. But seven frontier nations rank ahead of all of the BRIC (Brazil, Russia, India and China) nations. Brazil, the "least" corrupt of the BRICs, ranks 69th, and Russia is 136th on the list.

Liquidity

By nature, the frontier market opportunity is limited in size. As of April 30, 2015, the market capitalization (free-float adjusted) of the MSCI Frontier Markets Index was $313 billion—less than half of Apple's $721 billion market cap on that date. FMs' average daily trade volumes provide another gauge of FMs' liquidity. During 2014, the MSCI Frontier Markets Index traded approximately $328 million a day. To put this in perspective, Starbucks stock traded $355 million a day for the same time period. This limited liquidity can make it challenging for investors to build positions in the frontier markets.

On the other hand, to date, the majority of the investment in FMs has come from major institutions such as public and corporate pension funds. Institutional investors tend to represent "patient money," allocating for the long term and seeking to mitigate their risks through portfolio diversification. This suggests that at this point in their development, frontier markets may be less prone to massive sell-offs than other, more mainstream asset classes.

Operational Complexity and Costs

Given the relative immaturity of frontier equity markets, they can pose operational challenges. For example, the chances of failed trades may be higher, settlement processes may also be less automated and more prone to error, currency conversions and custodial relationships are more complex when dealing with smaller markets and foreign investors may encounter ownership restrictions or added reporting requirements. In evaluating prospective frontier managers, investors are wise to ask how their strategies and methods have been designed to deal with such issues.

It must also be noted that investing in smaller, less liquid markets is almost always more costly. More than 30 of the 142 frontier market names trade at bid-ask spreads exceeding 1.50%, and currency transactions may add costs as well. Trading commissions can also be high, particularly in some of the less developed markets, where they may exceed 2.0%. Furthermore, while annual custodial costs are generally negligible in developed markets, in FMs they can range as high as 0.60%.

Seeking a Prudent Course

Some risks can be partially mitigated through thoughtfully designed, diversified investment strategies.

Frontier markets offer an unfolding opportunity for investors who are seeking growth along with global diversification. But the risks of investing in these less mature markets need to be well understood. We believe frontier-market investors should:

- Make sure they are thoroughly educated about the asset class and its potential risks, including keeping up to date on developments in this fast-moving area of investment, especially since the "frontier" label refers to a shifting roster of nations. For example, Qatar and the United Arab Emirates graduated from frontier to emerging market status in 2014.
- Gain exposure to the asset class through a broadly diversified approach.
- Incorporate an allocation to frontier markets in a broadly diversified portfolio.

There is no doubt that the risks and costs of investing in frontier markets are greater than in emerging and developed markets. But when it comes to some risk factors, such as fiscal stability, frontier markets may be less risky than many assume. Beyond that, some risks can be partly mitigated through thoughtfully designed, diversified investment strategies. It is possible that in some situations, adding a frontier markets allocation to a portfolio may actually lower its overall risk, given historically low correlations between FM, EM and developed market indices.

Additionally, frontier markets offer growth potential, and low correlations within markets and with other asset classes, along with relatively attractive valuations. We believe that these nascent markets represent an opportunity that growth-minded investors should not overlook.

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RISKS

There are risks involved with investing, including loss of principal. Past performance does not guarantee future results, share prices will fluctuate and you may have a gain or loss when you redeem shares.

Foreign securities, especially emerging or frontier markets, will involve additional risks including exchange rate fluctuations, social and political instability, less liquidity, greater volatility and less regulation.

Asset allocation and diversification do not assure profit or protect against risk.

1. MSCI, as of December 31, 2014
2. World Bank, Global Economic Prospects, December 19, 2014
3. World Bank, as of April 22, 2015
4. Morningstar Direct, as of December 31, 2014
5. Morningstar, "Is 'Frontier' the New 'Emerging'?" November 20, 2013
6. Morningstar Direct, December 31, 2013
7. Morningstar, "Is 'Frontier' the New 'Emerging'?" November 20, 2013

Definition of Terms

2014 Corruption Perceptions Index measures the perceived levels of public sector corruption in 175 countries and territories.

Compound annual growth rate (CAGR) is a year-over-year growth rate of an investment over a specified period of time.

Correlation is a statistical measure of how two securities move in relation to each other.

MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. and Canada.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

MSCI Frontier Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of frontier markets.

Price-earnings (P/E) ratio of a stock is a measure of the price paid for a share relative to the annual income or profit earned by the firm per share. A higher P/E ratio means that investors are paying more for each unit of income.

S&P 500 Index is an unmanaged index of 500 common stocks chosen to reflect the industries in the U.S. economy.

Sovereign debt is the total amount owed to the holders of a country's sovereign bonds (bonds issued by a national government).

Valuation is the process of determining the value of an asset or company based on earnings and the market value of assets.

Volatility is a statistical measure of the dispersion of returns for a given security or market index.

One cannot invest directly in an index.

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